

# India Commodity Options: A Game Changer for Indian Farmers? A Speculator's Playground

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Global Research, November 10, 2016

Region: [Asia](#)

Theme: [Global Economy](#), [Poverty & Social Inequality](#)

*In a major push to widen the scope of commodity derivatives market in India, Securities and Exchange Board of India (SEBI) has recently allowed options trading on commodity exchanges. On September 28, 2016, SEBI issued an official notification allowing exchanges to launch options contracts in commodity derivatives market. Currently, trading in commodity futures contracts is only allowed in exchanges such as Multi Commodity Exchange of India (MCX) and National Commodities and Derivatives Exchange (NCDEX).*

It is expected that trading in options contracts will be introduced in the current fiscal year as the Finance Minister in his Union Budget Speech (2016-17) had announced that “new derivative products will be developed by SEBI in the commodity derivatives market.” In addition, Commodity Derivatives Advisory Committee, constituted by SEBI in January 2016 to advice on policy and regulatory issues, had also recommended the introduction of new products in the commodity derivatives market.

Like futures, commodity options contracts are traded on major commodity exchanges across the world. The majority of commodity exchanges (including CME and ICE) offer commodity options on underlying commodity futures. Eurex Exchange offers options contracts on underlying commodity spot (physical gold and crude oil). While Taiwan Futures Exchange allows market participants with open positions to seek delivery of physical gold in the case of gold options contracts.

Although options trading in equity segment was introduced in 2001, India's National Stock Exchange (NSE) occupies the top position in global index options trading. According to World Federation of Exchanges, 1765 million Nifty options contracts were traded at NSE in 2015.

As the SEBI has granted permission for options trading in commodities, market analysts predict that commodity derivatives trading may grow 10-fold over the next five years.

The government may soon allow foreign banks, mutual funds, institutional investors and other financial players to trade in Indian commodity derivatives market which will further boost trading volumes in both options and futures contracts.

At the time of writing, it is unclear how many commodities would be permitted for options trade in the Indian market. It is also not yet known whether the SEBI will allow European options (exercisable on expiration date only) or American options (exercisable any time on or before expiration date).

Currently, the modalities are being worked out and the options trading is expected to begin in early 2017.

Meanwhile commodity market experts have asked SEBI to develop eligibility criteria for option writers (based on financial soundness) given the high degree of risk involved in selling options contracts.

### **What are commodity options?**

An **option** is a financial contract between two parties (the buyer and seller) granting the right, but not the obligation, to buy or sell a futures contract at a predetermined price on or before a certain date.

Futures and options are both derivatives products but the key difference between them is that the options give the holder the right to buy or sell the underlying asset at expiration while the holder of a futures contract is obligated to buy or sell the underlying asset on a future date.

In the case of commodity derivatives market, options provide an opportunity or the right (not the obligation) to investors to buy or sell a commodity futures contract at a specified price. It needs to be emphasized here that the “underlying commodity” for the commodity options is a futures contract, not the physical commodity itself. Whereas futures contracts are derivatives of the physical commodity.

There are two kinds of options: call options and put options.

A **call option** gives the holder the right, not the obligation, to buy futures contract at a specific price on or before a certain date. Call options are most commonly used to protect against rising prices.

A **put option** is an option contract giving the holder the right, not the obligation, to sell futures contract at a specific price on or before a certain date. Put options are most commonly used to protect against falling prices.

The date on which the actual trade takes place is called **Expiration Date**.

The predetermined (fixed) price of the contract is called **Strike Price**.

**Premium** is the amount one pays to enter into an options contract. In other words, the cost of the option. The buyer loses the premium irrespective of the fact whether s/he has exercised the options contract or not.

In many ways, options act like insurance policies. For instance, put option buyers insure themselves against falling price of a commodity while the seller of a put option acts like an insurer by offering a price guarantee to buyers. Just like an insurance company, the seller of put option charges a premium whether the contract is exercised or not.

