FUTURE MARKETS : FUNDAMENTALS

PAPER -CC 303 MODULE -II

FINANCIAL ENGINEERING

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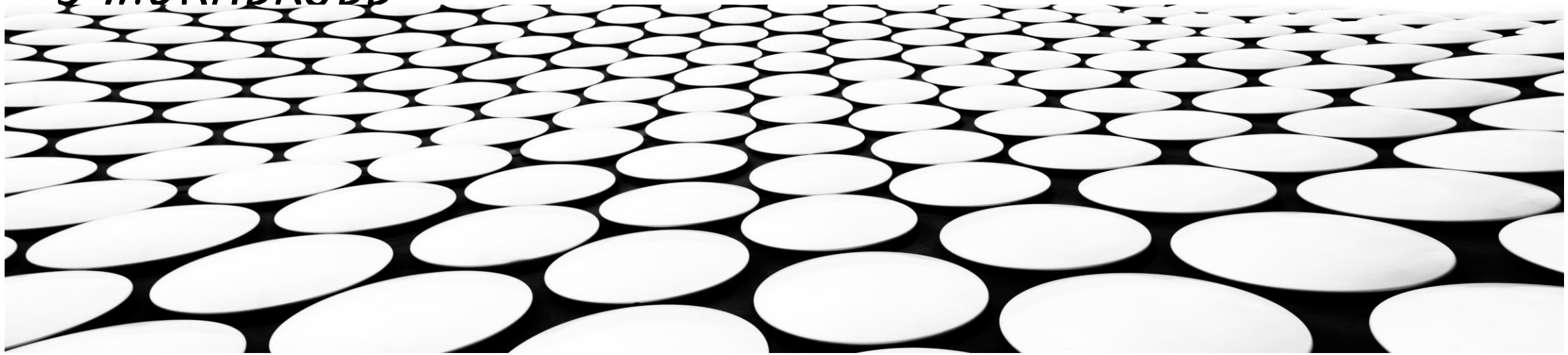

FUTURE MARKETS : FUNDAMENTALS

- This unit will cover the following concepts:
- Specification of a Futures contract
- Operation of margin accounts,
- Organization of exchanges,
- Regulation of markets,
- Way in which quotes are made,
- Treatment of futures transactions for accounting and tax purposes.

SPECIFICATION OF A FUTURES CONTRACT

- The exigency to get rid off the counter party risk leads to an interference by an exchange , which further leads to the standardisation of the contracts that are traded.
- A futures contract can thus be defined as a standardized forward contract that is traded on exchange, where the seller agrees to deliver a specified quantity of an asset of a defined quality at a predetermined date at a price contracted at a time in advance with the buyer (Srivastava).
- Specification of the future contracts are set by the exchanges where they are traded and these specification may vary from one exchange to another ; although there may be some similarity amongst the specifications

- Standardization of the futures contract deals with the factors like the underlying asset , size of asset , time , place, procedure of delivery, quality of underlying asset ,price adjustment in the variations in quality of the asset being delivered etc.

SPECIFICATION OF A FUTURES CONTRACT

When developing a new contract, the exchange must specify in some detail the exact nature of the agreement between the two parties. In particular, it must specify the asset, the contract size (exactly how much of the asset will be delivered under one contract), where delivery will be made, and when delivery will be made.

Sometimes alternatives are specified for the grade of the asset that will be delivered or

for the delivery locations. As a general rule, it is the party with the short position (the

party that has agreed to sell the asset) that chooses what will happen when alternatives

are specified by the exchange.

When the party with the short position is ready to deliver, it files a notice of intention to deliver with the exchange. This notice indicates selections it has made with respect to the grade of asset that will be delivered and the delivery location.

THE UNDERLYING ASSET

- When the asset is a commodity, there may be quite a variation in the quality of what is available at the market place. When the asset is specified, it is therefore important that the exchange stipulate the grade or grades of the commodity that are acceptable.
- The financial assets in futures contracts are generally well defined and unambiguous.

CONTRACT SIZE

- The contract size specifies the amount of the asset that has to be delivered under one contract.
- If the contract size is too large, many investors who wish to hedge relatively small exposures or who wish to take relatively small speculative positions will be unable to use the exchange.
- On the other hand, if the contract size is too small, trading may be expensive as there is a cost associated with each contract traded.
- The correct size for a contract clearly depends on the likely user. Whereas the value of what is delivered under a futures contract on an agricultural product might be $10,000to $20,000, it is much higher for some financial futures.

CONTRACT EXPIRY

- It refers to the time at which the contract comes to an end · Mutual obligations are to be settled on or before the expiry of the contract· The exchange specifies when the contracts for delivery will come to force and when they will be closed for trading·
- This has an important implications for the period during which hedging can be done or when a speculative position can be taken·

DELIVERY ARRANGEMENTS

- The place where delivery will be made must be specified by the exchange. This is particularly important for commodities that involve significant transportation costs.
- When alternative delivery locations are specified, the price received by the party with the short position is sometimes adjusted according to the location chosen by that party.
- The price tends to be higher for delivery locations that are relatively far from the main sources of the commodity.

PRICE QUOTATIONS

- The exchange in general defines how prices will be quoted. For example, in the US, crude oil futures prices are quoted in dollars and cents.
- The quotation is the basis on which the contract price , i.e. the value of the future contract is set . The price quotation for the product generally follows the convention of price quotations for the physical or the spot markets.

REFERNCES

- Options Futures and Other Derivatives (Eighth Edn.): J. Hull
- Derivatives and Risk Management (Second Edn.) : R.Srivastava