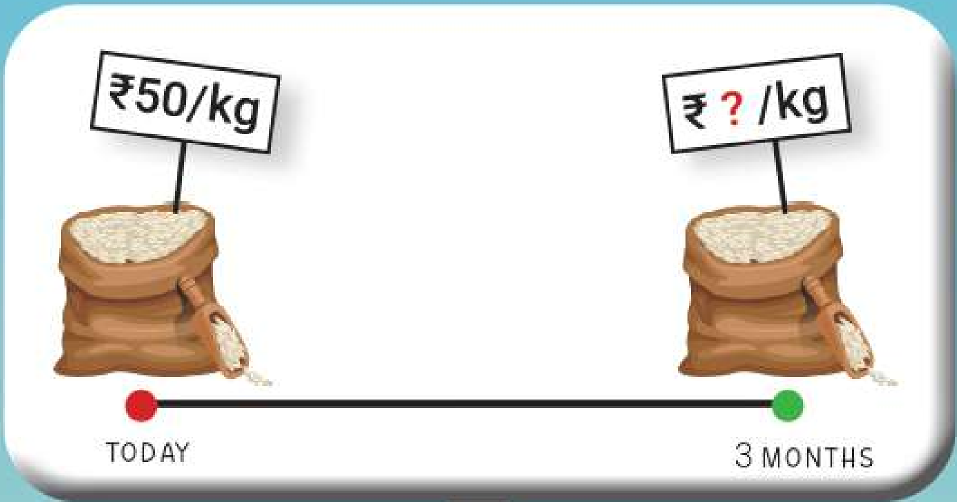
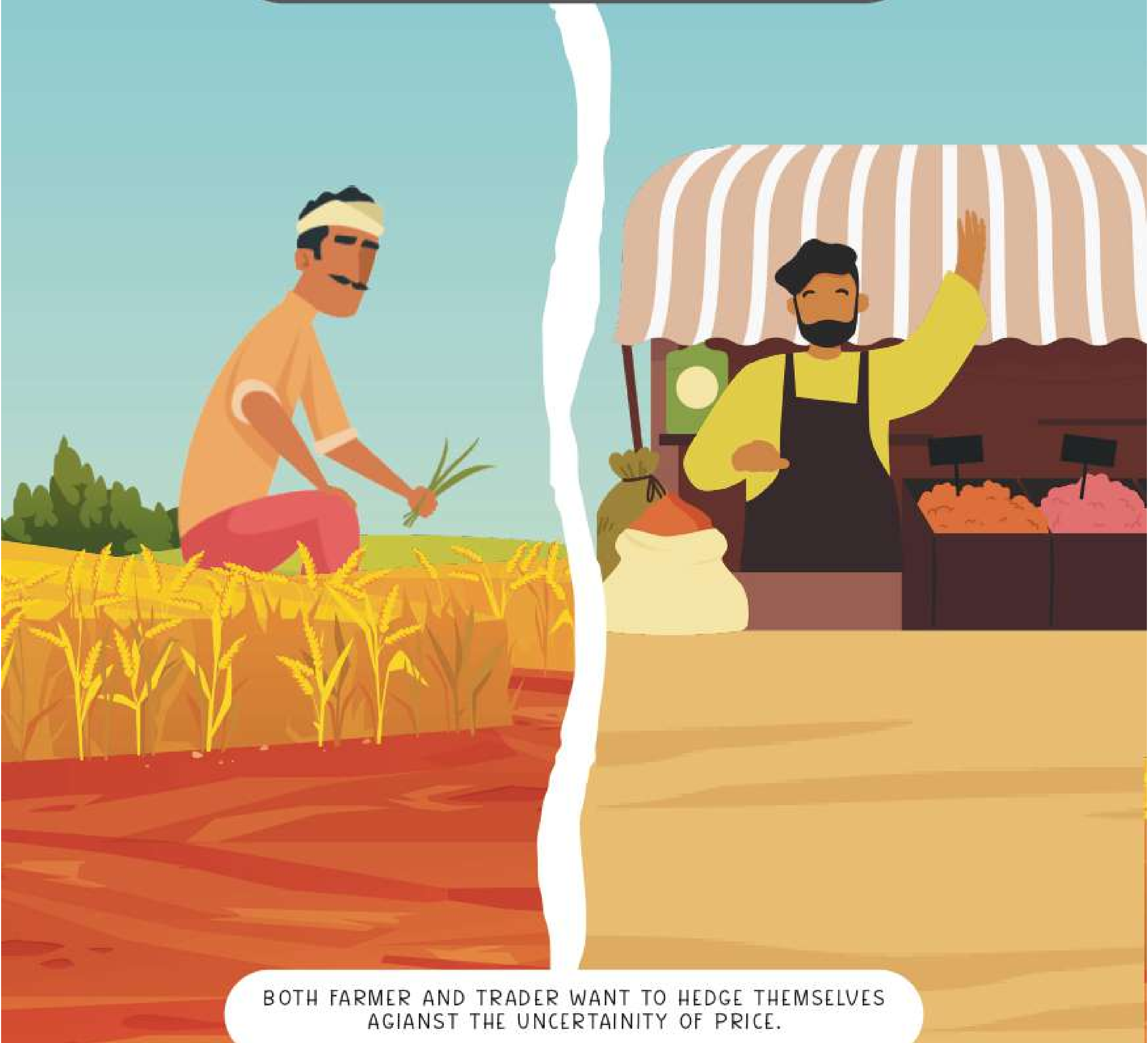
2.3 WHAT IS FORWARD CONTRACT ?

