Challenges in Agricultural Derivatives

What is the issue?

The nature of online trading, and marketing for agricultural commodities has witnessed some changes in the last two decades.

What are agricultural derivatives?

- A derivative which has agricultural produce (an agricultural commodity) as the underlying asset.
- Unlike financial assets, agricultural commodities are valued based on their future expected spot prices rather than future expected cash flows.
- For example, the value of a futures contract on wheat is based mainly on expected future spot prices of wheat and the storage costs of holding this commodity.
- Furthermore, seasonality affects commodity prices, as there arises a mismatch between production by harvest and consumption in an industrial process.
- Some commodity derivatives can be classified as agricultural derivatives.
- The idea behind the introduction of agricultural derivatives is to encourage cost-effective hedging for participants like farmers as well as broad-based participation, and enhancing liquidity in the market.

What initiatives supported boost in agricultural derivatives?

- In 2000, Indian government removed the prohibition on forward trading and demutualization of exchanges.
- The budget of 2015 announced Securities Exchange Board of India (SEBI) as the new regulator of the Indian commodity futures market, replacing the erstwhile Forwards Market Commission.
- From 2016 onwards, SEBI permitted options trading in commodity derivative market.
- Union Budget 2019 was also favorable to the option class of derivatives by simplifying the Securities Transaction Tax (STT).
- This is a major push to deepen the commodity derivative market in India, especially as a financial segment, but the primary objective of price discovery and reduction of volatility in the market should transcend other

motives.

What are the challenges involved?

- Data shows more presence of proprietors and clients (non-hedgers) than that of hedgers, as is evident from the open interest during the years 2015-16, 2016-17, and 2017-18 in agricultural commodity futures.
- This defeats one of the primary objectives of introducing agricultural derivatives.
- Often, unidirectional causality exist in price discovery, making the market efficient.
- But, a lot depends on the genre of the commodity, like food or non-food crop, India's position as consumer of the commodity or exporter in the market, and seasons during which respective commodity contracts are floated, i.e., lean or peak, which determines the volume and value of the commodity futures.
- Commodities like guar seed, soya bean, rapeseed/mustard seed are some examples of highly traded commodities in terms of both volume, and value from 2016-17, 2017-18, and 2018-19 in NCDEX platform.
- Interestingly, within MSP crops, wheat is less traded in the derivative market, compared with chana (another MSP crop), which is high on volume.
- Functioning of futures market is largely dependent on the nature of commodity, and thus, liquidity position (presence of non-hedgers), and market risk is commodity dependent.
- Guar seed is relevant for the international market, for shale gas extraction; castor seed is used in bio-diesel industries, and the high demand of zinc from Chinese market makes these commodities lucrative to be traded on the platforms.
- The flow of information between spot and future market also depends on perishability or storage of product.
- A situation of contango (or backwardation) might develop if storage cost is higher (lower).

What lies ahead?

- Physical market infrastructure is extremely important, along with transportation, and handling of commodity.
- At present, only few commodities, like guar gum, guar seed, chana, soya bean, and refined soya oil, are traded in NCDEX platform.
- A gradual opening of market under option derivative would deepen the

market, and has the potential to reduce post-harvest losses if adequate physical infrastructure is built.
- The derivative market is on the cusp of transformation, where synergies could be well brought through a combination of infrastructure and technology.
- It has the potential to enhance transparency, and efficiency given that existing APMC in states dictates the regulation and fee structures.
- In India, commodity derivatives should not be viewed only as a segment of financialisation, but a mechanism to mitigate/reduce risk, which farmers face from the time of sowing till the sale of the produce.

Source: Financial Express