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Effect of COVID-19 on Futures and Options Trading

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This research paper investigates the impact of the COVID-19 pandemic on the derivative market in India, with a particular focus on futures and options (F&O) trading. Drawing insights from a report by the Securities and Exchange Board of India (SEBI) highlighting the challenges faced by individual traders, the study explores the factors influencing F&O trading, profitability during the pandemic, and risk management strategies employed by market participants. Utilizing data from various sources, including online resources and market analysis reports, the paper examines the resilience of the derivative market amidst heightened volatility induced by the pandemic. Regulatory measures implemented by SEBI to safeguard market integrity and mitigate risks are analyzed, alongside the differential impact of the pandemic on specific industries and market sectors.

Through graphical representations and comparative analyses, the study elucidates the trajectory of the derivative market during the pandemic, emphasizing the role of derivative instruments in hedging market risks and capitalizing on market opportunities. Moreover, the paper offers recommendations for traders to navigate volatile market conditions effectively, emphasizing the importance of adaptive strategies, risk management techniques, and regulatory compliance. The research underscores the transformative impact of the COVID-19 pandemic on the derivative market in India, highlighting both challenges and opportunities for market participants. The findings contribute to a deeper understanding of the dynamics of derivative trading during times of economic uncertainty, ultimately shedding light on the resilience of the Indian financial system amidst crises.

Keywords: *covid-19 pandemic, derivative market, sebi, market volatility.*

LITERATURE REVIEW

This research paper draws upon several scholarly sources to explore the impact of the COVID-19 pandemic on futures and options (F&O) trading in India. The following papers have been instrumental in shaping the understanding of the derivative market dynamics during times of economic uncertainty: 'Impact of COVID-19 on Indian Financial Market' by Bhattacharya, 2022. This paper provides a comprehensive analysis of the effects of the COVID-19 pandemic on the Indian financial market, offering insights into market volatility, trading volumes, and the efficacy of risk management strategies. 'Rational repricing of risk during COVID-19: Evidence from Indian single stock options market' by Sobhesh Kumar Agarwalla, 2021. This source offers foundational knowledge on derivative markets, elucidating the workings of F&O trading and the role of derivative instruments in hedging market risks. It serves as a primer for understanding the complexities of the derivative market. 'Market Crash and Rebound: Lessons from COVID-19' by Chong Guan, Wenting Liu and Jack Yu-Chao Cheng, 2021. Through an in-depth examination of market crash phenomena and subsequent rebounds, this paper sheds light on the factors influencing market volatility and investor sentiment during crises. 'Regulatory Measures in Response to Market Volatility' by SEBI, 2020. Focusing on regulatory interventions by SEBI during the pandemic, this paper discusses measures aimed at safeguarding market integrity and mitigating risks, including changes in trading hours, margin requirements, and settlement procedures. 'Risk Management Strategies in Derivative Trading' by Feiran Xiang, 2022. This paper delves into effective risk management techniques employed by traders during times of heightened volatility, such as stop-loss orders, hedging, and diversification. It emphasizes the importance of adaptive strategies in navigating volatile market conditions. These papers collectively contribute to a deeper understanding of the derivative market dynamics during the COVID-19 pandemic, informing the analysis and recommendations presented in this research paper.

RESEARCH QUESTION

1). How did the COVID-19 pandemic impact futures and options (F&O) trading in the Indian derivative market, and what were the specific challenges faced by individual traders during this period?

2). What were the key factors influencing the profitability of F&O trading amidst the heightened volatility induced by the pandemic, and what strategies did market participants employ to mitigate risks and capitalize on opportunities?

3). How did regulatory measures implemented by the Securities and Exchange Board of India (SEBI) during the pandemic contribute to safeguarding market integrity and mitigating risks in the derivatives market?

4). What were the differential impacts of the COVID-19 pandemic on specific industries and market sectors, and how did these effects manifest in F&O trading volumes and trends?

INTRODUCTION

"Right Entry and Right Exit is necessary in the Market."

The Securities and Exchange Board of India (SEBI) released a report that says ninety percent of F and O individual traders incurred net losses in FY22.[1] This report justifies the quote mentioned above. The report also says there has been a 500 percent increase in traders from FY19 to FY22.[2]

Futures and options (F&O) are considered the major types of stock derivatives trading in the share market. These are the contracts signed by two parties for trading stock at a predetermined price later. These kinds of contracts try to hedge market risks involved in trading because the price is set beforehand.[3] F&O in the market derive their prices from the assets such as stock market indices, shares, commodities, etc. In F&O there can be substantial profits or losses if

[1] '90% Individual Traders Incurred Net Losses in Equity F&O Trading in FY22' *Outlook* (25 January 2023) <www.outlookindia.com/business/90-individual-traders-incurred-net-losses-in-equity-f-o-trading-in-fy22-sebi-news-256796> accessed 15 March 2024

