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Issues With Commodity Trading in India

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ABSTRACT *The Indian economy is witnessing a mini revolution in commodity derivatives and risk management. Commodity options trading and cash settlement of commodity futures had been banned since 1952 and until 2002 commodity derivatives market was virtually non-existent, except some negligible activity on an OTC basis. Now in September 2005, the country has 3 national level electronic exchanges and 21 regional exchanges for trading commodity derivatives. As many as eighty (80) commodities have been allowed for derivatives trading. The value of trading has been booming and is likely to cross the $ 1Trillion mark in 2006 and, if all goes well, seems to be set to touch $5 Trillion in a few years. This paper analyses the obstacles that need urgent attention if the market is to realize its full potential.*

The Indian commodity derivatives market

The importance of commodity derivatives market in India is increasing, with its economy becoming more aligned with the global economy. The direct and indirect value chain participants of varied commodities are getting increasingly exposed to the price risks inherent in the international trade. Price risks are also endemic to the domestic commodity trade. Under such environments where price risks remain integral components of commodity trades, the Indian commodity exchanges have played an important role in helping the market participants proactively manage their risk exposures and augment their business competitiveness. Their contribution in modernising the nation's commodity sector, revolutionising the commodity value-chain, and bringing about institutional changes in the marketing processes and the ecosystem, has been paramount.

Even those farmers who do not trade on commodity futures market have benefitted from the market significantly. Futures prices disseminated through various sources enable farmers to take informed decisions about production and marketing related activities, besides enabling them to get better prices for their produce. Moreover, futures contracts' specifications and collateral management agencies of exchanges not only improve awareness about quality testing and scientific storage, but also improve the infrastructure by developing sound commerce around such infrastructure.

History of Indian Commodity Derivative Market

Commodity futures markets have a long history in India. Cotton was the first commodity to attract futures trading in the country leading to the setting up of the Bombay Cotton Trade Association Ltd., in 1875. Subsequently, many exchanges came up in different parts of the country for futures trading in various commodities. After independence, with the subject of 'stock exchanges list, responsibility for regulation of commodity futures markets developed on government of India.

Structure, conduct and current status

Broadly, the commodities market exists in two distinct forms—the over-the-counter (OTC) market and the exchange based market. Further, as in equities, there exists the spot and the derivatives segments. Spot markets are essentially OTC markets and participation is restricted to people who are involved with that commodity, such as the farmer, processor, wholesaler, etc. A majority of the derivatives trading takes place through the exchange-based markets with standardized contracts, settlements, etc. The exchange-based markets are essentially derivative markets and are similar to equity derivatives in their working, that is, everything is standardized and a person can purchase a contract by paying only a percentage of the contract value. A person can also go short on these exchanges. Moreover, even though there is a provision for delivery, most contracts are squared-off before expiry and are settled in cash. As a result, one can see an active participation by people who are not associated with the commodity. As per the recommendation of the FMC, the Government of India recognized the National Multi Commodity Exchange (NMCE), Ahmadabad; Multi Commodity Exchange (MCX), National Commodity and Derivative Exchange (NCDEX), Mumbai and Indian Commodity Exchange (ICEX) as nationwide multi-commodity exchanges.

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Since 2009, India's commodity futures market has registered a growth (CAGR) of 33 per cent with the total value of commodity futures traded, growing from `52.49 trillion in FY2008-09 to 170.47 trillion in FY2012-13. India's commodity derivatives market still operates under the outdated Forward Contracts (Regulation) Act (FC(R)A), 1952. Within the existing statute, FMC has been successful in regulating the futures market and controlling manipulation by dynamically using the available market regulation tools. In FY2012-13, some of the key endeavours of FMC entailed: using regulatory instruments such as special margins and decreasing the open position limits of agri commodities (e.g. guar complex, pepper, turmeric, and soyabean) to curb volatility in prices; strengthening the investor protection fund; introducing staggered delivery in some commodities; initiating SMS and email alerts to individual traders; disallowing algorithmic/ high frequency trade in mini and micro contracts etc. Let us look at these and some more issues in detail.

Impact of future trading on the underlying spot asset

Critics of futures market claim that it destabilizes the spot market by increasing Spot price volatility as it attracts new speculators who do provide liquidity but can also create noise in the underlying spot market if they are less informed than the traders existing in the market. The other view is that spot market volatility decreases due to the liquidity pro-

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vided by speculators. This additional liquidity allows spot traders to hedge their positions and curb volatility. Informational efficiency of futures market stabilizes the spot market. Early research on the effect of futures trading in commodities has generally concluded that the existence of a futures market tends to stabilize price in the spot market.

