DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES BHARATHIDASAN UNIVERSITY, TIRUCHIRAPPALLI – 620024

MBA (Financial Management)

COURSE CODE: FMCC3/24
COURSE NAME: Financial Markets
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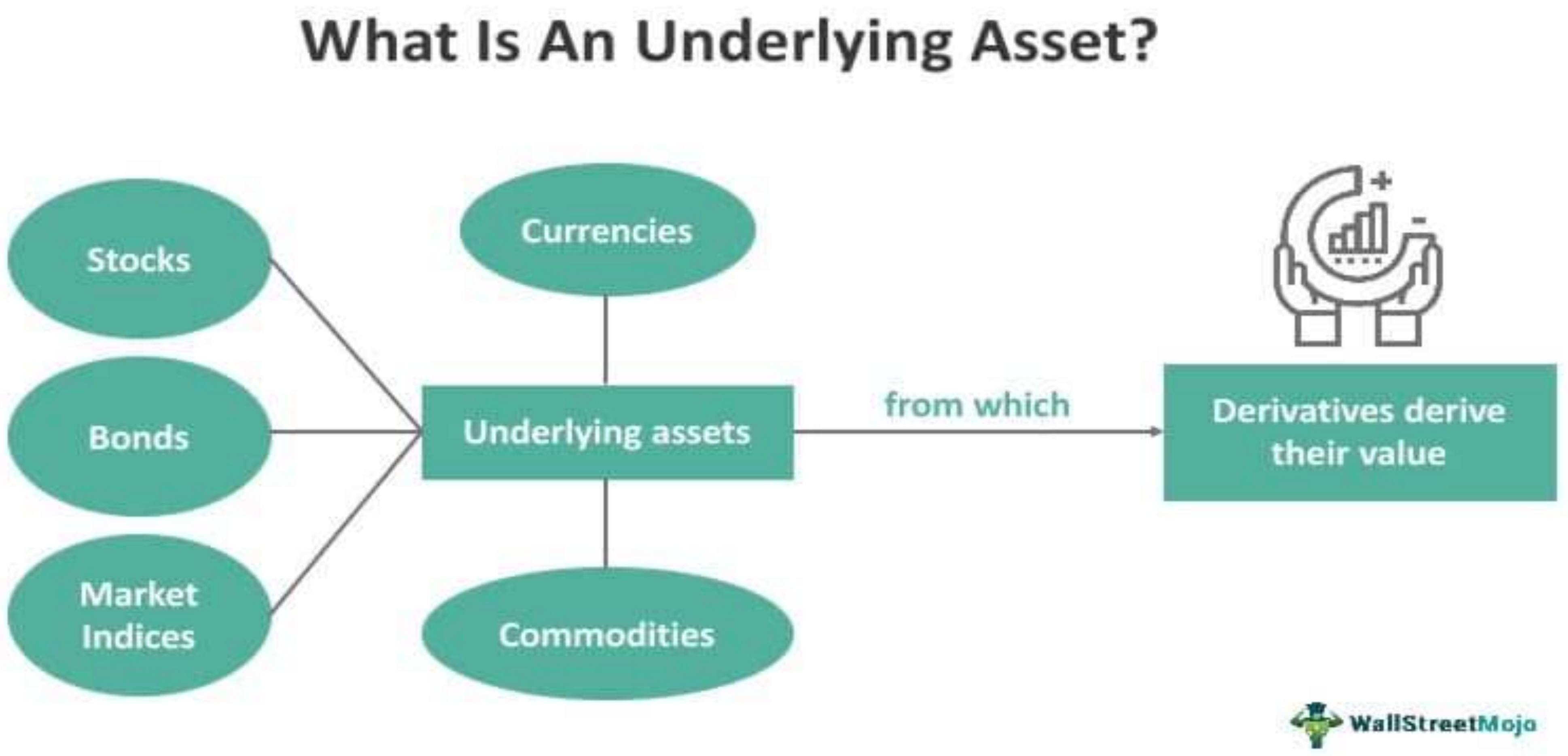
Scheme of Presentation Unit IV

- Types of Derivatives
- Option Premium
- Commodity Exchange
- Meaning of Commodity
- Commodity Derivatives Market
- Difference between Commodity and Financial Derivatives
- Depositories in India
- Benefits of Participation in a Depository
- Depository Participant (DP)
- ISIN
- Custodian
- Dematerializing Securities

Derivatives

Derivatives are financial contracts, which are traded on formal exchanges or in over-the-counter (OTC) markets. This financial instrument derives its value from a group of assets or specific underlying assets. They can take the form of options, futures contracts, swaps, or forwards, with their prices closely tied to changes in these underlying assets.

