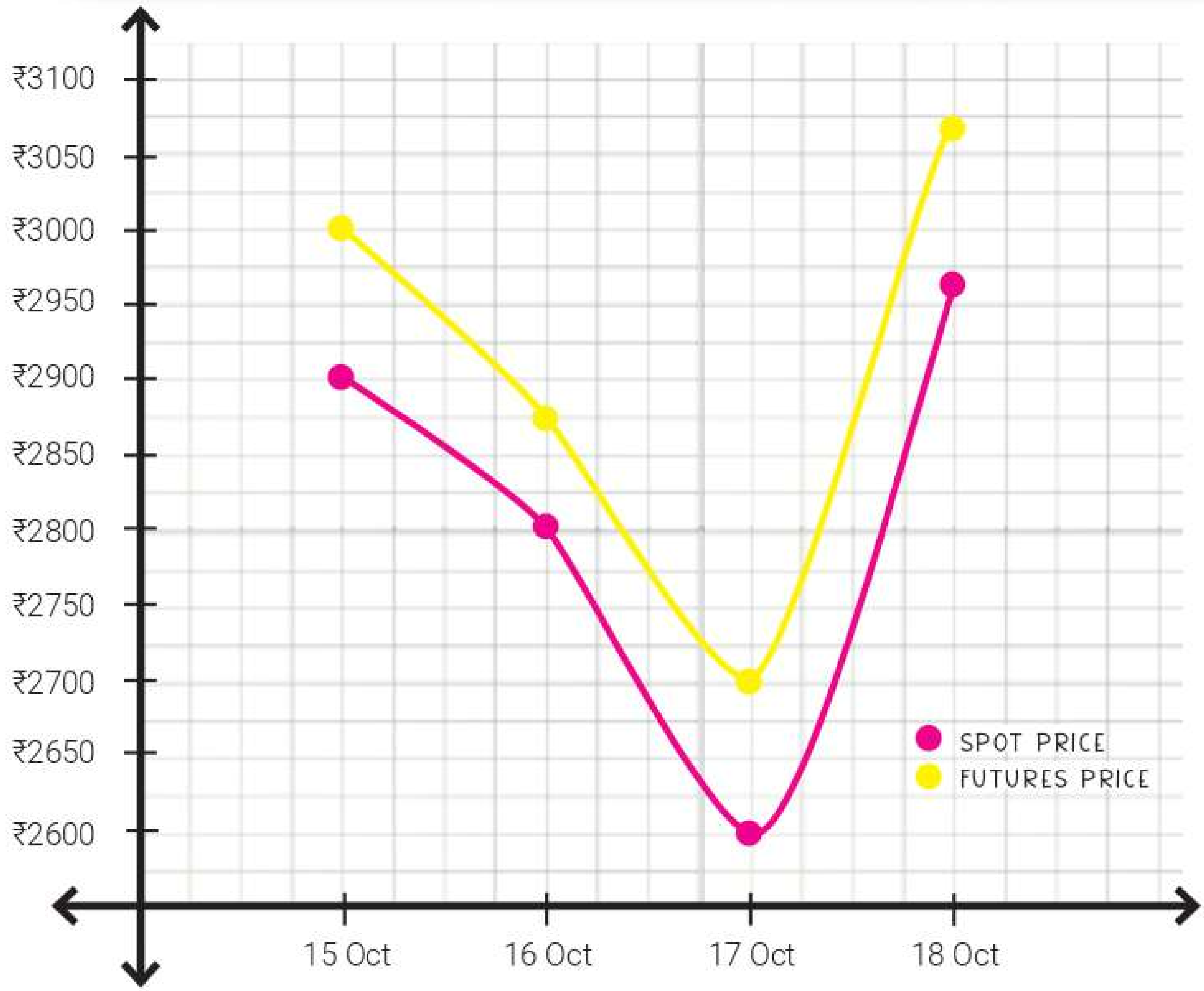
3.8 WHAT DOES MARK TO MARKET MEAN?

Explainer Video

Let us understand the Mark to market settlement with an example.

