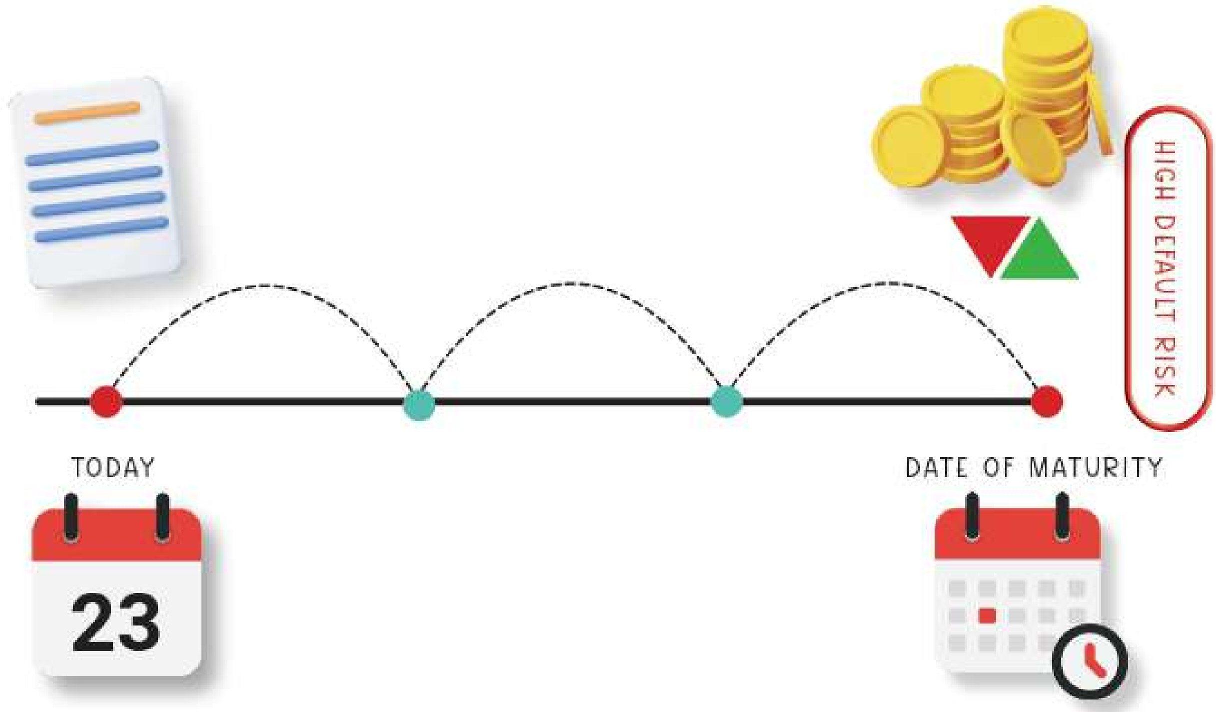
2.4 CONCLUSION

Forward contracts are a widely used derivative in over-the-counter practices. These are mainly used for commodity assets as physical delivery is possible in these contracts.

