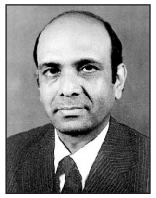
Everything you wanted to know about - The Commodity Futures Market

MCX Education Series - I : Simplifying Knowledge, Establishing Realities



Venkat R. Chary, I.A.S (Retd.)
Chairman
Multi Commodity Exchange of India Ltd.
Former Chairman - Forward Markets Commission, Government of India.

Dear Readers,

It is heartening to see the swift growth of the Multi Commodity Exchange (MCX) family with member representation from almost all States and commodity segments, Directors representing the Public and Corporate interest and Advisory Board members representing all major commodity segments. Some of our pioneering initiatives have been strategic alliances with leading industry associations like the Bombay Bullion Association, the Bombay Metals Exchange & the Solvent Extractors'Association of India and the launch of a monthly newsletter on commodity derivatives industry 'MCXComNews'. We strongly believe that knowledge is power and creating awareness about the commodities market through dissemination of reliable information and training will certainly result in the deriving of real benefits of the futures market by all stakeholders.

In order to achieve this goal, constant awareness creation on 'Commodity Futures Trading' is necessary. Accordingly, we are now publishing an educational series as an extension of our "Awareness Creation Drive". We are sure this will bring direct benefit to all entities in the commodity ecosystem and to society in general. Please do visit us at www.mcxindia.com or write to us at info@mcxindia.com with your queries, feedbacks and suggestions. We would be delighted to provide you with all necessary clarifications to remove any 'Myths' on the commodities market and to share with you the 'Reality'.

Happy Reading!

Regards,

Venkat R. Chary

Physical & Futures Commodity Markets - Basic Fundamentals

India has a long history of commodity futures trading, extending over 125 years. Still, such trading was interrupted suddenly since the mid-seventies in the fond hope of ushering in an elusive socialistic pattern of society. As the country embarked on economic liberalization policies and signed the GATT agreement in the early nineties, the government realized the need for futures trading to strengthen the competitiveness of Indian agriculture and the commodity trade and industry. Futures trading began to be permitted in several commodities, and the ushering in of the 21st century saw the emergence of new National Commodity Exchanges with countrywide reach for trading in almost all primary commodities and their products.

A commodity futures contract is essentially a financial instrument. Following the absence of futures trading in commodities for nearly four decades, the new generation of commodity producers, processors, market functionaries, financial organizations, broking agencies and investors at large are, unfortunately, unaware at present of the economic utility, the operational techniques and the financial advantages of such trading. The Multi Commodity Exchange of India (MCX) the premier New Order Exchange in the country is, therefore, launching this Commodity Futures Education Series to provide valuable insights into the rationale for such trading, and the trading practices and regulatory procedures prevailing at the Exchange.

For easy understanding and simplification of various issues and nuances involved in commodity futures trading, a convenient question-answer approach is adopted.

PHYSICAL AND FUTURES COMMODITY MARKETS

Q. What kind of statutory framework for regulating commodity futures exists in India?

A. Commodity futures contracts and the commodity exchanges organizing trading in such contracts are regulated by the Government of India under the Forward Contracts (Regulation) Act, 1952 (FCRA or the Act), and the Rules framed thereunder. The nodal agency for such regulation is the Forward Markets Commission (FMC), situated at Mumbai, which functions under the aegis of the Ministry of Consumer Affairs, Food & Public Distribution of the Central Government.

Q. What is "Commodity"?

A. Commodity includes all kinds of goods. FCRA defines "goods" as "every kind of movable property other than actionable claims, money and securities". Futures' trading is organized in such goods or commodities as are permitted by the Central Government. At present, all goods and products of agricultural (including plantation), mineral and fossil origin are allowed for futures trading under the auspices of the commodity exchanges recognized under the FCRA. The national commodity exchanges have been recognized by the Central Government for organizing trading in all permissible commodities which include precious (gold & silver) and non-ferrous metals; cereals and pulses; ginned and un-ginned cotton; oilseeds, oils and oilcakes; raw jute and jute goods; sugar and gur; potatoes and onions; coffee and tea; rubber and spices, etc.

Q. What is "Commodity Exchange"?

A. A commodity exchange is an association, or a company or any other body corporate organizing futures trading in commodities.

Q. What is the meaning of "Futures Contract"?

A. A futures contract is a type of "forward contract". FCRA defines forward contract as "a contract for the delivery of goods and which is not a ready delivery contract". Under the Act, a ready delivery contract is one, which provides for the delivery of goods and the payment of price therefor, either immediately or within such period not exceeding 11 days after the date of the contract, subject to such conditions as may be prescribed by the Central Government. A ready delivery contract is required by law to be fulfilled by giving and taking the physical delivery of goods. In market parlance, the ready delivery contracts are commonly known as "spot" or "cash" contracts.

