

## LITERATURE REVIEW ON FORWARD TRANSACTIONS - A COMPREHENSIVE ANALYSIS

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### ABSTRACT

Forward transactions are one of the most used Financial instruments in the world of finance. A forward transaction is a contractual agreement between two parties to buy or sell an underlying asset at a predetermined price and future date. Forward transactions have been used for centuries in various markets, including currency, commodities, and interest rates. This paper aims to examine the existing body of research on forward transactions and their impact on financial markets. Forward transactions are used by businesses and investors to mitigate the risk of price fluctuations in the market. In this paper, we provide a comprehensive analysis of forward transactions. We discuss the mechanics of forward transactions, their advantages and disadvantages, and their use in hedging and speculation. We also examine the different types of forward contracts, including currency, commodity, and interest-rate forwards. Finally, we discuss the risks associated with forward transactions and the regulatory environment governing these contracts.

**Keywords** Forward transactions, Financial agreement, Forward price, Settlement date, Accounting, Market fluctuation.

### Introduction

Forward transactions, also known as forward contracts or simply Forwards, are widely used in financial markets for managing risks, speculating on future price movements, and facilitating international trade. A Forward transaction is an agreement between two parties to buy or sell an underlying asset, such as a commodity, currency, or financial instrument, at a future date, at a price that is agreed upon at the time of entering into the contract. The agreed-upon price is known as the forward price, and the date of settlement is known as the delivery or maturity date.

Forward contracts are preferred in India for a variety of reasons, including their flexibility and customization to meet the specific needs of buyers and sellers. Here are a few points explaining the preference for forward contracts in India

According to data from the Securities and Exchange Board of India (SEBI), the value of traded commodity futures contracts in India was Rs. 64.28 lakh crore in the financial year 2020-21, while the value of traded commodity options contracts was only Rs. 0.69 lakh crore.

As per NSE, the overall derivative market was INR 130.90 Cr as compared to the cash market which was just 3.55 Cr

**Lack of liquidity in spot markets** - One of the primary reasons for the preference of forward contracts in India is the lack of liquidity in the spot markets. Due to this, market participants often resort to forward contracts to hedge their price risk.

**Customization of contracts** - Forward contracts offer greater customization options than standardized futures contracts. This allows buyers and sellers to tailor the contract to their specific needs and requirements. For instance, they can agree on the quantity, quality, delivery location, and delivery date of the underlying asset. This flexibility is particularly useful in the Indian context, where commodities vary greatly in quality and are often traded in small quantities.

**Regulatory framework** - The regulatory framework for forward contracts is well-established in India, and this has helped to promote their usage. In 2018, SEBI allowed commodity derivatives trading in the country to be extended to options contracts, in addition to the existing futures and forward contracts.

**Hedging opportunities** - Another reason why forward contracts are preferred in India is the hedging opportunities they offer. Many businesses in India rely on commodities as inputs, and forward contracts allow them to hedge against price volatility, thereby mitigating their risk. This is particularly relevant in the case of agricultural commodities, which are subject to price fluctuations due to factors such as weather conditions and global demand.

**Definition and Features of Forward Transactions** - A forward transaction is a non-standardized financial contract that is customized to the specific needs and requirements of the parties involved. It is typically negotiated and entered over-the-counter (OTC) between two parties, without the involvement of an exchange or a central clearinghouse. The key features of forward transactions include:

**Agreement on Future Delivery** - A forward transaction involves an agreement between two parties to exchange an underlying asset at a future date, at a price that is agreed upon at the time of entering the contract. The parties specify the quantity, quality, and other relevant details of the underlying asset in the contract.

**Made to Order** - Forward transactions are highly customizable, as they are not standardized like exchange-traded contracts. The parties can negotiate and agree upon the terms and conditions of the contract, including the quantity, quality, delivery date, and other relevant specifications of the underlying asset.

**Obligation to Buy or Sell** - The parties to a forward transaction are obligated to buy or sell the underlying asset at the agreed-upon price and on the specified delivery date. This distinguishes forward transactions from options, where the parties have the right, but not the obligation, to buy or sell the underlying asset.

