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COMMODITY FUTURES IN THE INDIAN FUTURES MARKET

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INTRODUCTION

Hedging involves taking one risk to offset another and there are many tools for hedging such as futures, forwards and swaps. Together these devices are termed as derivatives because their value is derived from the value of other assets. In India the Securities and Exchange Board of India (**"SEBI"**) approved the phased introduction of derivatives trading beginning with stock index futures.

Trading in futures has proved to be a profitable and successful source of investment in the recent past. This newsletter analyses the concept of futures trading with a special emphasis on the trade in commodity futures and carbon credits in the Indian futures market.

1. How does Futures trading work?

A forward contract when standardized is known as a futures contract. Simply put, a forward contract is one when two parties enter into a contract so that the price or value of the commodity traded is fixed on the day of execution of the contract but the delivery and payment takes place at a future date. In other words, both the parties are bound by the terms of the contract and are committed to buy and sell the commodity at the pre-determined price and at the pre-determined time.

These standardized forward or futures contracts are traded on a "futures exchange."[1] The price is fixed when the contract is executed but the payment is only made later. However, the "buyer" has to pay an amount termed as "margin," in order to demonstrate an ability to pay in the future, to provide reassurance not only to the opposite party but also to the exchange guaranteeing the contract in question.

In addition to this margin the traders are also required to pay a "mark to market margin."[2] The profits and losses on a contract are calculated for each day. These are usually collected and paid by the clearing house of the concerned exchange. Therefore, in futures trading, the buyer and seller are so placed that one makes a payment for the loss incurred while the other receives payment for the profit made.

A general practice followed globally by most futures exchanges is to guarantee the contracts on their exchange. They safeguard their interest by the mechanism of settling the profits and losses incurred on the contracts daily. The payment received by the clearing house is utilized to pay the profits to the other contracting party. In this manner trading in futures also eliminates counter party risk i.e. the risk that either party may not perform or pay as promised.

2. Trading in Commodity futures

In India, the Securities & Exchange Board of India (**"SEBI"**) and the Forward Markets Commission (**"FMC"**) regulate trading in futures**.** The FMC regulates the trading in commodity futures.

[1] "Futures exchange" is a formal platform where people can buy or sell standardized futures contracts.

[2] "Mark to market margin" is calculated on the basis of the difference between the contracted price and the current market value. For e.g., A enters into a contract with B to buy a commodity from B at $ 10 to be delivered by B to A at the expiry of one year. The price of the commodity may fluctuate everyday. If on a particular day the market value of the commodity is $ 15 then A suffers a loss of $ 5. It is this amount that he has to pay to the clearing house of the exchange and the exchange in turn shall pay this amount to B as his profit. This calculation is done on a daily basis.

It was established by the Ministry of Consumer Affairs and Public Distribution in 1953 under the Forward Contracts (Regulation) Act, 1952 (**"FCR"**).

Earlier this year the Reserve Bank of India (**"RBI"**) in consultation with the Government of India decided to allow foreign investment in commodity exchanges subject to certain conditions. These conditions include: a composite ceiling of 49% foreign investment with an FDI limit of 26% and an FII limit of 23%, FDI will necessitate a prior specific approval of the government, restriction of FII purchases in equity of commodity exchanges to secondary markets, foreign investment to be in compliance with the regulations issued by the FMC.[3]

2.1 Commodities that can be traded

Pursuant to a notification dated April 01, 2003 issued by the Ministry of Consumer Affairs, futures trading is no longer prohibited in any commodity. However, this freedom to trade in any commodity is still subject to the approval of the Government of India.[4] The Central Government can, by a notification, declare forward contracts in certain goods as illegal or void in certain circumstances.[5] Associations[6] (exchanges) organizing trade in commodities that have been notified under section 15 have to obtain recognition from the Central Government.[7] At present there are 91 commodities in the regulated list.[8] Futures trading in these commodities can be conducted only between, with or through members of recognized associations. This grant of recognition is at the discretion of the Central Government and may be subject to certain conditions. No timeline for granting this recognition has been provided under the statutory provisions. Commodities other than those mentioned in this list can be freely traded by all those exchanges that have registered themselves with the FMC.

The FMC has listed some of the commodities currently traded. These include fibres and manufactures, spices, edible oil seeds and oil, pulses, energy products, vegetables, metals, crude oil, natural gas, rubber, rice wheat, coffee and now even carbon credits.

2.2 Role and Functions of the commodity exchanges

At present there are 22 recognized commodity exchanges. The Department of Consumer Affairs granted recognition to 3 national level exchanges.[9] The associations (exchanges) recognized by the Government of India under the FCR Act,[10] can make their own bye-laws,[11] subject however, to prior approval of the Central Government. These bye-laws contain the provisions with regard to clearing, settlement and arbitration, contract guarantee, settlement guarantee fund, etc.

The exchange plays a very important role in futures trading. Contracts traded on an exchange are designed by the exchange itself and their terms cannot be modified by the contracting parties. The exchange also provides various facilities to its members/traders for clearing and settling the contracts. These facilities are provided for in the bye-laws of the exchange, and therefore, may vary from one exchange to another.

2.3 The facilities provided by an exchange

- To trade on an exchange one must be its member. The charter documents of an exchange prescribe the criteria for becoming a member. The members are required to pay an initial margin and later the mark to market margin. The amount of the

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[3] RBI Notification AP (DIR Series) Circular No. 41 dated April 28, 2008 and Press Note No. 2 (2008) Ministry of Commerce and Industry, Department of Industrial Policy and Promotion.
[4] See www.fmc.gov.in, visited on October 15, 2008.
[5] Section 15 of the FCR.
[6] Section 2 (a) of the FCR defines "associations" as a body of individuals, whether incorporated or not constituted for the purpose of regulating and controlling the business of the sale or purchase of any goods.
[7] Section 5 of the FCR.
[8] List of commodities notified under section 15 of the FCR.

