

Unit V

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MEANING AND DEFINITION OF CREDIT RATING

Moodys': "Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities".

Australian Ratings: 'A Corporate Credit rating provides lenders with an ample system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted'.

According to CRISIL, "Credit rating is an unbiased and independent opinion as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security."

According to ICRA, "ratings are opinions on the relative capability of timely servicing of corporate debt and obligations. These are not recommendations to buy or sell neither the accuracy nor the completeness of the information is guaranteed."

From the above definitions it is understood that:

- (i) Credit rating is an assessment of the capacity of an issuer of debt security, by an independent agency, to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument throughout the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.
- (ii) The ratings are expressed in code number which can be easily comprehended even by the lay investors. The ratings are the quickest way of understanding a company's financial standing .

FUNCTIONS OF CREDIT RATINGS

The credit rating firms are supposed to do the following functions:

1. **Superior Information** Rating by an independent and professional firm offers a superior and more reliable source of information on credit risk for three inter related risks: (a) it provides unbiased opinion. (b) due to professional resources, a rating firm has greater ability to assess risks. (c) it has access to lot of information which may not be publicly available.

2. **Low Cost Information** A rating firm which gathers, analyses, interprets and summarises complex information in a simple and readily understood format for wide public consumption represents a cost effective arrangement.

3. **Basis for a Proper Risk-Return Trade Off** If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

4. **Healthy Discipline on Corporate Borrowers** Public exposure has healthy influence over the management of issuer because of its desire to have a clear image.

5. **Formulation of Public Policy Guidelines on Institutional Investment** The public policy on the kinds of securities that are eligible for inclusion in different kinds of institutional portfolios can be developed with great confidence if securities are rated professionally by independent agencies.

BENEFITS OF CREDIT RATING

1. **Low Cost Information** Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust.

2. **Quick Investment Decision** In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

3. **Independent Investment Decision** For rated instruments, investors need not depend upon the advice of the financial intermediaries. As the rating symbol suggests the credit worthiness of the instrument and indicates the degree of risk involved in it, the investors can make direct investment decisions.

4. **Investors Protection** Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. The

objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

BENEFITS TO RATED COMPANIES

1. **Sources of Additional Certification** Credit rating agency provides additional information to the issue of debt/ financial instrument. A highly rated firm can enter the market with great confidence. Indian experience shows that use of rating, benefit a great deal by getting larger amount of money from a wider audience at a lower cost.

2. **Increase the Investors Population** A sound credit rating system gives an alternative method to name recognition as a determining factor in making investment and helps increase the population of those investing in debt obligations of the company.

3. **Forewarns Risks** Credit rating acts as a guide to companies which get a lower rating. It forewarns the management of the perception of risk in the market and prompts to take steps on their operating and marketing risks and thereby changes the perception in the market.

4. **Encourages Financial Discipline** Ratings also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their debt obligations.

5. **Merchant Bankers Job Made Easy** Merchant bankers and brokers will be relieved of the responsibility of guiding investors as to the risk of a particular investment. Merchant bankers and brokers, in the absence of objective information, go on the basis of name recognition in guiding their clients. With the advent of credit rating, what they would be required to do is to bring to the attention of their clients the ratings of debt obligations.

6. **Foreign Collaborations made easy** The foreign collaborators always ask for credit rating while negotiating with an Indian company. Credit rating enables to identify instantly the relative credit standing of the company.

7. **Benefits the Industry as a Whole** Relatively small and unknown companies use ratings to instil confidence in investors. Higher rate companies get larger amount of money at a lower cost. Thus the industry as a whole can benefit from ratings by direct mobilisation of savings from individuals rather than from intermediary lending institutions.

8. **Low Cost of Borrowing** A company with highly rated instrument has the opportunity to reduce the cost of borrowing by quoting lesser interest rate on fixed deposits or debentures as

the investors with low risk preference would invest in safe securities though yielding low rate of return.

9. Rating as a Marketing Tool Companies with rated instruments, use rating as a marketing tool to create better image in dealing with their customers, lenders and creditors.

CREDIT RATING AGENCIES IN INDIA

Currently there are four credit rating agencies in India.

1. Credit Rating Information Service Ltd. (CRISIL).
2. Investment Information and Credit Rating Agency of India (ICRA)..
3. Credit Analysis and Research (CARE).
4. -Duff Phelps Credit Rating Pvt.Ltd. (DCR India).

