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THE GROUP ON FORWARD AND FUTURES MARKETS

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ABSTRACT

Commodity futures trading in India commenced more than 100 years back. Major enactment to this effect was in the form of Forward Contract Regulation Act (FCRA), 1952. But, the situation has not matured due to the virtual banning of futures trading since the early 60s till late 80s when the scarcity environment prevailed. Presently, it remains in a state of flux and formation. The commodity futures trading suffers from a number of limitations. The limited and closed nature of membership, absence of many hedgers who have substantial underlying positions, absence of transparency (opacity), limitations of prudential regulation, absence of a legal framework for warehouse receipt system and its negotiability and transferability etc. are serious constraints under which the current system operates. Quite often, the system is criticized that no futures trading which serves the intended purpose of price discovery and risk management is currently taking place. However, since the beginning of 90s, concerted efforts have been made in expanding the scope of futures trading, along with general economic reforms. As a result of the renewed interest among the stake-holders, efforts have been made in both increasing the number of commodities permitted for futures trading and several institutional reforms. Among reforms, the regulatory framework has been strengthened, exchanges have been exposed to the best practices from across the world, institutional interface between the various related agencies have been strengthened, enabling provisions for commencing options trading etc. have been proposed by means of amendments to the Act, initiatives such as modern national level commodity exchanges have been proposed and warehousing aspects such as receipt systems are being actively pursued.

I. BACKGROUND OF FORWARD AND FUTURES TRADING IN INDIA

The number of individual commodities permitted for futures trading in India have increased from 11 in the mid-90s to 42 as of now, including derivatives of specific commodities. (In some of the commodities allowed futures trading is yet to start: eg, tea and sugar). 20 Commodity Exchanges located in various parts of the country are recognized/registered for conducting futures trading in these commodities.

In the light of the perceived advantages of Forward and Futures Markets in terms of price discovery and risk management, as market based instruments such markets have been identified as important tools of price stabilisation. In the light of comprehensive reforms in agricultural marketing contemplated by the Government, extension of the facilities of forward and futures markets to all major agro commodities has assumed tropical importance. This urgency is reflected in the National Agricultural Policy of Government of India announced in the year 2000.

In pursuance of the National Agricultural Policy 2000 of the Government of India an Expert Committee was set up in December 2000 by the Department of Agriculture and Cooperation to recommend various reforms in agricultural marketing; whose recommendations (submitted Report in June, 2001) include the following relating to forward and futures markets in commodities :-

- More commodities should be permitted for forward and futures trading to facilitate competitive and free marketing system.
- Govt. has to continue its efforts to strengthen the commodity exchanges and to instill confidence and awareness among market players.

II. THE PRESENT SYSTEM

Government have already been pursuing the necessary activities in widening and deepening the commodity futures market in the country in the last decade, particularly since the mid-90s. These efforts had two major components.

a. Increasing the number of commodities permitted for futures trading and
b. Strengthening the institutional structure and the legal framework for futures trading.

Commodity futures trading is conducted under a three-tier regulatory framework. The Exchanges themselves are the first-tier regulators, who are responsible for the orderly conducting of trade as stipulated under the rules, by-laws and other directions of the Forward Markets Commission (FMC), which is the market regulator, the second-tier of the regulatory frame. The FMC recommends (FMC), which is the market regulator, the second-tier of the regulatory frame. The FMC recommends approval of exchanges, approves by-laws of exchanges and engages in surveillance of exchanges for orderly conducting of futures trading. At the apex level is the Department of Consumer Affairs in the Ministry of Consumer Affairs, Food & Public Distribution that approves the exchanges, approves commodities for futures trading and formulate appropriate policies and rules for the development of this sector.

