India's Commodity Derivatives Market – Realising the Emerging Potential

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The Indian commodity derivatives market has been undergoing a transformational change during the last few years. A slew of measures have been introduced in the market by the regulator, which are helping to expand the market and bring in more depth and liquidity. These measures have indeed borne fruit: the average daily turnover in the domestic commodity derivatives exchanges recorded a robust 22% growth during 2018-19 and 24% in 2019-20, though it grew by only 2% in 2020-21 largely because of the pandemic Covid-19 and the restrictions on movement of goods and personnel.

Potential for Growth Strengthened by Recent Developments

Recent developments in the commodity derivatives market hold enormous potential for realizing further growth and inclusiveness in this market. The main components of such new developments include the expansion of products and eligible participant categories, apart from strengthening the processes connected to derivatives trading and clearing.

Expansion of Entities Eligible to Participate

Commodity markets received a shot in the arm in 2018-19 following announcement of the long awaited policy measures allowing the participation of institutional participants, such as eligible foreign entities (EFEs), Mutual Funds and Portfolio Management Services. Following release of detailed guidelines on participation of mutual funds in Exchange Traded Commodity Derivatives (ETCD), Asset Management Companies (AMCs) started participating in commodity derivatives. Today, several AMCs have included commodity derivatives as part of their mutual fund schemes, offering the benefit of portfolio diversification and inflation hedging to their clients. With this, the participant base in commodity derivatives has widened considerably, as compared to what was possible earlier.

At this juncture, it is important to note the significant contribution of the mutual fund industry to the Indian capital market, being the most preferred investment vehicle connecting retail investors. Total assets under management of mutual funds in India stood at about Rs. 33 lakh crore at the end of May 2021 (source: AMFI). The number of accounts or folios of mutual funds have been growing during the past 5 years or so and exceeded 10 crore at the end of May 2021. Their presence in the commodity derivatives space can, therefore, make a significant contribution to the development of this market.

It is evident from experiences in capital markets that mutual funds have enormous potential to boost liquidity in commodities derivatives markets while extending the diversification benefits of commodities to retail investors. By enhancing liquidity in the longer maturity contracts, they can facilitate the participation of corporates and other stakeholders with longer hedging requirements. Institutions like mutual funds can also expand the footprint of the market by reaching unreached commodity investors through suitable schemes fitting the requirements of small retail investors, or through exclusive commodity based funds or diversified funds along with other traditional assets like equities and bonds.

Within the community of institutional participants, the entry of banking institutions into the commodity derivatives market is particularly significant. The Reserve Bank of India, on September 25, 2017, permitted banks to become Professional Clearing Members (PCMs) and their broking subsidiaries to offer broking services in the commodity derivatives segment of SEBI recognized exchanges. Subsequently, a number of banks have become PCMs in the commodity derivative segments of exchanges, while several broking subsidiaries of banks have started distributing commodity derivatives products. With their high capital base and reputation, banks as clearing members bring more confidence among participants, especially among institutional participants. On the other hand, bank-owned broking subsidiaries have a large network and physical presence across the country, along with a large number of clients registered with them. They are significantly contributing in enlarging the footprint of the commodity derivatives market by making the products accessible to their vast client base.

Expansion of Commodity Derivative Products Suite

The expansion of the basket of products available for trading in the commodity derivatives market has been another significant development. Trading in commodity Options commenced in 2017, with the launch of Options on futures of Gold. Subsequently, Options trading on futures of commodities like crude oil, copper, silver, zinc, guar gum, etc. were also introduced. During the year 2020-21, regulatory permission was obtained for launch of Options on Goods, and currently Options on Gold Mini (1 kg) bar is also available in this segment.

In 2019, following release of SEBI guidelines on commodity indices, MCX launched indices with commodity futures as constituents. In accordance with the SEBI guidelines and conforming to international standards for financial benchmarks propounded by IOSCO, MCX launched the iCOMDEX series of indices in December 2019, which consists of a composite index, 3 sectoral indices and 9 single commodity indices. Subsequently, in August 2020 and October 2020, futures contracts on the MCX iCOMDEX Bullion Index and Base Metal Index were also launched to an enthusiastic response from the investing public. The MCX iCOMDEX Bullion Index (or, BULLDEX) was world's third most traded commodity index in 2020, as per data released by Futures Industry Association, despite being traded for little more than four months of 2020.

Towards *Atmanirbhar* Bharat: Promoting indigenization

India' economy has always been commodity intensive. As a result, the country is among the largest consumers and producers of a number of commodities. Despite this position in the global trade of commodities, the country remains a price taker of almost all commodities, especially bullion, energy and metals.

At the same time, there is a perpetual need for a transparent mechanism for discovering prices which are fully reflective of the fundamentals of the metals market, not just international benchmarks. In order to develop domestic price benchmarks in metals, a significant step has been the launch of delivery-based futures contracts of base metals on MCX, starting January 2019. These delivery-based contracts are traded and settled based on the prices polled from the stakeholders in the value chain of the domestic metal industry. Hence, the delivery based base metal futures are expected to not only bring transparency in the domestic price discovery process thereby setting domestic benchmarks, but also facilitate adoption of internationally accepted quality standards among stakeholders.

After the Bureau of Indian Standards issued good delivery standards for refined gold and silver bars, MCX has been taking steps so that bullion meeting the India good delivery standards can be assimilated into the country's bullion derivatives market, supporting the government's vision of financialisation of the stock of gold in Indian households. In order to bring in more local players into the Exchange delivery mechanism, MCX has expanded the Good Delivery list in Bullion by empaneling Indian refineries that meet the Exchange's eligibility criteria. With the same objective in view, the Exchange is also in the process of empaneling domestic producers in base metals like Lead.

Further actions for realizing the market's potential

While India's commodity derivatives market has made good progress over the last few years in terms of expansion of products and participants, some further actions can pave the way to a strong and sustained growth momentum in the market. These actions also lie in the realm of expansion in products and participants.

Among products, the market participants look forward to Exchange Traded Funds (ETFs) based on commodity futures. Being leveraged products, futures-based ETFs can provide collateral returns to investors while also possessing the benefit of a cash-settled product. The demand for ETFs in commodity markets has particularly grown after the launch of commodity indices, as the investing public is now looking forward to commodity index-based ETFs on the lines of ETFs in equity indices. Similarly, market stakeholders are also looking forward to introduction of new products like electricity futures.

Insofar as expansion of eligible participants is concerned, stakeholders have long been looking forward to banks' participation in the commodity derivatives market. Banks can play significant and diversified roles in enriching commodities markets with their wider outreach across large sections of the population by offering commodity-based loans and hedging such exposure, handholding smaller participants to hedge, as well as aggregating farmers and other small participants. Similarly, financial institutions with a long term investing perspectives, such as insurance companies and pension funds, would also play a catalytic role in market development through their participation, if permitted.

Foreign entities are another category of participants whose presence can enrich the market. Foreign hedgers, also termed as Eligible Foreign Entities (EFEs), are already allowed in the market, but the norms for their participation could be further liberalized to encourage their entry. Moreover, the market could be opened up to all types of foreign entities, including foreign investors like FPIs as well as NRIs. Foreign institutions, like the domestic institutions, would participate based on their professional research capabilities. As such, their participation is likely to contribute to higher quality of information flow into the price discovery process, thereby adding to the knowledge base of commodity ecosystem and buildup of technical expertise for better risk management using commodity derivatives.

Enhancing the scope of eligible participants, especially institutional participants, would benefit the market not only by enhancing its liquidity and depth, but also by attracting new retail participants, all of which would help in the overall market development.

Given the rapid and transformational developments witnessed in the Indian commodity derivatives market, this market is possibly undergoing a historic watershed moment currently. As the Indian economy looks towards a faster growth in the post-Covid era, it is essential to envision a vibrant commodity derivatives market, setting up global standards, facilitating better integration between spot and futures markets, and offering efficient derivative instruments with high liquidity and reaching out to diversified market participants of the commodity ecosystem. It is in realizing this vision that the institution of the commodity derivatives market would not just realize its true potential, but also play its rightful supportive role for the Indian economy.