(1) CREDIT RATING INFORMATION SERVICES LIMITED

Credit Rating Information Services Limited (CRISIL) the first credit agency was floated on January 1, 1988. It was started jointly by ICICI and UTI with an equity capital of Rs.4 crores. Each of them holds 18% of the capital. The other promoters are Asian Development Bank (15%), the LIC and General Insurance Corporation and its subsidiaries and the SBI (5% each), the Housing Finance Development Corporation (6.2%), nine public sector and private sector banks (19.25%) and 10 foreign banks (7.55%).

The principal objective of CRISIL is to rate the debt obligations of Indian Companies. Its rating guides investors about the risk of timely payment of interest and principal on a particular debt instrument. Crisil has five offices one each in Bombay, Delhi, Calcutta, Madras and Bangalore.

Rating Methodology

CRISIL commences a rating exercise at the request of a company. In accordance with industry practice all over the world, the methodology involves an analysis of the past performance of the company and assessment of its prospects, The first analysis relates to the past performance of the company. However, the past is viewed not as a guide, but to understand why the company performed in the way it did, what

problems it faced and what the Management's response to these problems was. To assess the future prospects, CRISIL studies the industry or industries in which the company operates and the company's position within the industry. It also makes an evaluation of the management and cash flow projections of the company and identifies the key issues concerning the company. The industry is studied by analysing demand and supply growth, nature and basis of competition, Government policy for the company and the effect of change in Government policy on the future of the company. The position of the company within the industry is studied to understand how the company would fare in the future. CRISIL, therefore, looks at the operating efficiency in terms of locational advantage, raw material, power and labour situation; its cost structure as compared to that of its nearest competitors and the company's market position in terms of its market share, product strength, selling and distribution arrangements, competitive advantage, customer delivery etc. CRISIL, evaluates the management of the company with reference to its track record, the recruitment and training system, planning and control system, depth of managerial talents and succession plans, goals for the company, the philosophy of doing business, attitudes towards taking business risks and the strategies for the company. The tenacity, determination and drive of the management to overcome problems as they arise in the company is yet another factor assessed by the CRISIL.

Then, CRISIL makes its own assessment of cash flows and decides the degree of comfort available from the cash flows to meet cash needs of the company for capital expenditure, working capital growth and debt servicing obligations. In addition, it assesses the company's ability to raise funds quickly in various ways in times of necessity to meet the requirements of servicing debt. In evaluating the ratings, CRISIL employs both qualitative and quantitative criteria. The judgement made by the CRISIL is necessarily subjective and the quantitative analysis is meant to assist in making best possible overall qualitative judgement. CRISIL employs a multi-layered decision-making process in assigning ratings. When it receives a request for rating, it assigns two teams on the job. The first team meets the officials and makes an assessment of the industry, company and management. The second team is also required to make its own study of the industry. Then the first team interacts with the backup team. The findings of the interactions are presented simultaneously in a detailed note to the Branch Internal Committee comprising at least three senior analysts of CRISIL and an Internal Committee of six senior executives and thereafter the note is presented with the recommended ratings to the Rating Committee comprising six directors of the company who

are not connected with any shareholders of CRISIL. The Rating Committee members are chosen carefully so that they do not have any links with industries or investment agencies connected with the units being rated. This multi-layered process ensures that no individual decides on rating and that prejudices and biases are eliminated. The evaluation of the company is made on a confidential basis. The rating process ensures complete confidentiality of information that may be provided by the company. Credit rating Symbols CRISIL uses the conventional rating symbols used in the USA and widely accepted in many other countries. The following table shows the investment-wise rating symbols assigned by “CRISIL and the meaning of each rating from the angle of safety to the investors.

CRISIL Debenture Rating Symbols:

High Investment Grades:

AAA (Triple A) - Highest Safety

AA (Double A) - High Safety

Investment Grades :

A : Adequate Safety;

BBB (Triple B) : Moderate Safety

Speculative Grades:

BB (Double B) - Inadequate Safety;

B: High Risk

C : Substantial Risk;

D : Default

Note : CRISIL may apply ‘+’ (plus) or ‘-’ (minus) sign for ratings from AA to C to reflect comparative standing within the category.

