Chapter 2

LITERATURE REVIEW

The present study is developed on the basis of a survey of large number of literatures on the topics related to the global derivative market, trading practices with derivatives in India, regulatory framework, investor's attitude towards derivatives, the recent trend and development on financial derivatives. This chapter intended to examine theoretical and empirical research related to the financial derivatives and its trading practices; and to determine the research gap by way of stating how the earlier studies differ from the current field of research.

2.1. The Review process

The review has been steered through three distinct phases. During the first phase the research problem was developed through searching literature related financial derivatives published in business journals, magazines and other stock market related write-ups in newspapers were considered. The bibliography of PhD theses published by Association of Indian Universities was considered during initial stage in order to avoid overlapping of research work and to develop and distinctive research problem.

The second phase of survey has been conducted with abstracting and indexing journals from different published sources. The third phase of literature survey was reinforced by identifying the most useful studies for the current topic of research and was supported by reviewing full text articles. The full text article was collected from different sources viz. various University and College libraries situated in Kerala & Tamil Nadu, IIM-K library, NIT-C library and purchasing research works from online sources.

2.2. Focus of the Review

For the review both theoretical as well as empirical works were considered. The earlier research works related to the current field of study was scrutinised thoroughly before fixing the review dimensions. The review focussed on the following dimensions.

- The Global Derivative Market and recent issues.
- Recent innovations with Derivatives.

Customer Preference towards Financial Derivatives with reference to South Kerala Market
2.2.1. The Global Derivative Market and Recent Issues

The Global derivative market was small until 1970, when economic conditions along with advance pricing of derivatives led to a spectacular growth. Until late 70’s the derivatives mostly took in the form of forwards, futures, options. Except for forward contract on commodities the trading were mostly done through over the counter exchange. Later the derivative market began to become more broad and popular. In order to justify that the author Rene M Stulz says that in December 2005, the total notional amount of derivatives traded over the counter was $285trillion (excluding credit default swaps). In 1987 the notional amount of outstanding of currency swaps, interest rate swaps, and interest-rate options was approximately $865 billion, 18 years later it was almost $213 trillion implying that an average annual growth rate of 36 percentage. The notional amount of exchange traded derivatives grew from $616 billion in December 1986 to $57.8 trillion in December 2005, for an average annual growth rate of 27 percentages.

With reference to a study conducted by Sankarshan Basu and Bappaditya Mukhopadhyay (2006) on derivatives in Asia Pacific Market reveals Asian derivative markets today account for one-third of the worldwide foreign exchange and over 40 per cent of equity derivative trading. Korea hosts the world’s largest derivative exchanges, while India has the world’s fastest growing exchange. Derivatives have made Asian capital markets more competitive. They also have significant developmental benefits, for example, as hedging tools for commodity producers and as cheaper financing tools for corporations. Policymakers all around the world have learned to emphasise good regulation, governance and risk management through central counterparties in order to minimise potential threats to financial stability. BIS reports that the over-the-counter (OTC) derivative markets have grown ten-fold over the last decade and in 2004 reached $248 trillion, with an average annual growth rate that exceeds 30 per cent since 1990. The fastest growth in equity derivative markets has been recorded in Asia, which
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currently accounts for over one-third of worldwide volumes. The Korean Stock Exchange, as already mentioned, has become the largest derivative exchange in the world, while China and India have registered rapid growth rates in 2005. Fourteen out of the largest 50 derivative exchanges in the world are now in the Asia-Pacific region. While many of them are focusing on equity derivatives (Korea, India and Hong Kong), others are specialising in fixed-income products (Brazil, Mexico and Singapore) and interestingly, there are also a few remaining commodity specialist exchanges (Dalian, Tokyo and Shanghai).

There are five main derivative products traded in Asian markets. Foreign exchange products for major currencies are traded in Tokyo, Singapore and Hong Kong. Asian FX markets are large with turnover accounting for one-third of the worldwide markets. Interest rate derivative markets in Asia are smaller and account for less than 5 per cent of world markets with a stagnating trend in OTC markets and a migration towards ETD markets (Korea has recently shifted its government bond derivatives on to the exchange). Tokyo and Singapore are two dominant locations that are trading mostly JPY and US$ swaps (OTC) and futures (ETD). Equity derivatives have witnessed the most rapid growth. They are mostly ETD markets with Korea, India and Hong Kong showing the most impressive recent expansion. Index futures as well as options are the most widely traded products with a large participation of institutional investors and significant foreign participation. Over 44 per cent of the worldwide ETD equity turnover is currently taking place on Asian exchanges. Commodity derivatives have a long history, especially in China where the soybean futures contract at the Dalian Commodity Exchange is the third largest derivative contract across Asia (among the world’s 20 largest derivative contracts). In addition wheat, rubber, gold and oil
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