Asset class: Derivatives (OTC and ETD)
Educational document for clients

Banque Bordier & Cie SCmA

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This educational document provides a simple overview of derivatives (exchange-traded and over-the-counter), how they work and their main risks.
It is intended for clients without in-depth financial expertise and ***does not replace the official contractual documentation or applicable regulatory information.***

1. Introduction

Derivatives are a special category of financial instruments whose value depends on the performance of an underlying asset. They are used for risk hedging purposes as well as for portfolio optimisation and diversification.

Unlike traditional investments (equities, bonds, real estate), derivatives do not confer ownership rights over an asset. They are based on financial contracts whose terms are defined in advance and may involve leverage.

Due to their complexity and the specific risks they entail, derivatives require a thorough understanding of how they work. They are generally intended for investors with sufficient experience and the ability to withstand potentially high volatility.

2. What is a derivative?

A derivative is a financial instrument whose value depends on the performance of an underlying asset.

The underlying asset may be, for example:

- a share,
- a stock market index,
- a bond,
- a currency,
- a commodity,
- an interest rate.

Unlike a direct investment, the investor does not purchase the asset itself, but enters into a contract whose value changes in line with that asset.

Derivatives can be used:

- to hedge against risk,
- to take a position on an anticipated change,
- to optimise portfolio management.

3. OTC and ETD: what is the difference?

Derivatives fall into two main categories:

3.1 Exchange-traded derivatives (ETDs)

These are standardised and traded on organised markets.

Examples: futures contracts, listed options.

Characteristics:

- standardised contractual terms,
- clearing via a clearing house,
- increased transparency,
- generally higher liquidity.

3.2 Over the counter (OTC) derivatives

These are traded directly between two counterparties (often a bank and a customer).

Characteristics:

- tailored terms,
- greater flexibility,
- direct exposure to counterparty risk,
- potentially lower liquidity.

4. Main types of derivatives

The main types of derivative instruments used in financial markets include the following categories:

- **Futures/Forwards**: Commitment to buy or sell an asset at a specified price on a future date.
- **Options**: The right (but not the obligation) to buy or sell an asset at a predetermined price during a specified period or on a specific date.
- **Swaps:** Contracts for the exchange of financial flows, e.g. exchange of fixed rates for variable rates, exchange of currencies.
- **Credit derivatives**: Instruments used to transfer or hedge default risk.

5. Key features of derivatives

Derivatives have several important characteristics. Their value depends on the performance of an underlying asset, without the investor necessarily owning that asset. They can incorporate leverage, which can amplify both gains and losses. Their duration is generally determined in advance and their valuation depends on several factors, including the price of the underlying asset and market conditions.

Due to these specific characteristics, it is important to have a good understanding of how they work before using them.

Derivative products have several important characteristics:

- **Potential leverage**: significant exposure can be obtained with a limited initial investment.
- **Contractual commitment**: some derivatives involve a firm obligation.
- **Fixed term**: specific maturity date or defined period.
- **Margin or security deposit**: required in certain cases.
- **Dynamic valuation**: depends on multiple parameters (price of the underlying asset, volatility, time remaining, interest rate).

6. Objectives of derivatives

Derivatives are financial instruments whose value depends on the performance of an underlying asset (e.g. a share, bond, interest rate, currency, index or commodity). Their purpose may vary depending on the investor's strategy.

Derivatives can be used for the following purposes, among others:

6.1 Hedging

A derivative can be used to reduce or neutralise an existing financial risk.

In this case, the instrument is used in direct connection with an underlying position held by the investor.

Examples:

- Protection against rising interest rates;
- Fixing an exchange rate for a future foreign currency transaction;
- Protection against a decline in the value of an equity portfolio.

In a hedging strategy, the derivative product is primarily intended to limit the adverse impact of market movements. However, it may generate costs or restrict the potential for gains in the event of favourable market developments.

6.2 Optimising the risk/return profile

Derivatives can also be used to adjust the risk/return profile of an existing portfolio.
In this context, they can be used to:

- improve potential returns (e.g. by collecting premiums);
- structure exposure to certain market conditions;
- combine partial protection with participation in rises.

These strategies generally involve accepting conditional risk or risk limited to certain market scenarios. They can significantly alter the initial risk profile of the portfolio.