CRISIL

Fixed Deposit Rating Symbols:

Investment grades:

FAAA (F-Triple A) - Highest Safety, FAA (F-Double A) - High Safety, FA : Adequate Safety.

Speculative Grades

FB - Inadequate Safety, FC - High Risk , FD- Default .

Note: (1) CRISIL may apply '+' (plus) or '-' (minus) sign for ratings from FAAA to FC to indicate the relative position within the rating category.

CRISIL monitors the ratings it assigns constantly. The ratings may be upgraded, downgraded or withdrawn depending upon new information or developments concerning the company whose debt obligation is rated. It has the right to widely disseminate the ratings through the media, through its own publications or through any other methods.

(ii) INVESTMENT INFORMATION AND CREDIT RATING AGENCY OF INDIA

(IICRA)

The IICRA was set up by Industrial Finance Corporation of India on 16th January 1991. It is a public limited company with an authorised share capital of Rs.10 crores. The initial paid up capital of Rs.3.50 crores is subscribed by IFC, UTI, LIC, GIC, SBI and 17 other banks. IICRA started its operations from 15th March 1991.

ICRA RATING SCALE

Long Term including Debentures including Bonds and Preference Shares :

LAAA : Highest Safety , LAA ; High Safety , LA : Adequate Safety, LBBB: Moderate Safety , LBB : Inadequate Safety , LB : Risk Prone , LC : Substantial Risk, LD : Default, Extremely Speculative

Medium term including Deposits Fixed

MAAA : Highest Safety , MAA : High Safety, MA : Adequate Safety, MB : Inadequate Safety, MC : Risk Prone , MD: Default.

Short Term Including Commercial Paper

A-1 Highest Safety, A-2 High Safety , A-3 Adequate Safety, A-4 Risk Prone, A-5 Default.

The rating symbols for different instruments of the same company need not necessarily be the same.

(iii) CREDIT ANALYSIS AND RESEARCH LIMITED (CARE):

The CARE was promoted in 1993 jointly with investment companies, banks and finance companies. Services offered by CARE are (1) credit rating (ii) information service (iii) Equity research (iv) Rating of parallel market of LPG and kerosene.

Investment Grade CARE

For Long term debt instruments

1, Highest Safety CARE AAA

2 High Safety CARE AA

3 Adequate Safety CARE A

4 Inadequate Safety CARE BB

5 High Risk CARE B

For Medium term debt instruments

1 Highest Safety CARE AAA

2 High Safety CARE AA

3 Adequate Safety CARE A

4 Inadequate Safety CARE BB

5 High Risk CARE C

For Short term debt instruments

1 Highest Safety PR1

2 High Safety PR2

3 Adequate Safety PR3

4 Inadequate Safety PR4

5 High Risk

DERIVATIVES

Meaning

In a broad sense, many commonly used instruments can be called derivatives since they derive their value from an underlying asset. For instance, equity share itself is a derivative, since, it derives its value from the firm's underlying assets. Similarly, one takes an insurance against his house covering all risks. This insurance is also a derivative instruments on the house Again, if one signs a contract with a building contractor stipulating a condition, that, if the cost of materials goes up by 15%, the contract price will also go up by 10%. This is also a kind of derivative contract. Thus, derivatives cover a lot of common transactions. In a strict sense, derivatives are based upon all those major financial instruments which are explicitly traded like equities, debt instruments, forex instruments and commodity based contracts. Thus, when we talk about derivatives, we usually mean only financial derivatives, namely, forwards, futures, options, swaps etc. The peculiar features of these instruments are that:

(i) they can be designed in such a way so as to cater to the varied requirements of the users either by simply using any one of the above instruments or by using a combination of two or more such instruments.

(ii) they can be designed and traded on the basis of the expectations regarding the future price movements of underlying assets.

(iii) they are all off-balance sheet instruments and

(iv) they are used as a device for reducing the risks of fluctuations in asset values.

As the word implies, a derivative instrument is derived from “something” backing it. This something may be a loan, an asset, an interest rate, a currency flow, a stock trade, a commodity transaction, a trade flow etc. Derivatives enable a company to hedge ‘this something’ without changing the flow associated with the business operation.

Definition

It is very difficult to define the term derivatives in a comprehensive way since many developments have taken place in this field in recent years. Moreover, many innovative

instruments have been created by combining two or more of these financial derivatives so as to cater to the specific requirements of users, depending upon the circumstances.