- Derivatives are financial contracts, set between two or more parties, that derive their value from an underlying asset, group of assets, or benchmark.
- A derivative can trade on an exchange or over the counter.
- Prices for derivatives derive from fluctuations in the underlying asset.
- Derivatives are usually leveraged instruments, which increases their potential risks and rewards.
- Common derivatives include futures contracts, forwards, options, and swaps.


What Is An Underlying Asset?
Stocks
Bonds
Market Indices
Currencies
Underlying assets
Commodities
from which
Derivatives derive their value
WallStreetMojo


Financial Claims or Stocks
Debt Securities or Bonds
Exchange Traded Funds
Market Index
Currency
Commodities
Types of Underlying Assets

Derivative Market

Why do investors enter derivative contracts?

Apart from making profits, there are various other reasons behind the use of derivative contracts. Some of them are as follows:

- **Arbitrage advantage**
- **Protection against market volatility**
- **Park surplus funds**

Participants in Derivative Market

The participants in the derivative markets an be Banks, FIIs, Corporate, Brokers. Etc...

1.Hedgers – He is a person who undertakes a position in future and other markets for purpose of reducing exposure to one or more types of risk.

2.Speculators – Speculators are operators who are willing to take a risk by taking future position with the expectation to earn profits.

3.Arbitrageurs – They are the operators who deal in different markets simultaneously for profit and eradicate the mispricing of securities across different markets.

4.Spreaders – He is a person who believes in lower expected return at the reduced risk .

DERIVATIVES INSTRUMENTS

DERIVATIVE is financial contract that derives its value from underlying asset. These underlying assets can be stock, currencies, commodities, and more. These are used for hedging and speculating.

TYPES OF DERIVATIVE INSTRUMENTS

FUTURES

- It is contract between two traders for purchase and delivery of asset at specific price at future date.
- These are traded on stock exchanges.
- Traders uses it to hedge their risk or speculate on the price of an underlying asset.
- Company A buys a three-month futures contract for oil for $20 per barrel. The other party now will have to deliver oil to Company A at $20 per barrel after expiry.

FORWARDS

- Similar to the Forward, it is contract between two traders for purchase and delivery of asset at specific price at future date.
- They are not traded on stock exchanges.
- The are not standardized. Buyers and sellers have to customize it.
- They are traded OTC (Over the Counter)
- Forward contracts carry a higher counterparty risk for both parties.
- Risk is for non fulfilment of contract conditions

OPTIONS

- Options also allow the buyer and seller to agree to buy or sell the underlying asset at a future date and a specific price.
- However, with options, there is no obligation on the buyer to exercise the agreement.
- The buyer gets right to buy or sell the underlying asset (but no obligation).
- Options are of two types – Call and Put.
- In both – call and put – option, the seller must fulfill the contract if the buyer wants.

SWAP

- It is an agreement that allows an investor to exchange one security with another.
- The objective here is to change the terms of contract.
- Interest rate, commodity, and currency swaps are the most common types of exchanges.
- Swaps are a private agreement, and thus carry a high amount of risk.
- Swaps are also risky because interest and currency are itself volatile.

Difference Between Commodity and Financial Derivatives

Commodity Derivatives:

- Based on physical goods like oil, gold, wheat, etc.
- Price is influenced by supply and demand of the underlying commodity.
- Primarily used by producers, consumers, and investors to hedge against price risk.

Financial Derivatives:

- Based on financial instruments like stocks, bonds, and currencies.
- Price is influenced by interest rates, market performance, or economic factors.
- Often used by traders and financial institutions to hedge or speculate on financial markets.

Commodity Market

Meaning of Commodity

A commodity is a basic good or raw material that is interchangeable with other goods of the same type. Commodities are used as inputs in the production of other goods or services. Examples include:

- Agricultural products (e.g., wheat, sugar, cotton).
- Metals (e.g., gold, silver, copper).
- Energy resources (e.g., oil, natural gas).

