

Commodity Futures Market

MCX Education Series : Simplifying Knowledge, Establishing Realities

Q. How does a Commodity Futures Exchange help in Price Discovery & Price Risk Management?

A. Unlike the physical market, a futures market facilitates offsetting the trades without exchanging physical goods until the expiry of a contract. As a result, futures market attracts hedgers for risk management, and encourages considerable external competition from those who possess market information and price judgment to trade as traders in these commodities. While hedgers have long-term perspective of the market, the traders or arbitrageurs, prefer an immediate view of the market. However, all these users participate in buying and selling of commodities based on various domestic and global parameters such as price, demand and supply, climatic and market related information. These factors, together, result in efficient price discovery, allowing large number of buyers and sellers to trade on the exchange. MCX is communicating these prices all across the globe to make the market more efficient and to enhance the utility of this price discovery function.

Price Risk Management: Hedging is the practice of off-setting the price risk inherent in any cash market position by taking an equal but opposite position in the futures market. This technique is very useful in case of any long-term requirements for which the prices have to be fixed to quote a sale price but to avoid buying the physical commodity immediately to prevent blocking of funds and incurring large holding costs.

Q. Who uses Futures market and how MCX members serve their needs?

A. The Futures market participants comprises of farmers, traders, producers, processors, exporters, importers and industries associated with commodities. The futures market is used for hedging the price risk and for trading or arbitrage. Brokers of MCX, who are located all across the country, serve the futures market users directly through their own branch offices' network or through the network of their franchisees or sub-brokers.

Q. How does one trade on MCX?

A. Only exchange members and their authorized users are entitled to trade on MCX. Those who are not members of MCX can trade through MCX members or their authorized users.

Q. How does one Clear the Trades on MCX?

A. All trades on MCX are supported by an initial margin. At the End-of-day MCX does mark-to-market of all the open positions. This activity results into final position of all members in respect to booked losses or losses on open positions. Members make the shortfalls good by way of pay-ins to MCX by next day and the members in profit on such positions are given the necessary credits. These payments are processed electronically through a country-wide network of clearing banks, like-Bank of India, HDFC Bank, IndusInd Bank, Union Bank of India and UTI Bank wherein members maintain their accounts.

Q. How settlement happens at the end of the contract? Is delivery compulsory?

A. A contract has a life cycle of one month or longer. At MCX, two weeks before the expiry of a contract, the contract enters into a tender period. At the start of the tender period, both the parties must state their intentions to give or receive delivery, based on which the parties are supposed to act or bear the penal charges for any failure in doing so. Those who do not express their intention to give or receive delivery at the beginning of tender period are required to square-up their open positions before the expiry of the contract. In case they do not their positions are closed out at 'due date rate'. The links to the physical market through the delivery process ensures maintenance of uniformity between spot and futures prices.

Q. How does a seller at MCX tender delivery to a buyer?

A. Sellers at MCX intimate the exchange at the beginning of the tender period and get the delivery quality certified from empanelled quality certification agencies. They also submit the documents to the Exchange with the details of the warehouse within the city, chosen as a delivery center. Sellers are free to use any warehouse, as they are responsible for the goods until the buyer picks up the delivery, which is a practice followed in the commodities market globally. Seller would receive the money from the exchange against the goods delivered,

which happens when the buyer has confirmed its satisfaction over quality and picked up the deliveries within stipulated time.

MCX has tied up with State Level Warehousing Corporations of Kerala, Gujarat, Tamil Nadu and Uttar Pradesh and is in the process of finalizing the arrangements with CWC and other State level Warehousing Corporations.

Q. How does a buyer at MCX receives delivery?

A. Buyers intending to take delivery will receive it, if there are sellers willing to give delivery. The Buyer will have to make the payment within three days after the delivery is allotted. The buyer will take actual delivery from the warehouse at the designated delivery centers on the designated delivery days. There are commission agents who help the brokers with handling of the delivery, logistic support, associated quality certification through

Question of the week asked by Mr. Dileep Prabhu, Chartered Accountant, Andheri, Mumbai.

Q. How efficiency is measured in commodities market? How efficient is MCX?

A. Efficiency in commodities market is measured in terms of bid ask spread, direct and indirect cost of trading and holding such positions. MCX has started trading last month and is witnessing a bid ask spread of Rs 2-3 at a price quote of around Rs. 6000 (10 Grams) and the buyers and sellers are available in the system at all times at such a narrow range. Moreover, the cost of trading in MCX is very optimal i.e. all you need is an initial deposit of Rs. 2.5 Lakhs only.

