# RETAIL INVESTORS' PERCPTION ON FINANCIAL DERIVATIVES IN INDIA

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**Abstract**

The Indian financial market has undergone paradigm changes during last two decades. One of the most significant changes is the introduction of derivatives during the year 2000 based on recommendation of expert committees to provide the facility for hedging in the most cost-efficient way against market risk. Though the Indian capital market size is wider around Rs.20,000,000 crores p.a. both in NSE and BSE even after 12 years, from introduction of derivatives, market participants especially small–retail individual investors are not familiar with the concept of derivatives. Still they have misconceptions about derivatives. They believe in the myths of derivatives instead of realities. Indeed, they feared derivatives due to lack of knowledge about them and their use. An attempt is made by the researcher to know what kind of perceptions had by retail investors in India based on Andhra Pradesh State reference with a sample size of 500 respondents by using simple percentage bar diagrams.. Ultimately, financial derivatives should be considered part of any investor's risk– management strategy to ensure that value – enhancing investment opportunities are pursued.

**Keywords:** Financial Derivatives, retail investors, myths, realities

## Introduction

The Indian financial market has undergone great charges during last two decades. One of the most significant changes is the introduction of derivatives in the year 2000. In March 1998, the L.C. Gupta Committee (LCGC) submitted its report recommending the introduction of the derivatives markets. The Committee strongly favors the introduction of financial derivatives in order to provide the facility for hedging in the most cost – efficient way against market risk. Even after ten years, from introduction of derivatives, market participants especially small-retail investors are not familiar with the concept of derivatives. Still they have misconceptions about derivatives. They strongly believe in the myths of

derivatives. Indeed, they feared derivatives due to lack of knowledge about them and their use. Access to risk-management instruments paper, a small attempt is made to demystify the myths of derivatives. At present total turnover of derivatives business in India is around Rs. 200, 00,000 crores p.a. both in National Stock Exchange and Bombay Stock Exchange.

Before coming to the theme of the topic in elaborative way, better to know the meaning of financial derivatives. A **financial derivative** has an underlying asset, that is, a financial derivative is evolved to hedge the risk involved in dealing in a particular financial asset such as a share or a foreign currency, interest rate etc,. Hence, the value of a financial derivative is derived from the underlying asset, and that is why it known as a **derivative security.** Financial derivatives are designed to provide protection to participants in financial markets against adverse movements in the prices of the underlying assets. They facilitate the exchange of financial assets in future at prices determined in the present.

Financial derivatives include **forwards, futures** and **options** and the underlying assets to which they relative include stocks, bonds, foreign currencies, interest rates and stock market indices. Standardized derivative contracts (e.g. futures and options) are traded or transacted on organized exchanges and these are known as *exchange-traded derivatives*. Other derivative contracts that are privately negotiated between parties (e.g. forwards) are known as *Over-the-counter derivatives* as they are not transacted on organized exchanges but are privately traded.

Forward contracts are commitments entered into by two parties to exchange a specific amount of money for a particular good or service at a specified future time. More informally, a forward contract may be described as an agreement to buy or sell an asset at predetermined price and at a specified future time. These forward contracts have been existence for many centuries. In fact, the historical origins of forward contracts are obscure. Some authors trace the practice to Roman and even classical Greek times. Strong evidence suggests that Roman emperors entered forward contracts to provide the masses with their supply of Egyptian grain. Others have traced the origin of forward contracting to India[1].

Whereas future contracts are standardized contracts/agreements to exchange specific types of goods, in specific amounts and at specific future delivery or maturity dates"[2.] These are modern and innovative contracts consists of various financial and non-financial assets, flexible delivery terms, price and price limits, Organized Exchange, margin system, clearing house and Long and Short Positions and Open Interest symptoms while making investments by investors.

A wide Varity of commodities and financial assets from the underlying assets in futures contracts. Wheat, sugar, wool, gold, aluminum,

copper, etc. are some of the commodities underlying futures contracts. Stocks, stock indices, foreign currencies, bonds, etc. are the financial assets underlying futures contracts.

In case of Option involves a choice. Financial options are typical examples of options contracts. They may relate to individual stocks, stock indices, bonds, interest rates, currencies or futures. There are two types of options: call options and put options. A call option provides the right to buy a specified hare at a specified price (known as strike price or exercise price) during a period of time (or at a point in time). A put option gives an investor the right to sell the underlying asset at the exercise price before the expiry date. So that financial derivatives concepts are more innovative, complex, flexible and more supportive to understand as well as cover risks to investor community. Hence, without understanding and dept knowledge entry is not so easy to any investor. Because these are double edged weapons to the investors.

In the recent past, many Multinational Companies such as Orange Country, California, and the Barings Bank etc became bankrupt due to poor investments in financial derivatives. At that time, many policymakers feared more collapsed banks and countries due to financial derivative products.

**Statement Of The Problem**

The tremendous growth of the financial derivatives market and reports of major losses associated with derivative products have resulted in a great deal of confusion about those complex instruments. Are derivatives a cancerous growth that is slowly but surely destroying global financial markets? Are people who use derivative products irresponsible because they use financial derivatives as part of their overall risk-management strategy? Are retail investors are investing their amount futures and options with full of knowledge? This study has been done to find the solution to these problems.

