Investor participation in Commodities Market: Current Status and Future Potential

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Commodities have a distinct place in the economic history of mankind. Before the advent of fiat currency, it was commodities which acted as a means of exchange; be it precious commodities such as gold/silver or agri commodities. Even post the advent of fiat currency, commodities continue to be considered as distinct asset class. The very nature of agricultural commodities endear them to investment, Agri commodities for example are cyclical in nature, get harvested once or twice a year with the demand fairly uniform across the year. Hence it is imperative for an investor to hold the commodity by purchasing it at harvest when the prices are low and reap profits when selling at higher prices through the year. As civilizations developed, sophisticated trade platforms and improved logistics played a role in streamlining this journey from production to consumption.

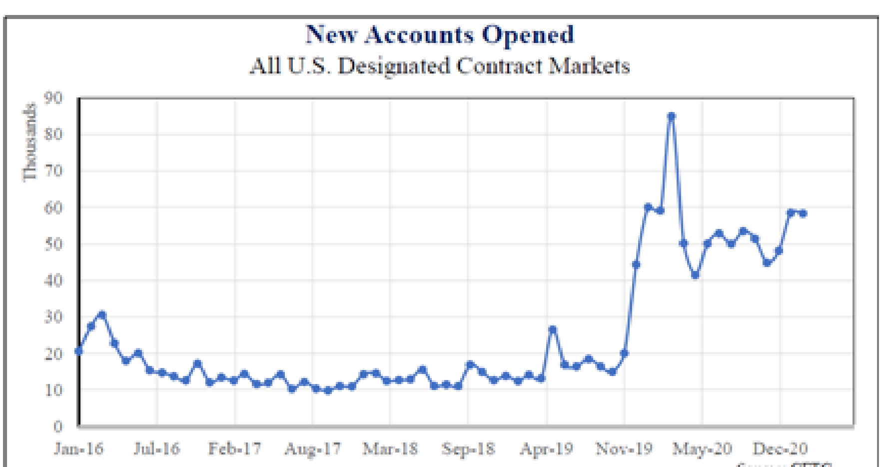
Commodity derivatives exchanges play an important role in helping the different ends of the supply/demand spectrum mitigate their risks by hedging on such platforms. These platforms serve two significant economic functions in the commodities ecosystem viz. price discovery and price risk management. They cater to the needs of a diverse set of commodity value chain participants such as producers, consumers, processors, importers/exporters and financial investors who primarily use these markets in managing their price risk. The retail investors, though few in number, are finding commodities as an alternative asset class for investing their savings. Apart from these, farmers through producers such as Farmers Producer Organizations (FPO) are also associating with these markets to hedge their price risk. However, there have been several factors which have stymied growth and development of the commodities market in India. A vibrant and flourishing domestic commodity market could help attain the status of becoming 3rd largest economy of the world.

World over the growth of commodities derivatives market has been directly proportional to economic growth of major countries. One reason for this is that as the countries grow, so does their domestic and international trade in commodities and hence a need for price risk management for the market participants. Recent addition in this is China which has seen major boom in their commodities market in last 15 years. It has also become the price benchmark for many major commodities such as Iron ore, egg, polymers etc. wherein it is major consumer or producer. Indian economy is on a healthy growth trajectory and we need to make efforts to develop the commodity market in terms of volume and participation so that India can play a leading role in commodity sector.

