Commodity Derivatives Market in India

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Abstract

India is among the apex producers of a number of commodities and has a long history of trading in commodity derivatives. The commodity market was quite prevalent till 1970s but its development was hampered due to certain restrictions and regulations introduced by Indian Government. In recent years these restrictions have been removed for the smooth functioning of commodity trading. Commodity market has occupied imperative position in Indian economy since the establishment of Forward Market Commission in April 2003. There are five national and sixteen regional commodity exchanges recognised and regulated by this Commission. Different types of commodities such as industrial, agricultural; bullion, plantation etc. is traded on commodity exchanges in the country. So considering these points an attempt has been made to know the regulatory framework of commodity futures market in India and to present the various developments in Indian commodity derivative market and commodity exchanges.

Key words: Forward Market Commission, Commodity Futures, Operations of Commodity Exchanges.

1. Introduction

The commodity future market in India dates back to more than a century. First organised future market in India was established by Bombay Cotton Trade Association Ltd. in 1875 to trade in cotton derivatives contracts. Due to malpractices of association, Bombay Cotton Exchange was set up in 1893. Future Exchange of Wheat came into existence in 1913 at Hapur (UP). Bullion future trading started in 1920. The future trading of raw jute and jute products took place in 1919 through Calcutta Hessein Exchange Ltd. But the organised future trading in raw jute and products started after establishment of East India Jute Association Ltd., in 1945. The commodity derivative market in India underwent rapid growth between the period of First and Second World Wars. A large number of commodity exchanges trading future contracts in several commodities like wheat, rice, cotton, groundnuts, groundnut oil, raw jute, jute good, caster seed, sugar, precious metal like gold, silver were flourishing throughout the country, before the outbreak of Second World War. Under the Defence Act of India, commodity trading came to prohibited during the Second World War. After India’s independence, in the early 1960s the commodity derivative trading again picked up. In mid 1960s most of the commodities were banned and future trading continued only in the minor commodities, viz. paper and turmeric. Future trading in potato, caster seed and jaggery was permitted in 1980s. In April 1999 future trading in various edible oilseed complexes was
allowed and in May 2001 future trading in sugar was permitted. Since April 2003, future trading was permissible in all the commodities by Government of India as National Agricultural Policy announced the positive role of derivative market.

With the increasing volatility of the markets, investors are now interested in diversified investment avenues that reduce the risk of investment. Commodities hold out vast prospective to become a separate asset group for market savvy investors and also provide an efficient portfolio diversification option because of being less volatile as compared to equity and bonds. Commodity trading helps investors to diversify their investment from the traditional choices like shares, bonds and portfolio. Trading of commodity futures execute two vital economic functions, price risk management and price discovery besides helping economy with improved resource allocation. Commodity derivative trading is helpful to all sectors of the economy. An efficient futures market provides export import oriented firms with greater risk management capabilities. The commodity derivative market in India has achieved substantial development in term of transparency, technology and trading activities. The total value of agricultural trading has reached to the amount of Rs. 345032 crore during the period of April 2012-13.

1.2 Review of Literature

Gopal and Sudhir (2001) pointed some of the commodity markets are efficient among all the commodity markets in terms of price risk management. The reasons for inefficiency of other commodity markets were found as low volume of trading during maturity period, lack of hedger’s participation. K.G. (2002) indicated the inefficiency of commodity future market in terms of providing hedge against price risk by observing the difference between future and spot prices. He found many factors like lack of participation of trading members, low market depth and thin volume with Government’s interference in Commodity markets etc., as major evils for inefficient price risk management. Narender (2006) Indian commodity market has made enormous progress since 2003 with increased number of modern commodity exchanges, transparency and trading activity. The volume and value of commodity trade has shown unpredicted mark. This had happened due to the role played by market forces and the active encouragement of Government by changing the policy concerning commodity derivative. Himdari (2007) pointed out that significant risk returns features and diversification potential has made commodities popular as an asset class. Indian futures markets have improved pretty well in recent years and would result in fundamental changes in the existing isolated local markets particularly in case of agricultural commodities. Kamal(2007) concluded that in short span of time, the commodity futures market has achieved exponential growth in turnover. He found various factors that need to be consider for making commodity market as an efficient instrument for risk management and price discovery and suggested that policy makers should consider specific affairs related with agricultural commodities marketing, export and processing and the interests involved in their actual production. K. Lakshmi, (2007), discussed the implications on the grant of permission to Foreign Institutional Investors, Mutual Funds and banks in commodity derivative markets. She found that participation of these institutions may boost the liquidity and volume of trade in commodity market and they could get more opportunities for their portfolio diversification. Brajesh and Pandy (2013) investigated the short run and long run market efficiency of Indian commodity futures market. They had tested four agricultural and even non-agricultural
commodities for market efficiency and unbiasedness. The result confirmed the long run efficiency of commodity futures prices and inefficiency of futures prices in short run.