Expanding the scope of commodity trading

India's commodity derivatives market is in its nascent stage of development. To unlock the latent potential of the market, it is imperative to bring the unreachable and small stakeholders within its ambit. In a developing economy such as India, where a sizeable section of the population is rendered vulnerable by the commodity price volatility, the price risk management and price discovery functions of a commodity derivatives exchange can have substantative impacts on livelihoods across commodity value chains.

Manipulation and speculation

The suspicion of excessive speculation causing food price inflation has become stronger in the background of the worldwide increase in prices of wheat, rice, oilseeds, and pulses last year. Wheat prices increased more than twofold with "open interest" positions declining to half of what prevailed at KCBT. Between March and December 2008, wheat prices declined by 50%, and open interest declined by more than 25%—probably because of the liquidation of longs. There have been allegations that speculation causes price volatilities in India as well. While there is some research on whether futures trading is responsible for such volatilities, such research has often been criticized on theoretical and methodological grounds.

Warehousing reforms (cash v/s physical settlement)

For commodity derivatives market to work efficiently, it is necessary to have a sophisticated, cost-effective, reliable and convenient warehousing system in the country. Further, independent labs or quality testing centres should be set up in each region to certify the quality, grade and quantity of commodities so that they are appropriately standardized and there are no shocks waiting for the ultimate buyer who takes the physical delivery. Warehouses also need to be conveniently located. It is probably due to the inefficiencies in the present warehousing system that only about 1% to 5% of the total commodity derivatives trade in the country are settled in physical delivery. Therefore the warehousing problem obviously has to be handled on a war footing, as a good delivery system is the backbone of any commodity trade. A particularly difficult problem in cash settlement of commodity derivative contracts is that at present, under the Forward Contracts (Regulation) Act 1952, cash settlement of outstanding contracts at maturity is not allowed. In other words, all outstanding contracts at maturity should be settled in physical delivery. To avoid this, participants square off their positions before maturity. So, in practice, most contracts are settled in cash but before maturity. There is a need to modify the law to bring it closer to the widespread practice and save the participants from unnecessary hassles.

Fragmented physical/spot market

The major stumbling block for the development of commodity futures markets in India is the fragmented physical/spot market. As is well known national level derivatives markets cannot be founded on fragmented, localised cash markets. There are still several barriers to free movement of commodities in the form of physical restrictions (under the Essential Commodities Act, APMC Act, Licensing restrictions) and fiscal hurdles (differential taxes, stamp duties).

Commodity options

Commodity options, once introduced, would open up another avenue for hedgers to trade on the exchanges. Apart from introducing options, introduction of broad based commodity indices, weather related products, freight index, etc. is expected to facilitate participants with wider investment and hedging tools. These instruments are particularly useful for farmers, small and medium enterprises, processors, and small producers, and many others who are risk averse.

Lack of economies of scale

There are too many (3 national level and 21 regional) commodity exchanges. Though over 80 commodities are allowed for derivatives trading, in practice derivatives are popular for only a few commodities. Again, most of the trade takes place only on a few exchanges. All this splits volumes makes some exchanges unviable. This problem can possibly be addressed by consolidating some exchanges. Also, the question of convergence of securities and commodities derivatives markets has been debated for a long time now. The Government of India has announced its intention to integrate the two markets. It is felt that convergence of these derivative markets would bring in economies of scale and scope without having to duplicate the efforts, thereby giving a boost to the growth of commodity derivatives market. It would also help in resolving some of the issues concerning regulation of the derivative markets. However, this would necessitate complete coordination among various regulating authorities such as Reserve Bank of India, Forward Markets commission, the Securities and Exchange Board of India, and the Department of Company affairs etc.

Wider participation

The existing statutes do not permit banks, mutual funds and foreign institutional investors to trade on India's commodity futures market. However, participation of such institutions can bring about greater benefits to all stakeholders of the commodity economy in our country, as also enable these institutions to manage their own risk and investment needs. Banks participation in commodity exchanges will lead to market inclusion of farmers as a result of their strong credibility in rural areas. The network of banks' branches could also be used for effective dissemination of futures prices. International experiences have also shown that banks may often act as aggregators and hedge risks on behalf of farmers. As such, banks themselves are exposed to high commodity risks by way of their lending to the farm community, SMEs, as also businesses and corporates in the domains of metals and energy. Hence, in order to hedge that risk, banks will find it beneficial to participate in commodity exchanges. Further, such institutional participation will help in bringing in more liquidity and depth to the commodity market; thereby, increasing the hedging efficiency, and concomitantly its role in price discovery. This would also enable domestic exchanges in attracting participation from Indian corporates that use global exchanges for hedging. Thus, reforms in this area will give the market the much needed impetus to grow.

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