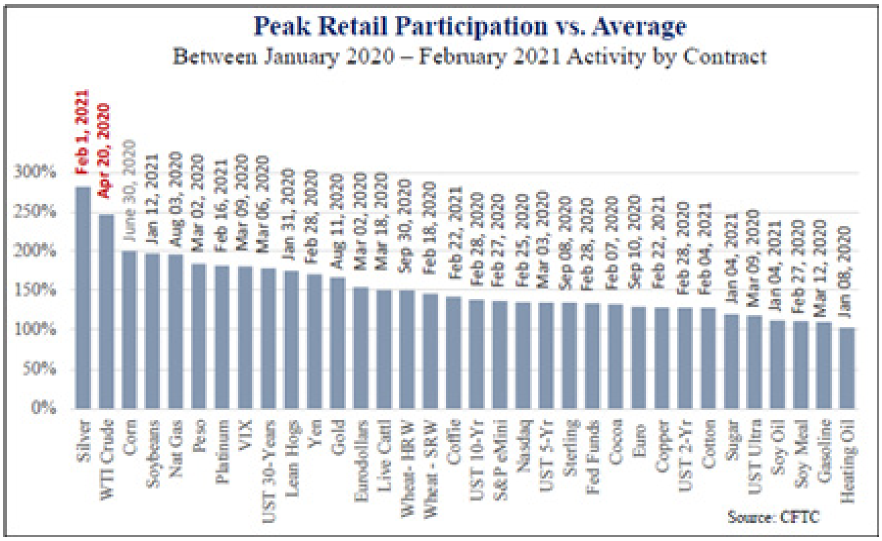
Recent Trend in Retail Participation in the International Commodity Market

A report published by the Commodity Futures Trading Commission in 2021 provides useful insights in the retail participation in the US commodity Market. It says that there is a visible growth of retail interest fuelled by easier market access (directly and indirectly), social media awareness creation, smaller and retail friendly contracts and exchanges. The potential commodity super cycle may further incentivize participation.

Fuelled by retail interest, the number of first time traders reached the highest levels during the early pandemic months. Contributors to this growth may be factors such as offering online account opening, reduced fees, and minimum balance requirements as well as the growth of smaller retail friendly contracts etc.



The most significant retail engagement in futures markets occurred in Silver (February 2021) and in WTI Crude Oil (April 2020).



Although the number of participants has grown exponentially, the direct trade volumes are approximately 10 15% of total activity. Asset/Money managers offering retail products (i.e., Exchange Traded Funds, Exchange Traded Notes) increase direct, indirect (via swaps), and tangential (cross market arbitrage) impact.

Retail activity adds to liquidity as almost all transactions are placed as resting or limit orders. Retail participation is also positive for liquidity diversification as retail trading strategies differ from those of the professional traders.

The retail participants' growth (both directly or indirectly) adds liquidity and diversification to derivatives markets. However, if this sector is to develop fully, a more even return profile is needed to emerge.

Specifically, two areas where more work may be necessary: (1) Investor protections, disclosure requirements, suitability standards, and establishing clear obligations that protect investor interests by all introducing brokers (2) Evaluate required market structure development and policy considerations such as the predatory type strategies that leverage or target broad retail engagement. (Source: The Global Markets Advisory Committee, Market Intelligence Branch, Commodity Futures Trading Commission, March 2021)

Historical Perspective of Commodity Trading in India

Commodity Futures market in India dates back to 1875 when Bombay Cotton Trade Association was set up to trade in Cotton contracts. Later on in 1893, a separate association, Bombay Cotton Exchange Ltd., was constituted. The Gujarati Vyapari Mandli was set up in 1900 to carry out futures trading in cotton, castor seed and groundnut. In 1939, cotton derivatives banned by the government. Thus, India had a futures market in till a prohibition was imposed during the Second World War on futures trading in commodities owing to the scarcity conditions prevailing in the economy. After independence, especially in the second half of the 1950s and first half of 1960s, the commodity futures trading again picked up and there were thriving commodity markets. The Forward Contracts (Regulation) Act, (FCRA) was enacted in 1952 and Forward Markets Commission (FMC) was established in 1953 to regulate the commodity futures trade. However, in mid-1960s, commodity futures trading in most of the commodities came to be banned.

