Benefits and Importance of Hedging Commodity Prices'

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The Indian agriculture sector has come a long way from the years of shortages of the early years of the decade starting 1951 to having surpluses in some key food grains since the last few years. The country of 1.3-billion is estimated to have produced over 300-million-tonne plus of food grains and over 326 million tonnes of horticulture output in 2020-21.In the production of several crops, India is the global leader or ranked among the top five.

The growth in farm output was achieved despite relatively lower penetration levels of modern agricultural practices, and mechanization like soil improvement, high yielding seeds, fertilizers, pesticides, and harvesting, thanks to a large number of small-holder farmers with a per-capita land-holding below two hectares. Unfortunately, the per-capita land holding continues to fall inversely affecting the benefits of economics of scale. With rising numbers of farmers under the category, the fragmented holding could threaten the viability of farming as an economic activity.

Further, while the country continued to grow its farm output year on year, the contribution of Agriculture to the GDP fell from 85% in the decade starting 1950 to around 17% in 2019, due to increased contribution from industry and services sectors. After 17 years of sub 20 contribution, the and rising back to around 20% in the next year due to Pandemic-led deceleration in non-farm sectors. Nevertheless, managing over 600 million tonnes of food grains, horticulture, oilseeds, and non-edible farm output poses a challenge for the country, especially when the agricultural marketing system and post-production activity could not grow in tandem with the pace of growth in agricultural production.

Fragmented Spot Market

600-million-tonne plus of food production, by any means, is large enough to confer a price-setter status and significant importance to the country in the world food market. However, India has not been able to reach its potential on this count, which again can be attributed to its inability to monetize its agricultural assets. Indian spot market continues to be fragmented and inefficient, which can largely be attributed to regulatory arbitrages emerging from the agri-market being the state subject, and also due to lack of technology absorption, and integration with modern market infrastructure. The fragmented spot market is the single biggest challenge for policy-makers in the wake of their efforts in establishing the National Agriculture Market.

Simultaneously, efforts are being made by commodity exchanges and other market infrastructure institutions to establish a national agriculture market. The introduction of the agri-commodity derivatives market has brought efficiency and standardization in the spot markets and integration of the same with a national agriculture market. National Commodity and Derivatives Exchange Ltd and its state-of-the-art complete market infrastructure have played a key role in the integration of spot markets since 2003. With the enactment of three farm laws, giving independence to farmers in marketing their produce, the process of the national agriculture market has taken a decisive step. Integration of spot markets with national agriculture markets and international markets may have a new set of challenges like managing the price volatility in raw material and finished products across the spectrum of stakeholders from producers, processors, stockists, and exporters. Here, national commodity exchanges like NCDEX are ready to play a big role.

Volatility in Commodity Prices

Factors that influence commodity prices include politics, seasons, weather, technology, and market conditions. Until the end of the last century, the annual volatility in prices of commodities had been in the single-digit, barring a few exceptions. In the last couple of decades, the volatility has gone up significantly, as high as 50% in many commodities. The volatility in prices has become a major challenge for sustaining for the stakeholders. Starting with current Covid-19 a once-in-a-century type occurrence, to the climate change risk. Added to the list are rising geopolitical tensions, international trade policies, and rising force majeure events that create logistics and supply chain disruptions. For a trader engaged in export-import activities an additional risk of currency fluctuation. At the farm level, distressed sales due to slump in prices at harvesting have become a structural problem, the volatile prices throughout the year pose several challenges to processors, traders, or stockists to maintain margins in the business. To overcome these challenges, the function of Price Risk Management has become crucial for long-term survival for all stakeholders.

Price Risk Management or Hedging

We have seen that the lack of risk management policy has wiped out several companies from the commodity business. But that's not all, the risk management policies are equally important for lenders to insulate from huge losses from likely defaults. As agri-commodities are perishable with a low shelf life, and sensitive to collateral management practices in terms of quality and quantity, any adverse movement in prices encourages the owner of these commodities to default on his obligations towards the lender. As a result, rising non-performing assets in the agri-sector have become a big issue in agri-financing. With rising annual targets for farm credit, Rs. 16.5 trillion for the current fiscal, risk management is critical for lenders in the public and private sector. Hence, a disciplined risk management policy and a proportionate risk allocation with proper checks and balances could make an ideal policy.