**Scope Of The Study**

In fact, financial derivatives topic/area is a wide area, of course, it comes as a part and parcel of Financial Markets. Based on the objective of the topic the researcher covered and confined only to retail investors participation and their perceptions about the futures and options area to make their investments to earn profits/incomes or they are using them as risk-hedging weapons only. In this regard, researcher approached retail investors with questionnaire through stock exchange brokers/dealers in the state of Andhra Pradesh, based on this how Indian retail investors perception, they are having towards financial derivatives.

## Objectives Of The Study

- To know and understand financial derivatives by retail equity investors;
- To study myths and realities related to Financial Derivatives, particularly Futures and Options from the point of view of retail investors;
- To try to demystify myths(misconception) about derivatives and to highlight realities of derivatives;
- To know how many people know about derivatives and using them as risk-hedging weapon.

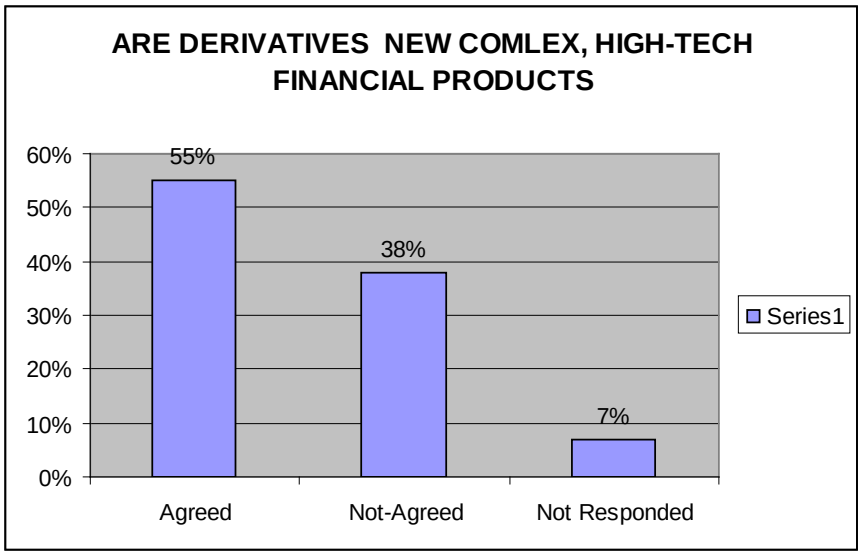
## Methodology

A small survey had been conducted to collect opinions of the ordinary retail investors about myths of derivatives from different parts of Andhra Pradesh (Andhra, Rayalaseema and Telengana regions). The sample size for this study is only 500 respondents during 2012. Questionnaire method has been used to collect primary data from the respondents. Secondary data has been collected from different sources such as internet, news papers, journals, magazines etc.

Ten common misconceptions about financial derivatives are explored in the study. Believing just one or two of the myths could lead one to avoid or totally ignore the use of the risks and rewards. Derivatives often, however, suggest that investors should learn the use of derivatives in order to enjoy its benefits.

## Data Analysis And Interpretation

**Myth Number 1: DERIVATIVES ARE NEW, COMPLEX, HIGH-TECH FINANCIAL PRODUCTS**



It is found that 55% of the small investors (respondents) are of the opinion that derivatives are new, complex, and high-tech products. 38% of the respondents, who are familiar with derivatives, said derivatives are not new, complex, and high – tech products. And the remaining 7% of the investors could not answer the question. This shows that a large number of investors are not familiar with derivatives.

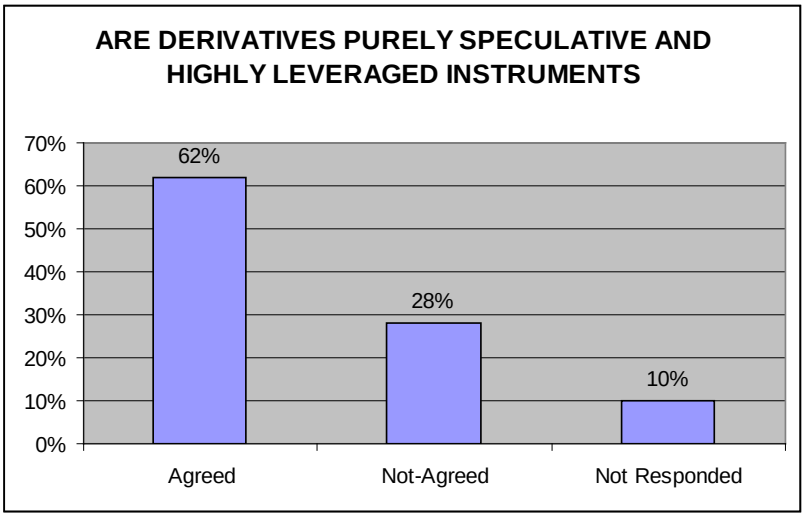
The Survey indicates that a big number of investors are not much familiar with derivatives and they think that derivatives are not easily understandable. Some respondents can't say that whether derivatives are new or old. It clearly indicates that awareness level about derivatives. Of course, derivatives are newly introduced in organized in Indian market. But, derivatives are not new to the world. They have been around for years. A description of the first known options contract can be found in Aristotle's writings. He showed the world that philosophers can easily be rich if they like, but their ambition is of another sort. The first known options contracts were exercised some 2,500 years ago. Options are just one type of derivative instruments, Derivatives, as their name implies, are contracts that are based on or derived from some underlying asset, reference rate, or index etc. Most common financial derivatives can be classified as one, or as a combination of four types: forwards, furtuers swaps and options that are based on interest rates or currencies etc.

