See 5 Key Differences between Futures and Forward Contracts

Futures and forward contracts are derivatives, which on paper look similar. It’s a simple mistake to make, since futures and forward contracts both sound like things yet to come.

However, when you look at the technical details, futures and forward contracts function differently and serve completely different purposes from a trader’s perspective.

In this article, we will dissect key differences between futures and forward contracts to determine which works best for your trading style.

This article will cover more information on forward contracts, because this financial instrument is not as widely known as futures contracts.

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Chapter 1: What are Forward Contracts?

A forward contract binds two parties to exchange an asset in the future and at an agreed upon price. Hence, the agreed upon price is the delivery price or forward price.

Forward contracts are not standard; the quantity and quality of the asset are specific to the deal.

While forward contract sounds really official because the word “contract” is in the title, it’s not always a sure thing.

Chapter 2: How Forward Contracts Work

Joe is a potato farmer nearing the harvest season.

Because the price of potato has recently displayed wild price swings, Joe isn’t sure he will receive the best valuation in the coming months.

While Joe is waiting for his harvest to come in, ACME Corporation (maker of potato chips) is also concerned about the impact the volatility of potato prices will have on their business.
Example of a Forward Contract

To reduce their market risk, Joe and ACME Corporation enter into a forward contract agreement. The terms of the contract call for Joe to serve as the producer and ACME Corporation the consumer.

The forward contract states 90 days after signing the contract Joe will deliver 2 tons of Potatoes to ACME Corporation at a price of 50 cents per pound.

Note, no money or assets change hands during the signing of the contract.

90 days later, Joe must deliver 2 tons of potatoes and ACME Corporation is required to provide $1,000 to Joe for the assets.

This forward contract supersedes the current spot market price of potatoes as Joe and ACME Corporation have entered into a forward contract agreement.

In this example,

- potatoes are the underlying asset
- 50 cents per pound is the delivery price or forward price (a.k.a cash settlement)
- quantity is 2 tons (a.k.a. physical delivery)
Risks of Forward Contracts

The main risk with a forward contract is when one party fails to deliver their part of the deal.

In the above example, Joe might fail to meet the agreed quota of 2 tons or ACME Corporation could have trouble coming up with $1,000 dollars.

Problems can also arise due to market conditions.

An increase in the underlying price of potatoes can be an incentive for Joe to default and seek another buyer. Conversely, a decline in prices could push ACME Corporation to pull out of the deal.

While it might seem unthinkable to break a forward contract, there have been well documented cases.

Westinghouse Electric Corporation announced in September 1975 it would not be honoring its fixed price contract to deliver 70 million pounds of Uranium, citing legal reasons. As you can see from the article, you can’t just walk away from an agreement without facing further legal ramifications.

However, if you have a strong enough legal team, you can develop a case to argue your point.
Breaking a Forward Contract
See How Messy Things Can Get

$40 a Pound
An International Uranium Cartel of 29 entities increase the price of uranium from $4 to $40 in 3 years.

1975
September 8, 1975 Westinghouse Electric says it will sell 70 million pounds of uranium because the rise in uranium prices was

493.4 Million in Judgments against Weestinghouse
Westinghouse but it's claim and was required to pay customers that were inspected by the breach of the forward contract

1980
By 1980 Westinghouse had recovered $25 million in cash and another $75 million in commissions when Westinghouse won a suit against some of the cartel members

$$$$
After all the legal fees and unrecoverable monies from overseas cartel members, Westinghouse saw over one hundred million dollars
Another important distinction is a forward contract binds two parties and are non-transferable unless explicitly mentioned. This is one of the reasons liquidity is so low in forward contracts.

Imagine if you had to take the time to actually find a seller? What would you do if the deal fell through?

Jump on Facebook and post an ad? Doesn’t make sense right? The administrative time and expense of finding a buyer, drafting legal documents and execution of the deal does not scale.

Imagine trying to day trade using forward contracts. I do not think it’s possible in case you were wondering.

In futures, traders can buy and sell contracts freely, even with third parties. The picture below depicts the buyer and seller relationships for futures and forward contracts.

Forward vs. Futures Contracts – Liquidity/Transferability

What is not coming through in this visual is the ease by which you can trade futures, because there is no solicitation...
required to identify a buyer or seller. You do not have to hire a legal team to draft and review agreements.

Just sit at your screen, select the futures contract of your choice and execute the trade. You can place as many trades as you desire assuming you meet the necessary margin requirements.

Sounds far more appealing right?

Chapter 3: Types of Forward Contracts

There are two types of forward contracts:

- Outright forward contracts
- Non-deliverable forwards contract or non-deliverable forwards (NDFs)

Outright Forward Contracts

An outright forward contract is the delivery of the asset (physical delivery) in exchange for cash (cash settlement).

Our fictitious story of Joe and the ACME Corporation is a basic example of an outright forward contract. Joe grows and harvests potatoes which he delivers to ACME Corp. at a set price.

Non-deliverable Forward (NDF)

A non-deliverable forwards contract, or NDF, is a type of forward contract in which counterparties agree to settle the difference at the prevailing spot price.

NDFs are popular in some emerging markets where forward FX trading is not allowed as the respective government hopes to reduce their exchange rate volatility.
In foreign exchange markets, a non-deliverable forward contract is a type of forward contract in which you can buy and sell a currency at a fixed future date for a predetermined rate. Below illustrates how to quote forward forward rates:

- spot rate – premium
- spot rate + discount

Interest rates will ultimately determine if there is a premium or discount.