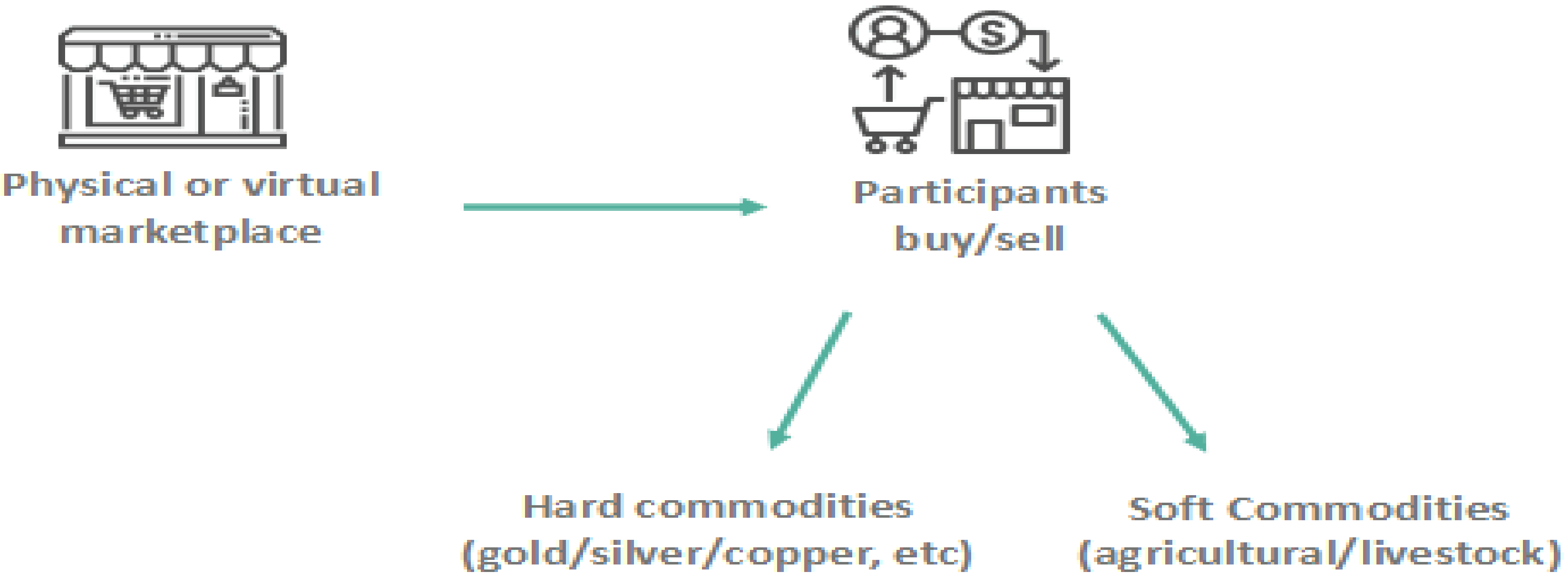
Commodities can be divided into two categories:

- **Hard Commodities**: Natural resources that are mined or extracted (e.g., oil, metals).
- **Soft Commodities**: Agricultural products or livestock (e.g., wheat, coffee, cattle).

Commodities Traded in the Commodity Market

1. Energy	2. Metals	3. Livestocks and Meat	4. Agricultural
Crude oil	Gold	Lean hogs	Corn, Cocoa
Heating oil	Silver	Pork bellies	Soybeans, Coffee
Natural gas	Platinum	Live cattle	Wheat, Cotton
Gasoline	Copper	Feeder cattle	Rice, Sugar

Commodity Market



Commodity Markets Work

A commodity market works similarly to any other market. It can be a physical/virtual space where an individual can purchase, sell and trade multiple commodities at current/future dates.