There is the common impression that derivatives are very difficult to understand and that it is not possible to invest in them unless one has profound knowledge in this area.

Most financial derivatives trades today are the "plain vanilla" variety – the simplest form of a financial instrument. But variants on the basic structures have given way to more sophisticated and complex financial derivatives that are much more difficult to measure, manage and understand. For those instruments, the measurement and control of risks can be far more complicated, creating the increased possibility of unforeseen losses.

Most of the newest innovations are designed to hedge complex risks in an effort to reduce future uncertainties and manage risks more effectively. But the newest innovations require a firm understanding of the trade – off of risks and reward. To that end, derivatives users should establish a guiding set of principles to provide a frame work for effectively managing and controlling financial derivative activities.

**Myth Number 2: DERIVATIVES ARE PURELY SPECULATIVE AND HIGHLY LEVERAGED INSTRUMENTS**




The survey found that 62% of the small investors are of the opinion that derivatives are purely speculative and highly leveraged instruments. 28% of the respondents are of the opinion that derivatives are not purely speculative and highly leveraged instruments, and the remaining 10% of the investors answered that they couldn't say. This shows that even those who are familiar with derivatives also believed that derivatives are speculative and highly leveraged instruments. Majority of investors misunderstand that derivatives are mainly used for speculative purpose. Investors ignore that the very important use of derivatives is in Hedging. Derivatives are mainly used for hedging and to avoid the risk involved in the underlying asset.

On other side of the coin, the myth is that "derivatives" is a fancy name for gambling. Has speculative trading of derivative products fuelled the rapid growth in their use? Are derivatives used only to speculate on the direction of market price interest rates or currency exchange rate etc? Of course not, indeed, the explosive use of financial derivative products in recent years was brought about by three primary forces: more volatile markets, deregulation, and new technologies.

Take the simple foreign-exchange forward contract that obligates one counterparty to buy, and the other to sell, a fixed amount of currency at an agreed date in the future. By entering into a foreign-exchange forward contract, customers can balance the risk large movements in foreign-exchange rate that destroy, for example, the economic viability of their overseas projects. Similarly, both institutional and individual investors can project their position by entering derivatives markets. Thus, derivatives were

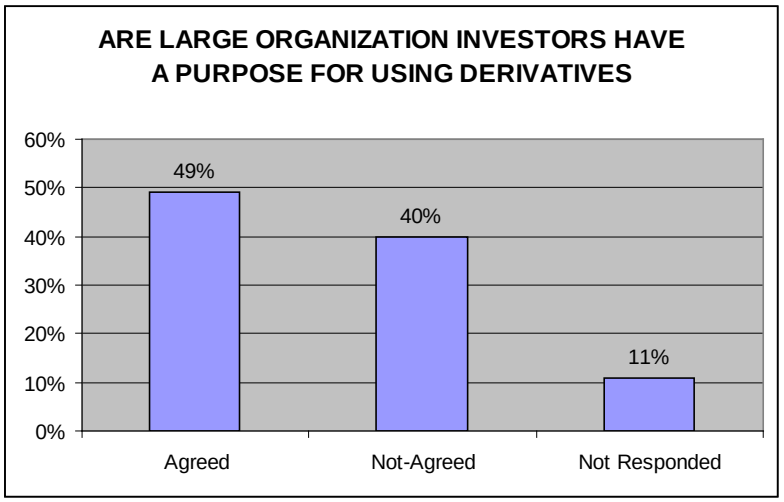
originally intended to be used to effectively hedge certain risks; and in fact, that was the key that unlocked their explosive development.

Deregulation of financial markets and the arrival of powerful but inexpensive personal computers directed analysis of information and breaking down of risk into parts in new ways. To serve customers better, financial intermediaries offered an ever-increasing number of novel products designed to manage and control financial risks more effectively. New technologies bring the pace of innovation and provided with superior methods for tracking and simulating their own derivatives portfolios.

Financial futures contracts were developed from simple forward agreements. Future are similar to forwards, except that futures are standardized by exchange clearinghouses, and this facilitates anonymous trading in a more competitive and liquid market. In addition, futures contracts are marked to market daily, which greatly decreases counterparty risk, the risk that the other party to a transaction will be unable to meet its obligations on the maturity date.

Leverage is, simply, the ability of derivatives to soar 100% in a few days, when the underlying security has only risen by a far smaller amount (say 10%). There is nothing magical in gearing. Anyone who has a mortgage is feared to the property market. Let's take the property owner with a mortgage as an example. A person buys a house for $100,000; he puts up $10,000 and borrows $90,000 from the bank. Six months later, the house is sold for $150,000. He pays back $90,000 to the bank (let us ignore interest etc.) and keeps $60,000 – not bad for an original investment of just $ 10,000. The principle is exactly the same in many derivatives investments – big bang for a little buck.

