DERIVATIVES

Watch a video about derivatives and fill in the gaps with missing words or phrases.

1. A derivative is a product that derives its value from …………………………….
2. In the example provided, the friend paid a £5,000 deposit to join the waiting list for a ……………………….
3. When the friend decided to sell his place in the queue, he sold it for …………………………….
4. The gap between the deposit paid and the price received from selling the place in the queue represents a …………………………….
5. In financial markets, the underlying asset for derivatives can be ……………………………., property, or a commodity.
6. The three main products that form the basis of the derivatives market are futures, options, and …………………………….
7. A future is a contract that tracks the price of an underlying asset without the need to ………………………….
8. An option gives you the choice to …………………………….or sell an underlying asset.
9. The term "swap" allows investors to change their exposure to a …………………………….without directly dealing with it.
10. The primary challenge for retail investors in the UK regarding futures is that it is quite …………………………….

Read the following text. Some sentences have been removed. Put them in appropriate gaps.

Derivatives is a collective term for financial market products whose value depends on (i.e. is derived from) the price of another underlying asset such as a stock, a stock index (the average value of representative stocks in a given market), a currency, a commodity, etc. The main derivatives are futures, options and swaps. **1. ______** This allows companies to plan more effectively.

Futures contracts are agreements to make or take delivery of specified commodities (foodstuffs, - metals, etc.) or financial instruments at a fixed future date, at a price determined when the contract is made. Futures contracts allow both sellers and buyers to hedge or reduce risks. 2**. ______** The seller eliminates the risk that the price will drop, and the buyer the risk that it will rise. The same logic led to the development of financial futures: contracts to buy and sell stocks, stock indexes, interest rates and currencies at a future date.

Options differ from futures in that they give the right, but not the obligation, to buy or sell an asset at a fixed price on or before a given date. Buying a call option gives you the right to buy an asset; buying a put option gives you the right to sell an asset. For example, if you expect the price of a stock to rise you can buy the right to buy that stock in the future at the current market price. **3. ______** If you are wrong, you do not have to exercise the option to buy or sell the stocks, but you lose the price of the option. **4. ______** Obviously, the expectations of the writer of an option about the future value of the assets are opposite to those of the buyer, and the writer does not - expect the option to be exercised. Futures and options are traded by speculators hoping to make a profit from price fluctuations, as well as by companies seeking to hedge. **5. ______**

Borrowers and lenders can also swap or exchange future interest payments. A company that has . borrowed money at a floating rate could protect itself from a rise in interest rates by exchanging - this for a fixed interest rate loan with another company or financial institution. **6. ______** Companies can also undertake exchange rate swaps, exchanging funds in two different currencies. At a future date the same amount of the currencies is re-exchanged at a predetermined . exchange rate. Over the term of the agreement, the counterparties exchange fixed or floating rate . interest payments in their swapped currencies.

- **A.** If you think the price of a stock will fall in the next few weeks or months you can buy the right to sell it in the future at the current price.
- **B.** This is the premium the writer or seller of the option receives from the buyer.
- **C.** For example, a cocoa grower can agree a price, quantity and delivery date with a chocolate - manufacturer.
- **D.** These are interest - rate swaps.
- **E.** In fact, much more derivative usage is based on speculation than hedging nowadays.
- **F.** They were developed to allow companies to reduce uncertainty by guaranteeing future prices, at a reasonable cost.

Read the text again and decide which answer is correct.

1. What is the primary function of derivatives?
   A. To allow companies to reduce uncertainty by guaranteeing future prices.
   B. To provide a platform for speculative trading and profit-making.
   C. To facilitate the exchange of funds in different currencies.
   D. To enable borrowers and lenders to swap future interest payments.

2. Which of the following is not mentioned as a main type of derivative?
   A. Futures
   B. Options
   C. Swaps
   D. Bonds

3. Which of the following statements best describes the key difference between futures and options contracts?
   A. Futures contracts are traded on exchanges, while options are traded over-the-counter.
   B. Futures contracts involve an obligation to buy or sell, while options give the right but not the obligation.
   C. Futures contracts are used primarily for hedging, while options are used primarily for speculation.
   D. Futures contracts have a fixed future date, while options can be exercised on or before a given date.