[9] "National level exchanges" are granted recognition by the Indian government in all permitted commodities i.e. commodities listed under section 15 of the FCR in addition to all other commodities while the other exchanges have to approach the government for grant of recognition for each futures contract separately. The 3 national level commodity exchanges are; National Multi Commodity Exchange of India, Ahmedabad, the Multi Commodity Exchange of India Ltd, Mumbai and the National Commodity and Derivatives Exchange Ltd, Mumbai.
[10] Section 4 of the FCR.
[11] Section 11 of the FCR.

initial margin is determined in accordance with the charter documents of the particular exchange.

- To protect the interest of its members and investors, many exchanges make a provision for a "Trade Guarantee Fund."[12]
- Usually every exchange has a clearing house. It performs post trading functions such as confirming trades, working out profits or losses on a contract and adjusting them among the contracting parties.
- With respect to delivery, the bye-laws vary from one exchange to another. Some give an option to the seller to state his intention to deliver, some give such option to both the buyer as well as the seller, and in some exchanges the sellers do not state the intention to deliver. In the last case all the outstanding profits and losses are settled at the due date rate.[13]
- Even though futures contracts are contracts for delivery of goods, since they are standardized and their terms cannot be modified, the place of delivery, packing, quality etc is fixed. Therefore, at a later stage it is possible that they do not meet the specific needs of the buyers. This is the reason that they hardly ever result in delivery. As a consequence, futures contracts are looked upon more often as a source of investment. Instead of delivery the parties can opt for cash settlement.[14] The method for fixing the price at which the contract is settled is usually prescribed in the bye-laws of the exchange.

3. Trading in Carbon Credits

3.1 Background

About a decade ago many countries, concerned with the increasing global warming and its adverse effects on the environment came together to sign an international treaty - the United Nations Framework Convention on Climate Change (**"UNFCCC"**). More recently many such countries approved an additional treaty i.e., the Kyoto Protocol. The main objective of the Kyoto Protocol is to ensure that countries reduce or limit their greenhouse gas emissions. It is towards fulfilling this object that countries have been assigned emission targets, which they have to meet. To aid them in this endeavor the Kyoto Protocol has provided 3 market based mechanisms:[15]

(i) Emissions Trading[16]
(ii) The Clean Development Mechanism (**"CDM"**)
(iii) Joint implementation

The units that can be traded under emission trading scheme are:

- A removal unit on the basis of land use, land use change and forestry activities such as reforestation.
- An emission unit generated by a joint implementation project.
- A Carbon Emission Reduction (**"CER"**) credit generated from a CDM project.

A CDM project allows a country with an emission reduction or emission limitation commitment under the Kyoto Protocol to setup an emission reduction project in developing countries. Such projects earn saleable CER credits. Such CER's can be traded and sold and used by industrialized countries to meet a part of their emission reduction targets.[17]

3.2 Indian position

India is the first developing nation to offer a hedging instrument for carbon credits. It is considered cheaper for developing countries to reduce emissions than developed countries. As a result a bulk of the buyers of CER's in these developed countries look to Indian shores. Of the 978 projects that are registered with the UNFCCC under the CDM, 332 are from India. By 2012 it is

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12 All members of an exchange that provides for this fund are required to make an initial contribution towards it. The existence and provision for such a fund also varies according to the bye-laws of an exchange. It is set up to protect the interest of the investors and members of the exchange.

13 This .is the average of both the spot (price of immediate delivery) and futures prices of the specified number of days as defined in the bye-laws of the exchange.

14 "Cash settlement" is a mechanism whereby the contract can be performed by payment of the money difference rather than actually delivering the commodity.

15 See official website of UNFCCC, i.e. www.unfccc.int, visited on October 15, 2008.

16 Countries that have emission units to spare i.e. emissions permitted but not "used" can sell this excess capacity to countries that are over their targets. Carbon is now tracked and traded like any other commodity.

17 See official website of UNFCCC i.e. www.unfccc.int, visited on October 15, 2008.

speculated that these projects are expected to yield about 400 million CERs.

The government of India via notification dated January 4, 2008 permitted trading in CERs by bringing carbon credits under the ambit of tradable commodities. India's MCX is the first exchange in Asia and third[18] in the world to launch futures trading in carbon credits. The National Commodities and Derivatives Exchange of India on April 10, 2008 marked its entrance in this area of the futures trade.

CONCLUSION

The benefits of futures trading are manifold. In times of violent price fluctuations futures trading helps to stabilize prices, to facilitate lengthy and complex, production and manufacturing activities while at the same time encouraging healthy competition.

Commodity futures trading perform two important functions: price discovery and price risk management with reference to a given commodity. This helps producers, consumers as well as exporters to speculate the price of the commodities they plan to trade in and use this to their advantage. By speculating on the future prices, producers, consumers and exporters can strategize and manage their costs and risks which in turn will enable them to make higher profits. Further, not only does the buyer earn an interest on his money, he also does not need to store the commodities. As a consequence he saves on warehouse costs, wastage, etc.

However, as with other speculative instruments futures trading suffers from a drawback of over speculation. Since it does not require a major initial investment people may tend to over speculate. As the market matures and evolves, inbuilt mechanisms will have to provide for safeguards.

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[18] The Chicago Climate Exchange and the European Climate Exchange are the other two exchanges to start trade in carbon credits.

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