III. CONSTRAINTS ON COMMODITY FUTURES TRADING

Commodity futures trading is like a Cinderella of derivatives trading. In many of the discussions on development of derivatives market, regulatory reforms and in designing other institutional structures, references to commodity futures trading is hardly even mentioned. This relative lack of recognition of commodity futures is mainly on account of the serious constraints under which this market now functions. Apart from physical/infrastructural limitations such as near absence of online trading, online surveillance and monitoring, prohibition on major products for derivatives trading, the non-availability of fool proof legal system of contracts, particularly relating to the warehouse receipt system etc are seriously constraining the futures market.

One of the major differences between securities derivatives market and commodities derivatives market is in the nature of delivery. While securities derivatives market is fully cash settled (even the spot market is in demat form) in commodities physical delivery does take place though to the extent of 1-2% of the total contracts. In fact the 'threat of delivery' is considered the centerpiece of the commodity futures market as it acts as an automatic equilibrating force in avoiding wild swings in this market. Hence quality certification and related procedures assumes importance along with the availability of quality warehouses. It also calls for the transferability and negotiability of the warehouse receipts fully backed by adequate legal provisions.

IV. REFORMS

Though, the history of futures trading dates back to the 19th century, futures trading in an organised fashion started in India in early 1950s with the enactment of the Forward Contract (Regulation) Act in 1952 and setting up of the Forward Market Commission in 1953, it had a chequered history. Since the early 60s, when the environment of shortage prevailed in most of the primary agricultural commodities, futures trading was banned in many of them. The institutional structure of the exchanges, was by early 90s weak in embarking on an ambitious programme of futures trading. Most of these exchanges had limited membership, extremely low volumes of trading (compared to production/marketed surplus) and very few modern practices.

A number of reform measures which needed to be introduced in the exchanges and at the regulator levels have indeed been identified and pursued. These include computerisation, professionalisation of exchanges by including non-trading interest in the Board and appointing professional sectt. support, time stamping, online trading, trade guarantee mechanisms, clearing mechanisms etc. With the help of a World Bank assisted IDF grant some of the selected exchanges have been exposed to the best international practices. The Forward Markets Commission has also been strengthened in terms of upgrading the board level posts and addition to the number of other posts. Modernisation of the office of the FMC has also matrialised in terms of equipment support and posts. Modernisation of the office of the FMC has also matrialised in terms of equipment support and monitoring and surveillance software.

V. REFORM INITIATIVES FOR FUTURES TRADING

The reform measures suggested by the Government and the FMC on the commodity exchanges are many:-

i. The system of daily mark-to market margining to improve financial integrity of the markets.
ii. The system of simultaneous reporting under which the member/brokers are required to put the transactions slips in a sealed box within fifteen minutes of execution of transaction. This measure facilitates audit trail and

ensures that clients' contracts are executed at a correct price.

iii. Trading ring discipline to be ensured by appointing a ring inspector, issuing of badges, prohibiting Reform initiatives have also reached other stake holders associated with futures trading, besides as the regulatory body (FMC), warehousing agencies, clearing corporations, trade guaranteeing agencies, settlement bodies all need to adapt to the emerging situation in order to make commodity futures trading vibrant. The regulator (FMC) has been substantially strengthened. Initiatives on introducing warehousing receipt system with concomitant changes in quality and grading system etc. have also been contemplated/initiated by the warehouses and financial institutions etc. Specialised clearing corporations and separate trade guarantee mechanism have been started by some of the Exchanges with the support of the financial institutions and banks. Overall, the reform initiatives are spreading across the spectrum of stake-holders associated with commodity derivatives market, though gradually.

VI. INSTITUTIONAL INTERFACE OF FUTURES TRADING SET UP

The success of commodity derivative trading is a multi-variant function with several stake-holders involved. They include the Exchanges, the regulators (both the market regulator as well as the Govt.) including other market regulators such as capital market, financial market etc., financial the Govt.) including other market regulators such as capital market, financial market etc., financial institutions, banks, warehouses and clearing and settlement corporations. For an all round development of this sector a clearly defined institutional interface is essential.

