Institutional Investors in Indian Commodity Derivatives Market: For Whose Benefit?

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A major policy shift has been taking place in the Indian commodity derivatives market since September 2015, when the commodity regulatory body, Forward Markets Commission, was formally merged with the capital market regulator – the Securities and Exchange Board of India (SEBI).

In June 2017, SEBI opened up the commodity derivatives markets to institutional investors for the first time by allowing hedge funds registered as category III Alternative Investment Funds (AIFs) to invest in commodity derivatives as 'clients'.[1] The category III AIFs raise money from high net worth individuals and corporates with a minimum contribution of Rs.10 million by each investor. AIFs have been allowed to invest in all commodity derivatives products on the conditions that they should not invest more than 10 per cent of the investable funds in one underlying commodity and they should periodically report their market exposure in commodity derivatives. These conditions have been specifically imposed on hedge funds because such players employ leverage on a substantial basis and use complex trading strategies to make short-term returns, thereby posing a systemic risk to the entire market.

On September 26, 2017, SEBI allowed Foreign Portfolio Investors (FPIs) to participate in commodity derivatives contracts traded in stock exchanges operating in International Financial Services Centre (IFSC).[2] Established as a part of a Special Economic Zone (SEZ), Gujarat International Finance Tec-City is the first IFSC in India that provides financial services to non-residents and residents in any currency other than the Indian Rupee.

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FPIs have been permitted to trade in commodity derivatives contracts subject to three conditions: they can only trade in non-agricultural commodities derivatives contracts (such as gold and silver); contracts would be cash settled on the settlement price; and all the transactions shall be denominated in foreign currency only.

The Entry of Banks into Broking Services

On September 25, 2017, the Reserve Bank of India (RBI) – the country's central bank – allowed banks to provide broking services to the commodity derivatives market through a separate subsidiary set up for the purpose or an existing subsidiary. In this regard, the RBI issued amendments to Master Direction (Financial Services provided by Banks, 2016) under which a new para 22 has been inserted which reads:

> "(a) No bank shall offer broking services for the commodity derivatives segment of SEBI recognised stock exchanges except through a separate subsidiary set up for the purpose or one of its existing subsidiaries and shall do so subject to the following conditions:
>
> i. The subsidiary shall, with the approval of its Board, put in place effective risk control measures including prudential norms on risk exposure in respect of each of its clients, taking into account their net worth, business turnover, etc.
>
> ii. The subsidiary shall not undertake proprietary positions in the commodity derivatives segments.

iii. The subsidiary shall ensure strict compliance with various margin requirements as may be prescribed by SEBI, its own board or the Commodity Exchanges."[3]

The RBI has prescribed minimum capital requirements and other conditions on banks to become clearing members of commodity derivatives segments. The RBI has asked banks to put in place internal risk control measures and prudential norms on risk exposure in respect of each of its trading members. Further, a bank's subsidiary cannot undertake trading in commodity derivatives using its own capital ('proprietary positions') so as to make a profit for itself. However, it can earn fees and commissions from processing trades done by trading members/clients.

This is for the first time that banks have been allowed to participate in the Indian commodity derivatives markets. It is important to emphasize here that all scheduled commercial banks (except regional rural banks) have been allowed to offer broking services for commodity derivatives trading. In other words, a wide range of banks in India, such as State Bank of India (state-owned), ICICI Bank (private sector), Deutsche Bank (foreign bank) and Apna Sahakari Bank (cooperative bank), can now offer broking services for commodity derivatives trading through subsidiaries.

There is no denying that additional regulatory measures related to risk control have been imposed on the entry of banks and other institutional investors in the commodity derivatives market, but many market observers believe that these measures could be gradually removed depending on market conditions and conduct of market players.

All the significant policy changes pertaining to the entry of institutional investors in the commodity derivatives segment have been introduced after the passage of the Finance Bill (2015).

All these significant policy changes pertaining to the entry of institutional investors in the commodity derivatives segment have been introduced after the passage of the Finance Bill (2015). This represent a major policy shift because till 2016, institutional players were not allowed to participate in the commodity derivatives market, even though trading in commodity futures began in India in 2003.