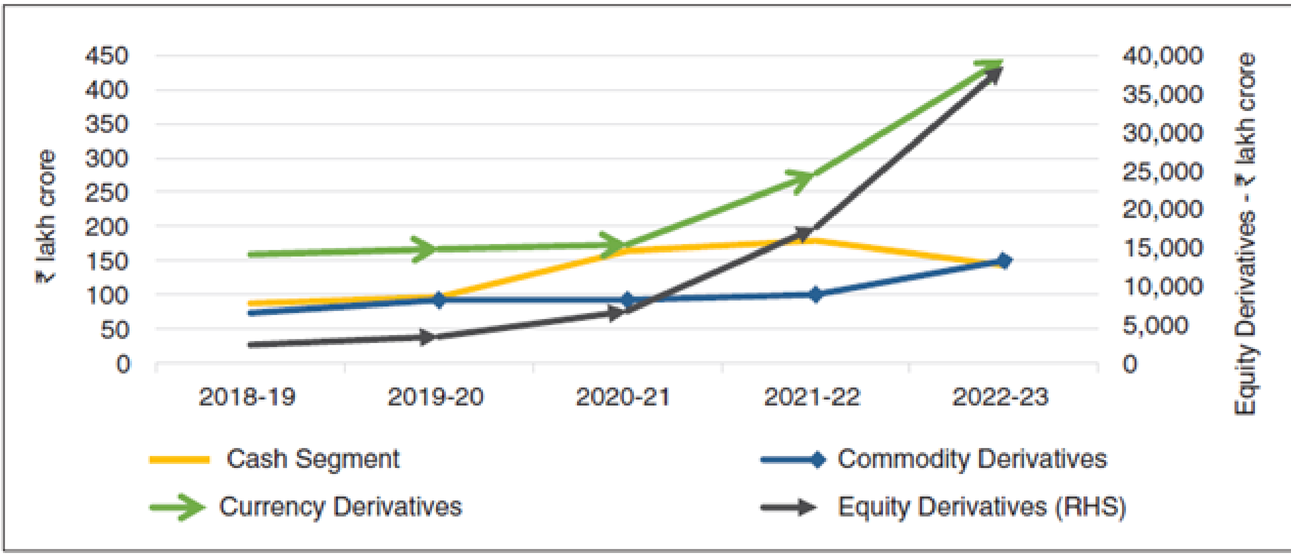
A paradigm shift in the Governments policy towards futures trading took place in late 1990s and in early 2000's, an initiative was taken to promote demutualised Commodity Exchanges with national status imbibing the best trading, clearing and settlement practices. The National Exchanges have changed the contours of commodity futures market in the country on the strength of superior technology and were able to attract substantial liquidity in a short span of time. With the merger of Forward Markets Commission (FMC) with Securities and Exchange Board of India (SEBI) by Finance Minister Arun Jaitley in Union Budget 2015, SEBI took over regulation of Commodity Exchanges from September 2015.

Market Size of Commodity Vs Equity Market: Current Status and Growth Drivers

Started in Year 2003, Commodity Derivatives Markets in India have grown reasonably during past two decades. However, there is immense growth potential in these markets. As an asset class, commodity market is relatively new when compared with the Equity market as an option of investment.

The turnover trend across financial products such as equity, commodity and currency is presented through a Figure shown below. It can be seen that equity derivatives have seen a robust growth in the past three years. The rate of growth of equity cash segment has stalled little bit in the recent years. The currency derivatives market also observed a decent growth between 2020-21 till 2022-23. Commodity derivatives turnover has seen sustained improvement particularly in 2022-23 over 2021-22. The pan-India turnover in commodity derivatives segment increased by 50% in 2022-23 to ₹150.1 lakh crore, up from ₹100.3 lakh crore in 2021-22.

Figure: Turnover across Products



Source: Annual Report, SEBI, 2022-23

(a) Remarkable Performance of Equity Market

Equity Market has a long history with the setting up of the Bombay Stock Exchange in July 1875. However, this market started attracting retail investor much later with the establishment of Securities and Exchange Board of India (SEBI) in 1989 as an informal body and in 1992 as a statutory autonomous regulator to protect the interests of the investors and developing and regulating the securities market. The equity markets have made enormous progress in recent years through carrying out several reforms. The state of the equity market today bears testimony to the role SEBI plays in building investors' confidence in these markets.

These reforms not only boosted the confidence of domestic investors but the international investors in the forms of foreign institutional investors (FIIs) also attracted towards Indian securities market. The growth of mutual fund industry and IPOs also began implying that the increasing interest of the retail participation in equity market.

The evolution of fintech and advent of new age brokerage firms has also aided to a great extent in the increased direct participation in the past few years. The number of demat accounts in these markets have jumped from around 409 lakhs in 2019-20 to 1145 lakhs in 2022-23 - a 180% growth in just four years. In comparison, the participation levels in commodity derivatives exchanges is a trickle at present.

