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Commodities Markets: Improving Trade Volumes

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Introduction

Commodity derivatives trading spanning over 130 years, has had a long and chequered history in India. Mumbai's Cotton Exchange is one of the world's oldest cotton exchanges founded in the 1850's, even before the country's stock market exchange came into existence in 1875.It was essentially a tale of two cotton markets , the spot market at Sewree and the futures exchange at Kalbadevi and was formally called the East India Cotton Association. Over the years the Mumbai Cotton Exchange evolved since 1921 and is still in existence though trading volumes are low in comparison with MCX and NCDEX. The commodity derivative exchanges have witnessed several ups and downs for the past 13 decades including a ban on such trading for almost a decade after the outbreak of Second World War in 1939. On January 26 1949, the subject of futures trading came under the Union list. The Central Government passed the Forward Contracts (Regulation) Act, 1952 (FCRA) and established the Forward Market Commission (FMC) in 1953. Under the FCRA, futures trading were allowed in select agricultural commodities and their products under the auspices of Associations recognized by GOI. By mid 1960's around 30 Associations were recognized for trading of commodities. Trading was subject to severe regulatory measures. Following the launch of economic reforms early in 1990s, the World Bank and UNCTAD submitted a joint report to GOI, recommending the revival of futures trading in farm commodities and their products to render trade in such commodities competitive in the world markets after the envisaged removal of trade and non-trade barriers. As a result, futures' trading was revived after a lapse of three and a half decades, towards the close of 20th century. The onset of the new millennium thereafter witnessed the setting of three new national commodity exchanges. At present, there are almost two dozen commodity exchanges, including 3 national exchanges. Trading takes place in about a 100 commodities.

The New Commodity Exchanges in India

The new national commodity exchanges marked a distinct shift in the commodity derivatives trading landscape in the country against the conventional commodity exchanges. The new national exchanges organized derivatives trading on a screen-based anonymous automated electronic system. Despite a long history of commodity futures trading in the country, future markets are still viewed with suspicion by many in academic and official circles. The recent deflation in the values of various assets underlying the different derivatives, including commodity derivatives, following the global meltdown since 2008, has provoked even more doubts about the much acclaimed economic utility of futures trading for price discovery and risk management.

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As a result, the authorities are yet to permit such trading in several food grains like rice and millets and some major pulses, too. The government also continues to suspend future trading in commodities as soon as it suspects that such trading may affect adversely the prices of those commodities to the detriment of one or the other classes of society. The Forward Market Commission (FMC) and the Union Ministry of Consumer Affairs in India strengthened, enlarged and upgraded the FMC with more regulatory powers. The FMC has been legalized and permitted to trade in intangibles with cash settlement provisions and has allowed the entry of financial institutions including foreign financial institutions in commodity derivative trading business to broaden and deepen the commodity markets. Against such conflicting views, commodity futures markets present a massive research agenda challenge on major policy and empirical issues.

Strengthening and expanding the scope of commodity derivative trading

The present Forward Contract Regulation Act (FCRA) is essentially an enabling Act and the Forward Market Commission (FMC) is merely an advisory and monitoring body rather than a full-fledged regulatory organization as it does not have specialized and long-term staff attached and the real regulatory powers are still vested under the Act with the Union Government. Hence, it is considered necessary to amend the existing laws to meet the challenges of the new commodity market ecosystem. The envisaged Amendment Bill has legalized options in commodity derivatives to facilitate trading in derivative contracts for intangibles like commodity indices, weather derivatives and also allow the cash settlement of derivative contracts. It may further permit foreign individuals and institutional investors, banks and other financial institutions to trade in commodity derivatives.

More specifically, the amendment has given greater teeth to FMC by raising its status to that of the counterpart in the securities market viz. Securities Exchange Board of India (SEBI) through up-grading, expansion and conferring upon it more regulatory and judiciary powers. There is a need for strengthening the FCRA, convergence of the FMC and SEBI for effective regulation of both the securities and commodity exchanges, development and strengthening of derivative contracts and markets, options on commodity futures necessary. It is desirable to settle all commodity futures contracts by payment of cash differences instead of insisting on compulsory deliveries on contract maturities and allowing banks, financial institutions, foreign investors, retail individuals and institutions like pension funds, hedge funds to trade.

Impact of futures trading on commodity prices

While producers have voiced their concerns about the alleged depressing influence of futures trading during times of surplus supplies, consumers and the end-use industries have complained about their aggravating influence on rising prices under conditions of short supplies, especially in inflationary periods. Even economists are divided almost vertically on the role of commodity derivative markets, marketing and pricing of physical

commodities. While the advocates of derivative markets vouch for their economic utility for price discovery and price risk management in domestic and export marketing, they argue that speculation in these markets primarily help in the performance of these twin economic functions. They even further contend that speculation essentially stabilises prices and does not aggravate price trends. The opponents of future markets state that after all, price volatility and not price stability gives rise to speculation markets. They, therefore, contend that the volume of speculation is directly correlated to the extent of price variability. Greater the price variability, higher is the speculation and vice versa. It follows that speculation essentially leads to price destabilisation.

