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Banking on Commodity Derivatives Trading

A Risky Proposition

On 10th December 2012, India's Finance Minister P Chidambaram added a new clause in the Banking Laws (Amendment) Bill 2011 which was not part of the original amendments vetted by the Parliamentary Standing Committee on Finance last year. The new clause allowed the entry of banks in commodity futures trading in India. It also allowed mutual funds, insurance companies and institutional investors to trade in Indian commodity futures markets.

Due to strong opposition by several political parties on the grounds of violation of Parliamentary procedure, the government was forced to drop this clause from the Banking Bill which was passed by Parliament on 20th December.

Nonetheless, this controversial clause would be incorporated in the Forward Contracts (Regulation) Amendment Bill 2010 which is likely to be tabled in the Parliament next year. In a report on this Bill, the Standing Committee on Food, Consumer Affairs and Public Distribution (2011-12) has recommended that banks (along with insurance companies and mutual funds) should be allowed to invest in the commodity futures markets in order to enhance market liquidity and provide better price discovery.[1]

Allowing banks to directly trade in commodity futures signals a major policy shift in the banking sector with wider ramifications and therefore it should be widely discussed and debated in the coming weeks.

The Current Status

As per the existing regulatory framework, banks in India are allowed to trade in financial instruments (such as shares, bonds and currencies) in securities market but the Banking Regulation Act of 1949 strictly prohibits banks (both domestic and foreign) from trading in goods. The Section 8 of Banking Regulation Act clearly states that "no banking company shall directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realisation of security given to or held by it."

Should banks get directly involved in building bridges, airports, highways, dams and power plants since they have large exposures in infrastructure sector?

However, banks are allowed to finance commodity business and provide fund and non-fund-based facilities to commodity traders to meet their working capital requirements. Banks also provide clearing and settlement services for commodities derivatives transactions. But banks cannot trade in commodities themselves.

Lack of Evidential Support

The arguments supportive of banks' direct entry into the commodity trading are backed by very little hard evidence. The proponents argue that this move would enable banks to hedge their exposure to agricultural lending arising out of price fluctuations. In reality, banks lend money to farmers (and commodity traders) but they don't have any direct exposure to commodities.

Following the same logic, should banks get directly involved in building bridges, airports, highways, dams and power plants since they have large exposures in infrastructure sector? At best, banks could advise borrowers to hedge their price risk in futures markets rather than hedging themselves. By acting as a trader/broker in the commodity derivatives market, banks would be moving away from their core competence — lending money to individuals and businesses.

There is no justification for allowing mutual funds and insurance companies in the agricultural commodity markets since they have no direct exposure to farm loans.

Further, there is no justification for allowing non-banking financial players (such as mutual funds, insurance companies and institutional investors) in the agricultural commodity markets since they have no direct exposure to farm loans and farming community in India. It needs to be emphasised here that 80 percent of farmers in India are small farmers (owning less than 2 hectares of land) and not even 0.01 percent of farm borrowers directly trade in the commodity futures exchanges.

The Liquidity Conundrum

The claim that the entry of banks and other financial players would enhance commodity market liquidity requires closer scrutiny in the light of recent national and international experiences.

Since 2009, Indian commodity derivatives markets are witnessing a worrying trend wherein too much money is chasing too few commodities such as silver, gold, rubber and guar seed. Out of 115 commodities listed in all national commodity exchanges, there are over 40 illiquid commodity futures contracts (such as aviation turbine fuel and imported thermal coal) which have not witnessed a single trading for years.

Indian commodity derivatives markets are witnessing a worrying trend wherein too much money is chasing too few commodities.

At present, only a handful of commodity futures contracts attract large trading volumes in the Indian markets. In the first quarter of 2012, all national commodity futures exchanges (except National Multi Commodity Exchange) generated over 75 percent of their turnover from just five commodities.[2] The Multi Commodity Exchange – country's largest commodity exchange – generated 86 percent of its business from five commodities (silver, gold, crude oil, copper and nickel) during this period.[3] In the case of National Commodity and Derivatives Exchange, top five commodities (soy oil, mustard seed, gram, soybean and guar seeds) contributed 78 percent of total business.[4]

In practice, too much liquidity (excess liquidity) in the commodity markets can have negative outcomes. Not long ago, excess liquidity fueled a speculative bubble in the US housing markets.