Indian: Size of Equity Market & Commodity Derivatives Markets (in Terms of Number of Investors)

<table>
<tr><th rowspan="2">Financial Year</th><th colspan="2">Number of Investors (Unit- Lakhs)</th><th colspan="2">Year over Year Growth</th><th colspan="2">Market Growth (2022-23 over 2019-20)</th><th rowspan="2">Commodity Derivatives Market size compared to Equity Market</th></tr>
<tr><th>Equity</th><th>Commodity</th><th>Equity</th><th>Commodity</th><th>Equity</th><th>Commodity</th></tr>
<tr><td>2019-20</td><td>409</td><td>4.22</td><td></td><td></td><td rowspan="4">180%</td><td rowspan="4">50%</td><td>1.03%</td></tr>
<tr><td>2020-21</td><td>551</td><td>4.79</td><td>35%</td><td>13%</td><td>0.87%</td></tr>
<tr><td>2021-22</td><td>897</td><td>4.85</td><td>63%</td><td>1%</td><td>0.54%</td></tr>
<tr><td>2022-23</td><td>1145</td><td>6.32</td><td>28%</td><td>30%</td><td>0.55%</td></tr>
</table>

Notes:

- *No. of Investors in Equity Markets are calculated by summing up the number of investors having "Demat Account" in NSDL and CDSL*
- *No. of Investors in Commodity Derivatives Market are calculated by summing up the number of investors having "Trading Account" in MCX and NCDEX*
- *Data sources: Annual Reports of NSDL, CDSL, NCDEX and MCX*

(b) Performance of Commodity Derivatives Market in India

The Commodity Derivative Markets in their current form are relatively new when compared with the equity markets.

They started functioning in Year 2003. Since then there has been gradual progress in these markets in terms of regulatory reforms, market size and participation by the investors. Commodity derivatives market are broadly bifurcated in two categories viz. agricultural commodity market and non-agricultural commodity market comprising of markets for metals and energy products. Two major Exchanges viz. Multi Commodity Exchange (MCX) and National Commodity and Derivatives Exchange (NCDEX) are two leading the growth story of the Indian Commodity Market.

Remarkable progress is seen in the past couple of years under the able guidance of Financial Market Regulator “SEBI” to bring confidence among the market participants and increase investors participation. Initiatives such as permitting institutional participation, mutual funds and portfolio management services in the commodities derivatives market to increase the market depth, allowing launch of commodity indices, introducing “Options” trading etc., allowing custodial services in goods underlying commodity derivative contracts in order to enable participation of institutional investors are brought to bring medium to long term sustainable benefits to the commodities market.

Initiatives have also been taken from other regulatory institutions like WDRA such as Enactment of “*Warehousing Development and Regulatory Authority (WDRA) Act* “ for ease of borrowing funds against electronic negotiable receipts (eNWRs) has made it safer for every stakeholder including farmers to transact efficiently. IT also enabled setting up repositories for commodity universe on the lines of Depositories for equities. Reserve Bank of India (RBI) permitted the bank subsidiaries to offer commodity broking services in September-2017. This was done in sync with the Securities and Exchange Board of India’s (SEBI) plan to deepen the market.

By the end of Year 2022-23, more than 6 lakh clients were participating on commodity exchanges (MCX and NCDEX). This investor participation has grown by 50% since 2019-20 i.e. during last four years. The year over year growth during 2022-23 was 30% in commodity market compared to 28% in equity market. Within the commodity market, non-agri segment attract a lion’s share (around 97%) in total investors participation compared to participation in agri segment. High percentage of participation in non-agri market is mainly due to the well-developed international markets for these commodity and our dependency on imports of most of the commodities such as precious metals like gold/silver and industrial commodities like copper, nickel, aluminium and crude oil etc. However, agri commodity market is more domestic oriented in terms of production and consumption. Further, frequent government interventions have adversely affected agri-derivatives market growth.

Despite the impressive growth in past few years, the market size in terms of investors participation in commodity market is hardly 0.50% of the investors numbers who are participating in the equity market. In absolute numbers, investors participating in commodity market was 6.32 lakhs as against 1145 lakhs (the number of investors registered with the depositories) in 2022-23. This indicates that there is a huge potential in the growth of the commodity market too in long term.