In the past one year, SEBI has undertaken other initiatives to introduce new products and removed restrictions on broking services. For instance, commodity exchanges have been allowed to introduce options trading. Besides, SEBI has allowed integrated broking activities in equity and commodity derivatives markets under a single entity. Now, a stock broker can deal in commodity derivatives trading without setting up a separate entity.

The Future Plans

In the coming weeks, SEBI plans to allow mutual funds and portfolio management services (PMS) providers to participate in commodity derivatives market. The PMS is used by high net-worth investors and is offered by various entities including banks, brokerages, independent investment managers and asset management companies.

Currently, SEBI is engaged in discussions with mutual funds and PMS providers to enable their participation in this segment. According to media reports, SEBI has already initiated discussions with Association of Mutual Funds in India (AMFI), the lobby group of mutual funds.[4]

Besides, the SEBI may also permit foreign institutional investors (FIIs) to invest directly in the commodity derivatives markets with new regulatory norms for such entities.

The Real Beneficiaries

The commodity exchanges, brokers and other entities involved in trading and depository services have welcomed these initiatives on the expectation that hike in trading volumes in Indian commodity derivatives market may bring higher revenues and earnings.

The institutional investors have also welcomed SEBI's move to open up Indian commodity derivatives market. For banks, entry into broking services via their subsidiaries offers a new business opportunity. Banks in India could potentially harness this new business opportunity given their large customer base and vast network of branches across the country, provided they acquire technical expertise and skills for offering broking services. Currently, most Indian public sector and cooperative banks lack such expertise as their core competence is lending money to individuals and businesses. In order to tap the broking business, these banks may have to divert their attention away from their core competency.

While the immediate beneficiaries of the move could be foreign banks (such as Goldman Sachs, Deutsche Bank, Citigroup and HSBC) who have considerable international experience and expertise in commodity derivatives trading, a few private sector banks (such as ICICI Bank and HDFC Bank) have also made forays into derivatives trading in recent years. Needless to say, Goldman Sachs, a global investment bank, would also benefit from increased trading volume as it holds stakes in Indian commodity exchanges.

The immediate beneficiaries of the move could be foreign banks (such as Barclays Bank, Citigroup, Deutsche Bank and HSBC) who have considerable international experience and expertise in commodity derivatives trading, a few private sector banks (such as ICICI and HDFC) that have also made forays into derivatives trading in recent years.

Similarly, the landscape of AIFs is dominated by foreign banks, big private sector banks and NBFCs (non-banking financial corporations), many of these funds have been launched in partnership with global private equity, hedge funds and pension funds.

Institutional Participation Does Not Necessarily Mean Better Participation

In the official circles, the entry of hedge funds, FPIs, mutual funds and other institutional investors is viewed as a prerequisite for deepening the Indian commodity derivatives market. SEBI and the finance ministry expect large-scale investments by such entities would improve the market's liquidity and depth.

In all likelihood, the entry of institutional investors will bring more speculative investments into the Indian commodity derivatives market. However, bringing more institutional investors may not necessarily improve the quality of commodity derivatives trading. Rather, it may act as an impediment in fulfilling the basic objectives of commodity derivatives market. Two most widely recognized objectives are to facilitate efficient price risk management and price discovery in a fair, transparent and orderly manner.

The commodity futures markets were created for the benefit of hedgers[5] (i.e., producers or users of the underlying commodity) who would like to get guaranteed prices for their products. In India, one the key objectives behind the introduction of futures trading was to help farmers hedge against potential risks arising out of price movements in agricultural commodities. At that time, tall claims were made that the futures market will help farmers hedge against potential risks arising out of price movements in spot markets so that they can get guaranteed price for their produce in the future. Besides, trading in futures would provide reliable price signals to farmers about the likely prices of their crops in the months ahead.

Weak Rationale

The arguments put forward in support of the participation of FPIs, hedge funds, mutual funds and other institutional financial players in commodity derivatives trading lack conviction simply because these players do not have any direct exposure to underlying commodities.