A recent empirical study provides evidence of a positive long-run relation between global liquidity and the development of food and commodity prices.[5] The growing financialisation of commodity markets has challenged the widely-held notion that commodity prices are purely determined by market fundamentals (the interaction of demand and supply).

The Indian policymakers need to recognise that futures contracts are purely speculative vehicles for banks, mutual funds and institutional investors. Unlike hedgers (the producers and consumers of physical commodities), financial players attempt to profit from buying and selling futures contracts by anticipating future price movements and they have no intention to actually own the physical commodity. In recent years, trading in commodity markets has become extremely popular among financial investors as commodities offer significant benefits in terms of enhanced portfolio diversification and attractive returns.

With the extensive use of leverage, banks and institutional investors can drive out physical hedgers from commodity futures markets.

With the extensive use of leverage, banks and institutional investors can drive out physical hedgers from futures markets. In the US, highly leveraged financial speculators overwhelmingly dominate commodity derivatives markets. Concerned over the declining participation of physical hedgers in several commodity futures contracts, the Commodity Futures Trading Commission of the US has recently proposed new regulatory mechanisms (such as position limits) to limit the flow of liquidity into the markets.

The Lack of Domain Knowledge

By and large, Indian banks (both public and private) lack market knowledge and expertise to benefit from trading in commodity futures. The Reserve Bank of India has also expressed concern on the risks posed by domestic banks that lack expertise and skilled manpower to deal with such risky trading instruments.

One of key beneficiaries of this move would be big foreign banks that have considerable international experience and expertise in dealing with futures trading.

One of key beneficiaries of this move would be big foreign banks that have considerable international experience and expertise in dealing with futures trading. Foreign banks and institutional investors also enjoy a competitive edge over small traders since they could use algorithmic trading and high frequency trading in the Indian futures markets.

Already foreign banks dominate the financial derivatives markets in India. Most of these products are financial in nature with no actual bank lending involved. The off-balance-sheet exposure of foreign banks (e.g., currency forward contracts, interest rate derivatives) is currently very high in India and should be a matter of concern to policymakers. The off-balance-sheet (OBS) exposure of foreign banks as proportion of their on-balance-sheet exposure was 1860 percent in 2010-11. In contrast, the OBS exposure of all domestic banks as a percentage of their total balance sheet was 198 percent in 2010-11.

The Weak Regulatory and Supervisory Framework

The commodity futures market in India is still in its nascent stage of development and the existing regulatory environment cannot handle the entry of big banks and institutional investors.

Banks' entry into commodity futures trading could turn out to be a risky proposition for several valid reasons. To begin with, the commodity futures market in India is still in its nascent stage of development and therefore the existing regulatory environment cannot handle the abrupt entry of big banks, mutual funds and institutional investors.

Unlike equity markets regulator (SEBI), the commodity trade regulator (Forward Markets Commission - FMC) is toothless. The FMC does not have any statutory power for compulsory registration of traders and brokers which makes it difficult to monitor and supervise traders.

There are plenty of instances where the FMC failed to curb malpractices (such as parallel illegal trading) and prevent excessive speculative activities which distorted the price discovery and hedging function of commodity future markets. The existing penalty provisions are grossly inadequate and not in tune with current trading volume in the Indian commodity derivatives markets. The total value of commodities futures traded in India was Rs.119489 billion (US$2212 bn) in 2011.

It may sound astonishing that FMC — regulating billions of dollars worth of commodity futures trade — has no powers to directly impose a

financial penalty on the rogue traders. At present, only a maximum penalty of Rs.1000 can be imposed on market participants by FMC and that too through court orders on conviction. A financial penalty of mere Rs.1000 (enforced through lengthy court process) does not act as a deterrent for potential offenders in the commodity markets.