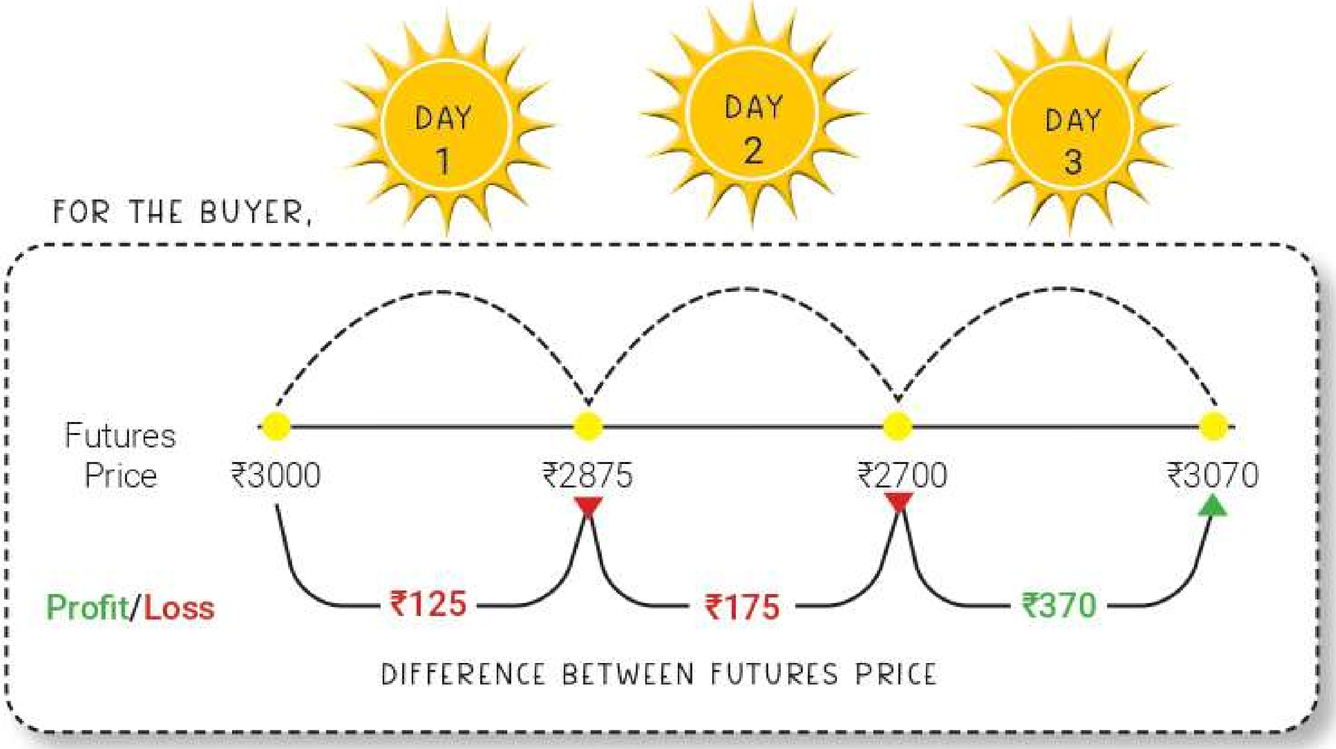
	OCTOBER 15	OCTOBER 16	OCTOBER 17	OCTOBER 18
Spot Price	₹2900	₹2800	₹2600	₹2965
Futures Price	₹3000	₹2875	₹2700	₹3070



As we can see, the date-wise Spot price and Futures price are mentioned for TCS with a :

LOT SIZE IS OF 100.

INITIAL MARGIN IS ₹60,000.



For a mark to market settlement, we will look at the futures price difference on a daily basis. Keep in mind that we need to focus on change in price of futures contract and not the spot contract.

Now let us move to the working by having the two positions of a futures contract in mind, i.e., long position and short position.

For the buyer of the contract, accounting for 15th October to 16th October price movement, there is a loss of ₹125. The total loss amount payable by the buyer to the seller is ₹12,500. This will be deducted from the margin account of the buyer.

The seller, on the other hand, is credited with ₹12,500 in his account. The balance on the seller's side stands at ₹72,500. The surplus of ₹12,500 is allowed to be withdrawn by him.