To understand this better, we shall observe a comparative analysis between deposit amounts required in MCX (i.e. Rs. 2.5 Lakhs) versus a deposit amount of Rs. 25 Lakhs (a hypothetical figure).

An optimum deposit amount does not mean a compromise on margin requirements and risk management checks, additional margins/ deposits required will be the same to hold open position as in any other Exchange as at MCX. But the difference at MCX is that you need to block money only when you create a position in the Exchange. Thus it ensures that there is no idle money or in other words, its utilization is most optimal as the interest (vyaj) meter runs for all 24 hours and 365 days.

At MCX, the margin % in case of Gold is 5%. Hence, with an initial deposit of Rs. 2.5 Lakhs, a member can create open outstanding position of Rs. 50 Lakhs. It is observed that normally 15% of daily turnover remains as open position, which is a good beginning and once the market matures this normally goes up proving the effectiveness of hedging. Hence, in this example, if the open position is Rs. 50 Lakhs, his daily business should be Rs. 3.30 Crore. If there are 100 members in the Exchange, then total turnover of exchange should be Rs. 330 Crore. Similarly, if there are 500 brokers then exchange daily turnover is Rs. 1650 Crore.

Thus it is very clear that initial deposit justifies the ground reality of achievable turnover as commodity futures market in India, is starting after 40 years of gap. So lot of awareness and education is required to be invested by all the stakeholders before this market starts witnessing substantial volumes.

For further clarity & understanding purpose, lets assume that MCX's initial deposit was Rs. 25 Lakhs, then to derive the real value of money invested, the total daily turnover on the exchange from day one has to be Rs.3300

empanelled agencies and associated billings due to tax implications. This support is required as the buyer may be in a different city than the place where the delivery is being received.

Q. What does a client of a buyer do with the physical delivery in the warehouse?

A. The client of a buyer may use this delivery for his consumption in the industry, or for exports, or he may sell in the spot market or may sell in futures market in the subsequent contract, if he is a regular trader. Generally the commodities available in the physical form are consumed by the industry and, rarely, commodities, are stored in the warehouse for a longer period.

Q. What is the percentage of delivery in the futures market?

A. The percentage is fairly low. Generally, the futures markets all over the world are used for hedging where actual delivery percentage is about 1%. Any user in the commodities ecosystem unlike the physical spot or forward

market does not use these markets for regular consumption.

Q. Is it possible to officially operate a futures market under FC(R)A, 1952 on cash settlement basis as seen in the Futures Market in Securities? What is the position at MCX?

A. No, the FC(R) Act, 1952 does not permit any exchange to create a market where settlement of contract happens only on cash basis, without giving the seller an option to tender deliveries. MCX permits the sellers to tender delivery if they chose to. This has to be followed by any commodity exchange recognized under FC(R) Act.

Q. How is the quality of a commodity given by a seller ensured?

A. MCX has specified the deliverable grades in the contract specifications, which are notified before commencement of trading in a contract. The seller

Crone if there are 100 brokers. And Rs 16500 Crore if there are 500 brokers. Conclusively, from the detailed analysis of cost, we realize idle money in commodities futures market is a crime especially since interest cost makes a tremendous difference even up to two digits after the decimal point. In short, the difference between a winner and a loser is determined by whose cost of interest is more efficient.

Another fact that adds to this analysis is that since commodities markets are seasonal, the users of commodities markets prefer to bring in capital when they have large business during the crop season and would like to maintain very low idle money during slack season.

This equation suits the traders as a result of which, three large trade associations have already joined MCX.

Efficient utilization of capital in MCX as explained above permits a Trading Member or user to hedge his risk better and at a lower cost. Hedging is like insurance and, therefore, at higher costs there is tendency to avoid insurance and instead carry the risk which is what the industry has been doing till date. At MCX, an Exchange member uses his deposits optimally at Rs. 3.3 Crore of business per day. In case the member's business commitment requires more money seasonally, then the member will bring more money when needed.

