19BAE710-FINANCIAL DERIVATIVES

Futures and options contracts are both derivatives, but they have distinct characteristics and differences in terms of their structure, obligations, and flexibility. Here's a brief overview of the key differences between futures and option contracts:

Futures Contracts:

1. **Obligation:**
   - Buyer/Seller Obligations: Both the buyer and seller of a futures contract are obligated to fulfill the terms of the contract. The buyer agrees to purchase, and the seller agrees to sell the underlying asset at the specified price on the contract's expiration date.
2. **Flexibility:**
   - Limited Flexibility: Futures contracts are standardized and have limited flexibility in terms of modifying contract specifications. The terms are set by the exchange.
3. **Rights and Obligations:**
   - Mutual Obligations: Both parties have mutual obligations to fulfill the contract. The buyer cannot choose to let the contract expire without taking delivery, and the seller cannot choose not to deliver.
4. **Traded on Exchanges:**
   - Exchange-Traded: Futures contracts are traded on organized exchanges, providing a centralized marketplace. The exchange acts as an intermediary, guaranteeing the performance of the contract.
5. **Settlement:**
   - Physical or Cash Settlement: Settlement of futures contracts can be either physical (delivery of the actual asset) or cash settlement (the difference in the contract's value is paid).

Options Contracts:

1. **Obligation:**
   - Buyer's Right, Seller's Obligation: The buyer of an options contract has the right, but not the obligation, to exercise the option. The seller (writer) is obligated to fulfill the terms if the buyer chooses to exercise.

2. **Flexibility:**
    - High Flexibility: Options contracts are more flexible, with various strike prices and expiration dates. Contract specifications can be customized through over-the-counter (OTC) markets.
3. **Rights and Obligations:**
    - Asymmetric Rights and Obligations: The buyer has the right to choose whether to exercise the option, while the seller has the obligation to perform if the buyer decides to exercise.
4. **Traded on Exchanges and OTC:**
    - Exchange-Traded and OTC: Options can be traded on organized exchanges, similar to futures, or traded over-the-counter (OTC) between two parties directly.
5. **Settlement:**
    - Physical or Cash Settlement (Depending on Option Type): Options can be settled through the physical delivery of the underlying asset (for some options) or through cash settlement (the difference in the asset's value).
6. **Types:**
    - Call and Put Options: Options come in two main types - call options, which provide the right to buy the underlying asset, and put options, which provide the right to sell the underlying asset.
7. **Premium:**
    - Option Premium: The buyer pays a premium to the seller for the right to exercise the option. This premium is the only financial commitment for the option buyer.

In summary, while both futures and options are derivatives, futures contracts involve mutual obligations and are standardized, with limited flexibility. On the other hand, options contracts provide the buyer with the right (but not the obligation) and offer more flexibility in terms of customization. Understanding these differences is crucial for investors and traders when choosing between futures and options based on their specific needs and risk preferences.