“Derivatives involve payment/receipt of income generated by the underlying asset on a notional principal”.

“Derivatives are a special type of off-balance sheet instruments in which no principal is ever paid”

“Derivatives are instruments which make payments calculated using price of interest rates derived from on balance sheet or cash instruments, but do not actually employ those cash instruments to fund payments”.

All these definitions point out the fact that transactions are carried out on a notional principal, transferring only the income generated by the underlying asset.

KINDS OF FINANCIAL DERIVATIVES

As already discussed, the important financial derivatives are the following:
(i) Forwards (ii) Futures (iii) Options and (iv) Swaps

Forwards: Forwards are the oldest of all the derivatives. A forward contract refers to an agreement between two parties to exchange an agreed quantity of an asset for cash at a certain date in future at a predetermined price specified in that agreement. The promised asset may be currency, commodity, instrument etc.

Example: On June 1, X enters into an agreement to buy 50 bales of cotton on December 1 at Rs.1,000/-per bale from Y, a cotton dealer. It is a case of a forward contract where X has to pay Rs.50,000 on December 1 to Y and Y has to supply 50 bales of cotton. In a forward contract, a user (holder) who promises to buy the specified asset at an agreed price at a fixed future date is said to be in the ‘Long position’. On the other hand, the user (holder) who promises to sell at an agreed price at a future date is said to be in ‘Short position’. Thus, ‘long position’ and ‘short position’ take the form of ‘buy’ and ‘sell’ in a forward contract.

Features of Forward Contracts In a forward contract, the supply of an asset is promised at a future date. This contract is usually referred to as ‘Forward Rate Contract’ (FRC).

(i) **Over the Counter Trading (OTC):** These contracts are purely privately arranged agreements and hence, they are not at all standardised ones. They are traded ‘over the counter’ (OTC) and not in exchanges.

Futures : A futures contract is very similar to a forward contract in all respects excepting the fact that it is completely a standardised one. Hence, it is rightly said that a futures contract is nothing but a standardised forward contract. It is legally enforceable and it is always traded

on an organised exchange. There is much flexibility since the contract can be modified according to the requirements of the parties to the contract. Parties enter into this kind of contract on the basis of the custom, and hence, it is also called 'customised contract'.

(ii) **No down Payment:** There must be a promise to supply or receive a specified asset at an agreed price at a future date. The contracting parties need not pay any down payment at the time of agreement.

(iii) **Settlement at Maturity:** The important feature of a forward contract is that no money or commodity changes hand when the contract is signed. Invariably, it takes place on the date of maturity only as given in the contract.

(iv) **Linearity:** Another special feature of a forward rate contract is linearity. It means symmetrical gains or losses due to price fluctuation of the underlying asset. When the spot price in future exceeds the contract price, the forward buyer stands to gain. The gain will be equal to spot price minus contract price. If the spot price in future falls below the contract price, he incurs a loss. The gain which one can get when the price moves in one direction will be exactly equal to the loss when the price moves in the other direction by the same amount. It means that the loss of the forward buyer is the gain of the forward seller and vice versa.

(v) **No Secondary Market:** A forward rate contract is a purely private contract, and hence, it cannot be traded on an organised stock exchange. So, there is no secondary market for it.

(vi) **Necessity of a Third Party:** There is a need for an intermediary to enable the parties to enter into a forward rate contract. This intermediary may be any financial institution like bank or any other third party.

(vii) **Delivery:** The delivery of the asset which is the subject matter of the contract is essential on the date of the maturity of the contract.

Features of Futures

(i) **Highly Standardised:** Futures are standardised and legally enforceable. Hence, they are traded only in organised Future exchanges, It is also difficult to modify the agreement according to the needs of the contracting parties. However, many variants of Futures are available. But, once the agreement is entered into, the chances of modifying it are very remote.

(ii) **Down Payment:** The contracting parties need not pay any down payment at the time of agreement. However, they deposit a certain percentage of the contract price with the exchange and it is called initial margin. This gives a guarantee that the contract will be honoured.