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The recent guar trading fiasco reveals how commodity exchanges are acting like casinos for speculators, moving away from their avowed objectives of price discovery and price risk management in an efficient and orderly manner.[6] Guar seed and guar gum prices surged 900 percent in the futures markets during the six months period between October 2011 and March 2012. Such was the magnitude of speculative trading that twice the size of annual production of guar was traded in the futures markets on a single day. When regulatory measures to rein in rampant speculative trading and market manipulation failed, the FMC suspended the trading in guar futures contracts in March 2012.

Under the Forward Contracts (Regulation) Amendment Bill 2010, FMC has been granted powers to impose higher financial penalties on rogue traders but the Bill is yet to get Parliamentary approval.

FMC Needs Financial and Administrative Autonomy

New Delhi should give more financial and administrative autonomy to FMC which presently works under the supervision of the Ministry of Consumer Affairs, Food and Public Distribution. To carry out effective market surveillance activities, FMC needs better technological tools as well as professionals with domain specialisation. The FMC is unable to recruit talented professionals due to its low remuneration policy. Most of its staff is drawn on the deputation from various government departments.

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Currently, the total staff strength of FMC is 77 – out of which 35 staff members perform purely administrative duties. It's not an easy task for FMC to regulate and supervise futures trading worth billions of dollars in 21 commodity exchanges (5 national and 16 regional exchanges) with such low staff strength.

Since FMC is unable to effectively monitor and supervise the existing non-financial players, it would require considerable time, resources and technical expertise to deal with the high trading volumes which the entry of banks into commodity trading would bring about.

Contrary to Pronouncements at G20

This policy move is contrary to the positions India has taken at G20 and other international forums. India has always been at the forefront of

international discussions seeking greater regulation, market transparency and orderly functioning of volatile commodity markets, especially oil. In September 2011, India's former Finance Minister, Pranab Mukherjee, strongly urged G20 to address the issue of "excessive financialisation" behind the increase in the level and volatility of global oil prices.

One of the key lessons to learn from the global financial crisis is to limit the financialisation of commodity futures markets.

At G20, India has backed the ongoing work of International Organization of Securities Commissions (IOSCO) on improving the regulation and supervision of futures and physical commodity markets at the global level. In a recently conducted survey of regulatory regimes in emerging markets (including India), IOSCO expressed concern over the potential risks of day trading, algorithm trading and other trading strategies on market integrity.[7]

We are living in a post-crisis world where US, UK and other developed countries are taking corrective steps to rein in "casino banking" which resulted in over-financialisation of the real economy. One of the key lessons to learn from the global financial crisis is to limit the financialisation of commodity futures markets.

Inflationary and Developmental Concerns

Even though there are various causes of high food inflation in India, the role of futures trading has remained contentious. The food price inflation and rising energy prices hurt the poor households more as they spend a larger proportion of their income on these commodities. In 2007, New Delhi had suspended the futures trading in key agricultural commodities due to their alleged role in triggering rapid price hike.

At a time when the Indian banks are struggling to raise an additional capital requirement to meet the Basel III requirements besides fulfilling mandatory financial inclusion targets, such a move could divert resources from developmental banking to speculative trading activities.

According to G Chandrasekhar, Commodities Editor of *The Hindu Businessline,* participation of banks and MFs can potentially distort the commodity markets instead of advancing it, as too much money would start chasing commodities in short supplies and result in inflation.[8]

At a time when the Indian banks are struggling to raise an additional capital requirement of Rs.5 trillion before March 2018 to meet the Basel III requirements besides fulfilling mandatory financial inclusion and priority lending targets, such a move could divert resources from developmental banking to speculative trading activities which may weaken the otherwise stable banking system in the long run.

If financial inclusion is considered a necessary pre-condition for inclusive growth, the key policy priority should be delivering banking services at an affordable cost to 400 million unbanked people in rural India and meeting the credit needs of small farmers and producers. Unfortunately, the government's performance is far from satisfactory on this front.

In the existing weak regulatory and supervisory framework, the hasty move allowing banks, mutual funds, insurance companies and other financial players to directly trade in the commodity futures markets could well prove counter-productive.

— Kavaljit Singh

The Briefing Paper is published by Madhyam in close collaboration with SOMO, Amsterdam (www.somo.nl).

Notes and References

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Briefing Paper # 9

December 2012

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