MARGIN MONEY IN DERIVATIVES

Understanding

“Margin Money” in derivatives

– By Prof. *Simply* Simple ™

MARGIN MONEY IN DERIVATIVES

Let me clarify 'Margin Money' in derivatives to you in this lesson.

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‘Margin Money’ is a term associated with derivative instrument transactions…

So what’s margin money?

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Let's say there are three parties A (Buyer), B (Seller) and C (Broker)

A is interested in buying a futures contract for Rs 100 as he thinks its price would go up by the settlement date

B, on the other hand, wants to sell the futures contract for Rs 100 as he thinks its price will go down by the settlement date

C is the broker who will be executing the deal on behalf of investors A & B

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Now, derivative trading is about taking a ‘call’ on the upward and downward movement of the scrip.

Hence the subject in question is the movement of price (upward or down ward) and not the absolute or actual price of the total contract.

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Therefore, the Stock Exchange has to be hedged by investors (A & B) to the extent of the expected margin of loss that the investor might incur. Thus, the Broker acts as a mediator between the Exchange & the Investors.

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For example in our case, where the cost of futures is Rs 100, in all likelihood its value would go up or down by say Rs 10 either way by the settlement date based on expected volatility which is calculated mathematically.

Hence the margin money sought by the Exchange through the broker from either party would be 10% of the total value (Rs.10 in the given example).

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Please note that irrespective of price movement, both the investors need to maintain 10% of the margin.

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Now let's say by the settlement date, the scrip would be valued at Rs. 108.

This means 'A' would have made a profit of Rs 8 while 'B' would have incurred a loss of Rs. 8.

The broker hence credits the investor 'A's account by Rs 8 along with the margin money of Rs 10.

Hence in total 'A' receives Rs 18.

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On the other hand ‘B’ who has incurred a loss will debit

Rs. 8 from his margin money which was with the broker and

the remaining Rs. 2 will be transferred to the investor’s account.

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Therefore the "funding" that goes to the broker to execute derivative deals is called "Margin Funding" or "Margin Money".

Just to appreciate that in case of buy/sell of actual stocks (spot trading) instead of derivatives trading, the broker would have needed enough funds to cover the entire cost of the scrip in order to execute a spot deal.

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In the case of derivative trading, he only needs funds to cover up the margin movements.

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I hope I have been able to explain to you what 'margin money' is all about.

Do give me your feedback about my lessons so that I can work on them and improve them for your better comprehension.

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Hope this story succeeded in clarifying the concept of 'Margin Money / Margin Funding'.

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