(iii) **Settlements:** Though future contracts can be held till maturity, they are not so in actual practice. Futures instruments are ‘marked to the market’ and the exchange records profit and loss on them on daily basis. That is, once a futures contract is entered into, profits or losses to both the parties are calculated on a daily basis. The difference between the futures price and the spot price on that day constitutes either profit or loss depending upon the prevailing spot prices. The spot price is nothing but the market price prevailing then. For example, on Monday morning X enters into a futures agreement with Y to buy 50 bales of cotton at Rs.100/per bale on Friday afternoon. At the close of trading on Monday, the futures price goes up by Rs.10/per bale. Now, X will get a cash profit of Rs.500/for 50 bales at the rate of Rs.10/per bale. X can also cancel the existing futures contract with the price Rs.100/per bale or he can enter into a new futures contract at Rs.110/ per bale.

(iv) **Hedging of Price Risks:** The main feature of a futures contract is to hedge against price fluctuations. The buyers of a futures contract hope to protect themselves from future spot price increases and the sellers from future spot price decreases. Parties enter into futures agreements on the basis of their expectations of the future price in the spot market for the assets in question.

(v) **Linearity:** As stated earlier, futures contract is nothing but a standardised forward contract. Therefore, it also possesses the property of linearity. Parties to the contract get symmetrical gains or losses due to price fluctuation of the underlying asset on either direction.

(vi) **Secondary Market:** Futures are dealt in organised exchanges, and as such, they have secondary market too.

(vii) **Non-delivery of the Asset:** The delivery of the asset in question is not essential on the date of maturity of the contract in the case of a futures contract. Generally, parties simply exchange the difference between the future and spot prices on the date of maturity.

OPTIONS

In the volatile environment, risk of heavy fluctuations in the prices of assets is very heavy. Option is yet another tool to manage such risks. As the very name implies, an option contract gives the buyer an option to buy or sell an underlying asset (stock, bond, currency, commodity etc.) at a predetermined price on or before a specified date in future. The price so predetermined is called the ‘strike price’ or ‘exercise price’.

In an options contract, the seller is usually referred to as a “writer” since he is said to write the contract. It is similar to the seller who is said to be in ‘Short position’ in a forward contract. However, in a put option, the writer is in a different position. He is obliged to buy

shares. In an option contract, the buyer has to pay a certain amount at the time of writing the contract for enjoying the right to buy or sell.

Types of Options Options may fall under any one of the following main categories: (i) Call Option (ii) Put Option (iii) Double Option Call Option

A **call option** is one which gives the option holder the right to buy a underlying asset (commodities, foreign exchange, stocks, shares etc.) at a predetermined price called 'exercise price' or strike price on or requirements of the writer and user. Thus, it combines the features of 'futures' as well as 'forward' contracts.

(ii) **Down Payment:** The option holder must pay a certain amount called 'premium' for holding the right of exercising the option. This is considered to be the consideration for the contract. If the option holder does not exercise his option, he has to forego this premium. Otherwise, this premium will be deducted from the total payoff in calculating the net payoff due to the option holder.

(iii) **Settlement:** No money or commodity or share is exchanged when the contract is written. Generally this option contract terminates either at the time of exercising the option by the option holder or maturity whichever is earlier. So, settlement is made only when the option holder exercises his option. Suppose the option is not exercised till maturity, then the agreement automatically lapses and no settlement is required.

(iv) **Non-Linearity:** Unlike futures and forward, an option contract does not possess the property of linearity. It means that the option holder's profit, when the value of the underlying asset moves in one direction is not equal to his loss when its value moves in the opposite direction by the same amount. In short, profits and losses are not symmetrical under an option contract. This can be illustrated by means of an illustration: Mr.X purchases a two month call option on rupee at $\text{Rs.100}=3.35$ \$. Suppose, the rupee appreciates within two months by 0.05 \$per one hundred rupees, then the market price would be $\text{Rs.100}=3.40$ \$. If the option holder Mr.X exercises his option, he can purchase at the rate mentioned in the option i.e., $\text{Rs.100}=3.35$ \$. He gets a payoff at the rate of 0.05 \$ per every one hundred rupees. On the other hand, if the exchange rate moves in the opposite direction by the same amount and reaches a level of $\text{Rs.100}=3.30$ \$ the option holder will not exercise his option. Then, his loss will be zero. Thus, in an option contract, the gain is not equal to the loss.

(v) **No Obligation to Buy or Sell:** In all option contracts, the option holder has a right to buy or sell an underlying asset. He can exercise this right at any time during the currency of the

contract. But, in no case, he is under an obligation to buy or sell. If he does not buy or sell, the contract will be simply lapsed.