Trade in Commodity Market

Commodity trading is managed by four major commodity exchanges in India-

1. Multi Commodity Exchange (MCX)
2. Indian Commodity Exchange (ICEX)
3. National Commodity and Derivatives Exchange (NCDEX)
4. National Multi Commodity Exchange (NMCE)

Commodity Derivatives	Financial Derivatives
In a commodity Futures, the underlying is a commodity which maybe Wheat, Cotton, Pepper, Turmeric, corn, oats, soybeans, orange juice, crude oil, natural gas, gold, silver, porkbellies, etc.	In a financial instrument, the underlying can be Treasuries, Bonds, Stocks, Stock-Index, Foreign Exchange, Euro-dollar deposits, etc.
Physical/Cash delivery.	Cash Settled mostly.
Quality is a major concern.	Quality of the asset is not a major concern in the case of financial derivatives.
Since commodities are perishable in nature, storage costs and transportation play a major role.	Generally, no storage or transportation costs.

Depository

A Depository refers to a place or entity that holds financial securities in a dematerialized form. A bank, organization, or any institution holding and assisting in security trading is referred to as a depository.

- A depository refers to a place or entity that holds financial securities in a dematerialized form, eliminating the risk related to holding physical financial securities.
- A depository functions as a connection between the public companies that issue financial securities and the investors or shareholders.
- A depository holds the securities of customers and gives them back when the customers want.

Functions of a Depository

1. Serves as a link between public companies and investors/shareholders

- A depository functions as a connecting link between the public companies that issue financial securities, and the investors or shareholders. The securities are issued by agents associated with depositories, who are known as depository participants. The agents are responsible for transferring the securities from the depositories to the investors. A depository participant can be a bank, an institution, or a brokerage.

2. Eliminates risk related to owning physical financial securities

- A depository allows traders and investors to hold securities in dematerialized form; thus, eliminating the risk related to holding physical financial securities. The buyers and sellers now do not need to check whether the securities have been transferred successfully without any loss or theft. The depository system reduces such risks by allowing the securities to be held and transferred in electronic form.

3. Allows the provision of loans of mortgages to interested parties

- A depository holds the securities of customers and gives them back when the customers want. The customers receive interest on the deposits, while the depository earns even more interest by lending the deposits to other people or businesses in the form of loans or mortgages.

4. Reduced paperwork and accelerates the process of transferring securities

- When a trade occurs, a depository transfers the ownership of securities from the account of one investor to another. It helps in reducing the paperwork associated with the finalization of a trade and accelerates the process of transfer of securities.

Types of Depository Institutions

1. **Commercial Banks**

Role: Commercial banks are the largest type of depository institution, offering a wide range of financial services, including accepting deposits, providing loans, and offering investment products.

Services: They provide checking and savings accounts, mortgages, personal and business loans, and credit cards. Example: Banks like HDFC Bank, State Bank of India (SBI), and ICICI Bank in India.