The policymakers cannot overlook a simple fact that hedging is vastly different from speculation. Hedging is carried out to lower market price risk by taking offsetting position while speculation is betting on the market price movement. Unlike a rice farmer or a miller who use futures to hedge or protect against the risk of losses from adverse market price movements in the future, institutional investors such as hedge funds, mutual funds and portfolio investors use futures to make a profit by betting on the future price of a commodity. Unlike hedgers, speculators[6] have no intention of making or taking delivery of the actual commodities.

The policy tilt towards financial players is inconsistent with the broader development objectives for which commodity derivatives trading was launched in India.

For institutional investors, investment in commodity derivatives contracts is a purely financial transaction. With the help of margin system, they operate in the futures market with minimum investments. They generally assume higher risk and also expect a higher return on their investments.

For derivatives markets to function efficiently, it is necessary to have a balance between the hedgers and speculators. A commodity derivatives market with little or no participation of actual users and hedgers defeats the very purpose for its existence. Further, there is no justification in allowing non-banking financial players such as mutual funds, hedge funds, and foreign institutional investors in the agricultural commodity derivatives segment since they have no direct exposure to farm loans and the farming community in India.

As discussed in *A Beginner's Guide to Indian Commodity Futures Markets*[7], speculative trading of commodity derivatives contracts by institutional investors and other financial players can have a major impact on the price volatility in the commodity markets. The speculators' only motive is to make a profit by trying to move the prices in their favor. This can result in volatile price behavior which could actually harm the interests of producers and users of commodities. Hence, it is highly debatable whether the entry of institutional investors in the commodity derivatives space would mitigate risks of price volatility.

The dramatic rise and fall in prices of oil and agricultural commodities during 2006-08 generated a heated debate in global policy circles whether speculation by financial players induced excessive price volatility. This issue was discussed at length at the G20 and several policy measures were recommended to improve the regulation and supervision of commodity derivatives markets.

What about price discovery? Price discovery occurs through collective assessment of a large number of individual market participants about the direction and price trends of a commodity in future.

In the case of agricultural commodities, such assessment is generally based on the participant's internal knowledge about the likely production, crop size, weather projections, etc. However, real price discovery may not happen if information flows in the market are not efficient.

Furthermore, several studies have found that Indian commodity futures markets performed their basic function of discovering efficient prices only in a few agricultural commodities and that too depending on the timely actions by the regulatory body.[8]

It must be emphasized here that price risk hedging instruments are not a panacea for all the ills that beset Indian agriculture as these instruments are usually used by big farmers and medium-sized producers. More than hedging instruments, an average Indian farmer actually needs cheaper credit through institutional sources, enhanced public investments in irrigation and rural infrastructure, minimum support price, crop insurance and technological support.

The government's top priority should be on enhancing the participation of farmers and commercial hedgers, rather than turning Indian derivatives market into a playground for speculators.

Resetting Policy Priorities: Putting Farmers First

The policy tilt towards institutional investors is inconsistent with the broader development objectives for which commodity futures trading was launched in India. As mentioned earlier, the futures trading was launched with the twin objectives of better price discovery and price risk management, which would bring benefits to both farmers and consumers.

Not long ago, Prime Minister Narendra Modi expressed the need for commodity derivatives markets to work for the benefit of farmers and the agriculture sector. "Our commodity markets must become useful to our farmers, not just avenues for speculation. People say that derivatives can be used by farmers for reducing their risks. But in practice, hardly any farmer in India uses derivatives. That is the fact. Unless and until we make the commodity markets directly useful to farmers, they are just a costly ornament in our economy, not a useful tool," said Modi at the inauguration of the National Institute of Securities Markets campus on December 24, 2016.[9]

From a public policy perspective, the government's top priority should be on enhancing the participation of farmers and commercial hedgers rather than turning commodity derivatives market into a playground for speculators.

There are plenty of factors that have defeated the very purpose for which derivatives futures markets were initiated in India. These include lack of effective participation of farmers and hedgers, fragmented nature of spot markets, few warehouses, poor grading and physical delivery infrastructure, and weak regulatory framework.