**Myth Number 3: ONLY LARGE ORGANIZATIONS / INVESTORS HAVE A PURPOSE FOR USING DERIVATIVES**



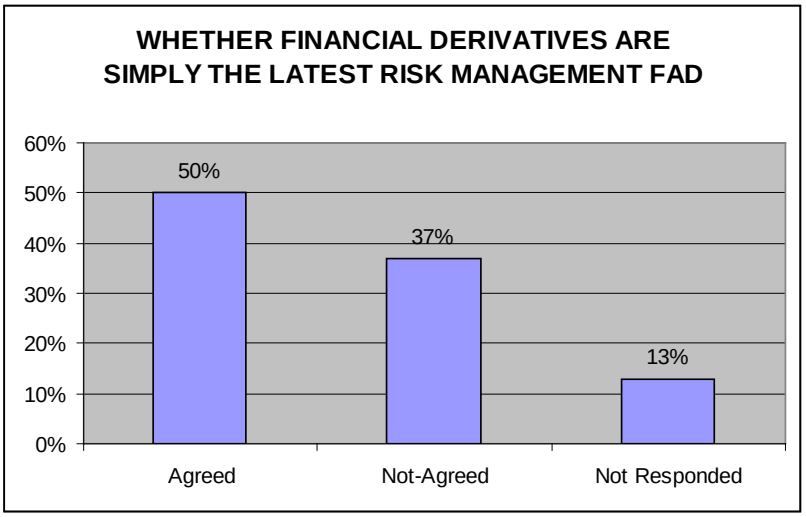
According to the survey, 49% of the small investors are of the opinion that only large organizations / investors have a purpose for using derivatives. 40% of the respondents are of the opinion that not only large organizations / investors have a purpose for using derivatives. The remaining 11% of the investors couldn't answer the question.

Of course, very large organizations / investors are the biggest users of derivative instruments. However, firms / investors of all sizes can benefit from them. By entering into derivatives contracts, one can lock in a guaranteed rate of return on investment portfolio and not be as concerned about market volatility.

The economic benefits of derivatives are not dependent on the size of the institution / investor trading them. The decision about whether to use derivatives should be driven, not by the company's size, but by its strategic objectives. The role of any risk-management strategy should be to ensure that the necessary funds are available to pursue value – enhancing investment opportunities. However, it is important that all users of derivatives, regardless of size, understand how their contracts are structured, the unique price and risk characteristics of those instruments, and how they will perform under stressful and volatile economic conditions. A prudent risk-management strategy that conforms to investment objectives and is complete with market simulations and stress tests is the most crucial prerequisite for using financial derivative products.

Securities and Exchange Board of India (SEBI) introduced in December 2007, mini-contracts in the derivatives markets based on the Sensex and the Nifty indices to improve liquidity and increase investor participation for the index – based products. Mini –contracts are a fraction of normal derivatives contracts, and will help individual investors to hedge risks of a smaller portfolio. The small size of the contract would be attractive for retail investors as there would be comparatively lower capital outlay, lower trading costs, more precise hedging and flexible trading. NSE introduced futures and options contracts CNX NIFTY JUNIOR and CNX 100 indices for trading in F&O segment on June 1, 2007. The Bombay Stock Exchange (BSE) also launched the mini-contracts on the Sensex from January 2008.

**Myth Number 4: FINANCIAL DERIVATIVES ARE SIMPLY THE LATEST RISK – MANAGEMENT FAD**




According to the survey, 50% of the small investors are of the opinion that Financial Derivatives are simply the latest risk – management fad. 37% of the respondents are of the opinion that Financial Derivatives are not simply the latest risk – management fad. The remaining 13% of the investors were unable to answer the question.

Trading on Financial derivatives is not the latest fashion; it is the latest innovation in the field of financial engineering. Financial derivatives are important tools that can help organizations/investors to meet their specific risk-management objectives. As is the case with all tools, it is important that the user understands the tool's intended function and that the necessary safety precautions be taken before the tool is put to use.

Financial derivatives can be useful tools in helping corporations / investors become more efficient and effective in meeting their risk – management objectives. But they can be dangerous when not used correctly or when used blindly. When financial derivatives are used improperly or without a plan, they can inflict pain by causing serious losses or by propelling the organization in the wrong direction where it is ill prepared for the future.

When used properly, financial derivatives can help organizations / investors to meet their risk – management objectives so that funds are available for making worthwhile investments. Again, a firm's decision to use derivatives should be driven by a risk – management strategy that is based on broader corporate objectives.

