Examrace

Derivatives (Part – 2) : Similarity and Difference between Forward and Futures Contract

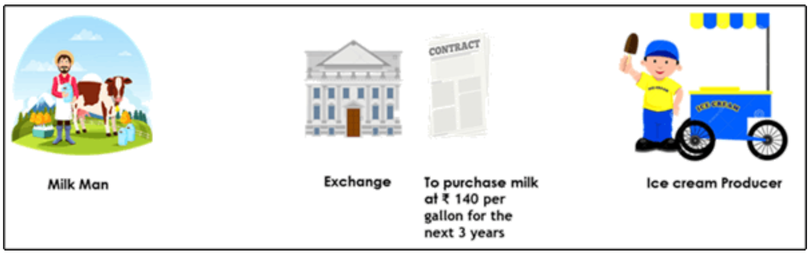
Topics to be Covered Are

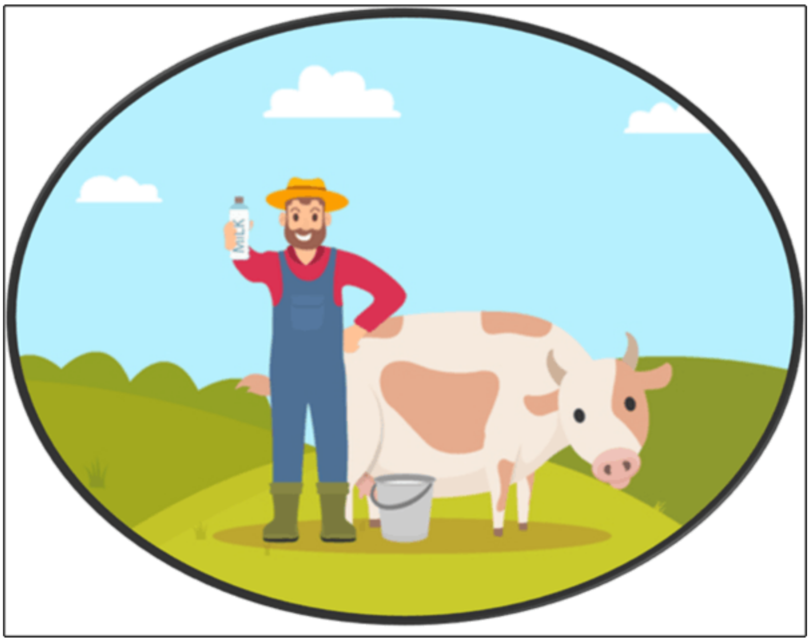
- Meaning of Derivatives
- Definition of Derivatives
- Types of Participants
- Functions of Derivatives
- Why do investors enter derivative contracts?
- Major types of Derivatives
  - Forward Contract
  - Future Contract
  - Options
  - Swap

Future Contract

A futures contract is a legal agreement to buy or sell a particular commodity asset, or security at a predetermined price at a specified time in the future. Futures contracts are standardized for quality and quantity to facilitate trading on a futures exchange.

Example:





Similarity and Difference between Forward and Futures Contract

Futures contracts are standardized, unlike forward contracts. Forwards are similar types of agreements that lock in a future price in the present, but forwards are traded over-the-counter (OTC) and have customizable terms that are arrived at between the counterparties. Futures contracts, on the other hand, will each have the same terms regardless of who is the counterparty.

Difference between Forward and Future Contracts

Basis	Forward Contract	Future Contract
Definition	A forward contract is an agreement between two parties to buy or sell an asset at a pre-agreed future point in time at a specified price.	A futures contract is a standardized contract, traded on a futures exchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price
Structure & Purpose	Customized to customer needs. Usually used for hedging.	Standardized. Usually used for speculation.
Transaction method	Negotiated directly by the buyer and seller.	Quoted and traded on the Exchange.

