

- **Derivatives** are instruments that derive their value and payoff from another asset, called underlying asset. Derivatives include options, forward contracts, futures contracts and swaps. Investors, including firms, are risk averse. They aim at reducing risk by hedging through derivatives.
- **Hedging** helps to (i) reduce costs of financial distress, (ii) isolate the effects of changes in external factor like interest rates and foreign exchange rates on profitability, and (iii) allow managers to focus on improving operating efficiency rather worrying about changes in factors on which they have no control.
- **Forward Contract** is an agreement between two parties, called counterparties, to buy and sell an asset at a future date at a price agreed upon today. There is no immediate flow of cash. Cash is paid or received on the due date. Forward contracts are obligations. They are not traded on organised exchanges.
- **Futures Contract** is like a forward contract. But, unlike forward contracts, futures contracts are traded on organised exchanges. Thus, they are liquid. Yet another feature of futures contract is that they are marked to market. Prices differences every day are settled through the exchange clearing house. The clearinghouse pays to the buyer if the price of a futures contract increases on a

particular day. The seller pays money to the clearing house. The reverse will happen if the prices decrease.

- **Swaps** are arrangements to exchange cash flows over time.
- **Currency Swap** The agreement provides for exchanging payments denominated in one currency for payments in another currency over a period of time.
- **Interest Rate Swap** one type of interest payments, say, fixed-rate payments, is exchanged for another, interest payments, say, floating-rate payments. The floating interest rates may be tied to LIBOR.