Role of Commodity Derivatives Market for Ushering in a Developed Economy

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To look at the future vision of India, it is pertinent to look back also and evaluate the journey of last few decades. If the achievements of the past have resulted in strong core competencies in the present, then we can surely project our future growth trajectory with confidence. The commodities derivatives markets journey began in India in the post liberalization era around 2002-03, with the ushering in of commodity exchanges. Ever since, we have witnessed continuous growth and development of the commodity ecosystem, maturing of the markets, expansion of products and participants even consolidation among regulators. India is now recognized as a powerhouse in terms of its capital markets' regulatory framework and infrastructure. India's journey towards digital innovation and financial inclusion has been phenomenal in the last few years. With this, the commodity derivatives markets have also seen its investor base increase. Digital innovation and extended financial inclusion post covid-19 era is providing opportunity for domestic exchanges to expand their base multifold.

Indian Economy

The world economy in 2022 has been strained by the rise in commodity prices brought on by geo-political conflicts. It has also exacerbated inflation, tightened financial conditions, increased financial fragility, and heightened policy uncertainty, in addition to causing supply disruptions, poverty, and food insecurity. Rising energy cost across the globe have affected our domestic economic situation as well.

Nevertheless, the RBI has predicted that India's economy will grow at one of the highest rates in the world as the war's cascading effects become less prevalent. As per RBI, India's GDP is predicted to grow by 7.2% during the current fiscal. In addition, a World Bank analysis notes that fixed investments made by both the private sector and the government, which has implemented incentives and reforms to improve the business climate, will assist India's growth. Indian economy is on the path of recovery from the setback caused by the global geopolitical tensions that we are currently witnessing.

Reforms in Commodities Market

Commodity markets lie at the foundation of the Indian economy, since it is highly commodity-intensive. As such, development of the commodity market is necessary for development of the economy. The dynamics of the commodity derivatives market have seen a massive change ever since they have come under the preview of the Securities and Exchange Board of India (SEBI) in 2015. The period since then has been marked by a plethora of reforms, most notably in the expansion of products and eligible participant categories.

The market received a shot in the arm in 2018-19 following announcement of the long awaited policy measures allowing the participation of institutional participants such as eligible foreign entities (EFEs), Mutual Funds and Portfolio Management Services (PMS). Following the release of detailed guidelines on participation of mutual funds in Exchange Traded Commodity Derivatives (ETCDs), Asset Management Companies (AMCs) started participating in commodity derivatives. Currently several AMCs have included commodity derivatives as part of their mutual fund schemes, offering the benefit of portfolio diversification and inflation hedging to their clients. With this, the participant base in commodity derivatives has widened considerably, as compared to what was possible earlier.

Within the community of institutional participants, the entry of banking institutions into the commodity derivatives market is particularly significant. The Reserve Bank of India, on September 25, 2017, permitted banks to become Professional Clearing Members (PCMs) and their broking subsidiaries to offer broking services in the commodity derivatives segment of SEBI recognized exchanges. Subsequently, a number of banks have become PCMs in the commodity derivative segments of exchanges, while several broking subsidiaries of banks have started distributing commodity derivatives. With their high capital base and reputation, banks as clearing members bring more confidence among participants, especially among institutional participants. Besides, bank-owned broking subsidiaries have larger distribution networks and physical presence across the country and have large number of clients registered with them. They are significantly contributing in enlarging the footprint of the commodity derivatives market by making these products accessible to their large client base.

FPIs' entry into commodities Market

There has been a long-standing demand from the foreign investor community to allow them to access the ETCD platform in India. In a recent development in June 2022, the Board of Securities and Exchange Board of India allowed FPIs to participate in the exchange traded commodity derivatives market. As per the latest guidelines, to begin with, FPIs have been permitted to trade in cash settled non-agricultural commodity derivatives contracts and index derivatives comprising of such non-agricultural commodities. Now, any foreign investor would be able to access the Indian ETCD market with or without having actual exposure to Indian physical commodities through the FPI route.

FPI participation is likely to enhance liquidity, which may also bring down the impact cost. Their participation would augment the market depth and act as a catalyst for even more efficient discovery of prices for the commodity sector.

Expansion and development of Product Portfolio

MCX, which had a market share of 93.6% in terms of the value of commodities futures contracts traded in financial year 2021-22, benefited both from the spate of regulatory reforms as well as the enthusiasm and renewed confidence of market participants. MCX offers Futures and Options trading in a number of commodities within non-ferrous metals, bullion, energy and agricultural commodity segments.

