
Derivatives and Risk Management

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“Derivatives are financial weapons of mass destruction”

– Warren Buffett, CEO of Berkshire Hathway.

As we all know even 2008 financial crisis occurred due to wide spread use of financial derivatives, many people believe that it has not flagged since the global economic meltdown. Contrary to popular belief, the improper use of derivatives, not the nature of derivatives securities themselves, caused the 2008 collapse. Still, many people are unable to understand the use of derivatives for the purpose of risk management. As per Richard Dooling, American Novelist:

“Over and over again, financial experts and wonkish talking heads endeavor to explain these mysterious, ‘toxic’ financial instruments to us lay folk. Over and over, they ignobly fail, because we all know that no one understands credit default obligations and derivatives, except perhaps Mr. Buffett and the computers who created them.”

In India, derivatives were introduced as late 2000. And in India also it's very painful to understand proper use of derivatives. However, many foreign author written books give some idea regarding "what is derivatives?" and "how it can be used for managing risk?" But most of books were in foreign context or many times without enough examples with it. Since last few year volumes of derivative markets on NSE (National Stock Exchange) were increase dramatically. At the same time, the market has witnessed introduction of several new products designed specifically for India, making it necessary for financial professionals to understand working of these new innovative derivative products.

"Derivatives and Risk Management" by Sundaram Janakiramanan Pearson Publication, 2011, pp. 544, INR 425 is one of the book giving proper understanding of different derivatives tools with suitable examples in Indian context. It also includes case studies whenever needed to explain proper use of derivatives to manage the risk.

In comparison to other books, text in this book is highly distinctive in terms of use of practical examples whenever needed in Indian context with theoretical explanation. A simple use of language for explaining different technical terms related to derivatives and risk management. With explanation of specific derivatives product in Indian market, this book mainly concentrates on four types of derivatives – forward contracts, future contracts, swap contracts and option contracts. It is targeted at postgraduate students of CFA examination, finance, management and commerce. It will also be use to mangers, risk-management specialists, treasury mangers and who wants to understand use of derivatives as risk management tool in Indian market. For the purpose of simplicity and quick reading, each chapter in books was divided in to four parts to conclude it, namely: Chapter Summary, Review Questions, Problems and Case Study.

Chapter Summary is given at the end of each chapter for getting overall idea of chapter. Review questions followed by Problems help to determine readers understanding about chapter. And at last case study gives more clear idea about how theory may used for practical situation to the reader. Also, author takes care to take cases from Indian company or in Indian context, which makes it simple to understand how theory works in practical situation.

Book covers introduction to derivatives and risk management; derivatives market in India; Interest rates and future; Future, forward and option contracts; Single stock and stock index future with hedging strategies using futures; Currency futures; Swaps; Put-Call parity and options valuation using binomial and black-scholes model; Options for Currency, Interest rate, Futures and Exotic; Greeks in Options; Credit derivatives.

First chapter starts with explanation of what derivatives are and risk is. While second chapter “The derivatives market in India”, Chapter seven “Single stock futures and Stock Index Futures”, Chapter nineteen “Exotic Option” and Chapter twenty “Credit Derivatives” make it distinct from the other books. In second chapter different derivatives used in India are explained with very good examples at the same time chapter seven explains how index futures work. Specifically, nineteenth chapter talk about different option availability in market and used for risk management in different condition with different options. Twentieth chapter discuss about specific types of derivative associated with credit risk.

However, other chapters are covering same topics as in other similar title book. Chapter three covers explanation of interest rate with explanation of interest rate futures in chapter eight. Chapter four and five covers understanding of forward contract and future contracts mechanism respectively. Chapter six elaborates the use of different hedging strategies using derivatives. Chapter nine and eleven explains mechanism for currency futures and fundamental options respectively. Chapter ten covers different types of swap and its use in practical situation. Chapter twelve, thirteen and fourteen concentrates on pay-off for call put option, trading strategies using combination of call put options and put-call parity relationship respectively. Chapter fifteen and sixteen talks about two model of option valuation namely: Binomial Option Pricing Model and Black-Scholes Option Pricing Model. Chapter seventeen tries to cover mechanism and use of options for currency, interest rate and futures. Chapter eighteen explains different Greek letters used in option market.

This book is also not being able to satisfy basic need of reader, who wants to check theoretical concept practically. Book is not being able to cover methodology of trading

available at different exchanges in India. And from where one can update oneself regarding settlement price, open interest, volumes etc... Book covers more of how derivative works and fail to associate use of derivatives for risk management in practical situation.

Overall, the book is good resource for those who would like to understand the different types of derivatives available in Indian market and how those derivatives works in practical situation. The book provides a novice an interesting learning contents as well as critical practical case studies where use of derivatives considered most important tool for risk management. Review questions and problems given at the end of each chapter also helps a lot for understanding concept and inside important of different derivatives in Indian market.