S. S. Jain Subodh Management Institute

MBA IVth Semester, (Model Paper & Suggested Answers)

Subject: Financial Derivatives

Paper Code: M-410

Time: 1 Hour **Max Marks: 10**

Attempt any two questions.

Q1. Briefly explain difference between future market and forward market. (5)

Q2. Explain following terms. (1*5)

(i) Forwards

(ii) Futures

(iii) Options

(iv) Swaps

(v) Warrants

Q3. Briefly explain characteristics of options. (5)

Suggested Answer:

Any 5 difference should be discussed and it carries one mark.

Answer 1:

S. No.	Future Market	Forward Market
1.	Trading is conducted in a competitive arena by "open outcry" of bids, offers and amounts.	Trading is done by telex or telephone, with participants generally dealing directly with broker-dealers.
2.	Contract terms are standardized with all buyers and sellers negotiating only with respect to price.	All contract terms are negotiated privately by the parties.
3.	Non-member participants deal through brokers (exchange members who represent them on the exchange floor.	Participants deal typically on a principal-to-principal basis.
4.	Participants include banks, corporations financial institutions, individual investors, and speculators.	Participants are primarily institutions dealing with one other and other interested parties dealing through one or more dealers.
5.	The clearing house of the exchange becomes the opposite side to each cleared transactions; therefore, the credit risk for a futures market participant is always the same and there is no need to analyze the credit of other market participants.	A participant must examine the credit risk and establish credit limits for each opposite party.
6.	Margins deposits are to be required of all participants.	Typically, no money changes hands until delivery, although a small margin deposit might be required of non-dealer customers on certain occasions.
7.	Settlements are made daily through the exchange clearing house. Gains on open positions may be withdrawn and losses are collected daily.	Settlement occurs on date agreed upon between the parties to each transaction.
8.	Long and short positions are usually liquidated easily.	Forward positions are not as easily offset or transferred to other participants.
9.	Settlements are normally made in cash, with only a small percent age of all contracts resulting actual delivery.	Most transactions result in delivery.

Answer 2: Explanation of each term carries one mark.

(i) Forwards: A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future. The price of the underlying instrument, in whatever form, is paid also to be.

(ii) Futures: a futures contract is a financial contract obligating the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a pre-determined future date and price.

(iii) Options: An options represent the right (but not the obligation) to but or sell a security or other asset during a given time for a specified price (the strike price).options are of two types – calls and puts.

(iv) Swaps: Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formulate. The two commonly used swaps are interest rate and currency swap.

(v) Warrants: longer-dated options are called warrants and are generally traded over-the-counter.

Answer 3:

<u>Suggested Answer:</u>

Any 5 difference should be discussed and each carries one mark.

The following are the main characteristics of options:

(i) Options holders do not receive any dividend or interest.

(ii) It yield only capital gains.

(iii) Options holder can enjoy a tax advantage.

(iv) Options are traded on all recognized stock exchanges.

(v) Options holders can exercise their rights on the underlying exchanges.

(vi) Options create the possibility of gaining a windfall profit.

(vii) Options holders can enjoy a combinations of risk returns.

(viii) Options reduce the total portfolio transaction costs.

(ix) Options enable a better returns with a limited amount of investment.