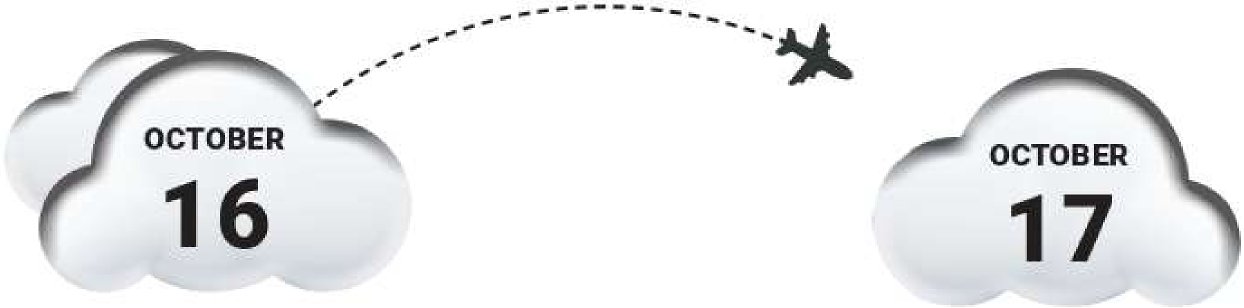
DAY 1

	SELLER	BUYER
Initial Margin	₹60,000	₹60,000
- Loss of ₹125 (125 x 100)	₹12,500	(₹12,500)
Total balance	₹72,500	₹47,500

The balance of the Buyer ₹47500 < ₹60000 (margin), due to which he would be required to bring in additional capital of ₹12,500.

- Withdrawals	—	—
+ Additional Margins	—	₹12,500
Total balance	₹72,500	₹60,000

NOTE : For the continuation of the example, let us assume that no withdrawals were made and the balance is the same as stated after profit adjustment.



For the buyer again, accounting for 16th October to 17th October price movement, there is a loss of ₹175. The total loss amount payable by the buyer to the seller is ₹17,500. This will be deducted from the margin account of the buyer.

The seller, on the other hand, is credited with ₹17,500 in his account. The balance on the seller's side stands at ₹90,000. The surplus of ₹30,000 may be withdrawn by him.

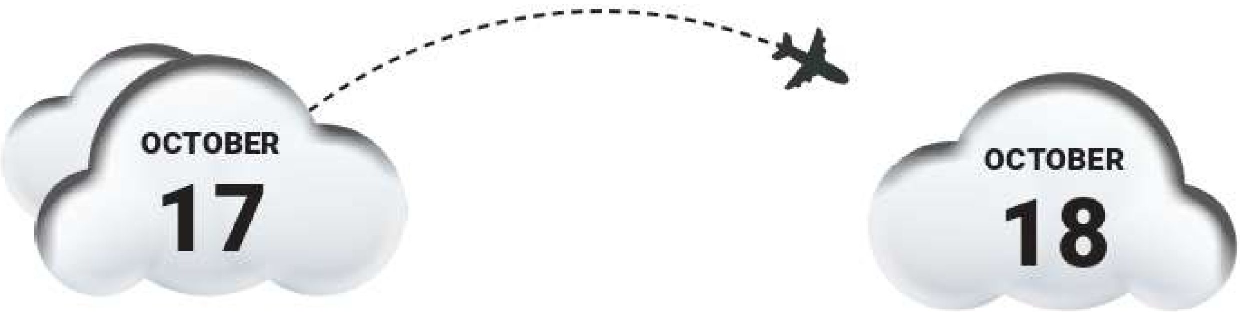
DAY2

	SELLER	BUYER
Balance b/f of day 1	₹72,500	₹60,000
- Loss of ₹175 (175 x 100)	₹17,500	(₹17,500)
Total balance	₹90,000	₹42,500

The balance of the Buyer ₹42,500 < ₹60,000 (margin), due to which a margin call would be sent to bring additional funds of ₹17,500.

	SELLER	BUYER
- Withdrawals	——	——
+ Additional Margins	——	₹17,500
Total balance	₹90,000	₹60,000

NOTE : For the continuation of the example, let us assume that no withdrawals were made and the balance is the same as stated after profit adjustment.