To understand the workings of commodity derivatives markets, read *A Beginner’s Guide to Indian Commodity Futures Markets*.

### **Risky options**

Since options are more complex instruments than stocks and bonds, they are not suitable for every trader, leave aside an average Indian farmer. Due to volatility factor, options require a higher degree of sophistication on the part of the trader.

Sophisticated traders can use options to benefit from any up and down market movements. Options enable traders to make money even in those situation when is no market movement either way. Most options traders do not simply buy call and put options. They use complex trading strategies by combining many options and futures contracts or use dual directional strategies to make speculative profits from price movements in either direction.

Therefore, commodity options are more suitable for sophisticated traders and investors who have in-depth understanding of commodity derivatives markets and strong financial base. Options contracts can be very risky if used purely for speculative purposes because of the high degree of leverage involved. Leverage magnifies both potential profits and potential losses.

There are plenty of instances where improper use of options by traders have led to huge financial losses and bankruptcy. For instance, Aracruz Celulose, a Brazilian firm and world's biggest producer of bleached eucalyptus-pulp, lost \$2.5 billion after its forex option bets to hedge against the US dollar went the wrong way in 2008.

It is important to note that the buyers of option contracts have a different risk than sellers. Unlike futures contract which can potentially expose a trader to unlimited losses, the risk in options to buyers is limited to the premium paid upfront plus commissions to brokers and exchange fees. Besides, there are no margin calls for options buyers so they know the amount of payment and the maximum risk involved in buying options at the outset.

But in the case of call options, the potential losses are theoretically limitless for sellers as the prices of underlying futures contracts can rise indefinitely and, therefore, the value of an options contract can also rise indefinitely. In the case of put options, the potential downside for sellers is limited to the value of the underlying futures contract. An option seller has to meet margin requirements (cash or securities deposited with brokerage firm as collateral) until the contract is exercised or expires.

What about positive spillovers? The arguments supportive of positive spillovers of options trading are highly overstated and backed by very little hard evidence, particularly in the context of commodity markets. The benefits in terms of greater information transmission, higher market liquidity and improved market stability are yet to be demonstrated empirically in commodity markets across the world.

### **A game changer for farmers?**

The commodity exchanges and brokerage houses have welcomed the decision to introduce options trading on the expectation that higher trading volumes would boost their fees and commissions. This is understandable considering the nature of their business model. What is really perplexing is that the hard selling of options trading on the grounds that this move is essentially meant to help the Indian farming community.

In a press statement, Samir Shah, Managing Director of NCDEX said, "This is a historic step which will go a long way in significantly deepening the commodities market. We are extremely excited and welcome this decision which will help expand the product basket and make it attractive for new participants. For the farmers, it will be a game changer. It would help them sell their produce in the derivatives market and thereby get the benefit of price protection in case the prices fall below their cost of production and also derive the benefit of any rise in the price. Options are also a much better hedging instrument as compared to

futures for hedgers.”

Not surprisingly, similar arguments were made in the 1990s to introduce commodity futures trading. At that time, tall claims were made that commodity futures trading would facilitate efficient price risk management and price discovery in a fair, transparent and orderly manner. It was claimed that futures market will help Indian farmers to hedge against potential risks arising out of price movements in spot markets so that they can get guaranteed price for their produce in the future. Besides, trading in futures would provide reliable price signals to farmers about the likely prices of their crops in the months ahead.

However, both these economic objectives have not yet been realized across agricultural commodities (and for some metals and minerals), even though commodity futures markets have been in operation in India since 2003. It is unfortunate that futures markets continue to be dominated by speculators and non-commercial players who frequently indulge in price rigging and other market abusive practices with impunity. The frequent trading scandals (from guar to pepper) have further eroded the trust and confidence of Indian farming community in the commodity futures markets which are popularly perceived as “Satta Bazaar” (gambling market).

