Commodity Options – A Financial Instrument Whose Time has come

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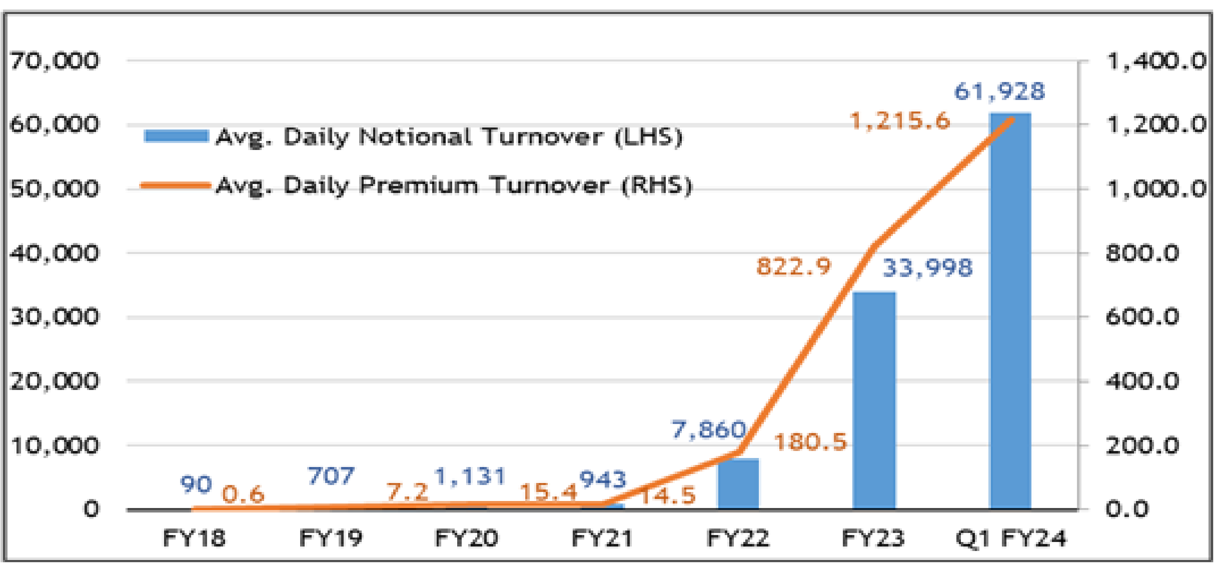
Commodity options, a relatively new entrant in India's financial market, has become one of the most popular instruments among the Indian investor community. This is almost difficult to believe, considering that till as late as 2015, options in commodity markets were disallowed under the then prevailing law, and till October 2017, the Indian market had not seen trading in this instrument at all. The 2015 amendment of the Securities Contracts Regulation Act, 1956, bringing India's commodity derivatives market within its ambit, was the first step towards permissibility of commodity options in India. The 2016 Union Budget witnessed the announcement made by Hon'ble Finance Minister that new derivative products would be developed by SEBI in the commodity derivatives market. Subsequently, the Commodity Derivatives Advisory Committee (CDAC) of SEBI recommended the launch of options products in commodity markets, which culminated in regulatory guidelines being issued on options trading on June 13, 2017. MCX was the first exchange to introduce commodity options products, with the launch of options on gold futures on 17 October 2017, coinciding with the auspicious day of *Dhanteras* that year.

From then on, the popularity of commodity options has only been on an upward trajectory. Volumes in options traded on MCX touched 87.9 million lots during the calendar year 2022, up 403% from 2021. In the first eight months of 2023, volumes were 176.4 million lots, with a turnover (notional) exceeding Rs.103 lakh crores. This translates into an average daily turnover of Rs. 60,633 crores in this segment during January – August 2023.

Average Daily Turnover in MCX options (Rs. Crores)



The popularity of commodity options has made MCX an exchange of global reckoning. As per data released by the Futures Industry Association (FIA), MCX was the world's 5th largest exchange in 2022 by the number of commodity options contracts traded in the year. The MCX crude oil options contract was world's most traded crude oil options; while MCX silver options and MCX natural gas options contracts were the second largest in their respective commodity segments in 2022.