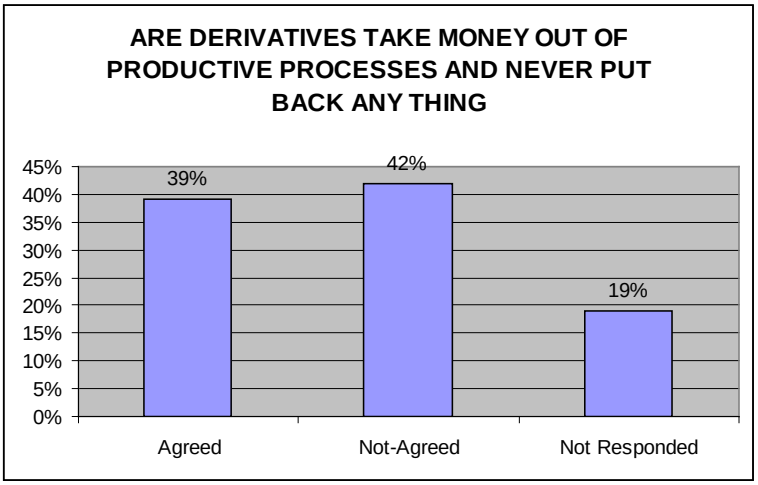
The most basic questions about a firm's risk-management strategy should be addressed: Which risks should be hedged and which should remain

unhedged? What kinds of derivative instruments and trading strategies are most appropriate? How will those instruments perform if there is a large increase or decrease in price? How will those instruments perform if there are wild fluctuations in price?

Without a clearly defined risk – management strategy, use of financial derivatives can be dangerous. It can threaten the accomplishment of a firm's objectives and result in unsafe and unsound practices that could lead to the organization's insolvency. But when used wisely, financial derivatives can increase shareholder value by providing a means to better control a firm's risk exposures and cash flows.

Clearly, derivatives are here to stay. We are well on our way to truly global financial markets that will continue to develop new financial innovations to improve risk – management practices. Financial derivatives are not the latest risk – management fad; they are important tools for helping organizations / investors to better manage their risk exposures.

**Myth Number 5: DERIVATIVES TAKE MONEY OUT OF PRODUCTIVE PROCESSES AND NEVER PUT BACK ANYTHING**



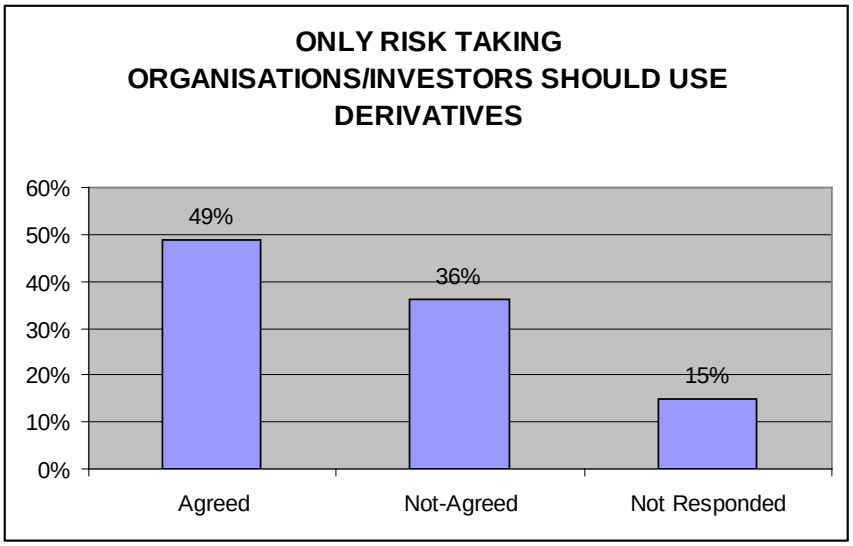

According to the survey, 39% of the small investors are of the opinion that Financial Derivatives take money out of productive processes and never put anything back. 42% of the respondents are of the opinion that Financial Derivatives do not take money out of productive processes. The remaining 19% of the investors left the question unanswered. It is good to see that majority of the investors do not believe in this myth. It depicts that investors believe that if derivatives are used properly, it will be definitely beneficial for the user.

Financial derivatives, by reducing uncertainties, make it possible for corporations to initiate productive activities that might not otherwise be pursued. For example, and Indian company may want to build a

manufacturing facility in the United States but is concerned about the project's overall cost because of exchange – rate volatility between the Rupee and the Dollar. To ensure that the company will have the necessary cash available when it is needed for investment, the Indian manufacturer should devise a prudent risk – management strategy that is in harmony with its objective of building a manufacturing facility in the United States. As part of that strategy, the Indian firm should use financial derivatives to hedge against foreign – exchange risk. Derivatives used as a hedge can improve the management of cash flows at the individual firm level.

To ensure that productive activities are pursued, corporate finance and treasury groups should transform their operations from simply bean counting to activist financial risk management. They should integrate a clear set of risk – management goals and objectives into the organization's overall corporate strategy. The ultimate goal is to unsure that the organization has the necessary funds at its disposal to pursue investments that maximize shareholder value. Used properly, financial derivatives can help corporations to reduce uncertainties and promote more productive activities.

