

# Commodity Futures Market - No Complexity, Only Simplicity.

## MCX is shattering quite a few myths in the process of educating market participants about the realities of commodity futures

The government, after prolonged prohibition, has finally approved futures trading in all commodities. In order to activate the futures market, the government has mandated four commodity exchanges to establish national level multi-commodity exchanges.

There have been various incorrect perceptions about the commodities market founded on experiences in the securities market. These have hindered the development of the commodities market and the protection of real trading interests. Multi Commodity Exchange of India Limited (MCX) believes that the commodities market would be successful only if the commodities' eco-system partners use the exchange for its economic function of price discovery and price risk management.

Busting some of the myths about the commodities market-

**Myth:** Commodities markets are small due to the transaction size and number of players.

**Reality:** Securities cash : Rs. 12,00,000 Crore

Derivatives: Rs. 25,00,000 Crore

Commodities cash: Rs. 4,00,000 Crore

Derivatives: 20 times internationally and assumed to be 10 times in India.

Possible commodity futures market size: Rs. 40,00,000 Crore

**Myth:** Commodities markets are very complex to understand.

**Reality:** The markets are not complex as the products are natural and therefore cannot be artificially manipulated. The demand and supply also depends on economic factors. It is easier to understand commodities, as in our everyday life we are familiar with commodities, we know the ruling prices of these commodities in the market, while in the stock market, we are not fully aware about the internal affairs of a company.

**Myth:** Only farmers are interested in trading and only they should be trading.

**Reality:** It is incorrect to say that only the farmers would use this market. Actually, the farmers only use the commodity futures prices as a tool to decide which crop to grow and some large farmers would use this market to hedge their price risk through an intermediary. These intermediaries would normally be the same commission agents who help the farmers to sell their crop in the cash market.

**Myth:** These markets are not really required and they only serve the need of speculators.

**Reality:** Commodities markets are needed for the most important economic function of price discovery and price risk management, Speculators constitute only one dimension of the market. They can work only because someone is hedging their risk in the market.

**Myth:** The economy does not need futures market.

**Reality:** A Futures Exchange provides price signals to producers and consumers based on which they meet their long terms requirements. These price signals are not available to the user unless there is a commodity futures exchange and in its absence, the markets have large price fluctuations. This is not in the interest of the producers and consumers. Price stabilisation comes from the price discovery process when market participants react positively to the information available to decide a price.

**Myth:** A Commodity Futures Exchange must have large capital.

**Reality:** A Commodity Futures Exchange has to be run and managed efficiently with optimal costs as the commodities markets

does not provide listing fees as in the securities market and therefore all costs have to be recovered from revenues earned through transactions. Large infrastructure costs may translate into large costs to traders and which would have direct implications on hedging making it expensive. If real users of the commodities market use this market as insurance and discover that the cost of hedging is considerably high, they would prefer not to hedge but bear the risk instead.

**Myth:** A Commodity Futures Exchange is represented by the size of its real estate.

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

**Reality:** Efficiency in commodities market is measured in terms of bidask spread, direct and indirect cost of trading and holding such positions. MCX is witnessing a bid-ask spread of Rs. 2 - Rs. 3 at a price quote of around Rs. 6000 (Gold 10 Grams) and the buyers and sellers are available in the system at all times even at such a narrow spread. 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, let us take an example to comparatively analyze deposit amount required in MCX (i.e. Rs. 2.5 Lakhs) and deposit amount of Rs. 25 Lakhs (a hypothetical figure).

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

At MCX, the margin requirement 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 a healthy indicator. Once the market matures open position normally goes up proving the effectiveness of hedging. Hence, in this example, assuming member's open position is Rs. 50 Lakhs, his daily business would be Rs. 3.30 Crore and if the number of members in the Exchange is 100, then total daily turnover of exchange would be Rs. 330 Crore. Similarly, if there are 500 members then exchange daily turnover would translate to 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 a gap of 40 years. Therefore, lot of awareness and education is required to be invested by all the stakeholders before this market starts witnessing substantial volumes.

Continuing with the previous example, for further clarity & understanding purpose, let us assume that MCX's initial deposit is 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 Crore (assuming there are 100 members on the exchange) and Rs 16500 Crore (if there are 500 members on the exchange). Conclusively, from the detailed analysis and observations from the

**Reality:** No, its not true that the Commodity Futures Exchange is known by the size of its real estate. The new order Commodity Futures Exchanges may not necessarily require large conventional real estate. In fact in the new era the real estate is defined by the power of processors deployed to handle system driven trading and post trading operations.