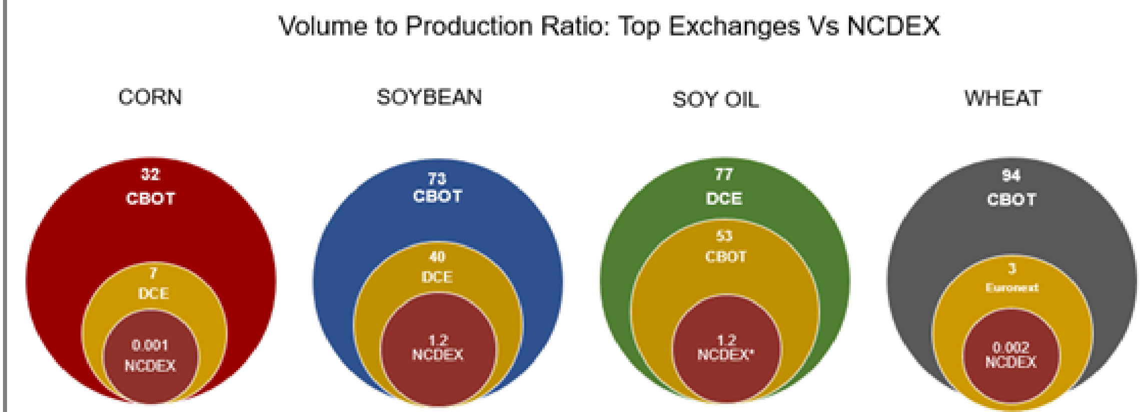
The big difference between the number of investors in equity and commodity market is also attributed to some of the inherent difference. Equity markets are primarily an investment market unlike commodity markets which are used more for price risk management purpose. Equity market offers products which are suitable for long term investment as well as for short term trading purpose. Further a diverse range of investment products are available in equity market unlike in commodity market where largely “futures and options” are the major investment products. However, commodity market products, especially agri commodities are consumption oriented, having government interventions, shorter useable life of majority of the commodities, cyclical nature of production etc. Lastly, Equity markets have both the Cash Segment as well as Derivatives segments on the Exchange whereas on the Commodity side it is only the Derivatives segment which requires a more sophisticated level of understanding. Then the commodity markets need to grapple with the myths like it is difficult to understand and one can see the wealth wiped out in no time, if one doesn’t play the markets well.

Policy Support for the Growth of Commodity Market

While, market growth in non-agricultural commodities is relatively better, the agri commodity market requires positive support from the policy circles for the growth and development of competitive domestic agricultural markets. India is a commodity based country and agricultural commodities are source of livelihood for a large number of value chain participants including farmers, the agricultural commodities markets are although big but need to grow and establish further.

The growth potential of the Indian agricultural commodity derivatives market can be assessed from the size of the agricultural derivatives markets in the US and China where the trading volumes are much higher than the production of the individual commodity. For example, in case of soybean the trading volumes in Chicago Board of Trade (CBOT) are 73 times of the production of US soybean. In China too, the trading volumes are around 40 times of the actual production. In case of India the trading volumes were 1.2 times of the actual production. The case of soy oil, wheat and corn are also not different from soybean. However a strong lobby of vested interest in against the transparency in the derivative market as they benefit from opaque system. Unfortunately, efforts of this lobby and the unfounded fear in government which feared consumer backlash led to suspense of major agri derivatives contracts in 2021.

Growth Potential for Indian Agriculture Derivatives Market



*Around 70% of the domestic consumption demand in India is met through imports. Hence, total supplies of Soy oil (domestic production + imports) has been considered to calculate the ratio.

Volume data source – FIA 2020; Production data source: USDA

Deepening of the commodity market ecosystem can be ensured with more and more agri-business industries coming and using this market for their price risk management purpose and by entry of new institutional investors for exploring commodities derivatives as an another asset class for value unlocking.

Limited understanding about derivative products and trading mechanism has also constrained the client participation and trading volumes. Increasing the number of products which are tailored as per the need of the value chain participants are also required to grow the market.