The NDF forward contracts represent the most common way to hedge currency volatility risks. Depending on the currency you want to hedge, the forward rate can go out as far as 10 years (for currencies such as the US dollar, Euro, British pound sterling or the Japanese yen).

Chapter 4: Who Benefits from Using Forward Contracts?

Below are four value propositions for when you would want to use forward contracts:

- Forward contracts are great for hedging business transactions where market conditions can greatly impact your profit margins.
- Some financial businesses use NDFs when investing in foreign securities or make capital payments in the acquisition of a foreign company.
- As detailed in the Joe/ACME Corporation example, outright forward contracts are used by merchants to hedge against price volatility.
- Even the average retail investor can engage in a forward contract. Let’s say you wanted to do a money transfer. Well, an NDF would allow you to lock in the exchange rate the day you sign the agreement to reduce currency volatility risk.
Chapter 5: 5 Key Differences between Futures and Forward Contracts

Now that you have a firm understanding of forward contracts, let’s dive into five key distinctions between futures and forward contracts listed in the table below.

Without giving away too much, forward contracts come from a place of no.

However, if you like to create custom deals and are not skittish when it comes to risk taking, forward contracts could prove a more attractive investment vehicle.

<table>
<thead>
<tr>
<th></th>
<th>Futures Contracts</th>
<th>Forward Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange Traded</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Regulated</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>-----------</td>
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<td>----</td>
</tr>
<tr>
<td>Standardized</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Counter party risk</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Upfront costs</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

1. Exchange Traded

Futures Contract

Futures contracts trade on exchanges and are more liquid. A speculator can trade futures markets with large contract sizes without having to worry about finding someone on the other side of the trade.

An exchange traded futures contract also allows for price transparency, providing all parties insight into each transaction.

Coming from a person that trades internationally, it always makes me sleep better at night knowing I can get out of a trade immediately.

Forward Contract

The buyer and seller privately determine the terms of the forward contract and an exchange is not required to execute the transaction. Therefore, there is no price transparency outside of these parties.

2. Regulated

Futures Contract

The Commodities and Futures Trading Commission regulate futures trading, which ensures trade transparency. Again, for me this is a must have in order to protect my money from any fraudulent activity.
**Forward Contract**

There are no exchange regulations for futures contracts vs forward contracts, and they trade over-the-counter. This also opens up more risks due to the lack of liquidity.

There are no definitive studies on the amount of forward contract scams as there is no exchange, but I would imagine the number is higher than on a futures exchange.

Many of the forward contract deals take place across country lines, so seeking justice is likely a tricky situation.

**3. Standardized**

**Futures Contract**

For example, a Crude Oil futures contract controls 1,000 barrels of Light Sweet Crude Oil. This contract does not change, no matter how far out you buy the futures contract.

Having a standard metric and pricing structure allows you to look at historical trends to identify trading opportunities.

**Forward Contract**

In forward contracts, products are not standardized; each contract is unique to the terms of the contract.

For example a buyer and seller can negotiate a forward contract of potatoes for a quantity of 2 tons, while someone else might negotiate another contract for 20 tons.

Herein lies a big opportunity if you are a great sales person. In the futures market, it’s virtually impossible to push a futures contract down to your desired price. However, on an individual deal basis, all you need to do is get someone to agree to the terms of the trade offline.

If a person sees the same value as you over the specified time frame, you my friend have a deal.
In addition, you can develop custom delivery time frames.

In the futures market, the exchange sets the expiration date for contracts. However, when creating forward contracts, you can setup custom delivery times that work best for both parties.

Just make sure you understand seasonal shifts, especially if you are transacting in commodities.

4. Counter-party risk

Futures Contract

When you trade futures, the exchange takes on the counter-party risk. Furthermore, a performance bond or an initial margin is required by both the buyer and seller of the futures contract.

Besides the initial margin, futures contracts are marked-to-market on a daily basis and depending on the price, both the buyer and the seller’s margin account is credited or debited. These measures ensure minimal risk of default by participants.

Forward Contract

With a forward contract, there is a high level of counter-party risk. Although both parties agree to the terms of the forward contract, as illustrated by the Westinghouse example, there are ways to break the arrangement.

Not only do you run the risk of losing the deal, but think about the potential opportunity costs of waiting 90 days on a deal, only to have it fall through.

The onus is on you to ensure the terms of the deal and the person you are trading with has skin in the game.

Why reference skin in the game?
Well, since no assets exchange hands when signing the deal, how do you know the individual can really deliver on the goods or cash? This level of certainty has to be developed over time as you build your relationships.

5. Upfront Costs

Futures Contract

Picking up where we left off in section 4, there are upfront costs to trade futures. Depending on the exchange you trade and your brokerage firm, you are required to have a certain amount of cash in your account.

As mentioned earlier, this performance bond and maintenance margin are required to execute trades. Fall below these thresholds and your account will slip into an inactive status.

Forward Contract

There are no upfront costs with forward contracts. All you need is to agree on price, but there are no financial obligations upfront.

This is great if you are the buyer, but if you work hard to deliver a product and the buyer flakes out, you better have a plan b.

Chapter 6: Should You Trade Future Contracts or Forward Contracts?

By now the obvious answer for me is futures contracts.

Besides the 5 key points mentioned in this article, the liquidity of the futures market really offers you a better chance of taking advantage of price volatility.

Also, futures trading allows you to trade in a regulated and transparent environment, which reduces the likelihood of any
Conversely, forward contracts may work better for you if you like to make deals with people and do not enjoy reviewing reams of data and historical price charts.

Remember, forward contract trading activity does not scale. The number of market participants is heavily dependent on your personal network.

Which contract type is best for you?