



DERIVATIVES IN RISK MANAGEMENT

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Abstract: Risk Management is not about the elimination of risk; it is about the management of risk; selectively choosing those risk and organization is comfortable with and minimizing those that it does not want. Financial Derivatives served a useful purpose in fulfilling risk management objectives. Through derivatives, risks from traditional instruments can be efficiently unbundled and managed independently. Used correctly, derivatives can save costs and increase returns. Financial derivatives can be used in two ways; to hedge against unwanted risk or to speculate by taking apposition in anticipation of a market movement. Organizations today can use financial derivatives to actively seek out specific risks and speculate on the direction of interest-rate or exchange-rate movements, or they can use derivatives to hedge against unwanted risk. Derivatives trading help improve market liquidity, raises skills and knowledge among market players, and is vital ingredient of market reforms such as the transition to rolling settlement. Derivatives trading include Futures contract, Option Contract, Index Futures, Index Options, Commodity Derivatives, and Swaps. When using financial derivatives, however, organizations should be careful to use only those instruments that they understand and that fit best with their corporate risk management philosophy. The main objective of this paper is to study the importance of derivative in risk management of the business.

Keywords: Derivatives, forwards, futures, options, swaps

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INTRODUCTION

Risk Management is not about the elimination of risk; it is about the management of risk; selectively choosing those risk and organization is comfortable with and minimizing those that it does not want. Financial Derivatives served a useful purpose in fulfilling risk management objectives. Through derivatives, risks from traditional instruments can be efficiently unbundled and managed independently. Used correctly, derivatives can save costs and increase returns. Risk taking is the core competence of entrepreneurial spirit, without embracing risks business can't reap rewards. Risk and return are two sides of a coin while risk taking has been known to businessman for ages. The emergence of risk management as a specialized field is fairly recent phenomenon, especially when we look at its evolution over the fast millennium. Risk management is an integral part of the financial service industry. Fund managers, merchant bankers, brokers and portfolio managers all have exposed to various kinds of risk in day-to-day business. In the previous years referred to the dark ages of the progress of mankind, the risk was associated with God. With the progress of mankind and business as well, the markets grew and the art of risk management also grew from primitive stages to the modern rocket science. So, as the businesses evolved, market expanded and financial markets mature and grew in complexity, the need for instruments to manage risk was felt. It is therefore not surprising that financial instrument for the management of risk has evolved, which are referred to as Financial Derivatives .

Derivatives are contracts whose payoffs depend upon the value of an 'underlying'. The 'underlying can be a commodity, a stock a stock index, a currency, or interest rate, or literally anything – not necessarily an asset. These are designed to shift risk from one party to another allowing an ever widening array of risks to be traded. Derivatives mainly consist of futures and forwards, Options and Swaps.

OBJECTIVE:

The main objective of this paper is to study the importance of derivative in risk management of the business.

DERIVATIVES MARKET

Derivatives become very popular in the developed markets and witnessing larger trading volume. It is used as a powerful risk management tool for hedging risk in the concerned



spot market. Various derivative products derived like bullion, real estate, stocks, and commodities are being traded in different exchanges in the world. In 1975, the world successful exchange Chicago Mercantile Exchange started trading of currency futures contract, then in 1983 Philadelphia Stock Exchange products got popularity and started trading in most of the stock exchanges. During these days Orange County, California, and the Barings Bank experienced bankruptcy due to poor investments in financial derivatives. At that time many policymakers feared more collapsed banks, counties, and countries. Those fears proved unfounded; prudent use, not government regulation, of derivatives headed off further problems. Now, however, the Financial Accounting Standards Board, the Federal Reserve, and the Securities and Exchange Commission are debating the merits of new rules for derivatives. But before adopting regulations policymakers need to separate myths about those financial instruments from reality.

TYPES OF DERIVATIVES

Future Contract : Futures contract means a legally binding agreement to buy or sell the underlying security on a future date. Future contracts are the organized contracts in terms of quantity , quality , delivery time and place for settlement on any date in future. The contract expires on a pre-specified date which is called the expiry date of the contract. On expiry, futures can be settled by delivery of the underlying asset or cash. Cash settlement entails paying /receiving the difference between the prices at which the contract was entered and the price of the underlying asset at the time of expiry of the contract.