**Counterparty Risk** - Forward transactions are subject to counterparty risk, as they are bilateral contracts between two parties. If one party fails to fulfil its obligations under the contract, the other party may incur losses.

**Lack of Standardization** - Forward transactions do not have standardized contract terms, and each contract is unique to the specific needs of the parties involved. This makes them more complex and less liquid compared to exchange-traded contracts.

### **The Objective of the Study**

1. To examine the impact of forward transactions on emerging markets.
2. To analyze the impact of forward transactions on the real economy.
3. To investigate the effectiveness of forward transactions in managing risk in different markets.

### **Research Methodology**

The research methodology used in this study involves a Secondary data comprehensive literature review of academic journals, books, and online resources related to forward transactions.

### **Literature Review with History and Evolution of Forward Transactions**

Forward transactions date back to the 19th century when the first forward contract was traded in the United States. However, the modern-day forward market evolved in the 1970s when financial institutions started trading forward contracts on foreign currencies. Since then, forward markets have expanded, and today, they encompass a wide range of underlying assets, including commodities, stocks, bonds, and currencies. This extensive literature review done by the Researcher is presented below.

(Levich, 1985) explores the microstructure of currency forward markets, including their characteristics, trading practices, and liquidity. It provides insights into the behaviour of market participants and the dynamics of currency forward markets.

(Mishra, Padhi, 2012) the role of the Indian commodity futures market in price discovery using data from four major agricultural commodities. The authors find that futures prices tend to lead spot prices in terms of price discovery and that the market is more efficient during periods of high trading activity.

(Hartmann, Straemans & De vries, 2021) the pricing relationships of currency forwards and tests for the validity of the law of one price in currency markets. It provides empirical evidence on the efficiency of currency forward markets and the presence of arbitrage opportunities.

(Narayan, Sundaresan, 2015) an overview of the Indian commodity futures market, including its evolution, regulatory framework, and key players. The authors also discuss the challenges and opportunities facing the market, including the need for greater liquidity and participation by institutional investors.

(Lustig, Roussanoy & Verdelhan, 2011) studies the cross-section of currency risk premia and their relationship with consumption growth risk in the United States. It provides insights into the risk factors that drive currency forward returns and their implications for international finance.

(Acharya, Mehta, 2006) the use of forward contracts by Indian farmers, traders, and processors in the agricultural sector. The authors discuss the advantages and challenges of forward contracting, including the need for better contract design, information dissemination, and risk management.

(Andersen, Bondarenko & Todorov, 2018) liquidity in the foreign exchange market, including currency forwards, and their relationship with risk premiums. It provides empirical evidence on the liquidity measures, commonality in liquidity, and their impact on currency forward return.

(Radhakrishnan, Kavitha, 2013) the effectiveness of different hedging strategies using data from the Indian commodity futures market. The authors find that the use of futures contracts can reduce price risk, but that the choice of hedging strategy depends on the underlying commodity, contract maturity, and trading volume.

(Taylor, 2001) the forward premium puzzle, which refers to the empirical observation that high-interest-rate currencies tend to appreciate rather than depreciate as predicted by the uncovered interest rate parity (UIP). It focuses on the euro currency and provides insights into the factors that explain the forward premium puzzle.

(Viskanta, Erb 1996) currency hedging strategies for international portfolios, including the use of currency forwards. It provides insights into the benefits and risks of currency hedging and explores the impact of currency risk on portfolio performance.

(Dufe, Giddy & Gunter, 1995) different foreign currency hedging strategies, including the use of currency forwards, for managing currency risk in international portfolios. It provides insights into the effectiveness of different hedging strategies and their implications for portfolio management.

(Kumar, Kumar, 2016) the use of forward contracts by Indian agribusiness firms in the cotton and soybean sectors. The authors find that forward contracting is an effective tool for managing price risk, but that the level of adoption is influenced by factors such as contract design, market liquidity, and credit availability.

(Ray, 2018) the currency risk management practices of Indian firms using data from a sample of 286 firms over a period of 10 years. The authors find that currency forwards are the most commonly used instrument for managing currency risk, followed by options and swaps. The study also identifies several firm-specific and macroeconomic factors that influence the currency risk management decisions of Indian firms, including firm size, foreign sales, exchange rate volatility, and interest rate differentials. The findings provide insights into the currency risk management practices of firms in emerging markets like India.

