**1. Financial Instrument**

Source : <https://www.investopedia.com/terms/f/financialinstrument.asp>

Financial instruments are assets (or packages of capital) that can be traded.

These assets can be cash, a contractual right to deliver or receive cash or evidence of one's ownership of an entity.

**Takeaways:**

(i) A financial instrument is a real or virtual document representing a legal agreement involving any kind of monetary value.

(ii) Financial instruments may be divided into two types: cash instruments and derivative instruments.

(ii) Financial instruments may also be divided according to an asset class, which depends on whether they are debt-based or equity-based.

(iv) Foreign exchange instruments comprise a third, unique type of financial instrument.

**Types of Financial Instruments:**

***(i) Cash Instruments***

- Cash instruments may also be deposits and loans agreed upon by borrowers and lenders.

- These can be securities that are easily transferable.

***(ii) Derivative Instruments***

The value and characteristics of derivative instruments are based on the vehicle’s underlying components, such as assets, interest rates, or indices.

For example, An equity options contract, is a derivative because it derives its value from the underlying stock. The option gives the right, but not the obligation, to buy or sell the stock at a specified price and by a certain date. There can be over-the-counter (OTC) derivatives or exchange-traded derivatives. OTC is a market or process whereby securities–that are not listed on formal exchanges–are priced and traded.

**Types of Asset Classes of Financial Instruments**

**(i) Debt-Based Financial Instruments**

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| **Short-term debt-based financial instrument** | **long-term debt-based financial instrument** |
| financial instruments last for one year or less. | Long-term debt-based financial instruments last for more than a year. |
| Exchange-traded derivatives under short-term : debt-based financial instruments for short term interest rate futures | these are bonds. Cash equivalents are loans.  Exchange-traded derivatives: bond futures and options on bond futures. |
| OTC derivatives: forward rate agreements | OTC derivatives: IR swaps, interest rate caps and floors, interest rate options, and exotic derivatives. |

**(ii) Equity-Based Financial Instruments**

Securities under equity-based financial instruments are stocks. Exchange-traded derivatives in this category include **stock options and equity futures**. The OTC derivatives are stock options and exotic derivatives.

Special Considerations

There are no securities under foreign exchange. Cash equivalents come in spot foreign exchange, which is the current prevailing rate. Exchange-traded derivatives under foreign exchange are currency futures. OTC derivatives come in foreign exchange options, outright forwards, and foreign exchange swaps.

**2. Derivative**

Source : <https://www.investopedia.com/terms/d/derivative.asp>

What Is a Derivative?

Its a type of financial contract whose value is dependent on an underlying asset or group of assets. A derivative is set between two or more parties that can trade on an exchange or over-the-counter (OTC). Prices for derivatives derive from fluctuations in the underlying asset.

**TAKEAWAYS**

* Derivatives are financial contracts, set between two or more parties, that derive their value from an underlying asset or group of assets.
* A derivative can trade on an exchange or over-the-counter.
* Prices for derivatives derive from fluctuations in the underlying asset.
* Derivatives are usually leveraged instruments, which increases their potential risks and rewards.
* Common derivatives include futures contracts, forwards, options, and swaps.

**Types of Derivatives**

There are two classes of derivative products: "lock" and "option." Lock products (e.g., futures, forwards, or swaps) bind the respective parties from the outset to the agreed-upon terms over the life of the contract. Option products (e.g., stock options), on the other hand, offer the holder the right, but not the obligation, to buy or sell the underlying asset or security at a specific price on or before the option's expiration date. The most common derivative types are futures, forwards, swaps, and options.

**Futures**

A futures contract, or simply futures, is an agreement between two parties for the purchase and delivery of an asset at an agreed-upon price at a future date. Futures are standardized contracts that trade on an exchange.

**Forwards**

Forward contracts, or forwards, are similar to futures, but they do not trade on an exchange. These contracts only trade over-the-counter. When a forward contract is created, the buyer and seller may customize the terms, size, and settlement process.

**Swaps**

Swaps are another common type of derivative, often used to exchange one kind of cash flow with another. For example, a trader might use an interest rate swap to switch from a variable interest rate loan to a fixed interest rate loan, or vice versa.

**Options**

An options contract is similar to a futures contract in that it is an agreement between two parties to buy or sell an asset at a predetermined future date for a specific price. The key difference between options and futures is that with an option, the buyer is not obliged to exercise their agreement to buy or sell. It is an opportunity only, not an obligation, as futures are. As with futures, options may be used to hedge or speculate on the price of the underlying asset.

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| Advantage | Disadvantage |
| * Lock in prices * Hedge against unfavorable movements in rates * Mitigate risks | * Changes in the amount of time to expiration * The cost of holding the underlying asset * Interest rates |