Feeler

1. A derivative, like a share traded on stock exchange, is also a type of security. Just like the value of shares is based upon the performance of the company, the value of derivatives is based on the value of a share or any other security. So indirectly the value of the derivatives is also based upon the performance of the company. However derivatives differ from shares or any other security from which it derives value in many ways. During this discussion you will get an idea as to how derivative is used by different people in the markets.

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2. To get the real feel of derivative, here is a simple example. Suppose you are chilling out with your friend in a bar and watching a cricket match. You say that Sachin Tendulkar will hit a half century while your friend thinks that he will not. You guys enter into a bet of ₹50 for the same. You enter into a oral derivative where the price of the derivative is the outcome of sachin's performance. Now suppose sachin has made 48 and your friend is fearing that he will lose the bet since the PROBABILITY of making a fifty is now very high. He wants to cancel the bet but u will not cancel because your probability of winning is high since sachin is very close to making a fifty. So u guys might want to settle for ₹40 as you feel that there is SOME PROBABILITY of sachin getting out at 49TH run. You will not take the risk of losing ALL for just 1 run and on the other hand ur friend is satisfied that he is paying ₹40 only instead of

₹50 since there is a high probability that Sachin will make a half century and he is happy saving ₹10. So here the price of the derivative is ₹40.

However if you guys wanted to close the deal when Sachin was only at 18 runs then the deal would have been a bit different. Your friend has an advantage here since there is more than 65% runs still to be made, but then there are chances that Sachin will make a half century since he is playing good today. so ur friend does not want to take the risk and he offers ₹10 to settle the bet. You also feel that the pitch is rough and Sachin might loose his patience so You also settle for a little amount of ₹10. The value of the derivative here is ₹10

This example explains only one type of derivative, but the basis for any of the derivative is the same. It is one's estimate of the pricing of any security on which the derivative is based. In our case the security was Sachin's performance and our estimate on how much he will make.

You can enter into a derivative in two ways.

1. Through a stock market (commonly known as exchange trade derivative)
2. Over the counter (OTC).

OTC type of derivative refers to a situation where two persons sitting in an office enters into a contract for derivative. Like in our above example you entered into a derivative with your friend in a beer bar. This was OTC derivative. Similarly you can walk into a bank/ Financial Institution/ Investor's office and enter into different types of derivative with them. In short whenever you enter into a derivative other than through a registered stock exchange it will be known as OTC derivative.

And whenever you enter into a Derivative with any other person THROUGH a Stock Exchange then you are entering into Exchange Traded Derivative.

Now the million dollar question is, what is the difference.

For that we have to get acquainted to a term called "Credit Default". In our above example if suppose you win the bet with your friend when sachin hits a half century, and your friend refuses to pay. Yes just like that he refuses to pay. This is called a credit default. What can you do. NOTHING. So you come home all sad swearing not to talk to your friend ever.

But in real world, the parties to the contract are not friends, the stakes are higher than ₹ 50, and being sad and returning home is not an option. What we need is certain security that the other party will not default. Stock Market or clearing house plays that role. And what he charges you for that is a small fees.
How does it work ?

You first enroll yourselves to a registered stock exchange. 100 others who want to buy or sell derivatives also do the same. The stock exchange prices derivatives based upon the demand and supply equation. Some wants to sell the derivative and others like you want to buy the derivative. Everyone enters the buy and sell amount they want to quote and based upon the common pricing you can buy a derivative at the price you want to if others are willing to sell it at the same or lower price. However before we buy or sell we have to deposit certain amount with the stock exchange called margin. Based upon the amount deposited with the stock exchange we are all allowed to buy and sell. So if you win (as per our example above which is like a derivative) the stock exchange will pay us because he already has the money from the seller (The deposit amount). So there is no default risk.