What are Derivatives?

This week's article focuses on a financial instrument that is not widely understood. A derivative is a financial security with a value that is reliant upon or derived from, an underlying asset or group of assets—a benchmark. The derivative itself is a contract between two or more parties, and the derivative derives its price from fluctuations in the underlying asset. The majority of derivatives are created via private transactions in the over the counter[1] (OTC) market. According to the Bank for International Settlements, the global gross market value of OTC derivatives, rose from USD $11.6 trillion to USD $15.5 trillion during the first half of 2020. The COVID-19-induced market turmoil and subsequent strong policy responses, drove developments in derivatives markets, in the first half of 2020.

[1] A market that does not include a formal stock exchange.

The Trinidad and Tobago securities industry has an OTC market; however, trades are dominated by fixed income[2] securities, but generally derivatives are neither created nor traded locally. Some international derivative exchanges include:

- National Stock Exchange of India
- Korea Exchange
- Taiwan Futures Exchange
- Hong Kong Exchanges and Clearing
- Japan Exchange Group
- Dubai Gold and Commodities Exchange
- Nasdaq Exchange - USA

Types of Derivative Contracts

The common types of derivates are Options, Forward Contracts, Future Contracts and Swap, which will be elucidated here.

Options – An Option is a contract between two parties (a buyer and a seller) that gives the buyer the right, but not the obligation, to purchase or sell something at a later date at a price agreed upon today.

The option buyer pays the seller a sum of money called the price or premium. The option buyer stands ready to sell or buy according to the contract terms, if and when the buyer so desires. An option to buy something is referred to as a '***call***'; an option to sell something is called a '***put***'.

Forward Contracts – A Forward Contract is a contract between two parties (a buyer and a seller) to purchase or sell something at a later date ***at a price agreed upon today***. A forward contract is similar to an option, however an option carries a right, not the obligation, to go through with the transaction. If the price of the underlying instrument changes, the -option holder may decide to forgo buying or selling at the fixed price.

On the other hand, both parties in a forward contract incur the ***obligation to ultimately buy and sell the good***, at the agreed upon price, and conditions.

Future Contracts – A Future Contract is also a contract between two parties (a buyer and a seller) to buy or sell something at a future date at a price agreed upon today. The contract trades on a futures exchange (included in the aforementioned list above) is subject to a daily settlement procedure. Future Contracts evolve out of forward contracts and possess many of the same characteristics.

Swaps – A Swap is a contract in which two parties agree to exchange cashflows. For example, one party is currently receiving cash from one investment, but would prefer another type of investment in which the cashflows are different. An example can be interest rate swaps.

[2] Fixed-Income securities are debt instruments that pay a fixed amount of interest in the form of coupon payments to investors. Bonds are the most common form of fixed-income securities.

Derivatives and Risk Management

Derivatives are used to mitigate financial risks. Financial risks are uncertainties related to interest rates, exchange rates, stock prices, and commodity prices. Derivative market participants seeking to reduce their risks are called ***hedgers*** and those seeking to increase their risk and return are called ***speculators***. Investors have different risk preferences, some are more tolerant of risk than others. The derivatives market enables those investors who wish to reduce their risk to transfer it to those wishing to increase it.

Apart from risk management, derivatives also offer several operational advantages such as lower transaction costs. This means that transaction commissions and other costs paid by investors are lower. This makes it easy and attractive to use the derivatives market. Derivatives markets also have greater liquidity when compared to spot markets (i.e. traditional stock exchanges).

As previously mentioned, the derivatives market requires the participation of hedgers (those attempting to reduce risk) and speculators (those willing to assume risk). However, it should be noted that derivatives help financial markets become more efficient and provide better opportunities for managing risk. These benefits ultimately spill over into society and contribute to economic development.

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