- Participation of diverse interests – growers, processors, exporters, importers, trade speculators;
- 'On-line' system of trading;
- Efficient clearing, settlement and guarantee systems;
- Delivery of underlying commodity backed by a warehouse receipt system;
- System of well-organized and capitalized brokerage houses;
- Real-time price and trade information dissemination;
- Transparency in operations and decision – making;
- Reliable, effective and impartial management, preferably demutualized form of organization; and
- Investment support from investors, including institutional investors.

The above major criteria were fixed for recognizing exchanges for futures trading in sugar also, which have been recently notified under section (15) of the FC(R) Act.

4. Expectations from the Banking sector

a. By becoming a member of the clearing house.
b. As an investment tool i.e. placing its money in warehouse receipts or futures contracts just as in the money market.
c. Advising the clients on various risk management strategies.

Bank as a clearing member

Traditionally clearing was normally handled through the companies which were operating on the exchanges. However, in the recent decade, clearing operations have shifted to those institutions having a comparative advantage in financial operations. The wide geographical reach of the banks gives them an inherent advantage in accepting such a role as the clearing houses of the Exchanges. Clearing functions of an exchange, whether commodity or a stock exchange, are profitable operations for the bank and that is why many banks have been forthcoming in accepting such a role.

VII. BANKS AS RISK MANAGEMENT ADVISERS

Banks while extending loans to the farmers for various agricultural related activities can impress upon them the need for managing the risk properly. This would not only ensure recovery of the loan extended but also inculcate among the farmers the need for understanding the risks associated with their investment decisions and managing them in an efficient and cost effective manner. This would help in the long run in transforming the agricultural economy of the country.

after taking into account the recommendations in this regard by another group of the task force, an expert group may be constituted.

3.12 Similarly the second tier regulator needs to build up systematic interface with not only the exchanges which are being regulated, but with other regulatory agencies as well. Because there are considerable grey areas in the context of the system of multiple regulators. The linkages between the Reserve Bank of India, Securities and Exchange Board of India, Ministry of Finance, Department of Company Affairs and Department of Consumer Affairs, all belonging to the current matrix of regulation, have to be systematised and strengthened to avoid grey areas and thereby ensuring 'optimal' regulation.

VIII. CANDIDATE COMMODITIES FOR FUTURES TRADING

Presently futures trading is allowed in 42 commodities. The agricultural sector is being opened up under the WTO. There is, therefore, a need for a mechanism to provide proper risk management and price discovery facilities has been felt which can give an indicative price to the farmers so as to help them plan their acreage accordingly. For this, the Forward Markets Commission have initiated steps for feasibility studies considering inclusion of more and more commodities for futures trading. In 1999 major edible oil seeds were permitted for futures trading. In May 2001 futures trading has been permitted in sugar and in November 2001 tea has been cleared. The FMC's recommendations on permitting futures trading in commodities like rubber, onion, gram, and chillies are being examined by the Govt. The Commission has sought the comments of Reserve Bank of India for permitting futures trading in gold and silver. The feasibility studies on various other commodities like arhar, maize, linseed, cardamom, fibre yarn, cashew nuts, ginger and basmati rice etc. for ascertaining their suitability for futures trading is under progress. ascertaining their suitability for futures trading is under progress.

All the commodities are not suited for futures trading. For a commodity to be suitable for futures trading it must possess the following characteristics :-

i. The commodity should have a suitable demand and supply conditions i.e. volume and marketable surplus should be large.
ii. Prices should be volatile to necessitate hedging through futures trading in this case persons with a spot market commitment face a price risk. As a result there would be a demand for hedging facilities.
iii. The commodity should be free from substantial control from Govt. regulations (or other bodies) imposing restrictions on supply, distribution and prices of the commodity.
iv. The commodity should be homogenous or, alternately it must be possible to specify a standard grade and to measure deviations from that grade. This condition is necessary for the futures exchange to deal in standardized contracts.
v. The commodity should be storable. In the absence of this condition arbitrage would not be possible and there would be no relationship between spot and futures markets.