2. Credit Unions

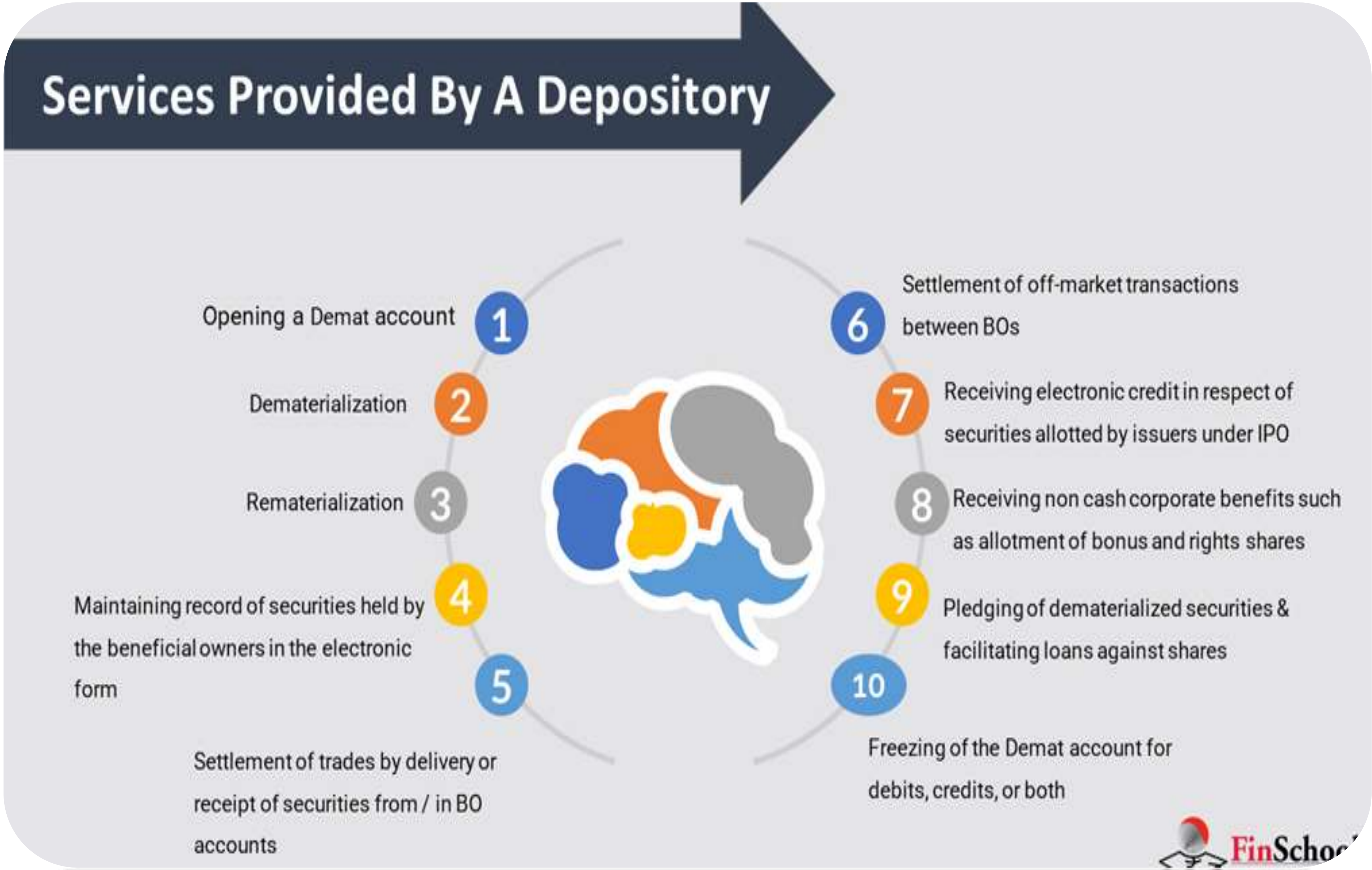
Role: Credit unions are member-owned, non-profit depository institutions that serve the financial needs of their members.

Services: They offer savings accounts, checking accounts, personal loans, and other financial products, often at lower rates due to their non-profit status.

3. Savings Institutions

Role: Savings institutions primarily focus on accepting savings deposits and providing mortgage loans.

Services: They offer savings accounts and specialize in home loans and personal loans. Their main objective is to promote home ownership.


Services Provided By A Depository
1 Opening a Demat account
2 Dematerialization
3 Rematerialization
4 Maintaining record of securities held by the beneficial owners in the electronic form
5 Settlement of trades by delivery or receipt of securities from / in BO accounts
6 Settlement of off-market transactions between BOs
7 Receiving electronic credit in respect of securities allotted by issuers under IPO
8 Receiving non cash corporate benefits such as allotment of bonus and rights shares
9 Pledging of dematerialized securities & facilitating loans against shares
10 Freezing of the Demat account for debits, credits, or both
FinSchoo

Depository Participants

A depository participant means a place that resembles a bank that stores money but instead of money, a depository participant acts as a store of assets such as securities

What are depositories & depository participants?