[2] *Ibid*

[3] 'What Is Futures and Options? - Definition and Types of F&O' (*Groww*) <https://groww.in/p/what-is-futures-and-options> accessed 15 March 2024

predicting the market goes wrong because individuals would have bought the assets at pre-determined prices.[4]

The outbreak of the COVID-19 virus took place in Wuhan City, China in December 2019. In India, the share market collapsed for several days after the first case was detected in March 2020. The derivative market plays an important role in India's emerging economy. From research, it is known that during the pandemic period, the volatility increased in the market, and this could be tackled with the help of instruments of the derivative market. During the pandemic, the financial derivates market was resilient, and a high rate of volatility led to the mispricing of instruments which often created opportunities for market participation.[5]

DERIVATIVE MARKET FROM THE GLOBAL PROSPECTS

Covid-19 had spread to the whole world which affected the economic condition of many countries. Sectors are interconnected where one sector affects the others around the globe which creates huge risk. It was evident that the cash market was badly affected by the pandemic and many market participants incurred huge losses. The derivative market acted as a protection against volatility. Market participants could get returns from the derivative market by using positional advantages along with various instruments. From the research, the author got to know that F&O has grown exponentially during critical economic times. The option instrument attracted many investors among other instruments.[6]

Hedging Against Volatility: Derivative markets, particularly F&O, provide avenues for investors to hedge against market volatility. During times of uncertainty, such as the COVID-19 pandemic, the derivative market becomes instrumental in managing risks associated with fluctuating asset prices.[7] By taking positions in futures contracts or employing options strategies, investors can protect their portfolios from adverse market movements.

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[4] *Ibid*

[5] Karkaria Dusmanta and Nigamananda Mohanty, 'Impact of COVID-19 Waves on Indian Derivative Market: Special Reference to Financial Derivative Segment' (2022) 11(8) International Journal of Science and Research <https://www.ijsr.net/archive/v11i8/SR22511114609.pdf> accessed 15 March 2024

[6] *Ibid*

[7] Dusmanta (n 5)

Liquidity and Market Functioning: Amidst market turmoil, derivative markets often exhibit higher liquidity compared to their underlying cash markets. This liquidity enables market participants to execute trades more efficiently and at fairer prices, thereby contributing to the overall functioning of financial markets.[8] During the pandemic, derivatives exchanges continued to operate smoothly, providing essential liquidity and price discovery mechanisms.

Investor Strategies and Opportunities: The heightened volatility induced by the pandemic created opportunities for savvy investors in the derivative market. Traders' adept at analyzing market trends and implementing effective strategies could capitalize on price fluctuations to generate profits. Options became attractive instruments for investors seeking to profit from both rising and falling markets through strategies like straddles, strangles and spreads.

Role of Regulatory Measures: Regulatory authorities, such as the Securities and Exchange Board of India (SEBI), implemented measures to maintain market stability and integrity during the pandemic. These measures included adjusting margin requirements, extending trading hours, and enhancing surveillance mechanisms to detect market manipulation. Such regulatory interventions were crucial in ensuring the orderly functioning of derivative markets amid unprecedented market conditions.

Impact on Market Participants: The pandemic's impact on different sectors of the economy varied, leading to differential effects on market participants.[9] While some industries faced severe downturns, others experienced increased demand or remained relatively resilient. Derivative markets reflected these sectoral dynamics, with traders adjusting their strategies based on changing market conditions and sectoral outlooks.

The COVID-19 pandemic underscored the importance of derivative markets as essential components of the global financial system. Despite challenges posed by market volatility and economic uncertainty, derivative instruments provided avenues for risk management, price

[8] *Ibid*
[9] *Ibid*

discovery, and investment opportunities, contributing to the resilience and adaptability of financial markets during crisis periods.

Indian derivative market during the pandemic:

Chart 1

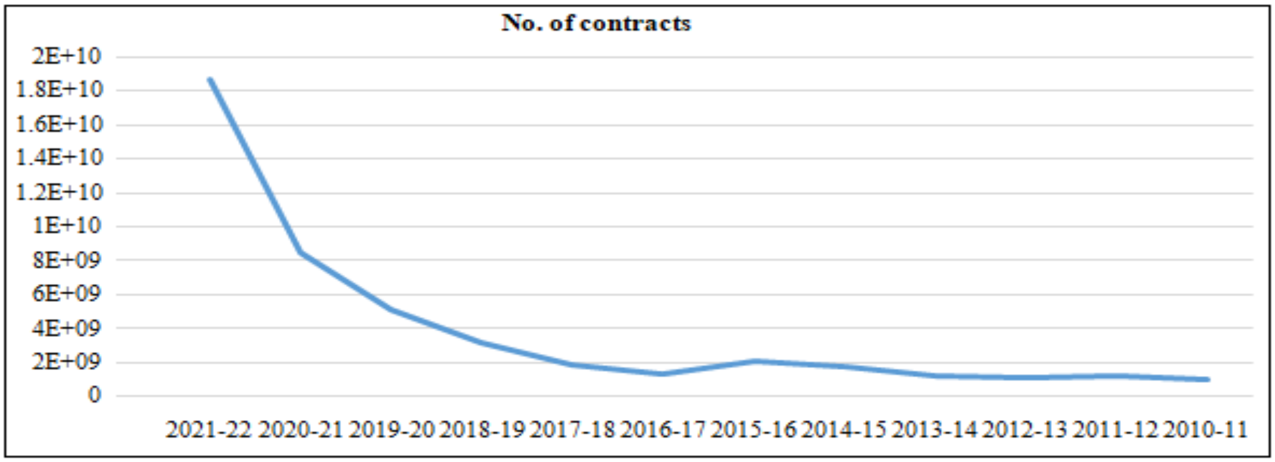
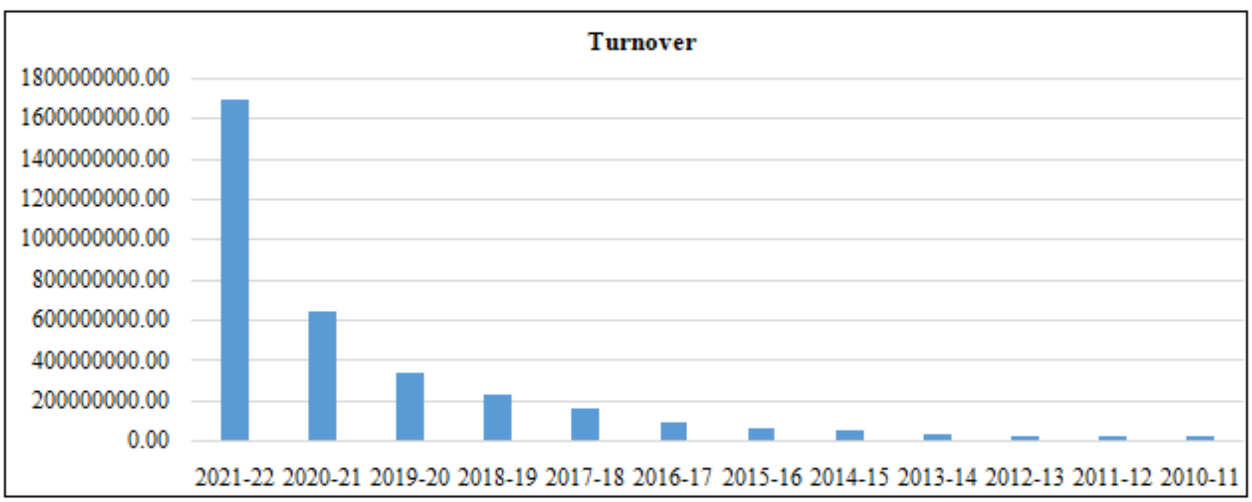


Chart 2



In the line graph, we can see an upward trend that is the number of contract trading and in the bar graph, we can see the turnover in the equity derivative section of the market. During the pandemic, the economic condition of the country wasn't good but then the market was not trailed down. The reason for it is potentiality in the market and derivative instruments were used to protect the financial assets. The economy of the world had been growing at a good pace, but then Covid-19 was an obstacle to it and that is the reason the 2020-2022 period is known as the black years. Everything got disturbed due to COVID-19, the production of goods and services, and the demand for the products in the market. The research found that there was a positive AR around the lockdown, and it had a positive impact on the stock market.[10]

The significant growth of the derivative segment can be seen through graphical representation. The market was stagnant till 2019 but then after 2019, you can see the market undergoes super annual growth. The Covid has increased the volatility in the market. There are two main indices in India, the National Stock Exchange (NSE), Nifty, and the Bombay Stock Exchange (BSE), Sensex. Nifty was 29 percent down and Sensex was 13.2 percent down on March 23, 2020, during the Covid pandemic. All companies and factories were closed due to the lockdown, this affected the market still more.[11]

ANALYSIS OF THE F&O DURING COVID-19 TIMES

During the COVID-19 pandemic, several events unfolded, and subsequent analysis revealed potential avenues for profit amidst the economic downturn. Additionally, the examination encompassed regulatory actions and measures implemented by authorities.

Volatility ascended because of the pandemic's considerable impact on market uncertainty, which also affected futures and options trading. The values of stocks and commodities fluctuated as a result, giving traders the chance to make money from their predictions.[12] The market had high trading volumes, notwithstanding the ambiguity, the epidemic saw a large spike in futures and options trading volumes. This was because traders and investors were looking for chances to manage risks and hedge their positions.

