UWEALTH

GUIDE TO UNDERSTANDING ASSET CLASSES :

FORWARDS AND SWAPS

U Wealth : Your partner in mastering financial instruments.

We want you to feel comfortable making suitable investment decisions based on knowledge of the opportunities and risks of given financial instruments.

SEPTEMBER 2026

FINANCIAL INSTRUMENTS: OPPORTUNITIES AND RISKS

The higher the complexity of a financial instrument, the higher its potential risk –but the higher, too, the opportunities for returns.

WHAT ARE FORWARDS AND SWAPS?

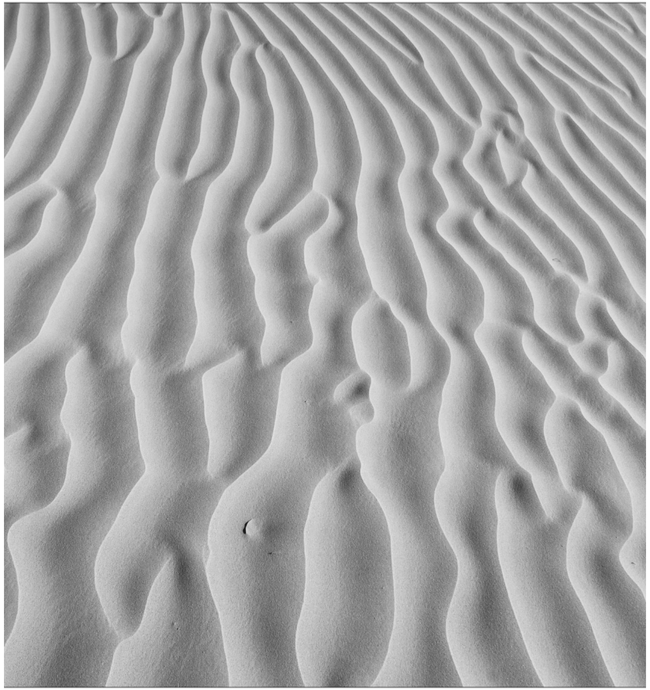
Forwards and swaps are derivative instruments.

A derivative is a **security whose price is dependent on,** or derived from, one or more **underlying** assets.
The derivative itself **is merely a contract** between two or more parties.

There is a crucial difference between a direct investment and an investment in a derivative :

- when **directly investing** in a financial instrument such as a stock or a bond, the investor **participates directly** in its risks, gains, and losses.
- when investing in a **derivative**, the investor invests **in a contract, note, unit, or certificate**. This **adds specific characteristics**, risks, obligations, and/or rights to the assets on which the derivative is based.

Forwards allow the investor to buy/sell an asset on a specific date in the future at a specific price.
Swaps are agreements between two parties to purchase and sell identical amounts of an asset at two different dates (usually spot to forward).
Both forwards and swaps are **private agreements** between the buyer and the counterparty.
The most common underlying assets of forwards and swaps are currencies or precious metal currencies.



ADVANTAGES/DISADVANTAGES

Advantages

- **Cost efficiency**
  By leverage: the gross amount invested is smaller than trading the individual underlyings.
- **Hedging instruments**
  Losses can be limited by long options (buying a right).
- **Flexibility**
  Ability to trade a wide range of underlyings and to lock in prices.

Disadvantages

- **Not standardized**
  Forwards and swaps are not standardized contracts such as futures and access to the forward market is therefore limited.
- **Risk of losses**
  If used with a speculative intention, strategies such as leveraging and short selling bear the risk of overproportional or even unlimited losses.

WHAT ARE FORWARDS AND SWAPS?

A **forward** is a customised derivative contract obligating counterparties to buy (receive) or sell (deliver) an asset at a specified price on a future date.

A **swap** is an agreement between two parties to exchange cash flows during a set period of time. Swap contracts have two legs – a spot transaction and a forward transaction – for the same quantity. Therefore, they offset each other.

Both forward and swap contracts can be used for hedging or speculation, although their non-standardised nature makes them particularly useful for hedging.

In forex markets, forwards are used to exploit arbitrage opportunities at the cost of carrying different currencies.