6.3 Directional exposure

A derivative can be used to take a position on the future performance of an asset or market without directly holding the underlying asset.

In this case:

- the investor anticipates a rise or fall in the market;
- exposure can be obtained with a lower initial investment than the total economic exposure;
- leverage may be present.

Leverage increases sensitivity to market fluctuations. Depending on the structure of the product, losses may be significant and, in some cases, exceed the initial capital invested.

6.4 General remark

The same type of derivative product may pursue different objectives depending on how it is used. The purpose depends on the investor's overall strategy and whether there is a corresponding underlying position.

The use of derivative products must be assessed in light of:

- the client's risk profile and financial situation;
- their experience and knowledge of financial instruments;
- the investment objectives defined in the contractual relationship.

The specific risks associated with derivatives are described in the relevant section.

7. What are the main types of derivative products?

Derivatives are a category of financial instruments whose value depends on the performance of an underlying asset (such as a share, bond, interest rate, currency, index or commodity).

They can take different legal and economic forms. Some involve a firm commitment between the parties, while others confer a right without an obligation. Their contractual structure determines, in particular:

- the nature of the reciprocal commitments;
- the settlement terms (physical delivery or cash settlement);
- whether or not there is leverage;
- the extent of the risk of loss.

Understanding the type of instrument used is essential in order to properly assess how it works, its risk profile and its suitability for the investment strategy pursued.

The main categories of derivative products are described below.

- **Forward and futures contracts**

  Forward contracts are derivative instruments whereby two parties make a firm commitment to buy or sell an underlying asset at a specified future date and at a price fixed when the contract is concluded.

Unlike options, these instruments create a bilateral obligation: at maturity, the transaction must be executed, unless it is closed out early or offset.

- **Options**

  An option is a derivative instrument that gives its holder the right, but not the obligation, to buy or sell an underlying asset at a specified price (strike price) during a specified period or on a specified expiry date.

  In return for this right, the buyer of the option pays a premium to the seller (writer) of the option.

- **Swaps**

  A swap is a derivative contract whereby two parties agree to exchange, according to predefined terms, financial flows calculated on the basis of a notional amount for a specified period.

  The notional amount serves as the basis for calculating the flows exchanged, but is not, in principle, exchanged between the parties.

- **Credit derivatives**

  Credit derivatives are financial instruments that enable the transfer of all, or part of the credit risk associated with an issuer or debt instrument, without necessarily transferring ownership of the underlying asset.

  They thus separate the default risk from the debt security to which it relates.

8. The main players in the derivatives markets

An investment in derivatives involves several participants, whose roles vary depending on whether the instrument is exchange-traded (ETD) or over-the-counter (OTC).

- **Investor**: The investor uses derivatives to take a position on the evolution of an underlying asset or to hedge against an existing risk (e.g., changes in interest rates or currencies). Depending on the strategy, the objective may be protection, optimization, or increased market exposure.

- **Financial intermediary**: The bank or broker executes orders and, where applicable, structures the contract. It may also provide advisory, clearing, and collateral management services. Its role is central for market access and the proper execution of transactions.

- **Clearing house (for ETDs)**: For exchange-traded products, a clearing house stands between the parties. It guarantees contract performance and reduces counterparty risk by centralizing and securing transactions. It may require margin deposits to cover changes in the value of positions.

- **Counterparty (for OTC)**: In the case of over-the-counter products, the contract is concluded directly between two parties, typically a bank and a client. The investor is therefore exposed to the credit risk of this counterparty, which must be able to meet its obligations.

- **Supervisory authorities**: The relevant authorities oversee derivatives markets, set requirements for transparency and risk management, and monitor participants to limit systemic risk. Their role is to preserve the integrity and stability of financial markets.

9. Stages of a derivatives transaction

The life cycle of a derivative depends on its nature (ETD or OTC, option, future, swap, etc.), but it generally follows several clearly defined contractual steps.

- **Conclusion of the contract**: The first stage consists of the conclusion of the contract between the parties. The essential characteristics are set at the outset: underlying asset, strike price or forward price, maturity, settlement terms and specific conditions. In the case of exchange-traded products, these parameters are standardised; for OTC contracts, they can be tailored to suit individual needs.

