4.3 DIFFERENCE BETWEEN FORWARDS AND FUTURES CONTRACT

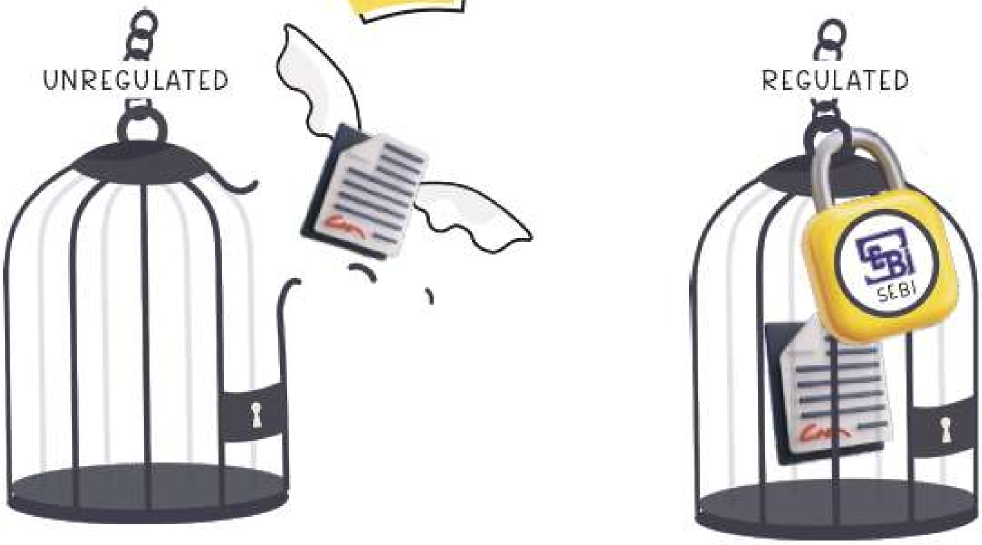
While the purpose that the two contracts serve is similar to each other yet the internal working and features of the two make each of these contracts unique for traders that use them.

1 STANDARDISATION

Forward contracts are customisable contracts as per the precise requirements and terms that are agreeable to both the buyer and the seller of the contract.

Futures contracts, on the other hand, are standardised contracts that are created by the exchange.

2 REGULATION

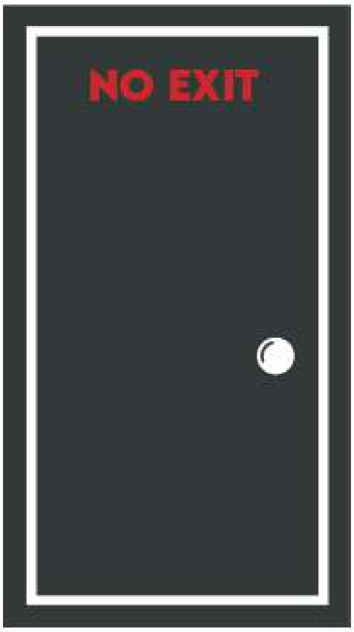


Forward contracts are contracts that trade in private over-the-counter markets. They are independent of the exchange regulations.

Futures contacts, on the contrary, are contracts that explicitly trade on the exchange and are well regulated as per the guidelines of Securities and Exchange Board of India (SEBI).

3 SQUARING OFF

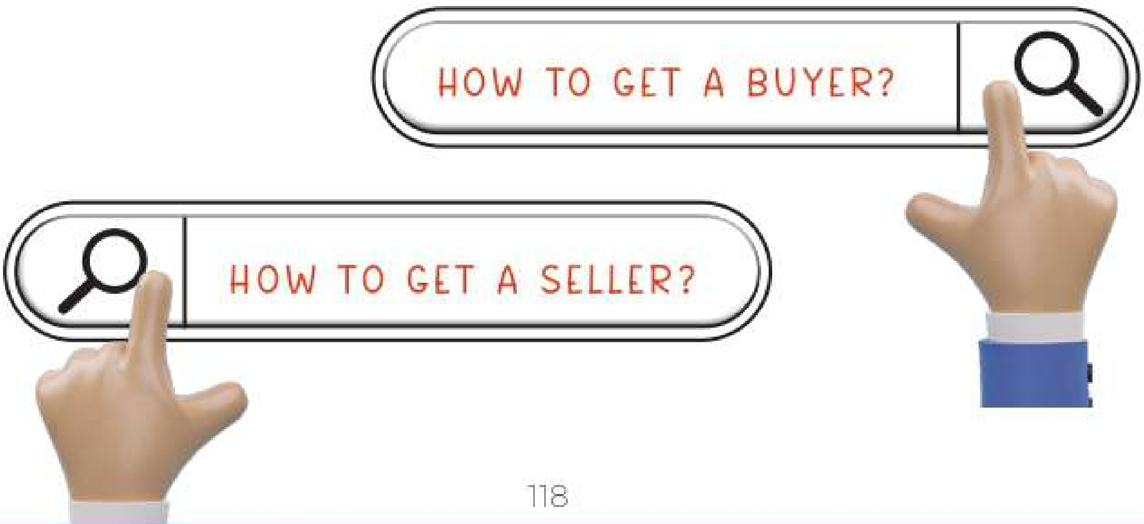
As *Forward contracts* are over the counter contracts, it may at times be difficult to find a party to square-off our position before the settlement date.



