

**School of Finance and Commerce**

**Course Code : BBAF3020**

**Course Name: Financial Derivatives**



# **Financial Derivatives**

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**UNIVERSITY**

**Name of the Faculty: GIRISH GARG**

**Program Name: BBA (FIA)**

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## Lecture -1

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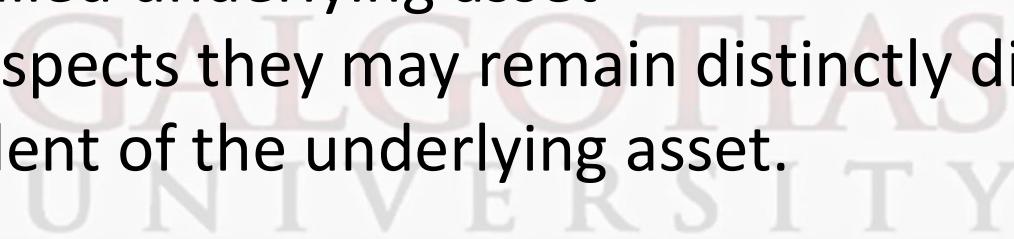
## Topic covered

- Definition of Derivative
- How to manage risk through derivative
- Derivative product
- Types of derivatives
- Types of participants
- Functions of derivatives
- Criticisms of derivatives

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## Derivatives

- Risks of price, exchange rate and interest rate can be managed through products that are specially designed for hedging.
- These products are classified as derivatives.
- Derivatives are the products that derive their value from some other asset called underlying asset
- but in other aspects they may remain distinctly different from and independent of the underlying asset.



## Managing Risks

- The ways to manage risk include attempt to control potential damage, diffuse it, diversify and/or transfer risk to those willing to accept it.
- One can manage risk by **transferring** it to another party who is willing to assume risk. Risk per se cannot be eliminated but can be transferred from those trying to evade to those willing to assume.
- Management of risk through derivatives is commonly referred as hedging which enable offsetting of risk emanating from a situation from another.

### Derivative Products

- Variety of derivatives are available; both standard products that are traded on an exchange as well as tailor-made, to suit various applications.
- Four broad types of derivative instruments are:
  - Forwards,
  - Futures,
  - Options, and
  - Swaps.

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## Types of Derivatives

- **Based on the underlying asset**
  - ❖ Commodities
  - ❖ Currencies
  - ❖ Shares/Indices
  - ❖ Interest Rates
- **Based on how traded**
  - ❖ Over-the-counter (OTC)
  - ❖ Exchange Traded



## Types of Participants

### Hedgers

those who use derivatives for hedging i.e. reduce or eliminate risk.

### Speculators

those who take positions in derivatives to increase returns by assuming increased risk. They provide much needed liquidity to markets.

### Arbitrageurs

those who exploit mispricing in different markets; They assume riskless and profitable positions.

**All 3 participants are essential for efficient functioning.**



## Functions of Derivatives

Three functions of derivatives

- Enable price discovery
- Facilitate transfer of Risk
- Provide Leverage

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## Criticisms of Derivatives

- **Increased volatility:**

Though used for efficient price discovery, derivatives when used as a speculative product can cause increased volatility in spot prices.

- **Increased bankruptcies:**

Derivatives being leveraged products enable taking disproportionate positions and have led to several disasters and bankruptcies.

- **Increased burden of regulations:**

Derivatives transactions hide more than what they reveal, as they escape accounting. For financial discipline and better disclosures new rules have to be

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## References:

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**Thanks you**

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