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Basis	Forward Contract	Future Contract
Market Regulation	Not regulated	Government regulated market
Institutional guarantee	The contracting parties	Clearing House
Risk	High Risk	Low Risk
Initial Guarantees Deposit	No guarantee of settlement until the date of maturity only the forward price, based on the spot price of the underlying asset is paid	Both parties must deposit an initial guarantee (margin). The value of the operation is marked to market rates with daily settlement of profits and losses.
Expiry date	Depending on the transaction	Standardized

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Option

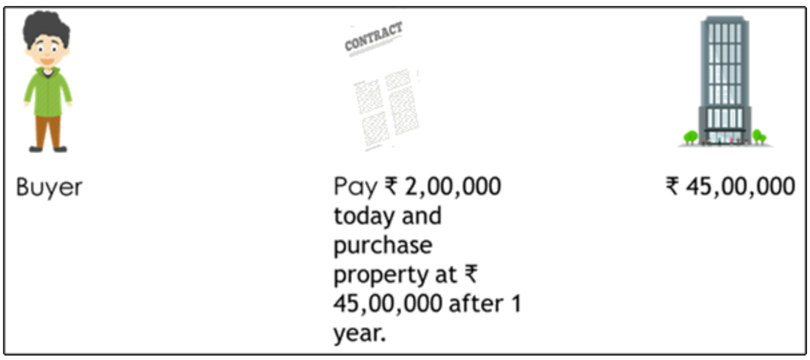
Option: An option is a contract, which gives the right, but not an obligation, to buy or sell the underlying asset at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore, obliged to sell/buy the asset, if the buyer exercises it on him.

Types of Option

- Call option
- Put option

Explanation:

Call Option: Call Option refers to the contract which gives the holder the right to buy an underlying security at an agreed price in the future. An investor buys a call option when he/she believes that the price of the stock is likely to increase in the future.



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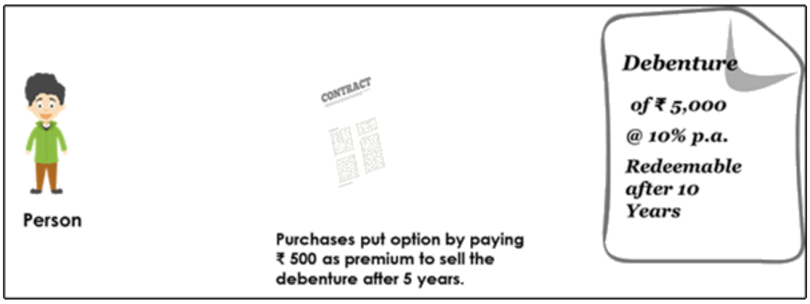
Put Option: Give the buyer the right, but not the obligation to sell a given quantity of underlying asset at a given price on or before a given future date.