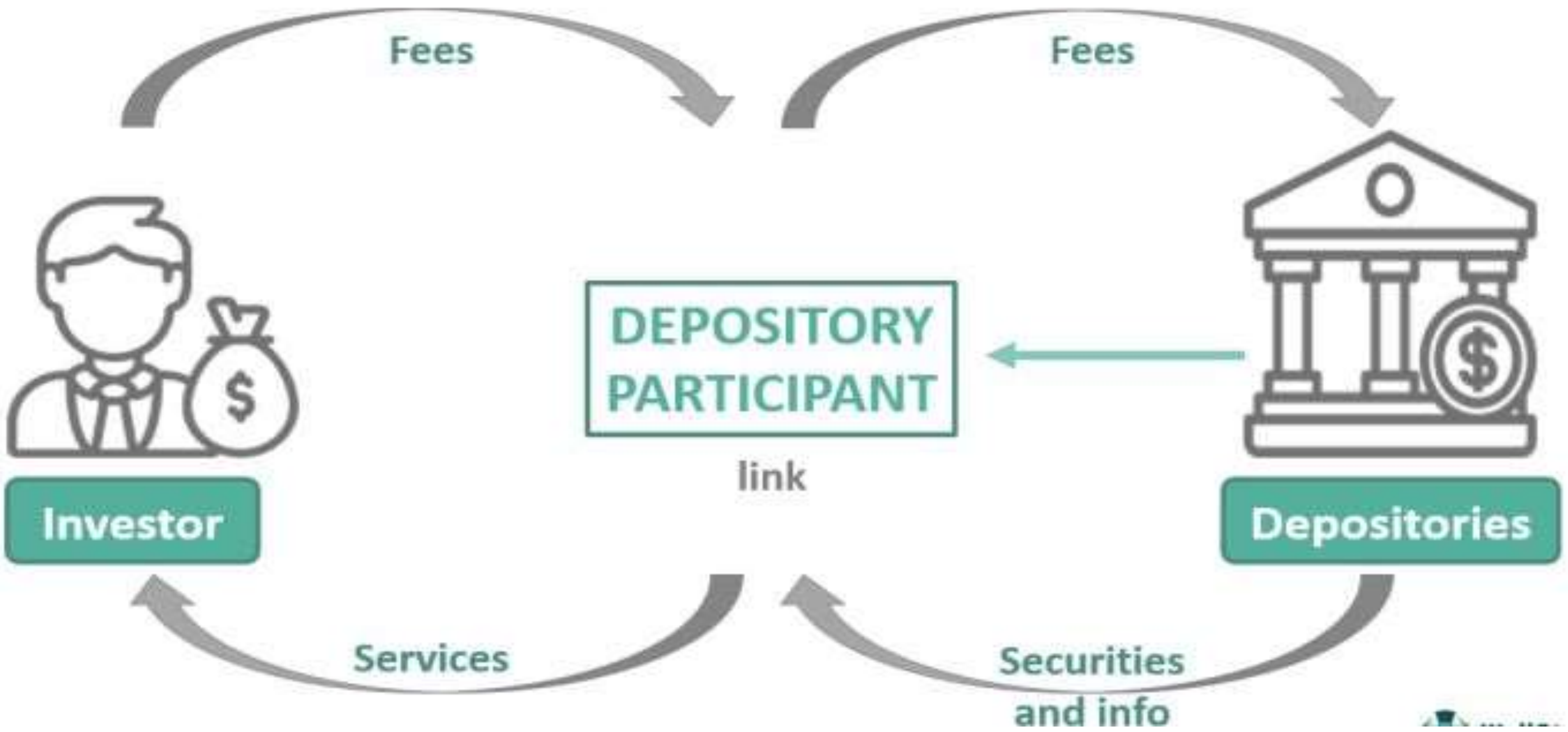
- A depository facilitates trading of securities and maintains them electronically
- Depository Participants (DP) act as a bridge between depositories and investors

While selecting a depository participant, consider:

- Platforms and technology offered by the DP
- The Reputation of the DP
- Charges levied by the DP


Account Opening
1
De-Materialization
2
Re-Materialization
3
Depositories Functions
4
Settlement
5
Initial public offer for corporate benefits
6
Pledging

Depository Participant Meaning



Role of a Depository Participant

1. **Account Opening and Maintenance**:

   DPs facilitate the opening of Demat accounts for investors. They manage the account by recording details of the securities held by the investor in electronic form.

   They help convert physical certificates into electronic form (dematerialization) and convert electronic securities back to physical form (rematerialization) upon request.

2. **Transfer of Securities**:

   DPs enable investors to buy and sell securities. When an investor buys securities, the DP ensures the securities are credited to their Demat account. Similarly, when securities are sold, the DP debits the corresponding securities from the investor's account.

3. **Settlement of Trades**:

   DPs facilitate the settlement of trades in the stock market by ensuring a smooth transfer of securities between buyer and seller during a transaction. They ensure that securities are transferred to the buyer and payments are received by the seller.

4. **Corporate Actions**:

   DPs handle corporate actions like dividend payments, interest payments, stock splits, bonus issues, rights issues, etc. on behalf of the investor. For example, if a company declares a dividend, the DP ensures that the investor's Demat account is credited with the dividend.