[10] *Ibid*
[11] Debakshi Bora and Daisy Basistha, 'The Outbreak of COVID-19 Pandemic and Its Impact on Stock Market Volatility: Evidence from a Worst - Affected Economy' (2021) 21(4) Journal of Public Affairs <https://doi.org/10.1002/pa.2623> accessed 15 March 2024
[12] Sumanta Bhattacharya, 'Impact of Covid-19 Pandemic on Indian Financial Market' (2022) 10(3) International Journal of Multidisciplinary Educational Research <https://www.researchgate.net/publication/362123744_IMPACT_OF_COVID-19_PANDEMIC_ON_INDIAN_FINANCIAL_MARKET> accessed 15 March 2024

Regulation Measures: The Securities and Exchange Board of India (SEBI) implemented many measures to safeguard the smooth running of the markets during the epidemic. They included shortening the trading day, raising margin requirements, and allowing traders to settle trades through electronic means.

Effect on specific Industries: The pandemic had a variable influence on different sectors of the economy, and this was reflected in the futures and options trading as well. For instance, while demand increased in the pharmaceutical and IT sectors, stock values in the aviation and hospitality industries suffered a large fall.

Risk Management: During the pandemic, effective risk management techniques were essential because the market was more difficult to navigate due to the heightened volatility and unpredictability. Effective risk management techniques used by traders, such as stop-loss orders, hedging, and diversification, increased their chances of success.[13] Ultimately, even while the COVID-19 pandemic did provide some difficulties for futures and options trading in India, it also provided chances for traders to benefit through wise financial decisions and risk management techniques.

THE ANALYSIS OF THE NATURE OF THE MARKET AND ITS EFFECT ON FUTURE TRADING DURING COVID-19

Certainly, the COVID-19 epidemic had an impact on futures trading at a time when the market was pessimistic. Falling stock prices, weakening economic conditions, and unfavorable investor mood are the hallmarks of a bearish market. The COVID-19 pandemic had a severe negative impact on the world economy and stock markets, which was reflected in the futures markets. Many futures contracts saw considerable value decreases during the epidemic, particularly in industries that were worst hit, like oil and gas, transport and hospitality, and retail.[14] Due to unfavorable market conditions, traders who held positions in these sectors may have suffered big losses. The gloomy market, however, also offered opportunities for traders to make money

[13] *Ibid*
[14] Tao Bing and Hongkun Ma, 'Covid-19 Pandemic Effect on Trading and Returns: Evidence from the Chinese Stock Market' (2021) 71 Economic Analysis and Policy <https://doi.org/10.1016/j.eap.2021.05.012> accessed 15 March 2024

through short sales or by utilizing put option methods. During the pandemic, traders who could correctly forecast market moves and modify their tactics to account for unfavorable conditions were able to benefit.

CONCLUSION

It's noteworthy that while the market was negative overall, there were also periods of turbulence and oscillations, which posed both risks and possibilities for traders. For traders to successfully traverse the difficult market conditions during the pandemic, effective risk management techniques and a solid awareness of market patterns and conditions were critical. From the above analysis, we get to know that the derivative market was initially affected by Covid, and the market later was adjusted to the volatility which was caused by health hazards. The market showed resilient features during critical economic conditions. The instruments of the derivative market were used which helped the cash market to normalize. The instruments were majorly used to tackle the uncertainties in the market and the performance of the instrument was above normal growth. Therefore, it is evident that the Indian financial system could undergo and overcome the hard times during COVID-19.

Several suggestions are made in response to the research on how COVID-19 affected India's derivative market. First and foremost, traders need to keep a close eye on the market and adjust their tactics accordingly. They also need to keep up with any changes to regulations and worldwide happenings. Diversification and stop-loss orders are two important risk management techniques that are necessary to reduce losses during periods of increased volatility.[15] Moreover, the capacity of traders to effectively go through complicated markets is improved by investing in education and skill development. Maintaining market integrity and protecting investors requires strict adherence to regulatory compliance requirements, such as those established by SEBI.[16] Investment portfolios can reduce their exposure to downturns in certain industries by diversifying across a variety of asset types. To make well-informed judgments and navigate volatile market situations, it's also essential to seek expert counsel and

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[15] Feiran Xiang, 'Financial Derivatives: Application and Risk Management' (*DeGroote School of Business*, 2022) <https://www.atlantis-press.com/article/125983689.pdf> accessed 15 March 2024

[16] *Ibid*

practice emotional restraint. Trading in the derivatives market during periods of economic uncertainty, such as the difficulties presented by the Covid-19 outbreak, may be made more resilient and successful by giving priority to these tips.[17]

[17] *Ibid*