Against the backdrop of a massive trading scandal at NSEL, the Forward Markets Commission (FMC) – the then regulatory body for commodity futures – was merged with SEBI last year.

In India, the participation of farmers in commodity futures markets is negligible. According to market estimates, not even 2000 farmers in India are directly trading on commodity futures exchanges. Even the participation of farmers marketing cooperative bodies (such as NAFED and HAFED) is very limited due to lack of adequate knowledge of the functioning of futures market. Such bodies can act as aggregators and hedge positions in futures exchanges on the behalf of their farmers.

While futures have failed to achieve their avowed objectives of price discovery and price risk management, it remains to be seen how options alone, or in combination with futures contracts would serve the interests of Indian farmers, especially small and marginal ones (owning less than 2 hectares of land) which constitute 78 percent of the country’s farming community.

The introduction of options trading in sensitive food security commodities calls for a cautious approach as price instability has been a major concern for producers and consumers in India.

An average Indian farmer lacks a basic understanding of what is involved in futures trading. The options trading is even more difficult to comprehend as it adds yet another layer of complexity on what is already a very complex trading instrument. Therefore, options contracts are not ideal for Indian farming community. In the same vein, small enterprises lack the resources and capacities to trade actively in derivatives contracts for hedging purposes. Even experienced traders struggle to understand the risks involved in trading both futures and options contracts.

Nowadays commodity exchanges are conducting short duration training workshops for small stakeholders but such workshops are inadequate to impart information and insights on the nuances of derivatives trading.

Instead of launching highly sophisticated derivatives instruments such as commodity options to help farmers, the Indian authorities should first focus on removing the bottlenecks such as fragmented nature of spot markets; over-politicization of state agricultural produces marketing committees (APMCs) and state agricultural produces marketing boards (APMBs); inadequate warehouses, storage and grading facilities; and poor condition of roads and other infrastructure in the rural India.

### **A speculator's playground**

The proponents argue that options contracts would complement the existing futures contracts and thereby would make Indian commodity derivatives more attractive to farmers and SMEs for hedging purposes.

Hedgers are market players (consisting of producers, processors and consumers) with an exposure to the underlying commodity and they use derivatives markets primarily for hedging purposes. The hedgers simultaneously operate in the spot market and the futures market. They try to reduce or eliminate their risk by taking an opposite position in the futures market on what they are trying to hedge in the spot market so that both positions cancel one another.

In the absence of strictly enforced guidelines classifying different categories of market participants, it is difficult to differentiate between speculators and hedgers in commodity derivatives markets. As a result, no one knows the true proportion of derivatives contracts used for purely hedging purposes in the Indian market. It is also difficult to determine whether a trader is buying or selling commodity derivatives contracts for purely speculative or hedging purposes.

Not long ago, the FMC had acknowledged that the bulk of trading in the Indian commodity futures market is carried out by speculators and non-commercial traders who attempt to profit from buying and selling futures contracts by anticipating future price movements but have no intention of actually owning the physical commodity, while the participation of hedgers is almost negligible. Most market analysts feel that the participation of hedgers in the futures market is relatively small. The frequent price manipulation scandals have further eroded their confidence and trust in the commodity derivatives market.

It should be noted that in the Indian equity markets where options contracts are traded, these contracts are mostly used as a speculative tool to profit from market movement, rather than to hedge existing portfolios.

In all likelihood, the introduction of commodity options trading will attract more speculative investments from big traders and speculators. These market players will now have a new instrument to add to their trading arsenal.

With the expected entry of foreign banks, institutional investors and other financial players, the Indian commodity derivatives markets would move further away from fulfilling the twin objectives of hedging and price discovery. The policy makers should take steps to avoid turning the entire commodity derivatives markets into an arena for pure speculative activities.

What is good for financial investors and commodity speculators is not necessarily good for Indian farmers and small entrepreneurs. This policy move will have significant implications

for inclusive growth and development and therefore requires a major rethink.

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