Let us understand this whole working of a forward contract with a practical example.

Imagine you are a farmer growing wheat on your farm. Now, there is a fair probability that by the time your crop is ready to be sold (say 3 months from today) the price might go down from its current rate of ₹50/kg. As a farmer, you do not want that. You cannot or do not wish to take the risk of price uncertainty in the market. You are afraid that you might have to sell your wheat at a lower price as you predict that the price is going to fall.

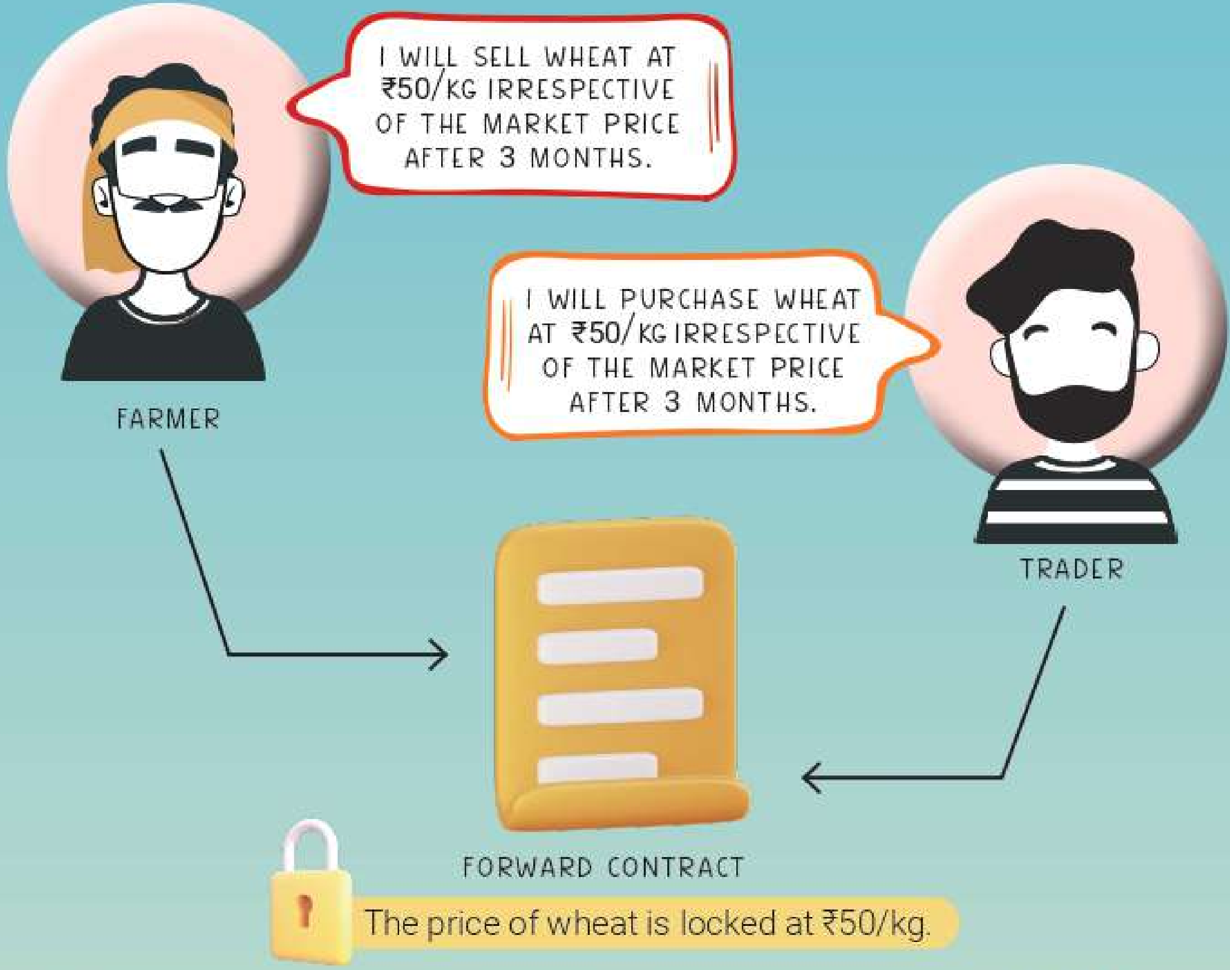
You know a friend, Sam (trader), who has a store where he sells wheat. This friend of yours is afraid that the price of wheat in the market after 3 months might go up.