Futures contracts, however, can be exited before the settlement date by simply squaring off the position in the market as they are exchange traded contracts.

EXISTENCE OF COUNTERPARTY 4

In the market of *forward contracts*, it might get difficult at times to even find a counterparty that would be interested to enter the contract with similar or same terms desired. This can be very time consuming and costly for that matter.



In the ***futures contracts*** market, counter-party is found via Exchange. At times, there may be illiquid markets for certain contracts. Relatively, its a smoother process though.

5 SETTLEMENT

In a ***forward contract***, physical delivery is one of the options that can be exercised. Cash settlement is also acceptable in forwards.

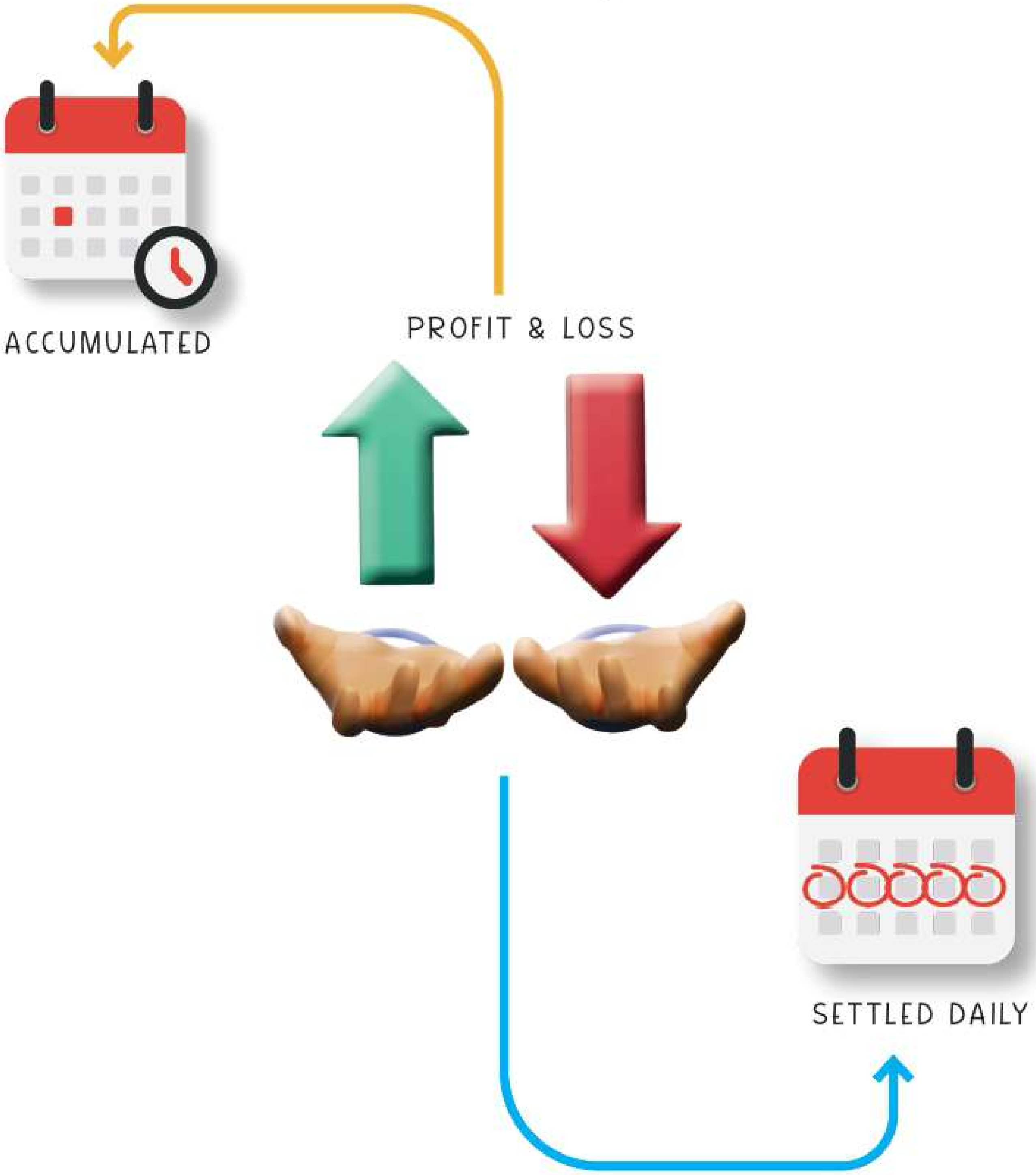
Futures contracts are exchange traded and therefore do not have the option of physical delivery of the underlying asset (say an agricultural product). They are settled in cash only.