MCX is among the top global commodity exchanges, the latest (calendar year 2021) yearly data from Futures Industry Association (FIA) shows. The Exchange is the world's 6th largest by the number of commodity Options contracts traded and 7th largest by the number of commodity Futures contracts traded, as per the 2021 report of FIA.

In terms of the products traded in the commodity derivatives market, the basket of products available for trading has been witnessing a steady expansion. Trading in commodity Options commenced in 2017, with the launch of Options on futures of Gold. Subsequently, Options trading on futures of commodities like Crude Oil, Natural Gas, Copper, Silver, Nickel, Zinc, etc. was also introduced. MCX has also introduced Options on Gold Mini futures and Silver Mini Futures, further expanding its product suite in the bullion Options segment.

MCX launched the MCX India Commodity Indices (MCX iCOMDEX) series on December 20, 2019, which conform to the global best practices set by the International Organisation of Securities Commissions (IOSCO). iCOMDEX series consists of one composite, three sectoral and several single commodity indices. Subsequently, MCX launched futures contracts on the three sectoral indices: the MCX iCOMDEX Bullion Index (BULLDEX), Base Metal Index (METLDEX) and Energy Index (ENRGDEX). MCX BULLDEX futures was the world's most traded commodity index futures in 2021, as per data released by FIA.

The exchange also set up a web-based application "ComRIS" (Commodity Receipts Information System) in order to maintain an electronic record of non-agricultural commodities deposited at the Exchange accredited warehouses and ensure flow of real time information about such stocks.

In March 2022, SEBI allowed exchanges with commodity derivative segment to launch trading in options on commodity indices, an opportunity MCX will take up at the appropriate time.

MCX has been making efforts to indigenise the metals and bullion contracts and make them more relevant to the physical market stakeholders. The effort that started in the fourth quarter of FY 2018-19 to migrate to 'Compulsory Delivery-based' contracts in all base metals successfully reached completion in FY 2019-20. The launch of indigenously benchmarked deliverable futures contracts of Copper, Aluminium, Zinc, Lead and Nickel on MCX, has paved the way for the Indian market prices for metals to be discovered on an exchange platform in a transparent manner. This fulfills an important step towards the development of domestic benchmarks which reflect domestic market fundamentals, while the delivery standards are in tune with international standards.

Besides, MCX has also been making efforts to improve the ecosystem of India's commodity markets. After the Bureau of Indian Standards issued good delivery standards for refined gold and silver bars, MCX has taken several steps so that bullion meeting the India good delivery standards can be assimilated into the country's bullion derivatives market. In order to bring in local players into the Exchange delivery mechanism, MCX has expanded the Good Delivery list in Bullion by empanelling Indian refineries that meet the Exchange's eligibility criteria. With the same objective of indigenisation and to bring local players in the Exchange delivery mechanism, MCX has been empanelling domestic producers in Base Metals too, starting with Lead.

India looking ahead

India's commodity derivatives market looks forward to further reforms for its development. One of the key agenda items is participation by banks in the commodity derivatives market. This requires the government to permit banks to trade in commodity derivatives under the Banking Regulation Act, 1949. Banks can play a significant role in enriching commodities derivatives markets with their wider outreach across not only large corporates, but also MSMEs, farmers and large sections of the population. These stakeholders can be handheld by banks to hedge their commodity risk on commodity derivative markets. Many independent studies, including committees set up by the Government of India and the Reserve Bank of India, have called for allowing banks to participate in the commodity derivatives market. A 2017 report of the RBI had, for instance, called for banks to offer commodity hedging facilities to their constituents, initially on a back-to-back basis, on both OTC and Exchanges.

Similarly, financial institutions with a long term investing perspectives, such as insurance companies and pension funds, would also play a catalytic role in market development through their participation, if permitted. Enhancing the scope of eligible participants, especially institutional participants, would benefit the market not only by enhancing its liquidity and depth, but also by bringing in new retail participants, all of which would help in the overall market development.

As India aspires to become a USD 5 trillion economy, liberalising the commodity derivatives market by enhancing its product suite and participant base will help in making Indian commodity markets world leaders for price discovery and price risk management. SEBI has struck the right chord by allowing FPIs in India's commodity derivatives market. Market stakeholders hope for more reform measures in the times to come, which can add vibrancy to the market and enable it play its critical role in India's developmental agenda.