**Myth Number 6: ONLY RISK SEEKING ORGANIZATIONS/INVESTORS SHOULD USE DERIVATIVES**



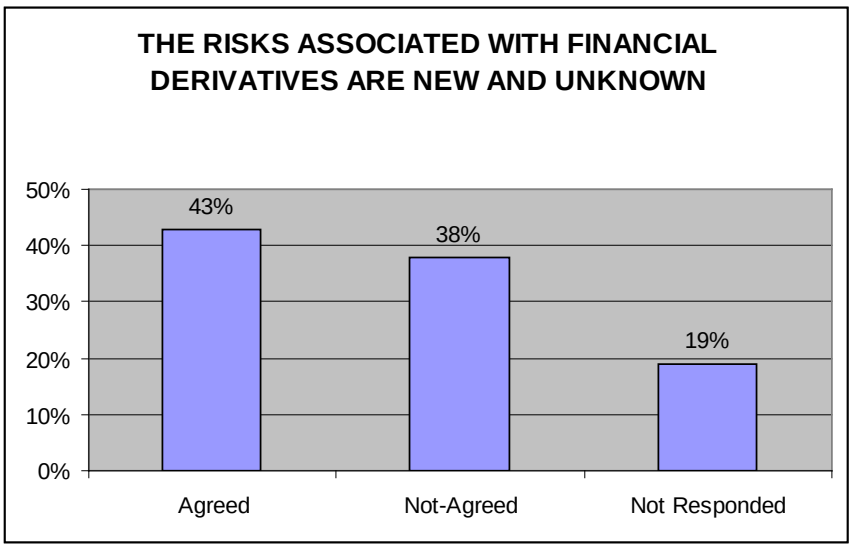

According to the survey, 49% of the small investors are of the opinion that only risk – seeking organizations / investors should use derivatives. 36% of the respondents are of the opinion that not only risk – seeking organizations / investors should use derivatives. The remaining 15% of the investors answered that they couldn't say. It is again sad to say that majority of investors believed that derivatives are only for risk seekers. In fact, derivatives are not for risk seekers but for risk avoiders. Those who

have fear about price changes in future of their underlying asset will go for derivatives.

Financial derivatives can be used in two ways: to hedge against unwanted risks or to speculate by taking a position in anticipation of a market movement. Organizations / Investors today can use financial derivatives to actively seek out specific risks and speculate on the direction of market price movements, or they can use derivatives to hedge against unwanted risks. Hence, it is not true that only risk – seeking institutions use derivatives. Indeed, organizations should use derivatives as part of their overall risk – management strategy for keeping those risks that they are comfortable managing and selling those that they do not want to others who are more willing to accept them. Even conservatively managed institutions can use derivatives to improve their cash-flow management to ensure that necessary funds are available to meet objectives. One could argue that organizations that refuse to use financial derivatives are at greater risk than those who use them.

When using financial derivatives, however, organizations / investors should be careful to use only those instruments that they understand and that fit best with their risk – management objectives. It may be prudent to stay away from the more exotic instruments, unless the risk / reward tradeoffs are clearly understood by the firm's senior management / investor. Exotic contracts should not be used unless there is some obvious reason for doing so.

**Myth Number 7 : THE RISKS ASSOCIATED WITH FINANCIAL DERIVATIVES ARE NEW AND UNKNOWN**



The survey found that 43% of the small investors are of the opinion that the risks associated with Financial Derivatives, are new and unknown. 38% of the respondents are of the opinion that the risks associated with Financial Derivatives are not new and unknown. And the remaining 19% of the investors did not answer the question.

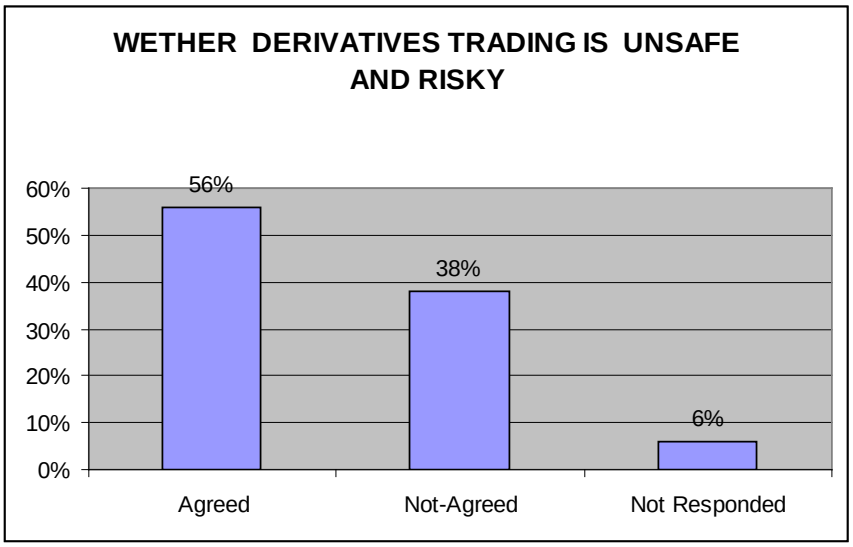
Derivatives are similar to other security options and have the same risks. The kinds of risks associated with derivatives are no different from those associated with traditional financial instruments, although they can be far more complex. There are credit risks, operating risks, market risks, and so on. Risks from derivatives originate with the customer / counterparty. With few exceptions, the risks are man–made, that is, they do not readily appear in nature. Many risks associated with derivatives are actually created by the dealers' customers or by their customer's customers. Those risks have been inherent in our nation's financial system since its inception.

