Chapter -5
Findings and Interpretations

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We have observed that derivative markets in commodities, equity, foreign exchange etc are in existence in the world since a very long time. In India too we find that derivative markets were in existence in commodities for a long time in an unorganized format. Although they have been formalised through an exchange much later. The equity derivative market was introduced in the year 2000 as a step towards an efficient stock market after a series of financial mishaps in the Indian stock market after the liberalization process in 1990’s.

Academicians and experts over the years have studied and built theories and models around the functioning of derivative markets.

After a detailed study of the concept of equity derivative markets and its regulatory structure, the researcher has arrived at the following conclusions:

1) Indian derivative markets are in a nascent stage as compared to the growth and development of this segment around the world.

2) We are yet to solidify and freeze our basic financial structures which govern/regulate our financial markets.

3) Since derivative markets are derivative of our basic financial markets like commodities or stock, it reflects the strength and weaknesses of the basic financial markets.

4) It is imperative that our financial markets have to be strong to absorb the shocks and triggers being created by the dynamics of the functioning of the financial markets.

5) It has been observed that the Indian banking system has been the most prudent amongst the banking systems of other countries. This has been due to the conscious and alert policy makers of the Indian financial systems and a very conservative approach of our banking system towards the business of banking which is majorly controlled by public sector banks, which are regulated and governed by Indian legislative laws. Private commercial banks and investment banks currently have a limited role to play due to the presence of the huge public banking system. A recent
newspaper report in Indian Express dated September 26 2012 (Wednesday) stated that in its Global Financial Stability Report, the IMF observes that “India seems insulated from the worst of effects of global financial crisis as it has relatively low degree of exposure to international banking”.

6) Our Indian financial regulators although multiple in numbers help with their dynamic and multi faceted leadership styles by bringing diverse views on the table.

7) Our financial markets have been developed very consciously and conservatively over the years to protect the interests of various stake holders in the Indian financial system. The integration with global markets has brought professionalism in the approach of the functioning of the markets.

8) The Indian financial markets have developed rapidly after liberalisation initiatives taken by the government of India. SEBI was formed to deal with stock market issues; the National Stock Exchange was formed by institutional investors with government support to bring in professionalism, automation, efficiency and modernity to the stock market operations. It acted as a counter part to the Bombay Stock Exchange.

9) The L C Gupta committee gauged the waters by conducting a survey before introducing derivative trading in the stock market. The survey findings showed that stock index futures ranked as the most popular and preferred type of equity derivative, the second being stock index options and the third being options on individual stocks. The fourth type, viz. individual stock futures, was favoured much less. Stock Index Futures are internationally the most popular forms of equity derivative. It has emerged in Indian Equity derivative market that the index options and stock futures were popular choices as products after the derivative trading introduction. The respondents also mentioned that they would wish to participate as hedgers, which too has emerged as a popular way of participation in dealing in derivative trades. Though it was responded (by 41.07%) that trading in stock index futures and options in India will grow moderately it has been observed that the growth in this area has been exponentially faster. The growth has been greater than the cash market in NSE as observed in the table (Source NSE Website):
<table>
<thead>
<tr>
<th>Year</th>
<th>Volume traded in CM</th>
<th>Volume traded in F&amp;O segment (No. of contracts), Index Futures, Stock Futures, Index Options, Stock Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>278,408</td>
<td>4196873</td>
</tr>
<tr>
<td>2002</td>
<td>364,065</td>
<td>16768909</td>
</tr>
<tr>
<td>2003</td>
<td>713,301</td>
<td>56886776</td>
</tr>
<tr>
<td>2004</td>
<td>797,684</td>
<td>77017185</td>
</tr>
<tr>
<td>2005</td>
<td>844,486</td>
<td>157619271</td>
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</tr>
<tr>
<td>2007</td>
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</tr>
<tr>
<td>2008</td>
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</tr>
<tr>
<td>2009</td>
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</tr>
<tr>
<td>2011</td>
<td>16,16,978</td>
<td>1205045464</td>
</tr>
</tbody>
</table>

10) The derivative markets have gained precedence over the cash market in NSE, leading to the Price Discovery Process. It has also helped price stabilization thus bringing down price volatility.

11) It has been observed that banks and financial institutions dealing in non exchange trades (OTC etc) have suffered huge financial losses, whereas exchange regulated trades are managed more transparently.

12) It has been observed that SEBI and the National Stock Exchange are highly responsive to the needs of the market in terms of compliant redressal mechanism, governance, change in compliance needs as per the market requirements. As per the Indian Express News dated 24th July 2012, SEBI has initiated steps to improve market integrity and check manipulation and has hiked the benchmark liquidity level for any script to be eligible for trading in the derivatives segment. Due to these initiatives, only 100 out of 220 scrips being traded in the F&O segment of the national stock exchange would be eligible to be traded. A new initiative of informing SEBI of investor relations with promoters of the companies they have interest in would also help in case of irregular or suspicious behaviour by an investor group. To assess the trading depth of scrip, SEBI has mandated an average monthly turnover of Rs 100 crores (for last three months). This reflects the sensitivity of the governance body towards making the markets efficient and effective.
13) It has been observed that the volatility in the stock market has considerably reduced after the introduction of derivative trading in the equity segment. This reinforces the fact that derivative trading helps reduce price volatility in the market leading to price stability.

14) It has been observed that derivative markets have emerged stronger in India taking over the cash segment in the national stock exchange. It has also grown exponentially around the world. The ability of a derivative instrument to transfer risk and price determination has made the instruments popular, although they carry high risk/losses in case used without proper knowledge and awareness.

15) It has also been observed that derivative trading help in enhancing liquidity in the market. Since initial investment in these instruments is lower than the cash segment, it helps participation of more players in the market.

16) It has been observed that the Indian regulatory body, SEBI’s approach to develop this segment in very cautious and balanced. It has strict entry and compliance procedures laid down for members to trade in the derivative instruments. Although it propagates innovation in introducing new products in the market, it follows a conservative approach, testing the market for its maturity and ability to absorb the products. A news report in Indian Express on November 20 2012, stated that SEBI had decided to discontinue with mini derivatives contracts on Sensex and Nifty indices, to discourage small investors from getting attracted to this segment.

17) It has been observed that our Indian equity derivative market segment is not adequately integrated with foreign markets. Their derivative products and markets are not accessible for trading. This in a way protects our markets against the shocks and turbulences at international level to some/large extent. Efforts are being made to internationalize our markets, with a cautious mindset.

We find that international market fluctuations in gold, silver and oil do impact Indian conditions. It would be interesting to find the level of impact through a detailed study.

18) It has been observed that as per the news in Indian Express on July 10, 2012 MCX-SX was allowed to trade in equity, equity F&O, interest rate futures and wholesale
debt segments. This demonstrates the positive and progressive policy of regulators to develop the financial markets.

19) It has been observed that financial irregularities happen due to uncontrolled and unsupervised back office operations. The front and back office operations being controlled by the same individuals. Unlimited power and authority were given to an individual leading to taking unilateral decisions with far reaching financial consequences. The same should be avoided and be promulgated as compliance.

20) It has been observed that statistics pertaining to equity and derivative market (as per the Committee on Financial Sector Assessment 2009 Report, RBI) the Market capitalisation a (as on December 31, 2008) (Rs. crore) for BSE and NSE was as follows:

GDP at market prices - 2007-08 (Rs. crore)

NSE - 29,16,768,
BSE - 31,44,767

47,13,148

Market capitalisation as per cent to GDP

NSE - 61.88 per cent
BSE -66.72 per cent

The market capitalization is quite substantial to India’s GDP earnings.