1.3 Objectives and Research Methodology

The objectives of this study are to know the regulatory framework of commodity derivative market in India and to present the various developments in the Indian commodity derivative market and commodity exchanges. The study is based on secondary data. The data has been collected through various web sites of commodity exchanges, commodity market bulletins and annual reports of Forward Market Commission.

1.4 Regulatory Framework of Future Trading

There is a three tire regulatory structure of future trading in India i.e. Government of India, Forward Market Commission and Commodity Exchanges.

**Government of India**: The central government makes policy regarding the forward trading in commodities. At present, the Ministry of Consumer Affairs, Food and Public Distribution Department of government is dealing with commodity derivative trading.

**Forward Market Commission**: The commission came into existence in 1953 under the provisions of Forward Contract (Regulation) Act, 1952. As a statutory body it functions under the administrative control of the Ministry of Consumer affair. As per section 4 of the FC(R) Act, 1952, the commission performs the following roles:

- To advise the central government on the subject of assigning or withdrawal of recognition from any commodity exchange.
• To observe the forward market activities and to take necessary actions within the powers assigned to it under the Forwards Contract (Regulation) Act, 1952.
• To gather and publish obligatory information related with forward trading.
• To give recommendations regarding the improvements in working of future trading and commodity exchanges.
• To examine the accounts and other documents of any recognised exchange/association or any member of such organisation.
• To execute other functions assigned to the commission by FC(R) Act, 1952.

1.6 Administration

Headquarters of Forward Market Commission is at Mumbai and a regional office at Kolkata. To carry out various assignments the Forward Market commission has following nine divisions:

Commodity Exchanges: Recognised exchange or Association is a place where trading of commodities takes place. Commodity Exchange works under the provisions of Forward Market Commission. FMC is the regulatory body to control the activities of commodity exchanges just like SEBI regulates the functions of Capital market. At present there are 6 National commodity exchanges and 16 regional commodity specific exchanges operating in Indian commodity futures market. These exchanges are recognised to regulate trading in a variety of commodities approved by Forward Market Commission under the Forward Contracts (Regulation) Act, 1952.

Multi Commodity Exchange of India Ltd.:– Based in Mumbai, MCX is an independent commodity exchange of India. It was incorporated in 2003. MCX offers futures trading in more than 40 commodities across various segments such as energy, bullion, metal and various agricultural commodities. With 3, 46,000 trading terminals spread over 1577 towns and cities in India, MCX is India’s No. 1 commodity exchange. In terms of the number of
contracts traded in 2011, it was the world’s third largest commodity exchange. At present, MCX hold a market share of 86% of the Indian commodity futures market. With respect to the number of futures contract traded, Multi Commodity Exchange is the world’s largest exchange in silver and gold, second largest in Natural gas and third largest in Crude Oil.

**National Commodity and Derivative Exchange Ltd.:** Promoted by national level institutions such as, LIC, ICICI, NABARD and NSE, NCDEX is an online multi commodity and professionally managed exchange with an independent Board of Directors not having vested interest in commodity market. NCDEX was incorporated as public limited company under the Company Act 1956 on April 23, 2003. Headquartered in Mumbai, the exchange facilitates futures trading in precious metals, energy, ferrous and non ferrous metals and agricultural commodities.