Further, the Exchanges need an efficient team of professionals who thoroughly understand the intricacies of the commodities market, state of the art technology support partners and dynamic members.

**Myth:** A Commodity Futures Exchange must have large number of members to be successful.

**Reality:** The Commodity Futures Exchange should focus on good and well-spread brokerage houses to penetrate the market. The market would soon move over to many intermediaries with separate trading rights and have few members with clearing rights like banks.

**Myth:** An Exchange must have cash settled contracts to avoid the pains of delivery handling process.

commodity experts who understand the practical aspects of commodities market, its realized that 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 in the above example permits a Trading Member or user to hedge his risk 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 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 additional deposit money seasonally, then the member will bring in more money as per the requirements.

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 and brings us to a fact that with an optimum deposit requirement of Rs. 2.5 Lakhs MCX is about 10 times (1000%) more efficient as explained in the above example.

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.

(This Question is ranked as 'Question of the Series' by our well-regarded readers)

**Reality:** Cash settled market would be no different than an online lottery system. In such markets, the price of the commodity futures will have no bearing on the spot market as delivery is not required and therefore money will be the only factor that determines prices. At MCX, there is a complete understanding of the commodities market and it has a large talent pool to handle deliveries to keep the link pulsating between the futures market and physical cash market. The commodities market has to be kept as real as possible.

**Myth:** The Depository system of electronic transfer of commodities is covered in the Depositories Act.

**Reality:** It is incorrect

**Myth:** The regulatory framework covers agencies in the chain of the Demat Process for commodities

**Reality:** No, it is merely an understanding being reached within the trade and industry.

**Myth:** The Depository/Warehouse guarantees the quality.

**Reality:** Quality of delivery is not guaranteed by anyone. Until the standards in warehousing management improves to ensure preservation of the quality of goods stored no exchange or depository will be able to guarantee quality of the commodity in a warehouse. If the quality is not assured no benefit accrues to the actual user. Therefore, the Exchange should provide a system, whereby the sellers must ensure quality certification before tendering delivery and the buyers must have option to recheck the quality at the time of collecting delivery and in case of any discrepancies compared to the contract specifications, they should have an option to reject it. Worldwide, no Demat delivery is operational in commodities.

**Myth:** There is no guarantee of quality in a physical settlement between member to member through a warehouse.

**Reality:** The seller guarantees the quality to the buyer and therefore he takes care of storing the commodity, as it may be rejected by the buyer. He keeps it in a warehouse where he ensures preservation of quality and quantity of the commodity. Further, the buyer also has the option to recheck the quality at the time of delivery. For performing all such checks, there are professional firms of international repute, which are experts in certification. India is exporting a large number of agro-based commodities to Europe and America on the basis of such certification. Therefore, a commodity Exchange has to educate the members about the effective prevailing systems and to implement a settlement process based on a similar infrastructure.

**Myth:** The operators can manipulate commodity futures prices and so it is not safe to operate in this system.

**Reality:** It is incorrect that commodities prices can be manipulated because all these commodities are under OGL and in case somebody tries to corner stocks of a commodity to manipulate price, some importer will import that commodity from any other country and deliver in India nullifying the attempt to manipulate the price. In the stock markets, the floating stocks are limited so if an operator buys a large number of shares, prices will rise, which is not the case in commodities, because supply and floating stocks are virtually unlimited. In terms of fundamentals and technical analysis commodity prices follow the trends with more accuracy than as compared to scrip, because the commodity markets truly reflect the demand and supply factors.

**Myth:** Commodity futures markets are more risky and so it is not advisable to trade in commodities

**Reality:** While a scrip price can go down even by 30-40 percent in a single trading session, it cannot happen in commodity futures as the commodity futures price is based on the intrinsic value of the commodity. For instance, a scrip future can go down from Rs. 4000 to Rs. 2800 in a single trading session, but Gold Feb 2004 contract would never come down from Rs. 6100 to Rs. 4100 in a single trading session, because the inherent value of gold would never fall so drastically. Therefore, it is always safe to operate in the commodity futures market as against the stock futures market.

It is only an issue of in depth understanding of the real market and anticipating and delivering what the commodity industry actually requires.

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