- **Possible margin deposit:** For certain derivatives, particularly futures contracts, a security deposit (initial margin) is required. This sum is intended to cover potential fluctuations in the value of the contract and reduce the risk of default.

- **Daily value adjustments**: For contracts cleared through a clearing house, the value of positions is revalued daily. Gains and losses are settled on an ongoing basis, which may result in additional margin calls if the position moves unfavourably.

- **Contract expiry**: On the scheduled date, the contract expires. Depending on its nature, it may be exercised (in the case of an option) or automatically settled.

- **Cash settlement or delivery of the asset**:
  The contract may be settled:
  - by cash settlement corresponding to the difference in value,
  - or by physical delivery of the underlying asset, if the contract so provides.

Early closure: In many cases, the position may be closed before maturity by an opposite transaction or a repurchase. The exit conditions depend on the type of derivative and the liquidity of the market.

10. Derivative yield structure

The return on a derivative depends on several interrelated factors.

It is influenced in particular by:

- **changes in the underlying asset**: changes in the price, rate or index to which the product is linked are the main determinant of its performance;
- **leverage**: economic exposure greater than the capital invested can amplify both upward and downward movements;
- **market volatility**: certain derivatives (particularly options) are sensitive to expectations of future fluctuations;
- **the time remaining until maturity**: the value may change depending on the remaining term of the contract;
- **associated costs**: margins, premiums, commissions or financing costs may reduce the net return.

When leverage is involved, both gains and losses may be amplified. Depending on the structure of the product, the loss may amount to the entire capital invested or even exceed it.

11. Main risks associated with derivatives

Derivatives present specific risks that may differ significantly from those of traditional financial instruments. Due to their contractual structure and the possible presence of leverage, their risk profile can be complex and change rapidly depending on market conditions.

The main risks are described below:

- **Market risk:** price fluctuations linked to general developments in the financial markets.

- **Leverage risk:** Certain derivatives allow for economic exposure greater than the capital invested.
  Leverage amplifies potential gains, but also losses. A moderate change in the underlying asset can therefore result in a significant loss. Depending on the structure of the product, the loss may be equal to or even exceed the total capital invested.

- **Counterparty risk**: In the case of over-the-counter (OTC) transactions, the investor is exposed to the risk that the counterparty may not be able to meet its contractual obligations.

  This risk depends in particular on the financial strength of the counterparty and the guarantee mechanisms in place (collateral, margin calls, central clearing).

- **Liquidity risk**: Some derivatives may be difficult to sell before maturity or may have only a limited secondary market.

  In times of market stress, liquidity can deteriorate rapidly, making it costly or temporarily impossible to close a position.

- **Margin call risk**: For certain instruments (particularly futures and cleared swaps), initial margin deposits and margin calls may be required in the event of adverse market developments.

  Investors must be able to provide additional liquidity at short notice, otherwise the position may be liquidated.

- **Legal and operational risk**: Derivatives are based on specific, sometimes complex contractual documentation. A differing interpretation of the contractual terms or a contractually defined credit event may influence the economic outcome.

  Operational errors, technical failures or settlement incidents may also affect the transaction.

Due to these various factors, **derivatives may have a high risk profile and are not suitable for all investors**. Their use must be assessed in light of the client's investment objectives, financial situation and experience.

12. Main advantages and disadvantages

Advantages	Disadvantages
▪ Risk management and hedging	▪ Structural complexity
▪ Strategic flexibility	▪ Risk of significant losses
▪ Access to certain markets	▪ Counterparty risk
▪ Leverage	▪ Liquidity risk
▪ Return optimisation	▪ Margin calls
▪ Capital efficiency	▪ Increased sensitivity to market conditions
	▪ Implicit and explicit costs

The above is a summary and non-exhaustive presentation of the main advantages and disadvantages of derivatives.

13. How to invest in derivatives

Investing in derivatives can be done in different ways, depending on the type of instrument and the investor's profile.

13.1 Direct trading on organised markets

Certain standardised derivatives (e.g. listed futures and options) are traded on organised markets. In this case:

- the contractual terms are standardised;
- a clearing house acts as a central counterparty;
- margin deposits and margin calls may be required;
- liquidity is generally higher for common instruments.

Investors must have an account authorised for derivatives trading and meet the applicable knowledge and financial capacity requirements.