What gives commodity Options the edge? For one, for options buyers, they are one of the simpler financial instruments which do not require more than a basic understanding of the fundamentals of the underlying commodity. For another, options buyers also do not have to worry about maintaining sufficient margins or incurring unlimited losses. The holder of an option only has to pay a premium to buy the instrument, and would only lose the premium paid if the price moves against them by letting the options contract expire. On the other hand, when the price moves in their favour they can exercise the option contract at the predetermined strike price and take advantage of the favourable movement in the market price. Besides, the availability of options on liquid energy products whose underlying are cash-settled futures contracts, such as crude oil futures or natural gas futures in the Indian commodity derivatives market, means that the investors also do not have to worry about delivery marking at expiry. Moreover, when the options are traded on a regulated exchange and cleared by its regulated Clearing Corporation, the credibility of the instrument gets enhanced, attracting the trust of investors in general. For the more matured investors, options (on their own, or together with futures) enable creation and execution of a large number of different trading strategies, as per investors' own expectations of returns based on their risk appetite.

Apart from being popular for reasons mentioned above, commodity options are also useful as a risk management tool. Businesses having commodities as an input or output face a multitude of risks arising from volatility and uncertainty in commodity prices, potentially leading to significant fluctuations in the firm's cash-flows. Commodity prices are highly sensitive to global economic upheavals, including geopolitical conditions. Many times, such global factors take a long time to settle down and raw material prices reach either multi-year lows or multi-year highs which results in huge losses to businesses. This highlights the need for businesses to understand about and undertake hedging of their commodity price exposure, especially through options, since it can protect them from losses on one hand, while allowing for profit maximization on the other.

Two recent examples of global economic upheavals, causing commodity price risks, are particularly noteworthy: the Covid-19 related lockdowns and the ongoing Russia-Ukraine war. On one side, oversupply conditions resulted when lockdowns were imposed in 2020 the world over, as demand was severely curtailed after a significant bull run in commodities. Once the unwinding of the lockdown began and consumption started increasing, it resulted in a massive rally in the prices of commodities due to relatively undersupply of raw materials vis-à-vis the pent-up demand. Prices of agricultural commodities, fuel and metals increased sharply just after the lockdown restrictions were lifted. The Dow Jones Commodity Index, which had dropped 27% from 621.85 (Dec 2019) to 450.17 (April 2020) during the initial phase of Covid-19, rallied by as much as 62.51% to a high of 731.89 by Dec 2020 once the news of vaccination roll-out started coming in.

Similarly, the Russia-Ukraine conflict has had significant impact on global commodity markets. The major impact was on the prices of crude oil which has a bearing on almost everything. Brent oil prices rallied from $98 per barrel to $133 per barrel, an increase of 36% within a span of nine trading sessions in 2022. Even prices of some agricultural commodities such as wheat sky-rocketed and rallied 70% within weeks following the start of the war in February 2022, as Ukraine is a significant supplier of grains.

Such sudden moves in commodity prices affects the profitability of industries which are dependent on commodities as a raw material. For example, the airline industry consumes jet fuel, FMCG industry consumes grains, electricity and metal producing companies consume fossil fuels as a raw material. Hedging commodity price risk becomes a critical financial decision for commodity-intensive industries, where price volatility upsets the profit margins of such companies. Therefore, it is universally recognized that companies using commodities as raw materials should consider hedging the price risks arising from commodity price volatility. Given the advantages of commodity options mentioned above, it is only obvious that such companies with exposure to commodities should explore these derivative instruments for price risk management.

Despite the advantages of using commodity options, like all derivative instruments, one needs to be careful in using options too. While the holder of options contract can encounter the risk of illiquidity, especially in strike prices which are farther from the underlying asset's current market price, the writer of an options contract bears the risk of unlimited loss. As such, investors have to understand the inherent risk of options before deciding to enter as a buyer or seller and map expectations of returns with their risk appetites. Further, while option writers are said to encounter the risk of unlimited loss, buyers of options contracts may also end up losing the premium paid as well as receiving delivery if the underlying futures contract is delivery-based and the option expires In-The-Money. Unless the buyers understand the nuances of margins on buyers' side, and the difference between cash settled and delivery-based options contracts, this is also a potential source of risk for buyers if they are not desirous of taking/ giving delivery.

Commodity derivatives trading in India, including products like commodity options, has gone through many developments in recent past. In the coming years, the effect of these developments and trends could be magnified, resulting in even more popularity of these instruments, attracting new players and higher retail participation. The Securities and Exchange Board of India (SEBI) has already issued guidelines on options on commodity indices. Given the popularity of index options in other asset classes, these products can also become popular as and when introduced.

The rise of India as an economic powerhouse, on the back of industries and services which are commodity-intensive, is going to place a higher demand for derivative instruments for risk management, price discovery and also as an asset class. Commodity options will surely have an increasing role to play in contributing to India's economic growth in the coming times.

Views are personal