The *Guide* has put forward a number of policy recommendations on reforming the Indian commodity derivatives market. Some of these recommendations related to agricultural commodities are summarized below.

First and foremost, a lot of work needs to be carried out at the ground level. For instance, price ticker boards – displaying futures and spot prices in the local language on a real-time basis – could be installed at local *mandis*, post offices, bank branches and community places. The dissemination of prices would immensely benefit farmers to take appropriate decisions during pre-sowing and post-harvest period.

Secondly, SEBI should launch micro and mini contracts (with small trading lots and tick size) across agricultural commodities to encourage direct participation of farmers and small traders. Algorithmic trading should be completely barred in this segment.

Thirdly, SEBI and exchanges should encourage farmer cooperatives and agricultural marketing federations (such as IFFCO and NAFED) to act as aggregators and hedge positions in futures exchanges on behalf of their farmers. Of course, it would be necessary for such federations to first gain adequate knowledge of the functioning of derivatives trading.

Despite massive manipulation of commodity futures prices by big traders and their cartels, there has hardly been any penal action against them by either regulatory authority or commodity exchanges.

Fourthly, the governments (both centre and state) should remove bottlenecks such as fragmented spot markets, lack of road connectivity, insufficient number of accredited warehouses, grading facilities and other infrastructure inadequacies that restrict the participation of farmers in the futures markets.

It is distressing to note that there are still information gaps about the actual quantity and the quality of the agricultural goods available in warehouses across the country.

Fifthly, the weak regulatory and supervisory framework has weakened the confidence of farmers and commercial hedgers in the futures markets, which are widely perceived by them as "*satta bazaar*" (gambling market).

Despite massive futures price manipulation by a handful of big traders and their cartels, there has hardly been any penal action against them by either the regulatory authority or commodity exchanges. Concerns about the lack of accountability are genuine and therefore a complete overhaul of existing regulatory and surveillance system is required to restore public confidence and market integrity.

Developed in consultation with farmers groups and commodity experts, all the above-mentioned policy measures are technically feasible and economically viable. These measures can be easily implemented if farmers and actual users of commodities become a top priority for New Delhi.

This means re-designing the current policy regime on commodity derivatives market and having an enabling regulatory framework, including a market surveillance system, in place to achieve desired policy goals.

Achhe Din for Hedge Funds

To sum up, by putting institutional investors first, the government has misplaced its priorities when it comes to improving the functioning of Indian commodity derivatives market. The participation of banks, hedge funds and institutional investors may bring in huge sums of speculative money but it may distort the basic functions of a commodity derivatives market.

By opening up Indian commodity derivatives market to hedge funds, foreign portfolio investors and other institutional investors, the Modi government has ushered in *achhe din* (good days) for highly sophisticated market participants that cater exclusively to ultra-rich private investors. But when will Indian farmers witness the *achhe din* that were promised in 2014? This is yet another example of how the government has got its priorities wrong.■

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5. Hedgers are essentially players with an exposure to the underlying commodity and associated price risk. They are producers or consumers of the traded commodities and are often interested in taking or making physical delivery of the underlying commodity at a specified price. The hedgers simultaneously operate in the spot market and the futures market. They try to reduce or eliminate their risk by taking an opposite position in the futures market on what they are trying to hedge in the spot market so that both positions cancel one another. They operate in the spot market to buy or sell the physical commodity, and in the futures market to offset any loss arising out of price fluctuations in the spot market. It is true that a player who is a hedger now may turn into a speculator in the next moment. Therefore, there is a need for a strict classification criteria to segregate different

market players in order to identify whether trading in derivatives contracts is carried out for hedging or speculative purposes.

6. Speculators are traders with no genuine commercial business to the underlying; they do not hedge but trade in derivatives contracts with the objective of making profits from movements in prices. The speculators generally assume higher risk and also expect a higher return on their investments. They do not have any real need to buy, sell or take delivery of the actual commodities.

7. Neeraj Mahajan and Kavaljit Singh, *A Beginner's Guide to Indian Commodity Futures Markets*, Madhyam, 2015. Available at http://www.madhyam.org.in/wp-content/uploads/2015/04/Commodity-Guide.pdf.

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