Investors should view themselves as risk managers–blending their knowledge of financial market with their needs to help themselves anticipate change and have the flexibility to pursue opportunities that maximize their success. They must be able to understand measure and manage financial risks effectively.

The types of risks faced by corporations / investors today have not changed; rather, they have become more complex and interrelated. The increased complexity and volatility of the financial markets have paved the way for the growth of numerous financial innovations that can enhance returns relative to risk. But a thorough understanding of the new financial–engineering tools and their proper integration into their overall risk–management strategy and corporate philosophy can help turn volatility into profitability.

Risk management is not about the eliminations of risk, it is about the management of risk, selectively choosing those risks an organization/investor is comfortable with and minimizing those that it does not want. Financial derivatives serve a useful purpose in fulfilling risk – management objectives. Through derivatives, risks from traditional instruments can be efficiently unbundled and managed independently. Used correctly, derivatives can save costs and increase returns.

**Myth Number 8: DERIVATIVES TRADING UNSAFE AND RISKY**




According to the survey, 56% of the small investors are of the opinion that derivatives' trading is an unsafe and risky. 38% of the respondents are of the opinion that derivatives 'trading is not unsafe and risky. And remaining 6% of the investors answered can't say. This shows that a large number of investors were intimidated about derivatives trading. It clearly indicates that majority of the investors have fear of derivatives use and they feel derivatives themselves involved risk.

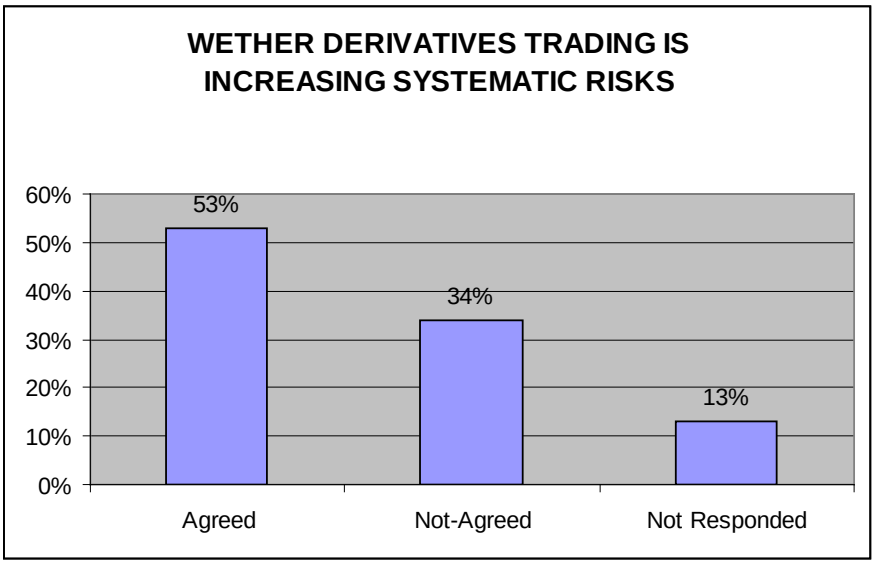
In general, every investment is risky. There is no strategy which is 100% risk – free, whether you invest on spot or derivatives market. It is not that derivatives are risky, but the strategy used for them might be risky; just as many share strategies are risky. For example, car driving can be either safe or risky, depending on who is driving. The majority of accidents are caused by drivers and not by the cars themselves. The danger comes from how a driver drives the car. It is the same with derivatives; intrinsically, derivatives are neither unsafe nor risky.

But in reality, derivatives also help to improve market efficiencies because risks can be isolated and sold to those who are willing to accept them at the least cost. Using derivatives breaks risk into piece that can be managed independently. Investors can keep the risks they are most comfortable managing and transfer those they do not want to others who are more willing to accept them. From a market–oriented perspective, derivatives offer the free trading of financial risks.

The viability of financial derivatives rests on the principle of comparative advantage, that is, the relative cost of holding specific risks. Whenever comparative advantages exist, trade can benefit all parties

involved. Financial derivatives allow for the free trading of individual risk components.