This time for the Buyer, accounting for 17th October to 18th October price movement, there is a profit of ₹370. The total profit amount payable by the seller to the buyer is ₹37,000.

On the other hand,the seller is debited with ₹37,000 in his account. The balance on the seller's side now stands at ₹53,000. This will be deducted from the margin account of the seller.

DAY3

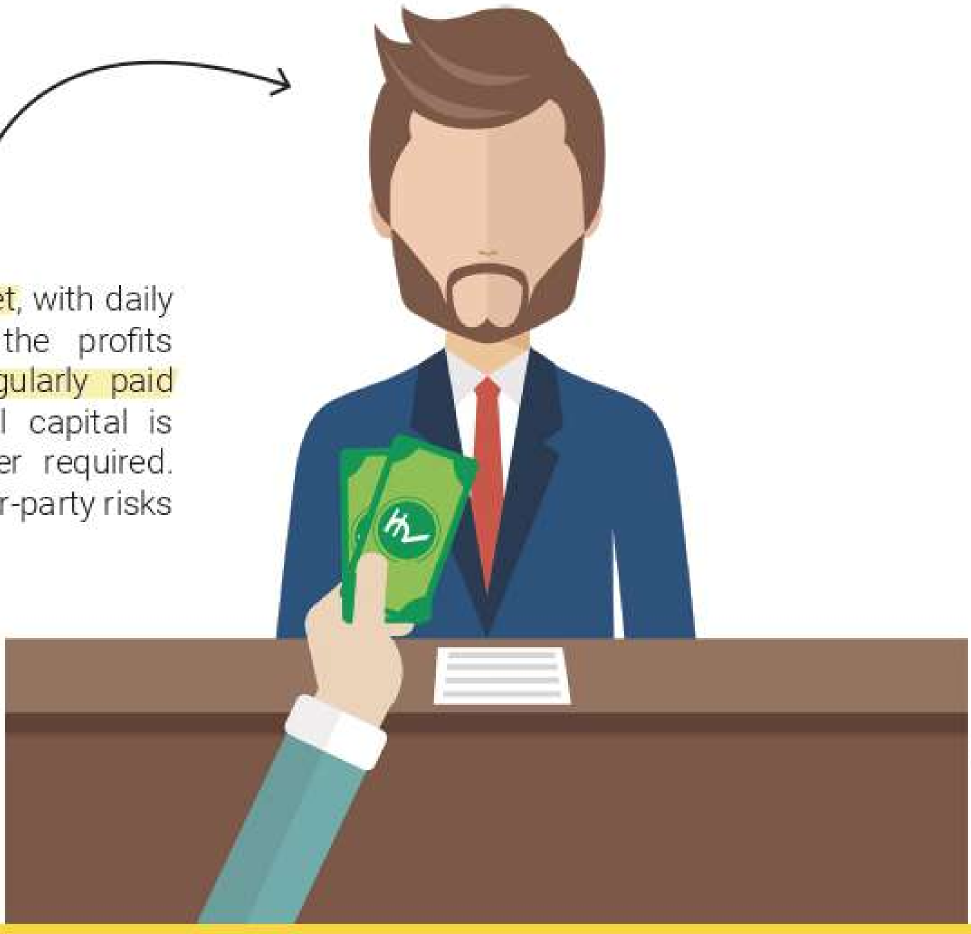
	SELLER	BUYER
Balance b/f of day 2	₹90,000	₹60,000
- Loss of ₹370 (370x 100)	(₹37,000)	₹37,000
Total balance	₹53,000	₹97,000

The balance of the Seller ₹53,000 < ₹60,000 (margin), due to which the seller is now required to add additional ₹7000 to their account to maintain the margin and keep the position.

- Withdrawals	—	—
+ Additional Margins	₹7000	—
Total balance	₹60,000	₹97,000

NOTE : For the continuation of the example, let us assume that no withdrawals were made and the balance is the same as stated after profit adjustment.

Had this been a forward contract, these profits and losses on each side would have been accumulated until the maturity or expiry date of the contract. Actual settlement would have occured on date of maturity which would have created room for Counter-party risk.



But in futures market, with daily mark to market, the profits and losses are regularly paid off. Also, additional capital is introduced whenever required. This reduces counter-party risks quite significantly.