SWAP Swap is yet another exciting trading instrument. In fact, it is a combination of forwards by two counterparties. It is arranged to reap the benefits arising from the fluctuations in the market either currency market or interest rate market or any other market for that matter.

Features The following are the important features of swap:

(i) **Basically a forward:** A swap is nothing but a combination of forwards. So, it has all the properties of a forward contract discussed above.

(ii) **Double coincidence of wants:** Swap requires that two parties with equal and opposite needs must come into contact with each other. As stated earlier, it is a combination of forwards by two counterparties with opposite but matching needs. For instance, the rate of interest differs from market to market and within the market itself. It varies from borrowers to borrowers due to the relative credit worthiness of borrowers. Therefore, borrowers enjoying comparative credit advantage in floating rate debts will enter into a swap agreement to exchange floating rate interest with the borrowers enjoying comparative advantage in fixed interest rate debt, like bonds.

(iii) **Necessity of an intermediary:** Swap requires the existence of two counterparties with opposite but matching needs. This has created a necessity for an intermediary to connect both the parties. By arranging swaps, these intermediaries can earn income also. Financial companies, particularly banks can play a key role in this innovative field by virtue of their special position in the financial market and their knowledge of the diverse needs of the customers.

(iv) **Settlement:** Though a specified principal amount is mentioned in the swap agreement, there is no exchange of principal. On the other hand, a stream of fixed rate interest is exchanged for a floating rate of interest, and thus, there are streams of cash flows rather than single payment. For instance, one party agrees to pay a fixed rate interest to another party, and, at the same time, he agrees to receive a floating rate interest from the same party. Both these rates are calculated on a notional principal and there is a continuous exchange of interest rates during the currency of the agreement. There is no such thing as single payment on the due date.

(v) **Long term agreement:** Generally, forwards are arranged for short period only. Long dated forward rate contracts are not preferred because they involve more risks like risk of

default, risk of interest rate fluctuations etc. But, swaps are in the nature of long term agreement.

Importance of Derivatives

Thus, derivatives are becoming increasingly important in world markets as a tool for risk management. Derivative instruments can be used to minimise risk. Derivatives are used to separate the risks and transfer them to parties willing to bear these risks. The kind of hedging that can be obtained by using derivatives is cheaper and more convenient than what could be obtained by using cash instruments. It is so because, when we use derivatives for hedging, actual delivery of the underlying asset is not at all essential for settlement purposes. The profit or loss on derivative deal alone is adjusted in the derivative market. Moreover, derivatives do not create any new risk. They simply manipulate risks and transfer them to those who are willing to bear these risks. To cite a common example, let us assume that Mr.X owns a car. If he does not take an insurance, he runs a big risk. Suppose he buys an insurance, (a derivative instrument on the car) he reduces his risk. Thus, having an insurance policy reduces the risk of owing a car. Similarly, hedging through derivatives reduces the risk of owning a specified asset which may be a share, currency etc.

Hedging risk through derivatives is not similar to speculation. The gain or loss on a derivative deal is likely to be offset by an equivalent loss or gain in the values of underlying assets. 'Offsetting of risks' is an important property of hedging transactions. But, in speculation one deliberately takes up a risk openly. When companies know well that they have to face risk in possessing assets, it is better to transfer these risks to those who are ready to bear them. So, they have to necessarily go for derivative instruments. All derivative instruments are very simple to operate. Treasury managers and portfolio managers can hedge all risks without going through the tedious process of hedging each day and amount/share separately. Till recently, it may not have been possible for companies to hedge their long term risk, say 10-15 year risk. But with the rapid development of the derivative markets, now, it is possible to cover such risks through derivative instruments like swap. Thus, the availability of advanced derivatives market enables companies to concentrate on those management decisions other than funding decisions. Further, all derivative products are low cost products. Companies can hedge a substantial portion of their balance sheet exposure, with a low margin requirement. Derivatives also offer high liquidity. Just as derivatives can be contracted easily, it is also possible for companies to get out of positions in case that market reacts otherwise. This also

does not involve much cost. Thus, derivatives are not only desirable but also necessary to hedge the complex exposures and volatilities that the companies generally face in the financial markets today.

The contents in this E-Material have been prepared from the text books and reference books given in syllabus.