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On the right trajectory

Local markets will have to remain competitive to retain liquidity

BY INVITATION

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INDIAN derivatives markets have come a long way in the last decade-and-a-half since the time equity derivatives were allowed on Indian exchanges in 2000. Today, the Indian equity derivatives market is one of the world's largest, liquid and vibrant markets, with NSE's derivatives market being the world's biggest in index options and single stock futures.

Financial derivatives represent some of the basic tools necessary in the mechanics of efficient capital markets. Derivatives provide three important economic functions: 1) risk management 2) price discovery, 3) transactional efficiency. The primary purpose of risk management is to protect existing profits. Risk management involves the structuring of financial contracts to produce gains or losses that counterbalance the losses or gains arising from movements in underlying prices.

Derivatives are exceptionally well suited for the role of providing price information. They are tools to assist everyone in the marketplace determine value efficiently. The wider the use of derivatives, the better is the price discovery and distribution.

Transactional efficiency is the product of liquidity. Derivatives significantly increase market liquidity. As a result, transactional costs are lowered, the efficiency in doing business is increased, the cost of raising capital is lowered and the amount of capital available for productive investment is expanded.

Despite the beneficial effects of derivatives, some market participants and commentators tend to view the product as speculative and risky though one of the key purposes of derivative products is management of unwanted risk.

This erroneous perception is essentially based on the way derivatives markets evolved and are structured in the US and Europe, where most of the derivatives transactions are conducted outside regulated exchanges in what is called 'over the counter' (OTC) markets. These transactions were outside the regulatory purview with zero oversight and very little reporting. This has led to huge build up of positions and risk, which have not been properly supervised. Only after the financial crisis, regulatory oversight is being contemplated initially with reporting requirements and settlement through clearing corporations.

In complete contrast, the Indian equity derivatives market evolved under extremely close oversight of the Securities and Exchange Board of India (Sebi). Equity derivatives contracts in India can be traded only on recognised stock exchanges and off exchange transactions are not allowed.

Sebi has put together a stringent framework for derivatives trading right from which indices/securities can have derivatives contracts to who can trade to risk management, which encompasses margining and position limits. Margining, unlike in other markets, is online, real-time and at the client level. Portfolio approach to margining ensures that entire risk of the portfolio is taken into consideration.

Advanced statistical and risk management tools have been applied to ensure that risks are adequately covered by the margining system.

These important structural differences in equity derivatives market have laid the foundation for a liquid, robust and safe environment for investors to manage their risk efficiently in the Indian derivatives market. Unfortunately, some of the commentators do not sufficiently understand these structural differences and get swayed by general debate in the US and Europe.

NSE is the number one exchange in the world in equity index options contracts. NSE stands at second position in stock futures, stock options and currency derivatives.

This fantastic growth in derivatives market has a beneficial impact on cash market liquidity. This has been established by academic studies that examined the activity in some of the securities on which derivative contracts were withdrawn subsequent to a regulatory change in the eligibility criteria. The studies concluded that subsequent to removal of derivative contracts, volatility in the underlying market has increased and liquidity has decreased compared to the period in which derivatives contracts were available.

These findings substantiate that an active derivatives market could induce liquidity in the underlying market and make the cash market efficient for retail and other long-term investors. At present, only about 150 stocks have single stock derivatives contracts. The number of stocks has come down from over 280 a couple of years ago when the eligibility criteria was changed. In order to make underlying cash market more vibrant, it may be useful to allow derivative contracts on larger number of liquid stocks.

Over the years, the Indian derivatives market have evolved into multi-asset class derivatives market, with products ranging from equities, equity indices, forex, interest rates, commodities and volatility indices. The derivative market is amenable to significant innovation to cater to the needs of investors across the risk spectrum, from low risk tolerance to high appetite for risk. Structured derivative products that are popular among retail investors in some markets could be an ideal product for investors with low risk appetite. A wide range of index derivative products could offer multiple options to manage the risk and also act as market entry products for asset managers and investors. It is, therefore, critical that continuous streams of new derivative products are allowed into the market.

Derivatives markets are becoming global with contracts getting traded across markets. For example, Nifty and USD-INR contracts are getting popular in other countries and could potentially pose liquidity and regulatory problems. But these developments cannot be wished away.

Therefore, the way forward is to ensure that the local market stays competitive so that the liquidity, which has been built over the years, is retained. To achieve this, regulatory and tax structures have to be stable and comparable to structures in other international jurisdictions.

Derivatives products — the most efficient tools for managing risks — are an important component in the making of a world-class capital market, which ensure efficient capital allocation to emerging sectors that would strengthen the economy.

(All views expressed in this article are personal and not necessarily that of the NSE)

WAY FORWARD: Derivatives markets are becoming global with contracts getting traded across geographies

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- They are the tools, which help everybody in the marketplace to determine value efficiently
- The wider the use of derivatives, the better is the price discovery and distribution