

The One Where We Learn About the Concept of Derivatives

The Oxford Dictionary^[1] defines derivative in a generic sense, as *a word or thing that has been developed or produced from another word or thing*. In the financial parlance, derivative is an instrument whose value is derived from an underlying variable. The value of the derivative fluctuates on the basis of the underlying asset and accordingly, the gains or losses are assigned to the parties to the derivative contract. For instance, a derivative based on crude-oil prices performs poorly in case of decrease in price of crude-oil. Thus, a derivatives instrument does not have any value of their own and are entirely dependent on the underlying asset. The underlying variable may be in any form such as commodities, credit events or even foreign currencies.

A derivatives contract does not entitle the buyer to the ownership of the underlying asset on purchase of the option, but merely gives him the right/obligation (depends upon the type of derivative contract) to purchase the underlying asset (settlement by delivery) or settle the profit/loss by exchange of money (settlement by cash).

“Derivatives” have been defined in various statutes. Section 2(ac) of the Securities Contracts (Regulation) Act, 1956^[2] (SCRA Act) defines derivative as:

- (A) *a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;*
- (B) *a contract which derives its value from the prices, or index of prices, of underlying securities;*
- (C) *commodity derivatives; and*
- (D) *such other instruments as may be declared by the Central Government to be derivatives;*

Chapter III D of the Reserve Bank of India Act, 1934^[3] (‘RBI Act’) contains provisions for regulation of derivatives. Section 45U(a) of the RBI Act defines derivative as:

"derivative" means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time;

As we see hereinabove, the scope of derivatives differs in case of SEBI and RBI. This demarcates the area of jurisdiction of the regulators, over different types of derivatives. While the RBI regulates financial derivatives such as currency derivatives and credit derivatives, SEBI regulates other non-financial derivatives such as equity derivatives and commodity derivatives. However, both the SEBI as well as RBI regulate interest rate derivatives.

The parties in a derivatives transaction are classified into following categories - the hedgers, the speculators and the arbitrageurs. The bifurcation is made on the basis of investors' intent behind entering into the transaction.

For instance, hedgers enter into derivatives contracts primarily to mitigate risk arising out of volatility in the prices at a future date. Whereas the speculators enter into derivatives contracts to gain or profit out of the fluctuation in the price of the underlying assets at the given future date. The arbitrageurs also intend to gain out of price differences in different derivatives market. However, unlike the speculators who intend to gain from the price of the underlying assets, they intend to gain from discrepancies between prices of two markets and take off-setting positions such that the losses in one market are netted off with profits in the other market.

In the next episode, we learn about how the derivatives are classified in the financial markets.

[1] https://www.oxfordlearnersdictionaries.com/definition/american_english/derivative_1

[2] https://www.indiacode.nic.in/show-data?actid=AC_CEN_2_11_00019_195642_1517807321094§ionId=14373§ionno=2&orderno=2

[3] <https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RBIA1934170510.PDF>