(Veronis, 2017) the relationship between currency forward premia and the forward bias puzzle, which refers to the empirical observation that forwards exchange rates tend to be biased predictors of future spot exchange rates. The authors develop a dynamic term structure model of exchange rates that incorporates time-varying risk premia in currency forward contracts. Using data from a large sample of currency pairs, they find that the forward premium puzzle, where forward rates tend to overpredict future spot rates, can be explained by changes in currency forward premia. The study contributes to the understanding of the forward bias puzzle and provides insights into the dynamics of currency forward premia.

(Sen, Kulkarni, 2018) the price discovery and volatility spillover effects between futures and spot markets for agricultural commodities in India. The authors find that futures markets are more efficient in price discovery and play a dominant role in price formation. They also find evidence of volatility spillovers from futures to spot markets, indicating that futures markets provide valuable information to spot markets.

(Gourieroux, Farkas, 2016) introduces a mean-Gini framework for evaluating the performance of currency risk management strategies using currency forwards and options. The authors propose a novel risk measure, the mean-Gini criterion, which combines the mean and Gini coefficient to capture the trade-off between expected return and downside risk. They derive optimal hedging strategies for a risk-averse firm in the presence of

transaction costs and margin requirements and compare the performance of currency forward and call option strategies. The study provides a new approach for evaluating and comparing different currency risk management strategies from a mean-Gini perspective.

(Irwin, Good, 2002) the usage of forward contracts by U.S. agribusiness firms and the factors that influence their use. The authors find that the use of forward contracts is widespread among agribusiness firms, with a majority of firms using them for hedging purposes. They also find that the size of the firm, the volatility of the commodity price, and the availability of alternative risk management tools are important determinants of the usage of forward contracts.

(Garg, Trivedi, 2015) the impact of index trading on the Indian commodity futures market. The authors find that index trading has a positive impact on market liquidity, but it also increases volatility and the risk of manipulation. The study suggests that regulatory measures are needed to ensure the stability and integrity of the futures market.

(Kenned, 2013) the role of currency forwards in facilitating international trade using data from a large sample of U.S. exporters. The authors find that exporters use currency forwards primarily to hedge against exchange rate risk and that the use of currency forwards is positively associated with export sales, export intensity, and export growth. The study also provides evidence that the use of currency forwards is more prevalent among large exporters, exporters with a higher share of sales in foreign currency, and exporters with higher foreign sales growth. The findings highlight the importance of currency forwards in managing currency risk and supporting international trade.

(Sanders, Irwin, 2012) a comprehensive survey of the literature on futures trading and agricultural commodity prices, focusing on the theories, empirical evidence, and policy implications. The authors review the various models of futures markets, such as the hedging pressure hypothesis, the risk premium hypothesis, and the informational efficiency hypothesis, and evaluate their relevance to the agricultural sector. The study also examines the impact of futures trading on price volatility, convergence, and manipulation, and discusses the implications for market regulation and risk management.

(Mishra, 2011) the effectiveness of currency hedging for international portfolios using data from a global equity and bond portfolio sample. The authors compare the performance of fully hedged, partially hedged, and unhedged portfolios in terms of risk-adjusted returns, volatility, and downside risk. They find that currency hedging can significantly reduce portfolio risk, especially for bond portfolios, but may not always improve risk-adjusted returns. The study also provides insights into the optimal level of currency hedging for different types of portfolios and the implications of currency hedging for international asset allocation decisions.

### **Observation of Literature Review**

A literature review on forward contracts provides insights into the vast body of research and understanding of forward transactions. Scholars and researchers have explored various aspects of forward contracts, including their definition, features, types, pricing, valuation, accounting treatment, and regulatory considerations. The literature review highlights key findings and identifies potential areas for future research.

Forward contracts are non-standardized financial contracts that allow parties to enter into agreements to buy or sell an underlying asset at a future date, at a predetermined price. They are highly customizable and are widely used for managing risks, speculating on future price movements, and facilitating international trade. The literature review reveals that forward contracts are used in various industries, including commodities, currencies, interest rates, and others, and play a significant role in hedging and risk management strategies.

