Futures and forwards

What are futures and forwards?
Futures and forwards are agreements whereby a buyer and a seller undertake to buy or sell a specific underlying at a predefined price at a specific point in time (the expiry date). The obligation applies regardless of the current market value on the expiry date.
Futures are standardised contracts in terms of the quantity of the underlying and the expiry date that are traded on an exchange. Some futures can give rise to a delivery obligation even before the expiry date.
Forwards, meanwhile, are not traded on an exchange. They can be either standardised or individually agreed between the buyer and seller.

What risks are associated with futures and forwards?
Futures and forwards can involve special risks. Only investors who are familiar with these financial instruments, have sufficient money available and are able to bear potential losses should invest in them.
With forward sales, the underlying must be delivered at the price originally agreed even if its market value has since risen above the agreed price. The loss risk is thus equal to the difference between the two prices. Since there is theoretically no limit to how far the market value of the underlying can rise, the potential loss is also unlimited.
The forward sale of an underlying the seller does not own at the time the contract is signed is known as a short sale. It entails a risk in that the seller may have to buy the underlying at a price higher than the agreed price in order to meet the delivery obligation on expiry.
Conversely, with forward purchases, the buyer must take delivery of the underlying at the price originally agreed even if its market value has since fallen below the agreed price. The loss risk is thus equal to the difference between the two prices. The maximum loss therefore corresponds to the originally agreed price.
In order to limit price fluctuations, an exchange may set price limits for certain contracts. Investors should inform themselves of such limits before investing in futures as it can be much more difficult or even impossible to close out a contract if a price limit is reached.
The market for standardised forwards is transparent and often also liquid, so contracts can normally be closed out without difficulty. There is no actual market for forwards agreed individually, so they may only be closed out with the counterparty's consent. Contracts featuring a combination of different elements can entail significantly different risks, in particular if not all of the elements can be closed out. Investors should thus consult their securities dealer for detailed information on the special risks before entering into such contracts. Security dealer is a natural person, legal entity or partnership that, on a professional basis, either offers financial instruments publicly on the primary market or trades them on the secondary market or that creates and publicly offers derivatives.

How initial and variation margins work
An investor forward selling or buying an underlying asset they do not possess (short selling) must be able to supply a specified initial margin when entering into the contract. This is usually a percentage of the total value of the contracted instruments. In addition, a variation margin Inoltre, nell'arco dell'intera durata del contratto viene calcolato periodicamente un margine di variazione, il «variation margin», pari all'utile contabile o alla perdita contabile derivante dalla variazione di valore del contratto e/o del sottostante is calculated periodically during the life of the contract. This corresponds to the book profit or loss arising from any change in the value of the contract or underlying instrument. The way in which the variation margin is calculated will depend on the rules of the exchange concerned and the terms of the contract. The investor must deposit the required initial and variation margin with the securities dealer for the entire life of the contract. In the event of a book loss, the variation margin can be several times as large as the initial margin. If the investor cannot make the variation margin payment quickly enough, the securities dealer may unilaterally close out the transaction, in which case the investor loses the opportunity to profit from a favourable trend in the underlying up to expiry.
The investor must deposit the required initial and variation margin with the securities dealer (see above) for the entire life of the contract. In the event of a book loss, the variation margin can be several times as large as the initial margin. If the investor cannot make the variation margin payment quickly enough, the securities dealer may unilaterally close out the transaction, in which case the investor loses the opportunity to profit from a favourable trend in the underlying up to expiry.

Cornèr Banca SA // Via Canova 16 // 6901 Lugano_Switzerland
Tel. +41 91 800 51 11 // corner.ch // info@corner.ch

Closing out

The investor can close out the transaction at any time before the expiry date or the next possible delivery date ("first notice day"), usually at normal market conditions. The nature of the closing out (closing out refers to closing an open position by executing a corresponding opposite transaction, so that the two cancel each other out.) will depend on the type of contract and the practice of the exchange, particularly with regard to price limits. Either the financial instrument is sold, or an offsetting trade under identical contractual conditions is agreed with the counterparty so that the obligations to deliver and receive cancel one another out.

Settlement and special risks

If the transaction is not closed out before the expiry date or the first notice day, the investor and the counterparty must settle it. If the underlying of a forward contract is a physical asset, the contract may provide for physical delivery or a cash payment. Generally, the asset is physically delivered. Only in exceptional cases do the contract provisions or exchange practice call for cash settlement. All other settlement specifications, especially the place of fulfilment, can be found in the relevant contract provisions.

The difference between physical delivery and cash settlement is that with physical delivery, underlyings amounting to the entire contractual value must be delivered, whereas with cash settlement, only the difference between the agreed price and the market value on settlement needs to be paid. This means that where the contract provides for physical delivery, the investor will need either more funds available than for cash settlement or the underlying assets.

DISCLAIMER

This information sheet contains an extract from the brochure “Risks Involved in Trading Financial Instruments” published by the Swiss Bankers Association (SBA), the complete version of which can be consulted at www.swissbanking.org or on the Bank’s website (www.corner.ch).

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Before making any investment decision, we invite you to consult a financial advisor and to examine carefully all documents and information available for each financial instrument (prospectus, basic information sheet, term sheet, etc.).