Option contract: Option contract is a type of derivatives contract which gives the buyer/holder of the contract the right to buy/sell the underlying asset at a predetermined price within or at end of a specified period. The buyer /holder of the option, purchases the right from the seller/ writer for a consideration which is called the premium. The seller / writer of an option is obligated to settle the option as per the terms of the contract when the buyer/holder exercises his right. The underlying asset could include securities, and index of prices of securities etc.

Index Futures: Futures contract based on an index i.e. the underlying asset is the index, are known as Index Futures contracts. For example, futures contract on NIFTY Index and BSE -30 Index. These contracts derive their value from the value of the underlying index.



Index Options: The options contracts, which are based on some index, are known as Index options contracts. However, unlike Index Futures, the buyer of Index Option Contracts has only the right but not the obligation to buy / sell the underlying index on expiry. Index Option Contracts are generally European Style options i.e. they can be exercised / assigned only on the expiry date.

An index in turn derives its value from the prices of securities that constitute the index and is created to represent the sentiments of the market as a whole of a particular sector of the economy. By its very nature, index cannot be delivered on maturity of the Index futures or Index option contracts. Therefore, these contracts are essentially cash settled on expiry.

Commodity Derivatives: Futures contracts in pepper, turmeric, jaggery, jute fabric, jute sacking, castor seed, potato, coffee, cotton, and soybean and its derivatives are traded in 18 commodity exchanges located in various parts of the country. Futures trading in other edible oils, oilseeds and oil cakes have been permitted. Trading in futures in the new commodities especially in edible oils, is expected to commence in the near future. The sugar industry is exploring the merits of trading sugar futures contracts.

Swaps: Around 1980 the first swap contracts were developed. A swap is another forward-based derivative that obligates two counterparties to exchange a series of cash flows at specified settlement dates in the future. Swaps are entered into through private negotiations to meet each firm's specific risk-management objective. There are two principal types of swaps: interest-rate swaps and currency swaps.

Financial derivatives have changed the face of finance by creating new ways to understand, measure, and manage financial risk. Ultimately, derivatives offer organizations the opportunity to break financial risks into smaller components and then to buy and sell those components to best meet specific risk management objectives. Moreover, under a market-oriented philosophy, derivatives allow for the free trading of individual risk components, thereby improving market efficiency. Financial derivatives should be considered as a part of any business's risk management strategy to ensure that value-enhancing investment opportunities exist.

Banks and other financial intermediaries responded to the new environment by developing financial risk-management products designed to better control risk. The first one simple foreign exchange forwards that obligated one counterparty to buy, and the other to sell, a



fixed amount of currency at an agreed date in the future. By entering into a foreign exchange forward contract, customers could offset the risk that large movements in foreign exchange rates would destroy the economic viability of their overseas projects. Thus, derivatives were originally intended to be used to effectively hedge certain risks; and, in fact, that was the key that unlocked their explosive development.

Internationally financial derivatives market worth is regularly reported as more than \$20 trillion. That estimate dwarfs not only bank capital but also the nation's \$7 trillion annual gross domestic product. Those often-quoted figures are notional amount. For derivatives, notional principal is the amount on which interest and other payments are based. Notional principal typically does not change hands; it is imply a quantity used to calculate payments. Financial derivatives can be used in two ways ; to hedge against unwanted risks or to speculate by taking a position in anticipation of a market movement. Organizations today can use financial derivatives to actively seek out specific risks and speculate on the direction of interest-rate or exchange-rate movements, or they can use derivatives to hedge against unwanted risks. Hence, it is not true that only risk-seeking institutions use derivatives. Indeed, organizations, should use derivatives as part of their overall risk-management strategy for keeping those risks that they are comfortable managing and selling those that they do not want to others who are more willing to accept them. Even conservatively managed institutions can use derivatives to improve their cash flow management to ensure that the necessary funds are available to meet broader corporate objectives. One could argue that organizations that refuse to use financial derivatives are at greater risk than are those that use them.

Derivatives help to improve market efficiencies because risks can be isolated and sold to those who are willing to accept them at the least cost. Using derivatives breaks risk into pieces that can be managed independently. Corporations can keep the risks in which they are most comfortable. From a market-oriented perspective, derivatives offer the free trading of financial risk.

CONCLUSION:

It is important that all users of derivatives, regardless of size, first of all understand how their contracts are structured, the risk characteristics of those instruments are also very important. A perfect risk management strategy that conforms to the goals of business,



without a clearly defined risk management strategy, use of financial derivatives can be dangerous.

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