CHAPTER 2

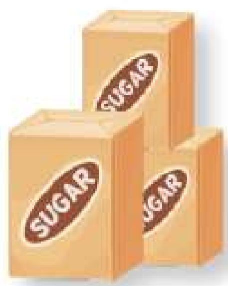
FUNDAMENTALS OF FORWARD CONTRACTS

2.1 INTRODUCTION

"FORWARD CONTRACTS ARE AN AGREEMENT OR CONTRACT TO BUY OR SELL AN ASSET AT A SPECIFIC PRICE FOR A SPECIFIC QUANTITY ON A SPECIFIC FUTURE DATE."

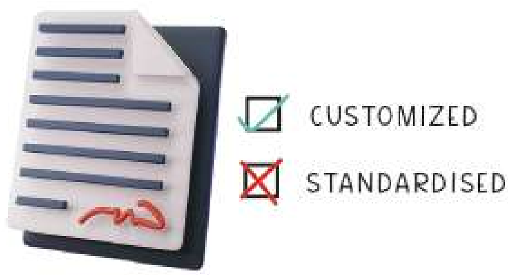
FUTURE DATE

SPECIFIC PRICE



SPECIFIC QUANTITY

These contracts are customized - as per the requirements of the two parties involved in the agreement. The flexibility of customizing the contract means that it is not standardised for all.

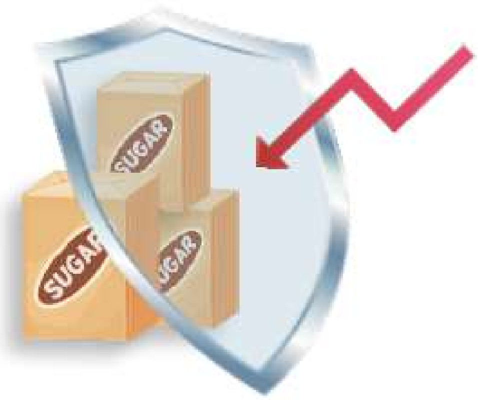


Since it is not standardised, it is an over-the-counter (OTC) contract. It means forward contracts are not exchange-traded contracts. Hence, they are unregulated by SEBI – Securities and Exchange Board of India. These contracts do not have a market as such. Two parties manually meet and agree to have this contract.

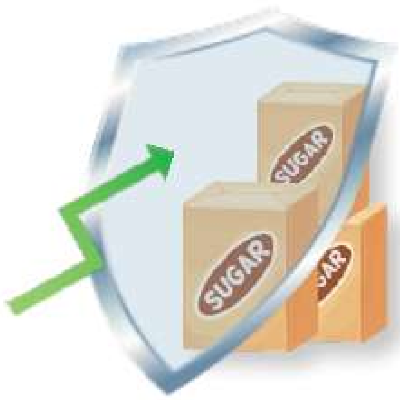
PERSON A PERSON B

☑ OVER THE COUNTER ☒ EXCHANGE TRADED ☒ REGULATED BY SEBI

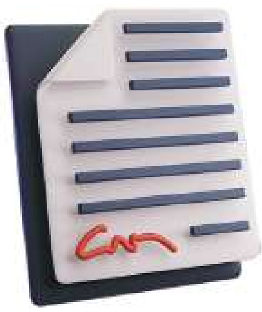
So, if you want to hedge against a price drop for a commodity, you will have to manually find someone who wants to hedge themselves against a price rise in the future of the same item.



PERSON WHO WANTS TO PROTECT THE COMMODITY AGAINST PRICE DROP



PERSON WHO WANTS TO PROTECT THE COMMODITY AGAINST PRICE RISE



BOTH ENTER INTO A CONTRACT

Then, you two shall mutually agree upon a specific quantity, price, and physical delivery date to enter this contract. And vice versa. There is no middle man or third party involved to regulate all this.