UniCredit Bank

INTEREST RATE FUTURES

Definition

Interest-rate futures are forward (future) contracts on short-term investments - money market or capital market instruments - with the standardised maturity and standardized size of contract traded on the stock exchange. Consequently, by making this contract the buyer assumes an unconditional commitment that must be fulfilled no matter how the futures price develops.

Return

The gains or losses achieved by speculative users of interest rate futures result from the interest rate or price differential at the end of the future period subject to the terms of the contract.

The use of interest-rate futures for hedging purposes reduces the financial risk of existing or future positions.

Interest risk

The value of an interest-rate future depends primarily on the yield trend of the underlying instrument. The buyer's risk is therefore comparable to that of a holder of the underlying instrument. The risk results from the uncertainty over future interest rate changes in the market. The interest-rate risk encountered by the buyer or seller of a futures contract is the obligation to put up further margin (to increase the margin) or to complete the deal upon maturity, if interest rates rise or fall. Generally, this risk is all the higher, the more pronounced the increase or decrease in current interest rates is. The resulting potential of loss may be many times higher than the original capital invested (initial margin).

Liquidity risk

In some markets, the closing out of futures positions (sale/repurchase of contracts) may lead – specifically closely before maturity - to heavy increase of supply or demand and to subsequent fluctuation in prices, or dramatic adverse price movements