**Myth Number 9: DERIVATIVES TRADING INCREASES SYSTEMATIC RISKS**

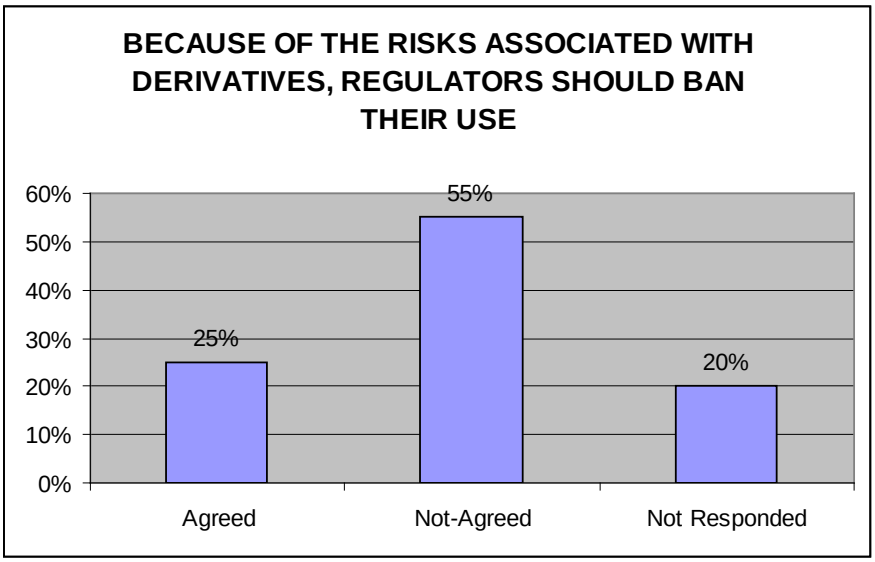



The survey found that 53% of the small investors are of the opinion that Derivatives trading increases Systematic Risks. 34% of the respondents are of the opinion that Derivatives trading doesn't increase Systematic Risks. And remaining 13% of investors left the question unanswered.

Financial derivatives do not increase or cause increase in market risk. In fact, derivatives provide protection against unwanted risks through hedging mechanism. Furthermore, a major shock that would shake financial markets in the absence of derivatives would also affect financial market in which the use of derivatives was widespread. But because the holders of various risks would be different, the impact would be different and presumably not as great because the holders of the risks should be better able to absorb potential losses.

There is no strong evidence that derivatives trading causes increase in market risk. In fact, there is no perfect reason for rise in market risk. Market itself is multifaceted and an indicator of multiple factors that prevail. Moreover, some of the studies proved that derivatives trading have no significant impact on the underlying market volatility from a larger perspective. Derivatives do not have any stabilizing (or destabilizing) effect by decreasing (or increasing) the volatility in any in the spot market.

**Myth Number 10: BECAUSE OF THE RISKS ASSOCIATED WITH DERIVATIVES, REGULATORS SHOULD BAN THEIR USE**




The survey found that 25% of the small investors are of the opinion that because of the risks associated with derivatives, regulators should ban their use. 55% of the respondents are of the opinion that because of the risks associated with derivatives, regulators should not ban their use. The remaining 20% of investors answered that they could not say./ it is good to see that more than 50% respondents did not believe in this myth and opposed the ban of derivatives. Even though most of the investors are not familiar with the use of derivatives, and think that derivatives are complex and risky, they oppose a ban on derivatives.

The problem is not derivatives but, it is the responsibility of a user to ensure that risks are effectively controlled and limited to levels that do not pose a serious threat to their investment position. Regulation is an ineffective substitute for sound risk management at the individual firm / user level. However, it is likely that derivatives have become so enmeshed in modern life that it is impossible to back and remove them. The ban on any derivatives is unreasonable, ignorant of realities of the futures market, and possibly disastrous for the futures trade.

Regulators should emphasize more disclosure of derivatives positions in financial statements and be certain that institutions trading huge derivatives portfolios have adequate capital. In addition, because derivatives could have implications for the stability of the financial system, it is important that users maintain sound risk–management practices. Regulators should educate the investors to overcome their misconception on derivatives. Securities and Exchange Board of India, which is a powerful regulatory

authority in India, has taken steps to create awareness, but it is not reaching the small retail investors effectively. It should issue guidelines that firms with substantial trading or derivatives activity should follow.

**Suggestions & Conclusion**

Believing the 10 myths (misconceptions) presented here or believing just one or two of them could lead, one to advocate legislative and regulatory measures to restrict the use of derivatives. Derivatives–related disasters, such as the Orange Country bankruptcy and the collapse of Barings have led to questions about the ability of individual derivatives participants to internally manage their trading operations. In addition, concerns have surfaced about the regulators' ability to detect and control potential derivatives losses.

But regulatory and legislative restrictions on derivatives activities are not the answer, primarily because standardized rules most likely would only impair one's ability to manage risk effectively. A better answer lies in greater reliance on market forces to control derivatives–related risk taking, together with more emphasis on government supervision, as opposed to regulation. The best regulations are those that guard against the misuse of derivatives, as opposed to those that severely restrict, or even ban, their use. Derivatives – related losses can typically be traced to one or more of the following causes: an overly speculative investment strategy, a misunderstanding of how derivatives relocate risk, an ineffective internal risk–management audit function, and the absence of systems that simulate adverse market movements and help develop contingency solutions. To address those concerns, supervisory reforms should focus on increasing disclosure of derivatives holdings and the strategies underlying their use, appropriate capital adequacy standards, and sound risk – management guidelines.

For the most past, however, policymakers should leave derivatives alone. The development of derivatives was brought about by a need to isolate and hedge against specific risks. Derivatives offer a proven method of breaking risk into component pieces and managing those components independently. Almost every investor has unique risk profile inherent in his investment portfolio and market place that can be better managed through derivatives trading. The freedom to manage risks effectively must not be taken away.

Ultimately, financial derivatives should be considered part of any investor's risk – management strategy to ensure that value – enhancing investment opportunities are pursued. Derivatives allow for the efficient transfer of financial risks and can help to ensure that value – enhancing opportunities will not be ignored. It is important that derivatives players should fully understand the complexity of financial derivatives contracts and

the accompanying risks. Users should be certain that they do not, take unnecessary risks.

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