



Commodity Market in India: An Overview

By

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Commodity Derivatives Market:-

Derivative Market can broadly be classified as commodity derivative market and financial derivative market. As the name suggest, commodity derivatives trade contracts for which the underlying assets is a commodity like, wheat, soyabean, cotton etc or precious metal like Gold and Silver. Financial derivatives markets trade contract that have a financial assets or variable as the underlying. The most financial derivatives are those, which have equity, interest rate and exchange rate as the underlying. Financial derivatives are used to hedge the exposure to market risk. The commodity derivatives differ from the financial derivatives mainly in the following two aspects: Firstly, due to the bulky nature of the Underlying assets, physical settlement in commodity derivatives creates the need for warehousing.

Secondly, in the case of commodities, the quality of the asset underlying a contract can vary largely.

Commodity Market in India:-

India has a long history of future trading in commodities. In India, trading in commodity future has been existence from the 19th Century with organised trading in Cotton, through the establishment at Bombay Cotton Association Ltd. in 1875. Over a period of time, other commodities were permitted to be traded in future exchanges. Spot trading in India occurs mostly in regional mandis and unorganised market, which are fragmented and isolated.

There were booming activities in this market at one time as many as 100 unorganised exchanges were conducting forward trade in various commodities. The securities market was a poor competitor of this market as there were not many papers to be traded at that time.

However, many feared that derivatives fuelled unnecessary speculation and were detrimental to the healthy functioning of the market for the underlying commodities. As a result, after independence, commodity option trading and cash settlement of commodity future were banned in 1952.

A further blow came in 1960's when following several years of several droughts has forced many farmers to default on forward contract and even caused some suicides, forward trading was banned in many commodities considered primary or essential. Consequently, the commodities derivatives market dismantled and remained dormant for about four decades until the new millennium when the Govt. in a complete change in policy, started actively encouraging the commodity derivatives market.

The year 2003 marked the real turning point in the policy framework for commodity market when the government issued notifications for withdrawing all prohibitions and opening up forward trading in all commodities. This period also witnessed other reforms, such as, amendments to the Essential Commodities Act, Securities (contract) Rules, which have reduced bottlenecks in the development and growth of commodity markets of the country. Commodity markets of the country are total GDP, commodity related and dependent industries constitute about roughly 50-60% which itself cannot be ignored.

Why are commodity derivatives required:-

India is among the top 5 producer of the most of the commodities in addition to being a major consumer of bullion and energy products. Agriculture contributes more than 23% to the GDP of Indian economy. It employs around 57% of the labour force on a total of 185 million hectares of land. Agriculture sector is an important factor to achieving a GDP growth of 8.10. All this indicates that India can be promoted as a major centre for trading of commodity derivatives.

It is important to understand why commodity derivatives are required and the role they can play in risk management. It is common knowledge that prices of commodities, metals, shares and currencies fluctuate over time. The possibilities of adverse price change in future creates risk for business. Derivatives are used to

reduce or eliminate price risk arising from unforeseen price change. A derivatives is a financial contract whose price depends on, or is derived from the price of another assets.

Two important derivatives are future and options:-

(1) Commodity Future Contract:- A future contract is an agreement for buying or selling a commodity for a predetermined delivery price at a specific future time. Futures are standardized contract that are traded on organised facture exchanges that ensure performance of the contract and remove the default risk. The commodity futures have existed since the Chicago Board of Trade (CBOT) was established in 1848 to bring farmers and merchants together the major function of future market is toe transfer price risk from hedger to speculators. For example suppose a farmer is expecting the crop of paddy to be ready in two months time, but is worried that the price of paddy may decline in this period. In order to minimise his risk. He can enter into a future contract to sell his crop in two months time at a price determined now.

Just take an another example. All we know that woolen garments demand picks up in winter season. A garment factory owner can by a factory contract of cotton to get the raw material for his products as predetermined price. This way both time is able to hedge their risk arising from a possible adverse change in the price of their's commodity or raw material.

(2) Commodity Option Contract: Like futures, option are also financial instruments used for hedging and speculation. The commodity option holder has the right, but not the obligation to buy (or sell) a specified quantity of a commodity at specified price on or before a specified date. Option contract involve two parties – the seller of the option writes the option in favour of the buyer (holder) who pays a certain premium to the seller as a price for the option. There are two types of commodity options. A 'call' option gives the holder a right to buy a commodity at an

agreed price, while a 'put' option gives the holder a right to sell a commodity at an agreed price on or before a specified date which is called expiry date.