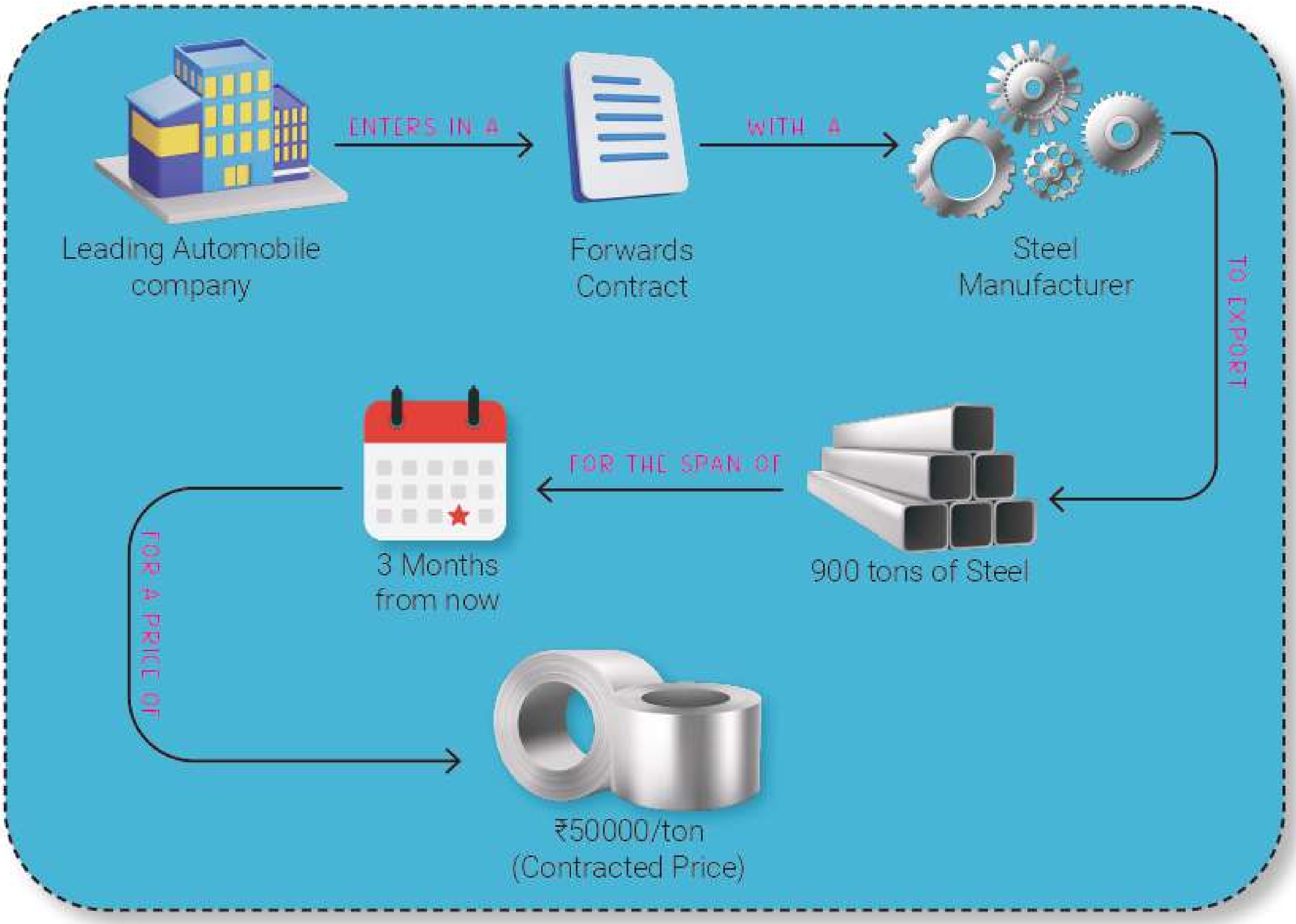


However, due to the lack of a reliable counterparty risk assurance, these contracts can be problematic for the profit-making party at the expiry. Since, in a forward contract, the profit or loss is accumulated to the date of maturity of the contract, therefore, the default risk involved is immense.

Therefore one must be careful about the counter-party when entering any forward contracts. They must be trusted parties who have a track record of meeting such liabilities.

SUMMING IT UP

Process of a Forward Contract



POSSIBLE OUTCOME 1

CURRENT MARKET PRICE ▼ CONTRACT PRICE

The automobile company will incur a loss as they will have to pay a higher amount than the current market price. However, doing so, it has ensured uninterrupted supplies for itself.

POSSIBLE OUTCOME 2

CURRENT MARKET PRICE ▲ CONTRACT PRICE

The automobile company will make a profit for itself as they can secure the supplies at a cheaper price. The steel manufacturer will incur a loss.

POSSIBLE OUTCOME 3

CURRENT MARKET PRICE = CONTRACT PRICE

Zero potential profit or loss to both parties.