BOTH FARMER AND TRADER WANT TO HEDGE THEMSELVES AGIANST THE UNCERTAINITY OF PRICE.

Both of you agree upon solving this fear of price uncertainty by entering a forward contract with each other.



You both lock the price of wheat on a mutually agreed price : ₹50/kg. As per this contract, after 3 months, you agree to sell your entire wheat grown (quantity agreed mutually) to your friend Sam at ₹50 per kg and Sam agrees to purchase your entire wheat at ₹50 per kg.

This is how both parties can reduce risks. Now at the time of transaction, one party will profit and other will incur losses. However, both parties win as the overall risk and uncertainty is reduced.

WHAT IF THE PRICE GOES DOWN?

ACTUAL DELIVERY OF ITEMS

You go to your friend Sam's store to physically deliver the wheat at ₹50/kg. Sam honours the agreement, buys the wheat at ₹50/kg, makes the payment, and sells the wheat in the market at a loss of ₹5/kg.

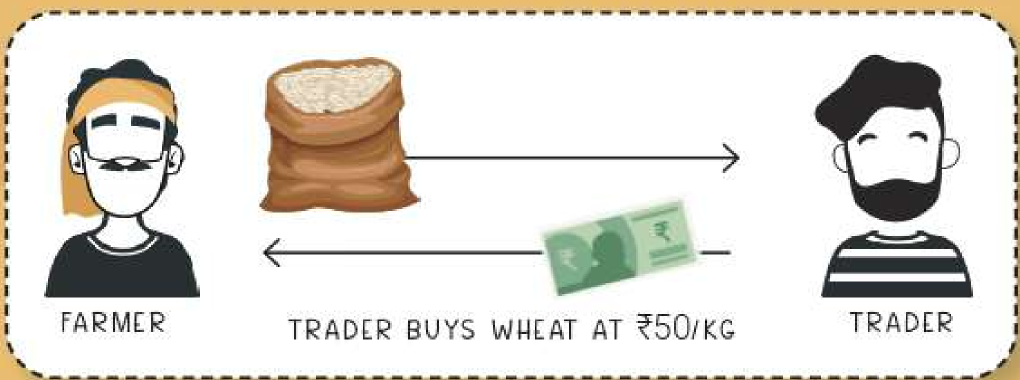
PAYING THE DIFFERENCE

Sam calls you and says that you need not come to deliver the wheat, I am sending you the difference amount of ₹5/kg to settle the agreement.