The option holder will exercise the option only if it is beneficial to him, otherwise he will let the option lapse. Suppose a farmer buys a put option to sell 10 MT of wheat at a price of Rs. 13000/- MT and pays a 'premium' of Rs. 500/- MT. If the price wheat decline, to say Rs. 10000/- MT before expiry, the farmer will exercise his option and sell his wheat at the agreed price of Rs. 13000/- MT. However, if the market price of wheat increase by Rs. 1000/-MT, it will be better for the farmer to sell it directly in the open market at the spot price, rather than his option to sell at Rs. 13000/- MT.

Future and options trading therefore helps in hedging the price risk and also provide investment opportunity to speculators who are willing to assume risk for a possible return. Future trading and the ensuing discovery of price can help farmers to deciding which crops to grow. They can also help in building a competitive their earning because non-hedging of the risk would increase the Volatility of their quarterly earnings. Thus future and options market perform important functions that can not be ignored in modern business environment. At the same time. It is true that too much speculative activity in essential commodities would destabilize the markets and therefore, these markets are normally regulated as per the law of the country. Option on trading is not permitted till now in commas.

Modern Commodity Exchange:-

To make up the loss of growth and development during the four decades of restrictive Govt. policies, FMC and the government encouraged setting up commodity exchanges using the most modern system and practices in the world. Some of the main regulatory measures imposed in the FMC include daily market to market system of margins, creation of trade guarantee fund, back office

computerization for the existing single commodity exchanges , online tradig for the new exchanges, demutualization for the new exchanges and one third representation of independent Directions the Board of existing Exchanges etc.

National Level Commodity Exchanges in India are:-

- (1) NMCE : National Multi Commodity Exchange of India.
- (2) NCDEX : National Commodity Derivatives Exchange Ltd.
- (3) MCX : Multi Commodity Exchange of India Ltd.
- (4) ICEX : Indian Commodity Exchange Ltd.

Now we will discuss in brief about these commodity exchanges:-

NMCE : (National Multi Commodity Exchange of India Ltd.) is the first de-mutualised electronic commodity exchange of India granted the National exchange on Govt. of India and operational since 26th Nov, 2002.

Promoters of NMCE are, Central warehousing corporation (CWC), National Agricultural Cooperative Marketing Federation of India (NAFED), Gujarat Agro-Industries Corporation Limited (GAICL), Gujarat state agricultural Marketing Board (GSAMB), National Institute of Agricultural Marketing (NIAM) and Neptune Overseas Ltd. (NOL). Main equity holders are PNB.

The Head Office of NMCE is located in Ahmadabad. There are various commodity trades on NMCE Platform including Agro and non-agro commodities.

NCDEX (National Commodity & Derivates Exchange Ltd.)

NCDEX is a public limited co. incorporated on April 2003 under the Companies Act 1956, It obtained its certificate for commencement of Business on May 9, 2003. It commenced its operational on Dec 15, 2003. Promoters shareholders are : Life Insurance Corporation of India (LIC), National Bank for Agriculture and Rural Development (NABARD) and National Stock Exchange of India (NSE) other shareholder of NCDEX are: Canara Bank, CRISIL limited, Goldman Sachs, Intercontinental Exchange (ICE), Indian farmers fertilizer corporation Ltd (IFFCO) and Punjab National Bank (PNB).

NCDEX is located in Mumbai and currently facilitates trading in 57 commodity mainly in Agro product.

MCX Multi Commodity Exchange of India Ltd.):- Headquartered in Mumbai, MCX is a demutualised nation wide electronic commodity future exchange. Set up by Financial Technologies (India) Ltd. permanent recognition from government of India for facilitating online trading, clearing and settlement operations for future market across the country. The exchange started operation in Nov, 2003.

MCX equity partners include, NYSE Euronext,, State Bank of India and its associated, NABARD NSE, SBI Life Insurance Co. Ltd. , Bank of India, Bank of Baroda, Union Bank of India, Corporation Bank, Canara Bank, HDFC Bank, etc.

MCX is well known for bullion and metal trading platform.