Role of a Depository Participant

5. Pledging of Securities:

Investors can pledge the securities held in their Demat account to obtain loans. The DP facilitates this by marking the pledged securities, which can be released once the loan is repaid.

6. Statement and Record Keeping:

DPs provide periodic account statements to investors, showing the securities held and the transactions carried out in the Demat account. This helps investors keep track of their holdings and transaction history.

7. Nomination and Transmission:

DPs facilitate the nomination process, where investors can nominate a person to inherit their securities in case of death. They also handle the transmission of securities in case of the death of the account holder.

International Securities Identification Number

The **International Securities Identification Number (ISIN)** is a unique 12-character alphanumeric code used to identify specific securities such as stocks, bonds, mutual funds, and other financial instruments. It is globally recognized and standardized by the **International Organization for Standardization (ISO 6166)**, which makes it easier to track and trade securities across different markets.

- **Role of ISIN**

- **Global Identification**: ISIN provides a standardized and globally accepted identification for securities, allowing seamless cross-border trading and settlement.

- **Facilitating Trade**: ISIN ensures that securities are easily identifiable in electronic systems, reducing the possibility of errors in buying, selling, or holding securities.

- **Efficient Settlement**: It helps in tracking and settling trades across international markets, ensuring smooth operations in depository systems.

- **Transparency**: The ISIN improves transparency in the global financial markets by clearly distinguishing one security from another, especially in cases where different securities have similar names or symbols.

Format of ISIN

Know Your ISIN

IN	000AAA0A0	A
Country Code	Security Specific Code (alphanumeric/numbers)	Checking No.

cleartax

login: https://cleartax.in/save

Market Makers
Purchaser's Custodian
Seller's Custodian
Stock Exchange(s)
Purchaser's Broker
Seller's Broker
Share Purchaser
Share Seller

Dematerialization: Meaning and Process

- **Dematerialization** (often referred to as "Demat") is the process of converting physical certificates of securities, such as shares, bonds, or debentures, into electronic form. In this process, investors surrender their physical certificates, and the equivalent number of securities is credited to their **Demat account**, held with a **Depository Participant (DP)**.
- **Electronic Form:** In dematerialization, securities are held electronically, which eliminates the need for physical certificates.
- **Demat Account:** To hold dematerialized securities, an investor must open a Demat account with a Depository Participant (DP) that is registered with a depository like NSDL (National Securities Depository Limited) or CDSL (Central Depository Services Limited) in India.
- **Conversion:** Once securities are dematerialized, they exist only in electronic form and can be easily traded, transferred, or held in a Demat account.
- **Efficiency and Safety:** Dematerialization removes the risks associated with physical certificates such as theft, loss, forgery, or damage, making trading and investing more secure and efficient.

Process of Dematerialization

- **Opening a Demat Account**:

  The investor needs to open a Demat account with a Depository Participant (DP), like a bank or broker, registered with a depository (such as NSDL or CDSL).

- **Submitting Physical Certificates**:

  The investor submits a **Dematerialization Request Form (DRF)** along with the physical certificates of the securities they wish to convert to the DP.

  The certificates should be in the investor's name and must be free of any liens or encumbrances.

- **Verification by Depository**:

  The DP forwards the DRF and certificates to the concerned company or the registrar of the company for verification.

  Once the company or registrar verifies the documents, the securities are confirmed for dematerialization.

- **Credit to Demat Account**:

  Upon verification, the physical certificates are destroyed, and an equivalent number of securities are credited to the investor's Demat account in electronic form.

- **Transaction Notification**:

  The investor receives a confirmation from the DP, and the details of the dematerialized securities are reflected in the Demat account.

Benefits of Dematerialization

- **Safety**: Electronic securities eliminate the risks of loss, theft, or forgery associated with physical certificates.
- **Convenience**: Securities can be easily transferred, bought, or sold without the need for paperwork, reducing administrative burden.
- **Efficient Settlements**: Transactions such as buying and selling securities are settled faster in a Demat system, improving liquidity and reducing delays.
- **Reduction in Costs**: Investors no longer need to worry about stamp duties or handling charges associated with the transfer of physical certificates.
- **Corporate Benefits**: Dividends, interest, and other corporate benefits like bonus shares are directly credited to the investor’s account without delays.

Thank you

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