On the policy front, government has remained quite active in commodities market either through direct interventions in the physical market through MSP procurement, disposal of stocks, distribution of food-grains to needy, applying stock holding limits on trade participants and export-import restrictions/ duty changes etc. or through intervening in the commodity derivatives market mainly through suspending or halting trading in a particular commodity. These interventions over a period of time seems to have discouraged the wider market participation as the confidence of the value chain participants has shaken. Such policy interventions should be addressed in a more objective and structured way so as to benefit the market in long run.

It is widely acknowledged that Govt. intervenes in the agricultural market primality through MSP procurement operations and meet out twin objectives i.e. Distribution of these food-grains to the needy population and keep a sizable amount of food-grains as a buffer stock to maintain food-security of the country. This whole process involves investment of lakhs of crores of rupees. Government interventions can be complementary for the Commodities Market in the areas of Price Support and Price Risk Management through its participations in commodity derivatives market. States and Central government can use the modern markets such as e-Auction platforms and commodity derivatives for procurements, using OPTIONS as complimentary to MSP. As in the case of China, roping-in government trading & marketing agencies for their risk-management through Exchange-Traded derivatives, which will significantly improve the efficiency of commodity value chain.

Institutional Investors like Mutual Funds can also contributes to Commodity Market in Big Way. Retail participation can also route through Mutual funds in commodities market as small clients find it difficult to directly participate due to unique nature of the commodities market. Mutual Funds in the financial markets have played a pivotal role in connecting millions of customers and channelized Lakhs of crores of rupees in financial markets bring efficiency in these market.

Steps needed to make the commodities market attractive

China is inching towards highest volumes in commodity derivatives and challenging the supremacy of the US commodities market like CBOT. This could happen as the China is one of the largest user of the commodities and their markets are backed by the wider market participation and desired policy support. India is not far away; we are moving from a short supply country to the surplus country in terms of many of the agricultural produces. Our agricultural exports are continuously rising and we are in a position to supply a large chuck of world's requirement of variety of food items. In this backdrop, our derivatives markets need to grow proportionately and in line with the development of our physical commodities markets so that India can also become a global benchmark in many of the commodities and lead the commodity business on the global commodity business front.

Awareness Creation:

Spreading awareness about the commodity market is utmost necessary for the sustainable growth of these markets so that the whole value chain, especially farmers and SMEs derive benefits. It is also imperative for market intermediaries to play a similar role in getting clients to participate in the commodities segment.

Agricultural sector employs more than half of our working population and drives the sustainability of our economy by addressing concerns regarding food security. It is of utmost importance that individuals should have the requisite knowledge and competencies to understand the nuances of the commodity markets along with the relevance of commodity derivatives markets.

A tailor made curriculum on commodity markets should be included in the curriculum at the graduate level that will help create investment awareness as well as skilled workforce to meet the requirements of this sector.

Other steps that can help the commodity derivatives market include

Infrastructure development – Upgrading storage, grading and technology

Mandating the Companies with large borrowings having commodity exposure to hedge their risk,

Allowing Banks to directly participate in Commodity Derivatives Market,

Domestic Players to use Domestic Exchanges to hedge commodity price risks,

Mandating Banks to lend against Electronic Negotiable Warehouse Receipt (eNWR),

Allowing support provided to FPOs as CSR activity etc.

Concessional finance for eNWR on the lines of KCC

Conclusion

India today is one of the largest equity markets in the world. In terms of technology use, investor protection, sound regulation etc. we are second to none. This journey has been well planned out and a consequence of joint efforts of Regulators, Exchanges, Intermediaries, Fintech and most importantly an enthusiastic investor. However, consolidation of investment into a single asset class such as equity is not healthy and diversification is appropriate. For an economy to really develop however, businesses should have the confidence to spread their wings and trade. Exposed to the volatility of commodity prices, this is difficult to achieve without a developed derivatives exchange to mitigate their commodity price risk. In a country like ours, such platforms are also vital for Farmers and other producers to take informed decisions. Hence it is time to focus on development of commodity derivatives platforms, provide enabling policies and look at ways to develop products which are apt for retail participation.