Integration of Securities and Commodity Markets: An idea whose time has come

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Integration of securities and commodities markets to be successful has to provide a level playing field by creating a fair and just environment, so that the 'animal spirits' generated by competition can drive the commodity markets to the next higher level.

The Union Budget – 2017-18 has provided a road map for achieving high economic growth, in a sustainable manner. Since infrastructure is a necessary condition for kick-starting the investment and growth cycle of the economy, high allocative priority has been given to infrastructure creation. The total budgetary allocation for infrastructure development in 2017-18 at ₹3,96,135 crore, is 13.5 per cent higher than the current year's allocation (budget estimates). As for the impact of such allocation on commodity markets, higher expenditure on rural roads, transportation, housing, skill development centres, etc. is expected to channelize private investment in areas which are ancillary to commodity derivatives market such as warehousing, quality testing and grading centres. Similarly, the setting up of an expert committee to study and promote creation of an operational and legal framework to integrate spot market and derivatives market in the agricultural sector is a major step to take the benefits of electronic trading for commodities to all stakeholders.

A significant announcement in the Union Budget is for integrating the different segments of the financial markets. In his Budget speech, the Finance Minister announced that "The commodities and securities derivative markets will be further integrated by integrating the participants, brokers, and operational frameworks" (Ref: Annex I to Part A of Budget Speech). The integration of the operational frameworks between the two segments is being considered by the Securities and Exchange Board of India (SEBI) and considerable progress in this regard has already taken place. More importantly, this integration is expected to clear the path for participation of new classes of investors such as financial institutions in commodity derivatives market, which are so far barred from participating in this market. The Commodity Derivatives Advisory Committee (CDAC) of SEBI has extensively deliberated on the issue of entry of new participant categories in the commodity derivatives market and decisions on the basis of its recommendations would help in the development of commodity markets.

There is a broad agreement on strengthening the commodity derivatives market by undertaking reforms to broaden and deepen the market. An important consideration for potential hedgers to minimise risk in an exchange platform is the impact cost of trade, which is a direct function of the liquidity on the exchange. Thus, a vibrant domestic market in commodity derivatives can be created if access is provided to a large variety of participants, who while participating in the exchange-traded commodity derivatives market manage their risks, inject liquidity, lower the impact cost and make the market more attractive for potential hedgers. This is a virtuous cycle which needs to be created and nurtured to further develop India's commodity derivatives market.

Entry of financial institutions in commodity markets

To meet the abovementioned objective, financial institutions should to be permitted to trade on India's commodity derivatives market. Currently, only non-financial firms and individuals are permitted to take positions in India's commodity derivatives markets. Financial institutions such as banks, mutual funds, pension funds, insurance companies and foreign investors are not allowed to trade in this market. The participation of these entities is essential not only for making the commodity derivatives market more robust and inclusive, but also to provide the Indian investing public more options for investment and undertake risk mitigation measures.

Take mutual funds, for instance. For a growing economy like India, it is necessary to channelize public savings away from physical assets. The mutual funds are already doing this by investing in the equity and debt markets. By playing the role of an intermediary between financial markets and millions of risk averse small savers who are looking for safe investment instruments with high returns, mutual funds have been able to channelize public savings towards debt and equity markets. If the mutual funds are also allowed to trade in other regulated markets, such as the exchange-traded commodity derivatives market, a larger bouquet of safe, transparent and regulated market instruments for investment will be available to retail investors.

Banks have a special role to play in India's commodity markets. Their near-universal presence places them in a unique position to connect millions of stakeholders of the commodity ecosystem to the commodity derivatives markets—a low risk, high reward proposition. Many of these stakeholders are unable to trade in commodity derivatives because they are unaware of the modalities of such trading, or do not have the wherewithal or knowledge for such trade. The example of several developing countries demonstrates that banks can handhold their customers by creating special products for financing their margins, aggregating several small borrowers or providing innovative solutions so that their customers can manage risks arising out of commodity price volatility.

Entry of institutions such as FIIs/FPIs and Alternative Investment Funds (AIFs) can only strengthen the commodity derivatives market. Apart from providing access to many investors who otherwise are unable to enter the market, participation of these large institutions would provide the much-needed depth and liquidity, especially in far-month contracts. Higher liquidity in far month contracts would attract hedging interest in India's commodity derivatives market, and make this risk management platform more efficient. Besides, large scale participation of institutions with deep professional expertise would lead to better price discovery, ultimately increasing the robustness and public confidence in Indian traded prices. This is an important step in making India a price-maker in the global commodities market.

Opening investment opportunities to institutions

The commodity derivatives market provides ample investment opportunities for all classes of investors. By opening the market to new investor classes, its benefits will be made available to a wider stakeholder group, including retail investors. The appeal for this segment as an attractive investment proposition arises from the benefits it provides for portfolio diversification and a hedge against inflation. It has been found that over a long period, the risk-weighted returns (RAR) from investment in the commodity derivatives market are better than those in other comparable asset classes. It has also been historically experienced that commodities are less volatile as an asset class compared with other asset classes, while the returns are comparable, making commodity derivatives an attractive diversification proposition for inclusion in investors' portfolios.

Integration to the last mile

Given the benefits of integrating the participants of the securities and commodity markets, the Union Budget's announcement to this effect has the potential to unleash a new wave of growth and development in the commodity derivatives market. At the same time, to maximise benefits, it is desirable that the integration of participants and practices of the two markets be done in a manner that extends the benefits of the securities market to the commodities market, so that the participants find it as attractive to trade as in the securities market. For instance, gains made in the short run in the securities market are taxed at 15 per cent. However, this benefit is not available to the gains made in commodity markets. Integration to be successful has to provide a level playing field by creating a fair and just environment, so that the 'animal spirits' generated by competition can drive the commodity markets to the next higher level.

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