IMPORTANT RISKS TO CONSIDER

Counterparty risk

The unregulated nature of the forwards market means that it may be difficult to assess the creditworthiness of the counterparty in a worst-case scenario.

Settlement risk

Forwards are only settled on the settlement date and are not marked-to-market like futures.

Over-the-counter only

Forwards and swaps are unregulated and non-standardised contracts that can be acquired only through the over-the-counter market.

WHAT TO EXPECT FROM FORWARDS AND SWAPS

Investment horizon

- Shorter term
- Medium term

Income expectation

- Capital gain

Market expectation

- Increasing
- Decreasing

A CLOSER LOOK AT FORWARDS AND SWAPS

GENERAL TYPES OF FORWARD PRODUCTS

There are two major types of transactions.

Spot transactions

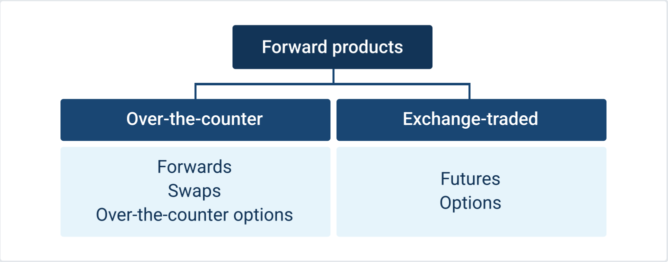
Spot transactions are transactions based on the foreign exchange rates currently available.
They include:

- currencies
- precious metals

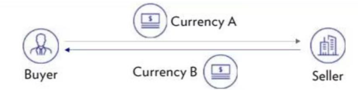
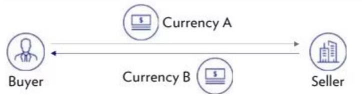
Forward products

Forward products are transactions that are settled in the future.
They include:

- outright
- other forward products, such as options. These types of transactions carry different risks and require additional knowledge of derivative instruments.



HOW FORWARDS AND SWAPS WORK

Example	Characteristics	Motivation
Spot Today 	• Spot trades are usually **settled within two working days.**	• Direct need for currency
Forward Future date 	• Agreement to buy/sell **in the future at a price fixed today.**	• Speculation • Hedging
Swap Today (spot leg) Future date 	• Agreement to purchase a defined amount of a currency today with the agreement to sell the same amount of this currency again at a future date.	• Speculation • Hedging

DIFFERENCES BETWEEN FORWARDS AND FUTURES

Forwards are similar to futures with regards to their purpose: they allow the investor to buy/sell an asset on a specific date at a specific price.

The major difference is that **futures are standardised exchange-traded contracts**, while **forwards are basically private agreements** between two parties that are less rigid in terms and conditions.

Settlement and delivery differ.

Forwards

Forwards have one settlement date and are cleared/settled on that date only

Futures

Changes in market price are cleared daily. Settlement can occur on a range of dates.

Due to these differences, futures and forwards differ in their risk exposure.

Counterparty risk

Since forwards are agreements that are traded over the counter, the counterparty risk tends to be higher than in the case of futures and requires the respective carefulness in the selection of the investment.

Liquidity risk

Depending on the type of contract, forwards tend to have higher liquidity risks.

Thus, selecting a trustworthy counterparty is crucial.

NON-DELIVERABLE FORWARDS

Forwards on currencies are often used as a hedge against the volatility of currency exchange rates.

Non-deliverable forwards are currency forwards that involve

- one freely obtainable currency (e.g. USD) and,
- a **currency that is not freely obtainable**, thinly traded, or on which forward trades have been banned (hence are non-deliverable).

The trade is defined by:

- a notional amount
- the non-deliverable forward rate: actually the estimated forward rate of the non-deliverable currency
- fixing and settlement dates.

The non-deliverable forward is traded over the counter and **always settled in cash** as the difference between the actual spot rate at the fixing date and the non-deliverable forward rate.

FOR FURTHER INFORMATION ON RISKS OR ON OTHER AVAILABLE FINANCIAL INSTRUMENTS, PLEASE REQUEST TO YOUR RELATIONSHIP MANAGER ON U WEALTH EDUCATIONAL MATERIAL.

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