13.2 Over-the-counter (OTC) transactions

Other derivatives (e.g. swaps or customised forwards) are concluded directly between two parties. These transactions:

- can be tailored to the specific needs of the investor;
- are based on specific contractual documentation;
- expose the investor to counterparty risk;
- may require collateral to be put in place.

13.3 Indirect investment

Exposure to derivatives can also be obtained indirectly:

- through investment funds that use derivatives;
- through structured products incorporating a derivative component;
- through strategies managed under a management mandate.

In these cases, the investor does not directly enter into the derivative contract, but bears the economic effects.

13.4 Prerequisites

Before investing in derivative products, it is generally necessary to:

- assess your experience and knowledge of complex instruments;
- analyse one's ability to bear significant losses;
- understand margin call mechanisms, where applicable;
- verify that the instrument is appropriate for your investment objectives

Investing in derivatives requires a proper understanding of how they work and the risks involved. **These instruments are not suitable for all investors**.

14. Closing or liquidating a position in derivatives

A derivative position may be closed in various ways, depending on the nature of the instrument and the contractual terms. The "liquidation" of a derivative does not necessarily correspond to a sale, as in the case of a share. It may result from offsetting, contractual maturity or financial settlement.

The main terms and conditions are described below:

14.1 Closure by reverse transaction

For instruments traded on an organised market (e.g. listed futures or options), a position may be closed out before maturity by entering into an opposite transaction:

- sale of a previously purchased contract;
- purchase of a previously sold contract.

This transaction neutralises the initial exposure. The economic result corresponds to the difference between the entry price and the exit price, adjusted for any costs.

14.2 Contractual maturity

If the position is not closed out before maturity, it expires on the date specified in the contract.

Depending on the type of derivative:

- a cash settlement may occur;
- physical delivery of the underlying asset may be required;
- the instrument may expire worthless (e.g. certain options).

14.3 Early termination (over-the-counter transactions)

For over-the-counter (OTC) derivatives, such as certain swaps or forwards, early termination may require:

- an agreement between the parties;
- the conclusion of an offsetting transaction;
- payment of a termination indemnity calculated according to market conditions.

The termination value then depends on the market value of the contract at the time of closure.

14.4 Margin calls and forced liquidation

For certain instruments involving margin deposits, unfavourable market developments may result in margin calls.

If additional funds or collateral are not provided within the required time frame, the position may be automatically liquidated in order to limit losses. This liquidation may occur under unfavourable market conditions.

14.5 Financial consequences

The closing of a derivative product may result in:

- a gain;
- a loss;
- or a neutral result.

The result depends on market conditions at the time of closing, associated costs and, where applicable, applicable contractual mechanisms.

Understanding the terms of closure is essential, as they **can have a significant impact on the financial result and on the investor's obligations**.

15. Bordier's range of derivative products

The Bank offers its clients a range of derivative products, whether traded over-the-counter (OTC) or on organised markets (ETD). Depending on the client's profile, these instruments can be used to hedge certain risks, optimise allocation or seize market opportunities. Their use is based on specialised analysis and careful assessment of the associated risks, within a strictly controlled framework that is consistent with the client's investment objectives. Thanks to its open architecture, Bordier ensures that it offers its clients the best market conditions.

16. Important information

This document is provided for informational and educational purposes only and does not constitute personalised financial advice. Nor should it be interpreted as an advertisement or an offer of financial instruments. The content presented is neither exhaustive nor intended to cover all the characteristics and risks associated with the relevant category of financial instruments.

This information is intended to provide a factual overview and should not be used as the sole basis for investment decisions. Past performance is not indicative of future results, and the value of investments may fall as well as rise.

For general information on financial instruments, please refer to the Swiss Bankers Association's brochure entitled 'Risks inherent in trading in financial instruments', available on our website under the heading Legal & Compliance, Switzerland, FINSA, Guidelines Risks Involved in Trading Financial Instruments (published by SBA): https://www.bordier.com/legal-and-compliance/switzerland/finsa/.

If, for the relevant type of financial instrument, a key information document (KID) or a prospectus has been drawn up in accordance with the applicable legal provisions, these documents can be viewed and downloaded from our website under the heading Legal & Compliance, Switzerland, FINSA, Key Information Document (KID), at the following address: https://www.bordier.com/legal-and-compliance/key-information-documents-kids/

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