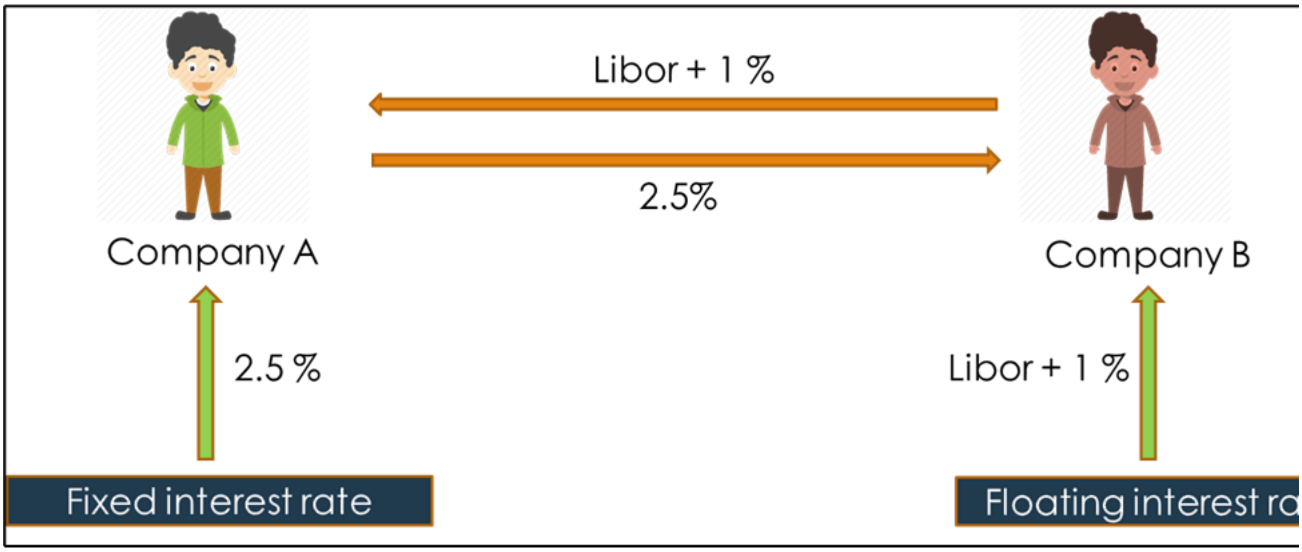
Swap

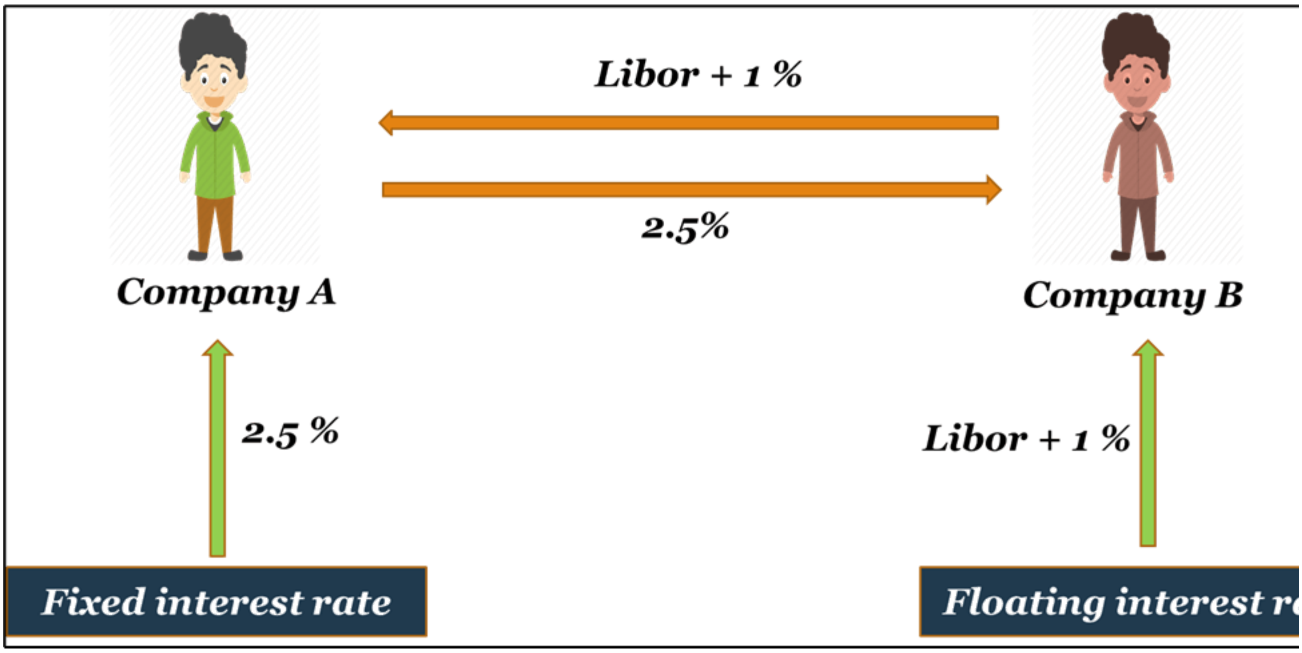
Swap: A swap is a derivative contract through which two parties exchange the cash flows or liabilities from two different financial instruments. Most swaps involve cash flows based on a notional principal amount such as a loan or bond, although the instrument can be almost anything. Basically, there are two types of swap i.e..

