Financial Derivatives:

Financial derivatives are financial instruments whose value is derived from the value of an underlying asset. This underlying asset can be anything from stocks, bonds, commodities, currencies, or even interest rates.

Purpose of Derivatives

- **Risk Management:** Derivatives are primarily used to manage risk. For instance, a company can use futures contracts to hedge against potential price fluctuations in the commodities it uses.
- **Speculation:** Derivatives can also be used for speculative purposes. Traders can buy or sell derivatives in anticipation of price movements and profit from them.
- **Arbitrage:** Derivatives are used for arbitrage, which involves simultaneously buying and selling assets in different markets to profit from price discrepancies.

Types of Financial Derivatives

Financial derivatives are categorized into three main types:

1. Futures Contracts

- **Definition: A futures contract is a legally binding agreement to buy or sell a specific asset (like a commodity, currency, or stock index) at a predetermined price on a future date.**
- **Purpose: Primarily used for hedging against price fluctuations and speculation.**
- **Example: A farmer may enter into a futures contract to sell wheat at a fixed price to protect themselves against potential price declines.**

2. Options Contracts

- **Definition: Options contracts give the buyer the right, but not the obligation, to buy or sell an underlying asset at a predetermined price (strike price) on or before a specified expiration date.**
- **Types:**
  - **Call Options: The right to buy an asset.**
  - **Put Options: The right to sell an asset.**
- **Purpose: Used for both hedging and speculation. They offer more flexibility than futures contracts.**
- **Example: An investor might buy a call option on a stock to limit their downside risk if the stock price falls.**

3. Swaps

- **Definition: A swap is an agreement between two parties to exchange cash flows based on different underlying assets or interest rates.**
- **Types:**

- **Interest Rate Swaps: Exchange interest rate payments based on different benchmarks.**
- **Currency Swaps: Exchange principal amounts and interest payments in different currencies.**
- **Credit Default Swaps (CDS): The buyer pays a premium to the seller, who agrees to pay the buyer if a specific debt instrument defaults.**

- **Purpose: Used to manage interest rate risk, currency risk, and credit risk.**
- **Example: A company with a floating-rate loan might enter into an interest rate swap to exchange its floating rate payments for a fixed rate.**

Key Participants in the Derivatives Market

- **Hedge Funds:** These investment funds often use derivatives to manage risk and generate returns.
- **Investment Banks:** They provide brokerage, advisory, and trading services in the derivatives market.
- **Commercial Banks:** They use derivatives to manage their own risk and offer derivative products to their clients.
- **Corporations:** Corporations use derivatives to hedge their exposure to commodity prices, interest rates, and foreign exchange rates.
- **Individuals:** While less common, individuals can also participate in the derivatives market through futures and options contracts.