CASH SETTLEMENT ONLY

MARKED TO MARKET 6

In a ***forward contract***, the profits or losses of the parties are accumulated and paid on the date of maturity or expiry of the contract.

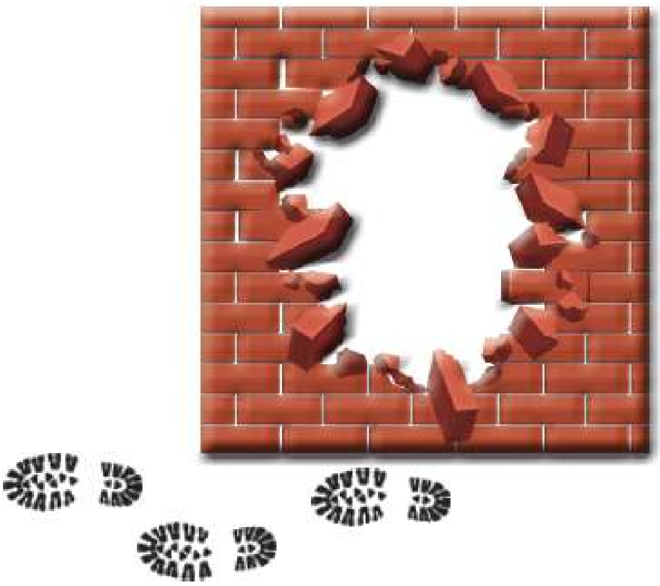
On the contrary, in a ***futures contract***, the daily price movements are noted and marked to market. The profit or loss is netted between the parties on daily basis.

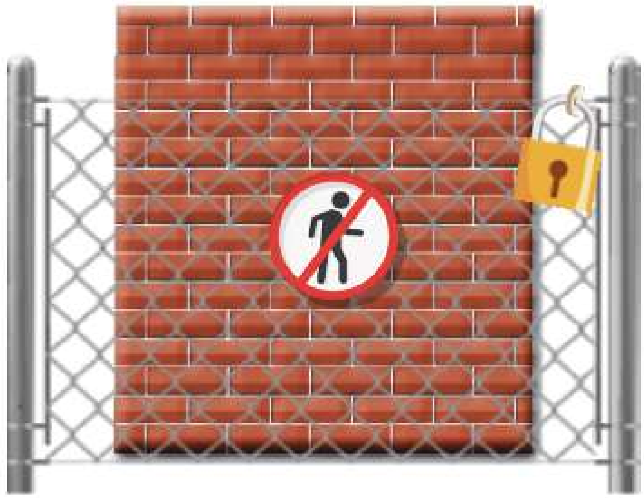


7 COUNTERPARTY DEFAULT RISK

In a ***forward contract***, there is a significant counterparty default risk involved even though the parties know each other.

Talking of the mark to market nature of ***futures***, these contracts have no default risk.





The contract is legally binding but the legal proceedings themselves are all the more time consuming and expensive to proceed with.

The buyer and the seller have the exchange as their counterparty. This removes the counter-party risk which was there with Forward contracts.