**National Multi Commodity Exchange of India Ltd.:** Founded in 2002, NMCE is India’s third largest commodity exchange. It was the first commodity exchange of India to be granted permanent recognition by government in the 2003. It was promoted by public agencies and a group of Indian commodity based corporations such as Punjab National Bank, NAFED, Central Warehousing Corporation, Gujarat Agro Industries Corp. Ltd., Gujarat State Agricultural marketing Board, National Institute of Agricultural Marketing and Neptune Overseas Ltd.

**Indian Commodity Exchange Ltd.:** Incorporated in 2009, ICEX is 4th National on line derivative exchange of India which has established a transparent, time-tested and reliable trading platform. It has its headquarter in Mumbai and many regional offices across the country which cover agricultural region with a objective to encourage farmers, traders and actual users participation to hedge their position against the extensive price fluctuations. ICEX is promoted by India bulls financial Services Ltd., Reliance Exchange Next Infrastructure Limited and MMTC Limited, KIRBHCO, Indian Potash Ltd., and IDFC among others as its partners. It deals with the commodity trading of bullions, Base Metals, energy and Agricultural Commodities.

**ACE Derivatives and Commodities Exchange Ltd.:** Promoted by Kotak Mahindra Group, HAFED, Bank of Baroda, Corporation Bank and Union Bank, ACE Derivative Exchange was set up in 2010 as fifth National Commodity Exchange of India. It has its registered office at Ahmadabad and corporate office at Mumbai. It facilitates futures trading in oils & Oilseeds, pulses, Guar Gum, Sugar and in Fiber. It also helps in the process of trade intermediation including registration of trades, contract settlements and mitigation of counter party risk along with a robust clearing and settlement infrastructure.

The following commodities are being traded in these exchanges.

**Bullion:** Gold, Silver, Platinum

**Base Metals:** Copper, Nickel, Lead, Zinc, Tin etc.

**Energy Products:** Crude Oil, Heating Oil, Gasoline, Natural Gas etc.

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1. Data published for CY 2011 on the websites of exchanges and FIA Annual Volume Survey released in March 2012
2. Data maintained by Forward Markets Commission (FMC), regulator of India’s commodity market.
Agricultural Products: Fibre, Pulses, Vegetables & Grains, Edible Oils, Oilseeds and Oil Cake etc

1.5 Developments in Indian Commodity Derivative Market

1.5 (i) Primary initiatives taken by the government since liberalisation of the Derivative Market

- Ban on future trading in all commodities has removes on 1st April, 2003.
- Future trading in gold and silver commenced for the first time after a ban of more than four decades at National Multi Commodity Exchange, Ahmadabad on 3rd Oct.2003. Similarly MCX, Mumbai and NCDEX. Mumbai also launched future trading in gold and silver in November and December 2003 respectively.
- To strengthen the infrastructure in commodity derivative market the Forward Market Commission issued guidelines on setting up of new National multi commodity exchanges and under these guidelines a fourth National Exchange named Indian Commodity Exchange (ICEX), NCR, Gurgaon was granted recognition in 2008. These National level commodity Exchanges can offer future trading in all the commodities with the authorization of the commission.

1.5 (ii) Enrichments in Regulatory Framework

To fulfill the needs of a modern electronic market and to strengthen the Forward Market Commission a Bill proposing amendments to Forward Commission (Regulation) Act 1952 has been approved by the Cabinet which provides for:

- Defining forward contracts as to as to include other commodity derivatives definitions of intermediaries, etc.
- Composition and functioning of FMC
- Levying of fees on intermediaries to finance the Commission activities
- Allowing trading of option and other derivatives in goods.
- Fortification the punitive provisions.
- Constitution of Forward Market Appellate Tribunal.
- Provision for grant by the central Government to meet transitional financial needs of FMC.
1. To fortify the regulatory arm, the Forward Market Commission has taken initiatives for collaboration with International regulators. FMC became associate member of International Organisation of securities Commission (IOSCO), which is a global forum for the market regulators. In addition, the commission also signed MOU with the United state Commodity Future Trading Commission (USCFTC) and with China securities regulatory Commission (CSRC). In January 2010, the commission also signed MOU with CVM (Securities and Exchange Commission of Brazil), Brazil.

