Financial Derivatives

Thecasesolution.com

Presented by: Fatimah Alawaji

Definition of Derivatives

- An instrument consists of contract between two or more parties whose value depends on – is derived from – the value of some other financial instrument, called the underlying asset.
- The common underlying assets include: bonds, commodities, currencies, interest rates, market indexes and stocks.

Players in the Derivatives Market

wish to bet on future movements in the price of an asset. The objective is to gain when prices move as per the expectation.

Arbitrageur: is in business to take advantage of a discrepancy between prices in two different markets.

is in the position where they face risk associated with the price of an asset.
Use derivatives to reduce or eliminate this risk.

Forwards

A forward, or a forward contract, is:
a private agreement between two parties giving the buyer an obligation to purchase an asset (and the seller an obligation to sell an asset) at a set price at a future point in time.

- Forwards are highly customized, and are much less common then the futures.
- The market for forward contracts is huge, since many of the world's biggest corporations use it to hedge currency and interest rate risk.

Futures

- Futures are financial contracts obligating the buyer to purchase an asset or the seller to sell an asset, such as a physical commodity or a financial instrument, at a predetermined future date and price.
- A future is a forward contract that has been standardized to facilitate trading, and sold through an organized exchange "future exchange".
- Some futures contracts may call for physical delivery of the asset, while others are settled in cash.

Futures

Hedging and Speculating with Futures

Options

Like futures, options are agreements between two parties but it gives the buyer of the option the right -not the obligation- to buy or sell a particular asset at a later date at an agreed upon price.

Two types of options:
- Call option
- Put option

Swaps

- A derivative contract through which two parties exchange financial instruments, this exchange takes place at a pre-determined time. These instruments can be almost anything, but most swaps involve cash flows based on a notional principal amount that both parties agreed on.
- Swaps do not trade on exchange, and retail investors do not generally engage in swaps. Rather, swaps are over-the-counter contracts widely used by businesses, Financial Institutions, or governments.

References

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Overview
• Definition of Derivatives.
• History of Derivatives.
• Basic Purpose of Derivatives.
• Players in the Derivatives Market.
• Major Categories of Derivatives (Forwards, Futures, Options, Swaps).

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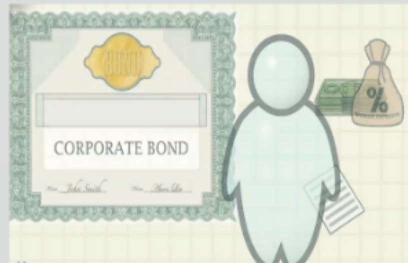

History of Derivatives

- Derivatives markets can be traced back to middle ages.
- Developed to meet the need of farmers and merchants.
- First future exchange was established in Japan in 16th century.
- The Chicago Board of Trade was established in 1848.
- The International Monetary Market was established in 1972 for future trading in foreign currencies.

Basic Purpose of Derivatives

- In derivatives transactions, one party's loss is always another party's gain. So the main purpose of derivatives is to transfer risk from one person or firm to another, that is, to provide insurance and manage the risk.

- **Price Discovery:** Derivatives play a crucial role in discovering the present and future price of any commodity or financial asset. This is an essential part of an efficient economic system.

- **Trading efficiency:** Investing in a derivative can be a more attractive alternative than investing in the underlying instrument. This might be a result of greater liquidity or lower transaction costs in the derivatives market.

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