All contracts in commodities providing for delivery of goods and/or payment of price after 11 days from the date of the contract are "forward" contracts. Forward contracts are of two types - "Specific Delivery Contracts" and "Futures Contracts". Specific delivery contracts provide for the actual delivery of specific quantities and types of goods during a specified future period, and in which the names of both the buyer and the seller are mentioned.

The term 'Futures contract' is nowhere defined in the FCRA. But the Act implies that it is a forward contract, which is not a specific delivery contract. However, being a forward contract, it is necessarily "a contract for the delivery of goods". A futures contract in which delivery is not intended is ab initio void (i.e., not enforceable by law), and is, therefore, not permitted for trading at any commodity exchange.

Q. What are the salient features of a "Commodity Futures Contract"?

A. A commodity futures contract is a tradable standardized contract, the terms of which are set in advance by the commodity exchange organizing trading in it. The futures contract is for a specified variety of a commodity, known as the "basis", though quite a few other similar varieties, both inferior and superior, are allowed to be deliverable or tenderable for delivery against the specified futures contract.

The quality parameters of the "basis" and the permissible tenderable varieties; the delivery months and schedules; the places of delivery; the "on" and "off" allowances for the quality differences and the transport costs; the tradable lots; the modes of price quotes; the procedures for regular periodical (mostly daily) clearings; the payment of prescribed clearing and margin monies; the transaction, clearing and other fees; the arbitration, survey and other dispute redressing methods; the manner of settlement of outstanding transactions after the last trading day, the penalties for non-issuance or non-acceptance of deliveries, etc., are all predetermined by the rules and regulations of the commodity exchange.

Consequently, the parties to the contract are required to negotiate only the quantity to be bought and sold, and the price. Everything else is prescribed by the Exchange. Because of the standardized nature of the futures contract, it can be traded with ease at a moment's notice.

Q. What are the main differences between the physical and futures markets?

A. The physical markets for commodities deal in either cash or spot contract for ready delivery and payment within 11 days, or forward (not futures) contracts for delivery of goods and/or payment of price after 11 days. These contracts are essentially party to party contracts, and are fulfilled by the seller giving delivery of goods of a specified variety of a commodity as agreed to between the parties. Rarely are these contracts for the actual or physical delivery allowed to be settled otherwise than by issuing or giving deliveries. Such situations may arise when unforeseen and uncontrolled circumstances prevent the buyers and sellers from receiving or taking deliveries. The contracts may then be settled mutually.

Unlike the physical markets, futures markets trade in futures contracts which are primarily used for risk management (hedging) on commodity stocks or forward (physical market) purchases and sales. Futures contracts are mostly offset before their maturity and, therefore, scarcely end in deliveries. Speculators also use these futures contracts to benefit from changes in prices and are hardly interested in either taking or receiving deliveries of goods.

Q. What is price risk management? How does a commodity futures market perform this economic function?

A. The two major economic functions of a commodity futures market are price risk management and price discovery. Among these, the price risk management is by far the most important, and is the raison d'etre of a commodity futures market.

The need for price risk management, through what is commonly called "hedging", arises from price risks in most commodities. The larger, the more frequent and the more unforeseen is the price variability in a commodity, the greater is the price risk in it. Whereas insurance companies offer suitable policies to cover the risks of physical commodity losses due to fire, pilferage, transport mishaps, etc., they do not cover similarly the risks of value losses resulting from adverse price variations. The reason for this is obvious. The value losses emerging from price risks are much larger and the probability of the recurrence is far more frequent than the physical losses in both the quantity and quality of goods caused by accidental fires and mishaps, or occasional thefts.

Commodity producers, merchants, stockists and importers face the risks of large value losses on their production, purchases, stocks and imports from the fall in prices. Likewise, the processors, manufacturers, exporters and other market functionaries, entering into forward sale commitments in either the domestic or export markets, are exposed to heavy risks from adverse price changes.

True, price variability may also lead to windfalls, when prices move favorably. In the long run, such gains may even offset the losses from adverse price movements. But the losses, when incurred, are, at times, so huge that these may often cause insolvencies. The greater the exposure to commodity price risks, the greater is the share of the commodity in the total earnings or production costs. Hence, the need for price risk management or hedging through the use of futures contracts.

Hedging involves buying or selling of a standardized futures contract against the corresponding sale or purchase respectively of the equivalent physical commodity. The benefits of hedging flow from the relationship between the prices of contracts (either ready or forward) for physical delivery and those of futures contracts. So long as these two sets of prices move in close unison and display a parallel (or closely parallel) relationship, losses in the physical market are offset, either fully or substantially, by the gains in the futures market. Hedging thus performs the economic function of helping to reduce significantly, if not eliminate altogether, the losses emanating from the price risks in commodities.

Watch out for Part - II : • Price Discovery & Price Risk Management • Role of Commodity Exchange

MCX kicks off Evening Session for Commodity Futures Trading to bridge the gap between Indian & Global Markets - December 8, 2003, yet another first from MCX.

Multi Commodity Exchange

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