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FORWARDS CONTRACT

What is a Forward contract?

Forwards are the most common form of derivatives and are contracts that specify the price of an asset today, but are settled at a later date.

For example, one may agree to sell foreign currency (say US $1,000) three months later with the price decided today at 36.65. Clearly, the other party would agree to buy US $1,000 at 36.65 three months later. Such a contract between the buyer and the seller of US dollars would be a forward contract. The price of the underlying asset, foreign currency in this case, is fixed beforehand.

The underlying asset can be a commodity, stock, currency, bond, index, T-bills, or a hypothetical asset.

Motive for Forward contracts.

Well, knowingly or unknowingly, we all enter into forward contracts. Booking a movie ticket over the phone is an example. It is a sort of forward contract, because we buy the ticket now (though there is no formal written contract) and pay its price only after reaching the cinema hall.

One might reasonably ask what the need is for entering into a contract that decides the price in advance. The main motive is to eliminate price risks.

Another Example- Mc Do Producer of potato chips, may enter into contract with potato- growing farmers to deliver their harvests later, at a price determined today.

In this way, both producer and farmers are assured of the transaction prices, the farmers know what price their crop would fetch, and Mc Do knows what it would have to pay to get the required potatoes. Without the forward contract, both of them would have to wait till the harvest time to know the price that would prevail then, which exposes both parties to price risk. Forward contracts would eliminate such price risk.

Settlement of Forward Contracts

There are two possible ways of settling these obligations

1. **By Delivery of the Asset and the Consideration.**

For e.g. An exporter, had sold EUR 10,000 to a bank 6 months forward at 40.50, then at maturity, the contract would be settled by delivery of Eur 10,000, by the exporter to the bank, who would pay the exporter, 455,000 MUR.

2. **Cash Settlement-**

Is an arrangement under which the seller in a contract chooses to transfer the net cash position instead of delivering the underlying assets.

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