Thus, MCX prevents any idling of money during slack seasons and facilitates a low level of turnover requirement for 100% utilization of deposits. This means a low breakeven level and early profitability. Therefore, MCX with 100 members will have to only do a daily turnover of Rs. 330 Crore (both sides) and Rs 1650 Crore (both sides), in case of 500 brokers to enable all brokers to operate at the most optimal level. This is a realistic target to achieve. MCX is about 10 times (1000%) more efficient than an Exchange with Rs. 25 lakhs or so as the entry norm. Beyond this level of turnover, the members will bring capital only when needed and do business as per the market demand and MCX is all set to do a turnover of Rs.10,000 Crore a day and above. However on MCX, due to quick breakeven level, the members will have early and higher profitability due to efficient use of money and windfall gains.

Thus MCX provides the most attractive entry route to a \$ 600 billion opportunity into the global commodities sector.

is required to submit the quality certification issued by MCX's empanelled quality certification agencies, like, SGS, Geo Chem, Dr. Amins, among others.

Q. What is the role of a Warehouse in Futures Market?

A. In India, vibrant spot markets, in various commodities, exists for 100s of years. In these markets, there are farmers, industrialists, warehouses, consumers, dealers and traders, who buy and sell commodities. There are warehouses, which stores commodities and there are consumers, who consume them eventually. MCX or, for that matter, any other Futures Exchange do not aim to replace, replicate or substitute such spot markets, rather the only value added service of MCX is to support the spot market players by developing their price risk efficiency through providing hedging tools. Therefore, a Futures Exchange has to base its delivery process on the basis of existing physical market practices and use existing warehouse infrastructure, which is capable of handling billion dollars worth of physical market trades. So the same infrastructure can properly take care of

minuscule delivery tendered in a futures market.

Q. When is the role of a Warehouse most necessary?

A. The role of a warehouse is most necessary in the spot market where a farmer after having harvested his crop sells them to commission agents who in turn sells them to a Mandi. The Traders in Mandi may then sell it to a large consumer or to a trader who in turn will sell it to some other consumer, industry, exporter or miller at the right time and right price. The Goods during this period are stored in the warehouse. It is seen that today 80% of the warehousing capacity is used by the Government for storing various commodities under the Public Distribution System and for storing fertilizers.

Q. What is a Demat Electronic Warehouse receipt?

A. Demat Electronic Warehouse Receipts are expected to be electronic records created by an approved agency after dematerialisation of the physical receipt issued by a Warehouse. In securities market the physical shares of the company are dematerialized by their Registrar and Transfer Agents using a Depository empowered under the Depositories Act. Also, the total shares of a company are monitored by the Registrar of Companies and the Stock Exchanges. In commodities market, there is no standardization of monitoring of warehouse receipts issued by a warehouse by any regulatory body. Similarly, the transfer of ownership also gets affected under a mutual agreement and not as per any Statutory Act. It remains to be seen whether such transfer will be considered good transfer under Negotiable Instruments Act and whether electronic records will be good title considering the above shortcomings. And also the fact that commodity is perishable and may not be a good delivery if the buyer finds out that it has deteriorated beyond the specifications mentioned in the contract.

Q. Are Demat electronic warehouse receipts necessary for futures trading like the demat shares in the securities market?

A. No. As 99% of the trading does not result in delivery, demat electronic warehouse receipts are not mandatory. Further, in futures market, since this 1% delivery also happens only once in a month or perhaps once in two months, it may not be economically viable to create such an elaborate system for futures market only.

In the securities market also, demat deliveries were useful only in the spot segment where the delivery percentage is 15-20% and it occurs on a daily basis across the country. Further, the demated shares in securities market are perpetual in nature and, therefore are rarely required to be used in the physical form. Whereas, in the commodities market such an elaborate system is pointless initially as commodities traded on the futures markets are consumed regularly and are rarely available in abundance for extended storage.

As far as commodities are concerned, there is no law, which regulates dematerialisation of warehouse receipts. Availability of a commodity at any point of time is a direct derivative of total production, carried forward stocks, imports and consumption. Equity shares are off the market if the issuing company buys them back. Commodities, on the other hand, are extinguished due to consumption, the perishable nature and exports.

Currently, 80% of the warehousing in India is used primarily for wheat, rice and fertilizers, among others. The import of commodities is spaced out at regular intervals to reduce storage cost and commodities produced seasonally are used completely, by the next season. Therefore, it may not be a feasible business proposition to recommend market participants to use electronic warehouse receipts without first providing for a legal secured framework, which guarantees the quantity, quality, title and ownership of the commodities held by a genuine buyer and covers issues like sales tax concerning sale and movement of goods.

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