Connecting Commodity Markets to Stakeholders

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With the current 'trade war' rhetoric and geo-political events increasing uncertainty in all markets, including that of commodities, volatility in financial markets is likely to remain. Direct or retaliatory imposition of tariffs on basic or processed commodities is leading to increased volatility in commodity prices, particularly in the markets for metals and agricultural goods. As such, management of commodity price risks has become increasingly essential to sustain the value-add to stakeholders of commodity based businesses and also the wider economy.

Hedging using exchange traded commodity derivatives is considered to be one of the safest, cost-effective and efficient mechanisms for the commodity businesses to manage price risk and a healthy balance sheet. Commodity exchanges are important market infrastructure institutions that are primarily intended to improve the competitiveness of the commodity ecosystem participants by providing two important functions of price risk management and price discovery. Indeed, the current phase of development in the Indian commodity derivatives markets commenced in 2002-03 in response to the need for an institution for price risk management amongst various stakeholders, as India's external trade had become increasingly liberalised.

Since its inception in 2002-2003, the commodity derivatives market in India has grown by leaps and bounds: the average daily turnover in commodity futures increasing from Rs.1970 crore in 2004-05 to a high of Rs. 58,928 crores in 2011-12, ebbing to Rs. 21,193 in 2017-18. The discovery of a referenceable 'national price' and the price transparency brought forth by it and the development of Information and Communication Technology (ICT) has aided in economic integration of geographically separated markets. The growth of this market is also reflected in the positive strides it has taken in reach, inclusiveness and economic impact on the underlying physical market. The development of marketing infrastructure, especially in warehousing and quality assaying infrastructure has been another significant development.

Notwithstanding the above, the significance of the commodity derivatives market is not in its size or even in the speed at which it grows, but in the impact it creates in the social and economic development of the country. Despite the growth achieved, it is also true that what has been achieved so far is only the tip of an iceberg of enormous possibilities. There is a need to focus on the broader goal of deepening the market so as to make it more inclusive and provide the right risk management avenues to the stakeholders it exists for.

CONNECTING TO LARGE HEDGERS - NEED FOR IMPROVEMENT IN LIQUIDITY AND MARKET EFFICIENCY

One of the parameters on which the success of a market institution is measured, is the connect it establishes with all its intended stakeholders. In the case of the Indian commodity derivatives market, however, large hedgers often find hedging costly and inefficient due to lack of market depth, leading to many of them approaching global markets to meet their risk management requirements. The biggest differentiating factor in cost is the incidence of Commodity Transaction Tax (CTT) and the absence of institutional participation. Apart from CTT alone accounting for more than 50 per cent of direct trading cost, it had resulted in widening of the bid-ask spreads and reduction of depth in the market.

Market efficiency can also come about with participation of financial institutions, which the commodity derivatives market is by and large devoid of. Alternative Institutional Funds –Category III were the first (and so far only) financial institution allowed to take trade positions, although a discussion paper for enabling participation from Mutual Funds and PMS was released late last year.

Market access to a large variety of participants can inject liquidity cutting across contract maturities, lower impact costs and make the markets more attractive for potential hedgers. The 'rich' long-term liquidity provided by hedgers, will be beneficial for institutional participants, for which this virtuous cycle for building liquidity and developing markets needs to be created and nurtured. Institutions such as fund houses can also help make the process of price discovery more robust through their strong research/analytics capabilities. Further, financial institutions can also play a critical role in improving the reach to the last mile.

CONNECTING TO INDIAN INVESTORS – BRINGING BENEFITS THROUGH INSTITUTIONS

Scores of investors – both large and small - are not able to access the commodities market for lack of knowledge.

This keeps them away from an asset class which can give them higher risk adjusted returns by means of portfolio optimization through portfolio diversification. Financial institutions like Mutual Funds, Portfolio Managers are crucial for rightly intermediating the retail investors and serve their need for investment in commodity derivatives with well-defined objectives.

However, in this regard, it needs to be remembered that the commodity derivatives is a very different asset class with a different risk-return profile, compared to other financial asset classes. Considerations such as roll yield, additional collateral returns, mean-reverting returns, portfolio diversification benefits and inflation hedging are typical of investing in commodities. The risk profiling, product structure, regulations and operational guidelines of institutions have to be tailored to the idiosyncrasies of the commodity markets, possible participation strategies, investor protection needs, and the requirements of the economy.

CONNECTING TO WEAKEST STAKEHOLDERS – THE FARMERS

The current rural distress indicates an urgent need for building capacity among farmers to withstand market volatility. However, Indian farming is fragmented and small land holdings are one of the major reasons for the inability of farmers to participate in the commodity derivatives market. Participation by small producers also encounters barriers like poor knowledge of markets, limited financial / technical capacity, limited last-mile reach of exchange members to remote locations due to the high cost involved and large size of contracts, among others. While large farmers can possibly surmount these difficulties, it is necessary for small farmers to get the hand-holding assistance of various institutions which could aggregate their produce and hedge on behalf of these small farmers. Collective hedging through Farmer Producer Organizations (FPOs), banking and cooperative institutions and farmers' Self Help Groups etc. needs to be promoted. Such aggregators can leverage their operational skills and knowledge in order to hedge on behalf of farmers in the derivatives market. With the same objective MCX has launched itself on a 'Cotton Mission' to help farmers achieve better prices for their value-added cotton crop with appropriate institutional connects.

In this regard, it is noteworthy to consider the role of banks. Given the rural economic environment, banks are best suited to act as aggregators for farmers, since they have sound linkage to exchanges and brokers; offer transparency in undertakings; have better access to market-related information; possess in-house expertise; offer tailor-made OTC products to farmers on the basis of their position on exchanges and develop a sustainable value proposition required for a successful aggregation model. Throughout the developing world, there are a number of examples to demonstrate that the presence of banks in the commodity market has bestowed significant benefits to the producer community. The role of banks in commodity derivatives market need to be augmented to permit them to participate in this market, as in addition to being an aggregator, they can hedge their commodity price risks, owing to their significant lending exposure to commodity sector.

Additionally, to encourage farmers to hedge, institutions directly engaged with farmers can trade on commodity exchanges, distributing the resultant gains among their constituent farmers. Entities which undertake Minimum Support Price (MSP) related procurement, for instance, can protect their selling prices by entering into a 'short' position in contracts that expire after the main harvesting months. Profits accrued through hedging can be given back to the farmers as an additional bonus. 'Bonus' to farmers, over and above the MSP, will increase the relevance of the commodity derivative to them.

For aggregation to succeed, financial assistance from banking institutions for meeting initial/daily mark-to-market margin requirements, and initial hand-holding will be essential.

THE ROAD AHEAD FOR COMMODITY MARKETS

The role of commodity exchanges in economic development is paramount. They facilitate the emergence of a modern commodity ecosystem by bringing in infrastructure providers and a neutral platform which offers economic functions of risk management and price discovery. There is a broad agreement across regulators and government agencies that the commodity derivatives markets needs to be strengthened by undertaking reforms that would broaden and deepen the market. Although a number of favourable policy changes have already taken in this direction in recent times, imposition of high fiscal burden, restrictions on institutional participation, etc. help little to the cause of market development.

India's commodity markets needs to function under enabling and liberalised rules relating to participants, products and market accessibility so that they are able to effectively utilize their existing capacity to develop the market and connect them to all stakeholders. These institutions have to be able to pursue a strategy that allows them to focus their efforts towards improved access of their markets to smaller stakeholders, coordinate with other agencies for reducing the inefficiencies in the Indian physical commodity markets and building a better risk management culture across the ecosystem.

Views are personal.