Based on the above criteria and as a follow up of the recommendations of the Kabra Committee the Government has permitted futures trading in various commodities. However, the current practice in USA and other Western countries is to allow futures trading in a range of commodities including live cattle, feeder cattle, hogs, pork bellies, fluid milk, rubber, tea, wool and industrial metals like copper, gold, lead, aluminium, silver, zinc and even in a number of 'non-commodities' such as weather index and pollution permits. The system of conventional criteria of identifying 'candidate commodities' needs to be reviewed afresh. It is possible, a priori, that wherever there are risks to be covered futures trading could be contemplated. It is, however, for the interested exchanges to examine the feasibility on a case-to-case basis based on concrete studies in deciding the appropriateness/usefulness of commencing futures trading in a particular product (as against commodity).

IX. COST AND BENEFITS OF ACTION PLANS FOR EXPANDED FUTURES TRADING

With a view to re-invigorate the near dormant commodity market in the country after liberalising futures trade and permitting it in increasing number of commodities, the Government and the FMC have drawn up an action plans to improve infrastructure and trade practices of commodity exchanges. Futures trade in many commodities which was under suspension for quite some time has been permitted. New commodities have been brought within the ambit of futures trading lifting the ban on them. Dormant exchanges have been persuaded/allowed to revive futures trading.

New exchanges have been recognised to organise futures trading in various commodities. The exchanges have been persuaded to upgrade their infrastructure such as trading ring, communication facilities, back office activities and other facilities. Some of the progressive exchanges have been encouraged to adopt screen-based on-line trading system. Simultaneously, best international trade practices, such as daily clearing, margining, creation of trade guarantee fund, transparency in trade and management practices to ensure market integrity and strict monitoring and surveillance of the trade in the exchange etc. were adopted.

X. CONCLUSION

a. Commodity specific approach to futures trading may be discontinued. Instead recognised associations /exchanges could apply for permission for trading in any 'contracts' other than for the commodities in the negative list from the Commodity Market Regulator under the overall rules, procedures and guidelines of the regulator. The negative list under section 17 of the FC (R) Act may be given a fresh look so as to drastically prune it. Prohibition and regulation of NTSD contracts under the Act may be discontinued.
b. Exchanges should come out with feasibility studies on commodities and products based on a costs and benefits analysis of futures trading in such commodities/products. The system of piecemeal opening up and permission based on the Regulator's/Government's evaluation may be discontinued. Contracts proposed by the Exchanges based on proper feasibility studies should be studied and approved by the Regulator.
c. The design of contracts and the type of contracts (TSD, futures, options – as and when statutorily permitted, etc.) should be left to the Exchanges to be decided. Only the appropriate regulatory mechanism and enabling provisions should be finalised with the approval of the market regulator.
d. As professional Self-Regulatory Organisations, much is to be done by the exchanges in promoting and developing institutional interface between the various stake-holders. Apart from such interface with the second and third tier regulators on a regular basis, it is equally important to have structured interface between other stake holders and ancillary bodies such as warehousing corporations, banks and financial institutions, clearing and settlement corporations, system of brokerages and institutions for risk containments.
e. The system of warehouse receipts needs to be universalised in futures trading to enable enhancing volumes and in minimising transaction costs. Warehouse Receipts should act as good evidence of the receipt for goods and the terms of the contract and storage, proof for their quality and conditions, or "apparent order and condition". Warehousing receipts (WHR) would go a long way in achieving these objectives apart from covering quality risk which is an important risk component of commodity futures trading. If quality risk is not covered price risk management by means of futures contracts have limited meaning and could have only limited success. Legal framework for making warehouse receipts transferable and negotiable should be strengthened in making negotiable warehouse system the demat of commodity futures trading. If need be an expert committee may be constituted to work out the details.

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