What is a Derivative?

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A derivative is an instrument whose value is derived from the value of one or more underlying, which can be commodities, precious metals, currency, bonds, stocks, stocks indices, etc. Four most common examples of derivative instruments are Forwards, Futures, Options and Swaps

As the term in itself suggests, a derivative 'derives' its value from some other source. The value or price of a derivatives contract is driven by the current value or price of the underlying.

Features of Derivatives:

Some common features that every derivative contract has are as under:

- Derivatives do not have an independent value and derive their value from an underlying.
- They require low initial investment, usually in the form of margins.
- This contract is to be settled in at a specified date in the future

Example: A manufacturer who will require copper as raw material 3 months in the future, purchases a futures contract to buy the copper at the specified date at a pre-decided rate. In this case the contract derives its value from the underlying, i.e. from the spot market price of the copper. The only initial investment required would be the margin payable on the contract. The contract will be settled at the future date, i.e. 3 months later.

Types of Derivatives on Indian exchanges:

Equity Derivatives:

- Equity derivatives are derivatives whose value is derived from equity securities. Futures and options are the common products available for these derivatives.

Index Derivatives:

- Index derivatives are a type of equity derivatives in which the underlying instruments are equity indices. Instead of the underlying being a single security it is an index such as the SENSEX or NIFTY. Index futures and options are available.

Commodity Derivatives:

- Commodity derivatives derive their value from the underlying commodity. Using such derivatives provide a safety net from the volatility and uncertainty in commodity prices. Futures and options are the common products available.

Currency Derivatives:

- Currency derivatives are available in the form of futures and options. They are contracts to exchange one currency for another at a specified date at a pre-decided exchange rate.

Interest Rate Derivatives:

- Interest rate derivatives are available in the form of interest rate futures. These contracts are based on specified GOI securities on the BSE and NSE.

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