- Interest rate swap
- Currency swap

Explanation:

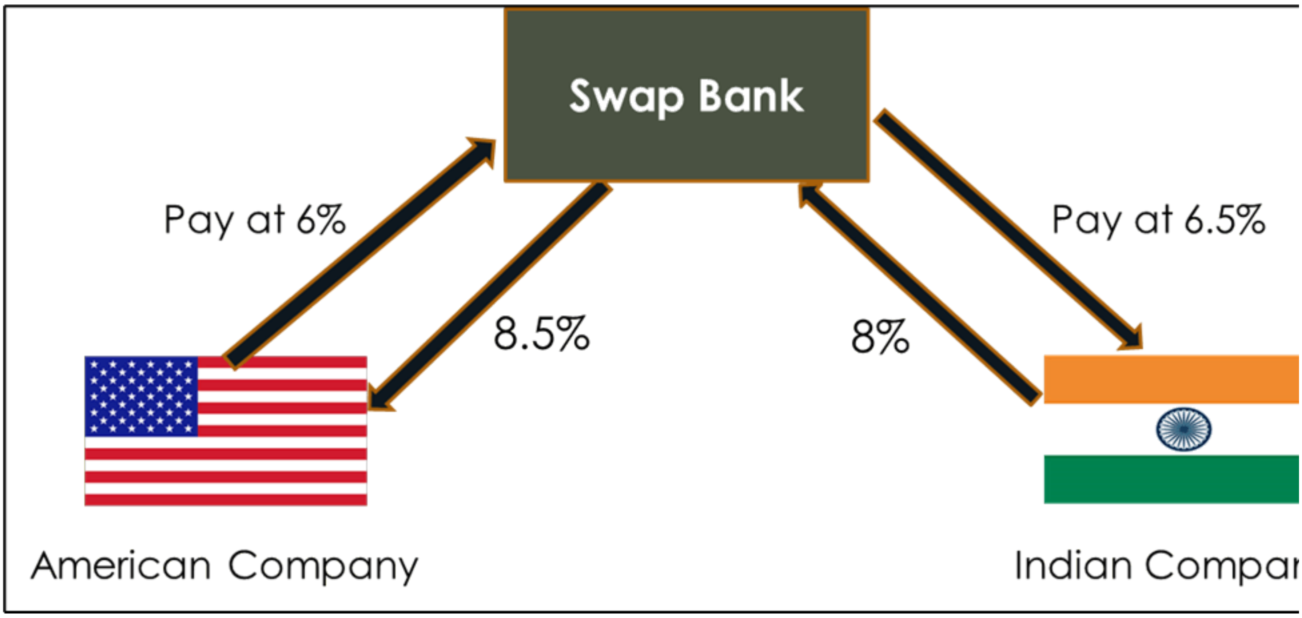
Interest rate swap: An interest rate swap It is a type of a derivative contract through which two counterparties agree to exchange one stream of future interest payments for another, based on a specified principal amount. In most cases, interest rate swaps include the exchange of a fixed interest rate for a floating rate.

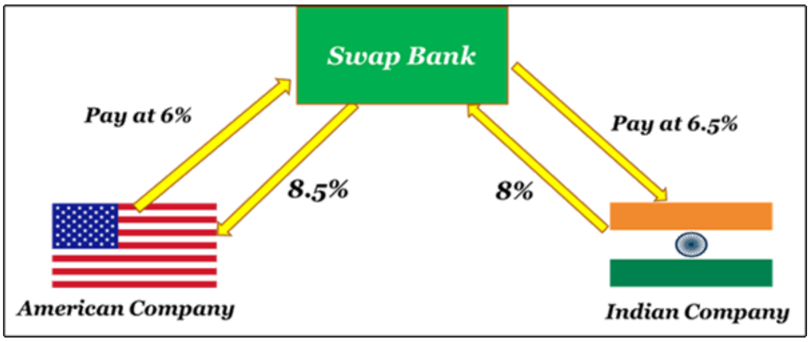

Libor + 1 %
2.5%
Company A
Company B
2.5 %
Libor + 1 %
Fixed interest rate
Floating interest ra



Currency swap: A currency swap contract (also known as a cross-currency swap contract) is a derivative contract between two parties that involves the exchange of interest payments, as well as the exchange of principal amounts in certain cases, that are denominated in different currencies.

Company/Country	America	India
American Company	6%	9%
Indian Company	11%	8%





#Derivatives #FutureContract #SimilarityAndDifferencebetweenForwardAndFuturesContract #DifferenceBetweenForwardandFutureContracts #Option #TypesOfOption #Swap #testprep

✍ Manishika