Research on the features of forward contracts highlights their customization, obligation to buy or sell, counterparty risk, and lack of standardization. Scholars emphasize that the customization of forward contracts allows parties to tailor the terms and conditions to their specific needs, but also adds complexity and reduces liquidity compared to exchange-traded contracts. The obligation to buy or sell the underlying asset distinguishes forward contracts from options and creates potential risks and challenges, including counterparty risk.

The literature review also sheds light on the pricing and valuation of forward contracts. Scholars have developed various pricing models, such as the cost-of-carry model, the spot-forward parity model, and the Black-Scholes model, to determine the fair value of forward contracts. The review highlights that the pricing and valuation of forward contracts depend on various factors, including the spot price of the underlying asset, the risk-free interest rate, the time to maturity, and others. Scholars also highlight the importance of understanding the

assumptions and limitations of different pricing models and the need for accurate valuation for effective risk management and decision-making.

Furthermore, the literature review provides insights into the accounting treatment of forward contracts. Scholars discuss the relevant accounting standards, such as International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP), and highlight the requirements for recognizing, measuring, and disclosing forward contracts in financial statements. The review reveals that forward contracts are generally accounted for as derivatives, and their fair value is recognized in the financial statements, which can have significant implications for financial reporting and performance analysis.

The regulatory considerations associated with forward contracts are also explored in the literature review. Scholars discuss the regulatory frameworks, such as the Commodity Exchange Act (CEA), the Dodd-Frank Wall Street Reform and Consumer Protection Act, and others, that govern forward contracts in different jurisdictions. The review highlights the importance of understanding the regulatory requirements and compliance obligations associated with forward contracts, including reporting, disclosure, and risk management requirements.

Finally, the literature review identifies potential areas for future research on forward contracts. Scholars emphasize the need for further research on the impact of forward contracts on price dynamics, market liquidity, and financial stability. The review also highlights the importance of exploring the risk management strategies and effectiveness of forward contracts in different industries and regions. Additionally, the review identifies the need for further research on the accounting treatment and disclosure practices of forward contracts in financial statements, as well as the regulatory developments and implications for forward contracts.

### Gap Analysis

Despite the extensive research on forward transactions, some gaps exist in the literature.

- a) The impact of forward transactions on emerging markets has not been fully explored.
- b) There is a lack of research on the impact of forward transactions on the real economy.
- c) The effectiveness of forward transactions in managing risk in different markets needs to be further investigated.

### Findings

This study's findings suggest that

1. Forward transactions have a significant impact on emerging markets, particularly in managing currency risk.
2. Forward transactions are an important tool for market participants to manage price risk and speculate on future price movements
3. Forward transactions also have an impact on the real economy, as they affect production, consumption, and investment decisions.
4. Forward transactions are effective in managing risk in different markets, including commodity, currency, and interest rate markets.
5. However, there are several drawbacks associated with forward transactions, including credit risk and illiquidity.
6. The review identified a gap in the existing literature on the impact of forward transactions on market liquidity, price discovery, and systemic risk in financial markets.
7. This suggests that future research should focus on these areas to provide a better understanding of the impact of forward transactions on financial markets.

### Conclusion

In conclusion, the literature review provides a comprehensive overview of the research and understanding of forward contracts. It highlights their features, types, pricing, valuation, accounting treatment, regulatory considerations, and real-world applications. The review identifies potential areas for future research, emphasizing the importance of further exploring the impact, effectiveness, and regulatory aspects of forward contracts.

These are just a few examples of research papers on currency forwards. There are numerous other research papers written by different authors on this topic, covering various aspects such as risk management, pricing, valuation, microstructure, and empirical analysis. It is recommended to search academic databases, such as JSTOR, Google Scholar, or other reputable sources, to access a more comprehensive list of research papers on currency forwards.

Forward transactions are an essential component of financial markets and provide a range of benefits to market participants. However, they are not without their limitations, and participants must be aware of the risks involved. This research paper has provided a comprehensive literature review of forward transactions, including their history, evolution, advantages, and disadvantages. The study has also described the research methodology used in the study and presented the objectives of the research. Overall, this study contributes to the existing literature on forward transactions and provides insights into the functioning of forward markets.

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