WHAT IF THE PRICE GOES UP?

ACTUAL DELIVERY OF ITEMS

You go to your friend Sam's store to physically deliver the wheat at ₹50/kg. Sam honours the agreement, buys the wheat at ₹50/kg, makes the payment, and sells the wheat in the market at a loss of ₹5/kg.



PAYING THE DIFFERENCE

Sam calls you and says that you need not come to deliver the wheat, he is sending someone to collect ₹4/kg from you.

WHAT IF ONE PARTY DEFAULTS?

Sam ghosts you and later refuses to honour the agreement of purchasing wheat from you at ₹50/kg. Since he can buy the wheat from the market at a lower rate, he dishonours the contract with you.

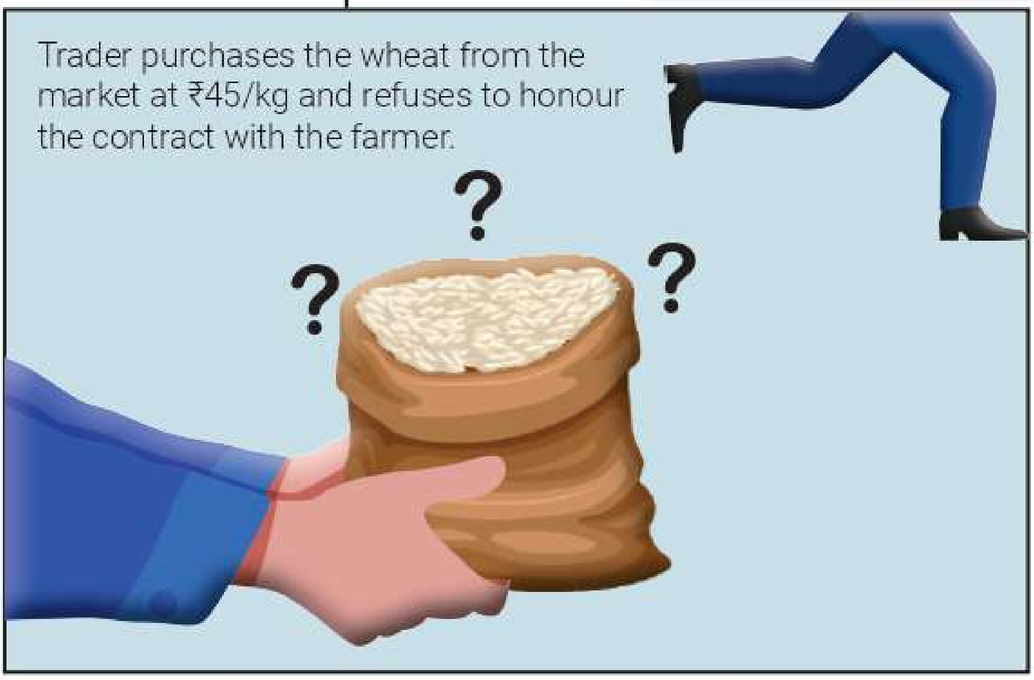
TRADER DISHONOURS THE CONTRACT

In a forward contract, no regulator is involved to ensure the agreement is honoured by the two parties involved. It creates room for counterparty default risk.

Although the contract is legally binding, the legal proceedings following the default may be very time-consuming and expensive.

EXPECTATION

REALITY



> "COUNTERPARTY DEFAULT RISK MEANS THAT THE PARTICIPANT WHO ENDS UP HAVING A LOSS AT THE END OF THE CONTRACT MIGHT REFUSE TO HONOUR THE AGREEMENT AND HENCE DEFAULT."