Meaning of Derivatives

A derivative is an instrument whose value is derived from the value of one or more underlying, which can be commodities, precious metals, currency, bonds, stocks, stocks indices, etc. Four most common examples of derivative instruments are Forwards, Futures, Options and Swaps.

What are Forward Contracts?

A forward contract is a customized contract between two parties, where settlement takes place on a specific date in future at a price agreed today. The main features of forward contracts are

- They are bilateral contracts and hence exposed to counter-party risk.
- Each contract is custom designed, and hence is unique in terms of contract size, expiration date and the asset type and quality.
- The contract price is generally not available in public domain.
- The contract has to be settled by delivery of the asset on expiration date.
- In case the party wishes to reverse the contract, it has to compulsorily go to the same counter party, which being in a monopoly situation can command the price it wants.

These contracts are not traded on an exchange but privately traded over the counter.

What are Futures?

Futures are exchange-traded contracts to sell or buy financial instruments or physical commodities for a future delivery at an agreed price. There is an agreement to buy or sell a specified quantity of financial instrument commodity in a designated future month at a price agreed upon by the buyer and seller.To make trading possible, BSE specifies certain standardized features of the contract. These contracts are traded on the exchange.

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What is the difference between Forward Contracts and Futures Contracts?

Sr.No	Basis	Futures	Forwards
1	Nature	Traded on organized exchange	Over the Counter
2	Contract Terms	Standardized	Customised
3	Liquidity	More liquid	Less liquid
4	Margin Payments	Requires margin payments	Not required
5	Settlement	Follows daily settlement	At the end of the period.

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