4. What is the primary reason companies use derivatives?
   A. To make a profit from price fluctuations.
   B. To hedge against risks and uncertainties.
   C. To swap interest payments with other companies.
   D. To exchange funds in different currencies.

5. How do the expectations of the writer and buyer of an option contract differ?
   A. The writer and buyer have the same expectations about the future value of the asset.
   B. The writer expects the option to be exercised, while the buyer does not.
   C. The writer receives a premium from the buyer, but the buyer does not expect to exercise the option.
   D. The writer and buyer take opposite positions in terms of the future value of the asset.

6. What is the purpose of an interest rate swap?
   A. To exchange future interest payments in the same currency.
   B. To exchange future interest payments in different currencies.
   C. To protect a company borrowing at a floating rate from a rise in interest rates.
   D. To provide a platform for speculation on interest rate movements.

7. What trend in the use of derivatives is mentioned in the passage?
   A. The use of derivatives is declining due to increased regulation.
   B. The use of derivatives is evenly split between hedging and speculation.
   C. More derivatives are being used for hedging than for speculation.
   D. Much more derivatives usage is based on speculation than hedging nowadays.

<u>Vocabulary practice</u>

Choose the correct option that best fits the sentence.

1. A contract that derives its value from an underlying financial asset is called a:
   a) Speculator
   b) Hedge
   c) Derivative
   d) Fluctuation
2. When a company locks in a future price for an asset to avoid risks, it is using a:
   a) Call option
   b) Hedge
   c) Floating rate
   d) Put option
3. A financial instrument giving the holder the right to buy an asset at a specific price is called a:
   a) Commodity
   b) Call option
   c) Fluctuation
   d) Hedge
4. The interest rate that can change over time depending on market conditions is a:
   a) Floating rate
   b) Speculator
   c) Fixed rate
   d) Underlying asset
5. Someone who takes risks by investing in financial markets is called a:
   a) Speculator
   b) Hedge
   c) Call option
   d) Exercise option

6. The agreed price at which an option can be exercised is known as the:
   a) Floating rate
   b) Strike price
   c) Hedge price
   d) Fluctuation price
7. An agreement to exchange cash flows based on different interest rates is called a(n):
   a) Call option
   b) Exchange rate swap
   c) Derivative
   d) Speculator
8. When the value of a currency changes unpredictably, it is called:
   a) Exercise option
   b) Underlying asset
   c) Fluctuation
   d) Hedge
9. A physical good traded on financial markets, such as oil or gold, is known as a:
   a) Derivative
   b) Commodity
   c) Put option
   d) Floating rate

Decide if the statement is true or false. Correct the false ones.

1. A *put option* gives the holder the right to buy an asset at a specified price.
2. *Exchange rate swaps* are used to manage currency risk in international transactions.
3. A *speculator* invests in assets to reduce risk.
4. *Commodities* are intangible assets like software licenses.
5. *Fluctuations* in market prices are always predictable.
6. *Floating rates* remain fixed throughout the term of a loan.
7. A *derivative* is a type of fixed-income investment.
8. An investor who anticipates market changes to profit is a *speculator.*

Warren Buffett: Derivatives Set the Stage for the Next Financial Crisis?

Warren Buffett will be answering a question about derivatives. Watch and fill in the gaps with missing information.

1. In September and October of 2008, the Federal Reserve poured 85 billion into .... to prevent a financial crisis.
2. Hank Paulson guaranteed money market funds at a time when .... million Americans were panicking.
3. The amount of money that left the non-government money market funds in just 3 days was .... billion.
4. The actions taken by Bernanke and Paulson during the panic demonstrated that strong leadership is needed to ....

5. According to the speaker, the ability to print money was crucial during the panic, as it allowed leaders to say they would do ....

6. Section 133 of the Federal Reserve Act was likely not intended to be used for ....

7. The speaker expresses concern that Congress is hesitant to give too much authority to the ....

8. The speaker notes that it is challenging to write regulations that prevent people from acting ...., especially when such behaviour has been profitable.

9. The analogy of Cinderella at the ball suggests that people often believe they will be able to leave the situation before it ....

10. The speaker reflects on the uncertainty of when the next panic will occur, stating that when it happens, the focus will be on whether people will ....