Hedging in finance refers to protecting investments and is used for investing in market-linked instruments. A hedge is an investment status, which aims at decreasing the possible risk, suffered by an associated investment. Hedging increases liquidity as it facilitates investors to invest in various asset classes. The use of Hedging as a risk mitigant has been low in India, except for the multi-national commodities trading houses that have a presence in India. Low awareness level, absence of requisite skilled manpower, and other resources to implement the risk management policies are the main reasons behind the low level of hedging. The commodity derivatives market is a platform that offers effective risk management for all stakeholders, from farmers to exporters in a most transparent and regulated environment and guaranteed settlement mechanism. Futures and Options are the popular means of hedging the price as well as raw material sourcing risks in a cost-efficient manner.

For a farmer, risk management can be done through locking of sale-price for his farm produce at the time of sowing the crop. Hedging offers definite advantages to producers and costs comparatively little. Hedging with futures allows a farmer to lock in a price for his crop that reflects the producer's sustainability and profit. The farmer can compare the price available in the futures market that will support their production cost and help them earn some surplus. Further hedging operations involve proportionately small initial outgo. If the price of futures goes up, the producer who has sold futures may be asked to pay additional margins; but the price of their agri-produce will correspondingly go up and they would not have any loss. In the event, if the prices of the agri-produce fall, the farmer will still be saved from the vagaries of the market and get money as per the contract. Hedging offers a flexible pricing mechanism. In case if the farmer feels they have made a wrong decision on the exchange, they can have an alternative order executed easily.

So far, futures contracts have been the most popular instrument for farmers and farmer producer companies to lock-in their sale prices. However, the inability to realize higher prices once hedged through futures contracts and the requirement of higher capital by way of margins and mark-to-market payments has capped the penetration of hedging among farmers. However, after the launch of the Option in Goods segment by NCDEX in November, farmers got an innovative market-based tool to lock-in their sale prices even before sowing by paying a mere one-time premium. Purchasing the Put Option gives dual benefits to farmers by limiting the downside and protecting the right to get the upside in prices as the case may be. The Put Option is steadily poised to revolutionize risk management among farmers.

For the rest of the stakeholders like processors, traders, and exporters of agri-commodities, futures, and options can be used based on their risk profiles and levels of proficiency in managing the risk. For corporates, where raw material cost accounts for the bulk of its expenses, securing raw material in futures contracts spread over a while helps manage the cost on one hand and reduces the requirement of working capital for procurement raising the efficiency of capital by lowering the interest cost. Similarly, selling the produce in advance through commodity futures saves corporates from any decline in prices due to unforeseen events. Thus, having a risk management policy helps companies to maintain margins and long-term visibility in the business and helps increase the shareholder value, and helps such corporates to raise the business finance at competitive rates.

Banks, by the very nature of their operations, face three types of risks — operational, credit, and market. Under the Basel frameworks, they would have to provide for additional capital commensurate with the higher risks they are exposed to. Indian Banks lend to customers engaged in activities related to agriculture. Volatility in agricultural commodity prices may negatively impact such customers and impact their repayment capacity. This proves a credit risk to banks. As a futures contract provides considerable price protection, going forward banks are more likely to finance producers, exporters, and traders who hedge their crops and positions than those who do not Banks will be able to mitigate these risks efficiently, have to set aside less capital to comply with Basel norms. Hence, hedging of agri-commodity price risk by the borrowers could be beneficial to both the borrowers and the banks.

Regulatory Push

While the need of having a risk management policy is identified, there is no matching willingness to implement one. The key reason for this is the argument that Indian commodity markets lack the necessary liquidity and depth to welcome hedgers. SEBI has taken a lot of developmental initiatives by allowing market making, institutional participation from Category-III Alternative Investment Funds, portfolio managers, and mutual funds.. It also allowed foreign entities to hedge their exposure to the Indian commodity market on Indian commodity exchanges. SEBI has made it mandatory for Corporates to disclose their exposures to commodity markets under the corporate governance norms while publishing their quarterly performance. SEBI is in dialogue with the Banking regulator to ensure mandatory hedging by corporates while availing loans from Banks. This step can bring a major change in the commodity derivatives market concerning depth and breadth and quality of participation and prove a win-win situation for corporates, lenders, and the Indian economy as a whole.