The way out

In view of the conflicting reports and inadequate evidence, there is a crucial need to understand the relationship and dynamics between the futures and the physical markets in commodities and more specifically the impact of derivative trading on the physical market prices. Discussions therefore, concentrated on the economic functions of commodity futures markets and their utility for different market functionaries separately. Whether futures markets will lead to price discovery? What is the meaning of the term "price discovery"? Why futures markets are believed to be leading to better price discovery? Are not prices discovered in the absence of futures markets? Who benefits from the price discovery made in the futures market? How do they benefit? How can one measure the pricing efficiency of the futures market? There are a lot of perplexing queries and not enough adequate answers.

Further deliberations were confined to the role and functions of speculation in a futures market, the characteristics of different types of speculation and benefits and evils of different types of speculation. Much debate emerged on the distinction between speculation and manipulation and impact of futures trading on commodity prices in the physical markets, with specific reference to short-term and seasonal price variability, as also cyclical fluctuations as depicted by the famous Cobweb Theorem in agricultural economics. Some academicians argued as to whether adequate empirical evidence exists to establish the price integrating influence both horizontally and vertically and whether commodity markets suffer from some inherent biases in price making that affect adversely one class of hedgers as against the others. We need to analyse reasons as to why the commodities markets are subdued now.

SWOT analysis of national-level commodity exchanges in India

Strengths

- Commodities centric economy of India – a leading producer/consumer in number of commodities.
- Rich history of commodity derivatives trading in the country.
- Risk-taking profile of the Indian masses.
- Online trading platform accessible from every nook and corner.

- Strong application of information technology enabling connectivity to trading stations through VSAT, Internet, leased line, CTCL etc.
- Offering large number of commodities across segment for futures trading – thus appealing to large number of commodity stakeholders for futures trading.
- Strategic alliance with global exchanges, domestic trade associations and educational institutions enabling the participants of commodity exchanges to leverage from the knowledge sharing between institutions.
- Extended trade timings overlapping with eastern economies (Japan, Australia etc.) and western economies (Europe, US etc.).

Weaknesses

- Commodity derivatives market is still regulated under the archaic law i.e. The Forward Contracts (Regulation) Act, 1952 – limiting the role and power of the commodity derivatives market regulator, Forward Market Commission (FMC).
- Absence of participation of financial institutions such as banks, FIIs and DIIs etc. It is widely perceived and internationally observed that presence of financial institutions (particularly banks) in the commodity derivatives market makes the market strong and inclusive.
- Absence of different derivatives products, viz. indices and options. These products are very much in demand in India as they can be tailor-made to suit the risk management demands of specific user groups.
- Fragmented underlying physical market especially in case of agricultural commodities.
- Inadequate support infrastructure across the country in terms of warehouses, quality testing labs etc.
- Administered pricing to a certain extent in few agricultural commodities and select energy commodities.
- Plethora of taxes – at local, state and central levels. The same commodity at times is subject to number of taxes at various levels. Besides, tax rules are introduced without considering the implications for the commodity markets. For instance, as per the existing provisions of Cenvat Credit Rules, only a manufacturer, first stage dealer or a second stage dealer is entitled to credit on the excise duty paid at the time of procurement. In the ecosystem of commodity derivatives, the final procurement is often the culmination of multiple unascertainable instances of purchase and sales. This deprives excise duty credit to the final buyer of the commodity who may take delivery several stages after the second stage of transaction. As a result, potential market participants are dissuaded from hedging in a transparent manner on the futures exchange.

Opportunities

- Increasing volatility of commodity prices-making commodity derivatives trading attractive both for hedgers as well as speculators.

- Large number of commodities yet to be tapped for derivatives trading.
- Despite growth in commodity futures trading in past decade, the future-physical multiplier in most global commodities are way below in comparison to global benchmarks – signifying huge potential for future growth.
- Derivatives instruments other than futures, such as options, indices etc. are yet to be launched – presenting huge opportunities for further growth, if allowed.
- Currently, institutional players such as banks, mutual funds, insurers, FIIs are not allowed to participate on commodity exchanges. Enabling of their participation can lead to huge growth in commodity derivatives trading.
- Cross listing of contracts between exchanges including from global arena can lead to huge growth opportunity for commodity exchanges in India.
- Big scope for foray into bringing forward commodities contracts on established regulated national level exchange

Threats

- Imposition of CTT (Commodity Transaction Tax) has not only crippled the growth in futures trading but in fact was led to significant fall in trading. Sustenance of CTT can further hamper commodity futures trading in the country.
- Any increase in the existing taxes levied on commodity futures transactions or imposition of any new tax—either by the central or state governments, can also adversely affect commodity derivatives trading.
- Government/regulatory interventions, which have the potential to disrupt commodity futures trading, e.g. restrictions on trading following inflationary conditions, can hamper commodity derivatives trading.
- Secular rise of equity market can wean away participants from commodity derivatives market.

With all these factors operating, innovative suggestions to improve trade are needed:

Suggestions for enhancing trading volumes of commodity exchanges

- Sustained awareness and education campaigns (including through print media) at various levels can help in deepening and widening the market participation. In this context, following activities could be undertaken:
    - Workshops for increasing hedge participation, targeting not only farmers but also finance/treasury department of companies exposed to commodity price risks.
    - Training trainers – faculty of colleges and universities, progressive farmers, etc. who can then be assigned the task of conducting awareness programs. Universities may be prevailed upon to include commodity derivatives in the compulsory subjects in their commerce/ economics/ finance courses.

  - Awareness campaigns at large scale need to be undertaken at all levels of commodity supply chain highlighting the benefit of commodity derivatives trading.
  - Special seminars aiming at non-hedging participants need to be conducted, helping them understand the benefits of participating in commodity derivatives trading.

- Efforts need to be put in hand-holding first-time/potential hedgers' with respect to their participation on commodity exchanges especially in terms of operational requirements.
- Product/service innovation – Futures contracts in new commodities or more variants of existing commodity contracts which suit the needs of most stake-holders can be launched.
- Similarly augmenting the existing services provided by the exchange, say in terms of adding the number of delivery centers, launching more services such as EFP (Exchange of future for physical) etc. can be initiated.

Desired policy-related initiatives

- Amendment to the Forward Contracts (Regulation) Act, 1952 would provide a major fillip to commodity derivative trading volume. The amendment would not only empower FMC with the necessary powers and policies necessary efficient regulation of the market, but would also enable the launch of derivatives products other such as options and indices, which are currently not allowed. The availability of commodity options, indices would not only help in the growth of trading volume but would also help in better risk management.
- Repeal of CTT, as it is already unfolding deleterious impacts for the commodity markets, can prove to be major boost in efforts towards rising trading volume. Fall in transaction cost-by way of repealing of CTT would certainly help in some volume restoration especially helping the smaller players like the SMEs, who need a cost-effective risk management platform.
- Currently banks are not allowed to participate in commodity derivatives trading – despite their exposure to commodity prices risk owing to their loaning to commodity specific enterprises. Hence, notifications be issued under the Banking Regulation Act, 1949 to permit Banks to deal in the business of commodities including their derivatives. The participation of Banks in the commodities market would ensure greater penetration of commodity-market-based or warehouse-receipt-based lending and commodity exchanges-linked risk management services to the masses.
- Similarly other institutional bodies such as mutual funds, insurers, foreign institutional investors etc. need to be allowed to trade in commodity derivatives trading. Their participation would not only help in their respective investment objectives, but also add quality liquidity in commodity market.

- In respect to the deterrent to hedgers participation due to existing provisions of Cenvat Credit Rules (seen above in Weakness section), Central Excise Rules, 2002 be amended so as to consider exchange accredited warehouse as a first stage dealer as well as a second stage dealer. Necessary provisions may be made in the new GST policy to reflect this requirement.

- Supporting market infrastructure – smaller warehouses, cold storages, vaults, quality testing labs, grading centers, advisory services, etc. which provide critical support services to the commodity derivatives market need to be developed.

Conclusion

The success story of the Chicago Board of Trade (CBOT) set up in 1848 in the USA needs to be replicated in India. The number of Farmers Associations which are members and actively trade on the exchange needs to be emulated especially for the smallholder farmers in India who earn only 12-18% of the produce profits after taking upon themselves 80% of the risks during the production stages. Traders who share only 20% of the risks towards marketing are able to siphon off over 70% of the profits which is totally and adversely affecting the smallholder farmer financial margins. With the help of USAID, the Department Of Agriculture (USA) and CBOT, as also FMC, Department Of Agriculture (India), Commodity Exchanges in India and Chambers of Commerce and Farmer Associations, NABARD and NABCONS, there is a need to ensure that Farmers' Associations and Farmer Producer Organizations are involved in commodity trades which in India are entirely trader-driven and trader-dominated. The only slender hope for smallholder farmers to improve their profit and financial margins is by forming Farmer Associations which will not only grade, sort and aggregate farm produce but also take trading positions in commodity exchanges. Only then can smallholder farmers break the monopoly of traders who have a stranglehold on profits and margins, thereby ensuring that farmers are reduced to a life of penury and abject poverty.

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