ICEX (Indian Commodity Exchange Ltd.):- ICEX is latest commodity exchange of India Started Function from 27 Nov, 09. It is jointly promote by Indiabulls Financial Services Ltd. and MMTC Ltd. and has Indian Potash Ltd. KRIBHCO and IFC among others, as its partners having its head office located at Gurgaon (Haryana).

BSE is also planning to set up a Commodity exchange.

Regulator of Commodity exchanges:-

FMCL forward Market commission headquartered in Mumbai, is regulation authority which is overseen by the minister of consumer affairs, food and public distribution Govt. of India, It is station body set up in 1953 under the forward contract (Regulation) Act 1952.

Needs for future trading in commodities:

Commodity futures, which terms an essential component of commodity exchanges, can be broadly classified into precious metals agriculture, energy and other metals.

Current future volumes are miniscule compared to underlying spot market volumes and thus have a tremendous potential in the near future.

Future trading in commodities result in transparent and fair price discovery an account of lapse-scale participation of entities associate with different value chains. It reflects videos and expectations of wider section of people related to a particular commodity. It also provides effective platform for price risk management for all segment of players ranging from producers, trades and processors of a commodity.

It also helps in improving the cropping platform for farmers, thus mimizing the losses to the farmers. It acts s a smart investment choice in providing hedging, trading and arbitrage opportunities to market players. Historically, pricing, in Commodities future has been less volatile compared with equity and bonds, thus providing an efficient portfolio diversification option.

Raw Materials form the most key element of industries. The significance of raw materials can further be strengthened by the fact that “increase in raw material cost means reduction in share prices”.

Industry in India a today runs the raw material price risk. Hence going forward the industry can hedge this risk by trading in commodities market.

Risk associated with Commodities Market:-

No risk can be eliminated, but the same can be transferred to someone who can handle it better or to someone who has the appetite for risk. Commodity enterprises primarily face the following classes of risk. Namely: The price Risk, the quantity risk, the yield/output risk and the political risk, talking about the nationwide commodity exchanges, the risk of the counter party not fulfilling his obligations on due date or at any time therefore is the most common risk.

This risk is mitigated by collection of the following margins:-

- Initial margins
- Exposure margins
- Mark to Market on daily positions.
- Surveillance.

Key Factors for success of commodities market:-

The following are source of the key factors for the success of the commodities market:-

- How are can make the business grow
- How many products are covered
- How many people participate in the Platform.

Key Factors for success of commodity exchanges:-

Strategy, method of execution, background of promoters, credibility of the institution, transparency of platforms, scaleable technology, robustness of settlement structure wider participation of Hedgers; speculators and arbitragers, acceptable clearing mechanism, financial soundness and capability, covering a wide range of commodity, reach of the organization and adding value on the ground.

In addition to his, if the Indian Commodity exchanges needs to be competitive in the Global Market, then it should be backed with proper “capital account convertibility”.

Future Prospects:-

With the gradual withdrawal of the Govt. from various sectors in the post liberalization era, the need has been left that various operators in the commodities market be provided with a mechanism to hedge and transfer their risk. India’s obligation under WTO to open agriculture sector to world trade require future trade in a wide variety of primary commodities and their product to enable divers market functionaries to cope with the price volatility prevailing n the world markets.

Following are some of applications, which can utilize the power of the commodity market and create a win-win situation for all the involved parties:-

- Regulatory approval/permission to FII'S to trading in the commodity market.
- Active Involvement of mutual fund industry of India.
- Permission to Banks for acting as Aggregators and traders.
- Active involvement of small Regional stock exchanges.
- Newer Avenues for trading in Foreign Derivatives Exchanges.
- Convergence of variance market.
- Amendment of the commodities Act and Implementers of VAT.
- Introduction of option contract.

Conclusion:-

The commodity Market is poised to play an important role of price discovery and risk management for the development of agricultural and other sectors in the supply chain. New issue and problems Govt. regulators and other share holders will need to proactive and quick in their response to new developments. WTO regime makes it all the more urgent to develop these markets to enable our economy, especially agriculture to meet the challenge of new regime and benefits from the opportunities unfolding before U.S. with risks not belong absorbed any more the idea is to transfer it as the focus is shifting to “Manage price change rather than change prices the commodity markets will play a key role for the same.”

- (1) History of Commodity Factor
- (2) Major Exchanges.
- (3) Benefit of Wane Trading
- (4) Future of Commodity Market.