2. The FMC had taken up the issue of introducing course on commodity derivatives in Universities and Management Institutes with the Ministry of Human Resource Development, GOI to promote commodity related education and to develop a talent pool. This need arise due to the loss of area expertise over two generations on account of prohibition on future trading in the 1960s through the 1980s.

3. To benefit the participants and other constituents of the commodity derivative market, the Commission organise various awareness programs and capacity building programs every year. There has been increment in the awareness programmes organised by the commission since 2007-08. In the year 2011-12 the number of awareness programmes and capacity building programmes were 818 and 100 respectively.

1.5 (iii) Renewal of recognition:

On the recommendation of the Forward Market Commission, the Government of India renewed the recognition of eight Exchanges /Association including, National Board of Trade, Indore, Bikaner Commodity Exchange Ltd. Bikaner, Rajkot Commodity Exchange Ltd., Rajkot, Rajkot Commodity Exchange Ltd., Rajkot, National Board of Trade, Indore, The Surendranagar cotton oil & oilseeds Association Ltd., Surendranagar and East India Jute & Hessian Exchange Ltd., Kolkata

1.5 (iv) Improvement in market integrity:

For the improvement of integrity of the commodity futures market, the commission have levied deterrent penalties to prevent the misuse of CCM (Client Code Modification) facility and trade execution without uploading unique client codes (UCC).

1.5 (v) Protection of Inventors interests:

To protect the interests of the investors and to boost their confidence in the futures market, investor protection fund has been constituted in which the 64.67 cr. Rupees have been contributed by all exchanges. The fund is operated by a separate trust. This would enhance the participation of investor which may increase the breadth and depth of the market.

1.5 (vi) Awareness of investor through “Jago Grahak Jago”:

To create consumer awareness in the country, the Government has been executing an inventive and intensive multimedia campaign, “Jago Grahak Jago” (Wake Up Consumer). For the purpose of educating the investors of commodity futures market, advertisements were published in 125 newspapers in 9 regional languages across the country.
(vii) Improvement in Compliance:

The Forward Market Commission has set the compulsory audit of all the brokers/members of national exchanges at least one in three years, which would be uniform audit manual. The commission also issued code of conduct for auditors to address the conflicts of interest issues.

1.6 New Developments in Commodity Futures Market

At present 113 commodities being regulated under the section 15 of the FC9R) Act 1952, which are traded on 5 National and 16 Regional commodity exchanges. During the year 2011-12 the share of major commodities in the trading activity was as follows:

- Bullion 56%
- Energy Products 16%
- Base Metals 16%
- Agricultural Commodities 12%

1.6 (i) Share of different commodity exchanges to the total volume traded of commodities during 2011-12

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Value of trade (in Cr.)</th>
<th>% Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>MCX, Mumbai</td>
<td>15597095.47</td>
<td>86.05%</td>
</tr>
<tr>
<td>NCDEEX, Mumbai</td>
<td>1810210.1</td>
<td>9.99%</td>
</tr>
<tr>
<td>NMCX, Ahmadabad</td>
<td>268350.95</td>
<td>1.48%</td>
</tr>
<tr>
<td>ICEX, Mumbai</td>
<td>258105.67</td>
<td>1.42%</td>
</tr>
<tr>
<td>ACE, Ahmadabad</td>
<td>138654.61</td>
<td>0.76%</td>
</tr>
<tr>
<td>Others</td>
<td>53687.0</td>
<td>0.30%</td>
</tr>
</tbody>
</table>

Conclusion:

In its history of commodity derivatives, commodity futures market has witnessed several developments since 2003. There has been tremendous growth in commodity futures market in terms of volume of trade, number of products on offer participants and technology. Commodity futures are diversified asset class they do not boost resources for firms to invest, rather they allow producers to gain insurance for the future value of their outputs. Commodity futures perform two vital functions of the economy i.e. price discovery and risk management. Futures markets provide liquidity and facilitates to hedge against future price risk. It helps buyers and sellers of agricultural products to quickly manage their trade at a fair price. Commodity trading also offers a chance for financial leverage to hedgers, speculators and other traders. The growth of Commodity derivatives market of India will lead to further
development in the field of electronic warehouse receipts which may facilitate seamless nationwide commodity spot market. It would strengthen the Indian economy to face the challenge of globalization.

References:


