ROADMAP:

COMMODITY FUTURES MARKETS DEVELOPMENT IN INDIA

2005 AND FORWARD

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COMMODITY FUTURES MARKETS DEVELOPMENT PROJECT

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Financial Markets International, Inc. (FMI) is a U.S. based international consulting firm that specializes in assisting countries to develop sound and efficient markets. FMI has worked in over 25 countries with the U.S. Agency for International Development (USAID), World Bank, Asian Development Bank, and private corporations since 1992. www.fmi-inc.net

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Executive Summary

The Government of India (GoI) and the United States Agency for International Development (USAID) commissioned this report to help determine the best approach to develop the commodity futures markets of India. The examination included a broad review of the commodity futures markets and the exchanges' operational practices, the legal and regulatory environment governing the industry, and the risk management needs of the agricultural sector.

This report is timely and vital for several reasons: 1) the GoI has authorized the development of national multi-commodity futures exchanges that operate on the basis of advanced international "best practices"; 2) the legal and regulatory framework for commodity futures in India is fifty years old, and it evolved in an environment where the regulators' principal task was more to police sequential GoI bans on the trading of commodity futures, than to develop those markets; 3) a credible regulatory regime is essential for the development of the commodity futures markets; 4) numerous educational and facilitating issues must be addressed in order to extend the risk management benefits of commodity futures markets to India's vast agricultural sector; and, 5) India is competitively poised to become an international commodity futures trading center.

The GoI decision to modernize and liberalize commodity futures markets, in order to gain the economic benefits of hedging and price discovery, represented the culmination of more than a decade of careful evaluation of the implications of such for the agricultural sector. GoI officials, and international and Indian commodities and securities markets experts, conducted a series of studies that, taken together, point to a consensus on several fundamental issues which recommend the development of commodity futures markets now.

The conclusions of these expert reports can be summarized as follows:

- Indian agriculture has evolved beyond self-sufficiency and is opening up to internationally competitive world markets.
- These world agricultural market opportunities present new challenges, because engaging them will require a *market-based* agricultural sector.
- Indian policy makers had traditionally coped with the uncertainty of crop yield

Indian Commodity Markets Studies

Khusro Committee Report (1980)

Kabra Committee Report (1994)

World Bank & UNCTAD: Managing Price Risks with Futures Markets (1996)

World Bank: Brokerage (2000)

World Bank: Clearing Houses (2000)

World Bank: Improving Commodities Futures Markets (2000)

World Bank: Warehouse Receipt Systems (2000)

Guru Committee Report (2001)

The Report of the Group on Forward and Futures Markets (2001)

The Ramamoorthy Committee Report (2003)

The Report of the Inter-Ministerial Task Force on Convergence of Securities and Commodity Derivatives Markets (2003)

A detailed summary of these key reports is provided in Appendix A.

and price volatility by resorting to policy instruments such as a virtually closed external trade regime, pervasive government controls on private sector activities, extensive market interventions, setting up the Food Corporation of India, and licensing Fair Price Shops to ensure food security.

- The historic GoI policy approach is being reconsidered both to foster a *market-based*, internationally competitive, agriculture sector, and because of the high fiscal and economic costs of previous policies.

- Major advances have occurred in the technology of commodity futures exchange operations elsewhere in the world. Such systems are commercially available, and they can ensure highly reliable, on-line, electronic trading and margining operations that eliminate certain types of trading abuses that historically plagued commodity futures markets.

These basic conclusions call for a course of action to achieve a modern commodities futures industry, accompanied by a strong regulatory regime for that industry. Properly functioning commodity futures markets promote more efficient production, storage, marketing and agro-processing operations, financing, and improved overall agriculture sector performance. It is precisely because of these benefits that transition and developing economies with large agricultural sectors have embraced commodity futures markets in recent years. Countries such as Brazil, China, Hungary, Poland, South Africa, Russia, and Turkey have sought to emulate the successful commodity futures markets of Chicago, London, and Tokyo.

The GoI decision to charter national multi-commodity exchanges that *meet certain stringent criteria* was the first step toward such a serious commodity futures markets development program. Further development steps will include significant policy, legal, operational, and educational challenges in five inter-related areas. Importantly, a broad spectrum of Indian leaders interviewed in the course of conducting this assessment recognize that the challenge for success is an *inter-related* development plan across each of these five areas.

I. Regulatory Purpose and International Approaches.

The economic functions of commodity futures and securities markets are different: commodities futures markets provide risk management and price discovery, and securities markets provide capital formation. Consequently, different regulatory objectives follow from these substantive differences. This section of the report provides an analytical framework for Indian policy makers to consider as they make decisions about regulatory approaches for the two industries.

Various regulatory approaches are used in nations that have successful commodity futures markets. Common approaches are: 1) a unified regulatory approach, with one regulator for both commodity futures and securities markets; 2) a dual regulatory approach, with a separate regulator for *all* futures contracts irrespective of the nature of the underlying commodity (agricultural, energy, financial, or securities derivatives), and a separate regulator for the offering and trading of securities, companies' shares; and, 3) a multi-body approach, where commodity futures are regulated by *product*.

Country specific criteria are presented to assist the GoI in evaluating these alternative approaches. This section also offers detailed background on the United States dual regulatory approach; the Chinese and United Kingdom unified regulatory approach; and summarizes the regulatory approaches of five Asian nations.

This section concludes that the GoI should proceed rapidly in providing substantial resources to revise and invigorate its dated regulatory scheme for commodity futures markets. This is necessary to minimize the possibility of a market scandal that could severely harm the burgeoning reputations of the three national multi-commodity exchanges, and thus stall their needed growth in hedge participation. Whether this support eventually leads to an enhanced and autonomous FMC - - or to the convergence of the FMC with SEBI - - is not, *at this point*, a critical decision. That decision can be made over time as the FMC is strengthened, and as the commodity futures markets continue to develop.

II. Agenda for Regulatory Reform of the Forward Markets Commission.

The FMC was created as an advisory body with limited powers over the commodity futures exchanges and intermediaries. Despite this, the FMC has nonetheless succeeded at working with exchanges to see them adopt effective Articles of Incorporation and Bye-Laws. Because of this ad-hoc approach, however, the FMC has essentially no standardized body of regulations that affects all commodities futures exchanges alike. A credible regulatory regime is imperative for the sound development of internationally competitive commodity futures markets.

This section offers detailed *Recommended Regulatory Approaches* to achieve reform in core principles which affect three areas: the financial integrity of futures markets actors; the monitoring, market surveillance, and compliance provisions; and the business practices of exchanges and intermediaries. Achieving a sound new regulatory scheme will require an effort similar to "*changing the engines while the plane is in flight*". The FMC must continue to monitor and supervise the futures industry. At the same time, it needs to introduce new requirements as it invigorates the regulation of the commodity futures industry, as well as its own regulatory practices.

This section also assesses the capacity of the FMC and finds its regulatory authority can be substantially improved through more aggressive use of its powers, and through the infusion of resources to address its current staffing deficiencies. The FMC has a sanctioned strength of approximately 140 staff members, yet its total current level is 87. While the future work of the FMC should be intense on both legal and investigative matters, the FMC has no lawyers and no accountants on staff. A more efficient organizational structure is outlined and recommended for the commodity futures markets regulator.

III. Education Initiatives for Price Risk Management.

The vast preponderance of the agricultural sector actors in India are *not* engaged in price risk management, and are *not* hedging with commodity futures. Indeed, the Indian agricultural sector as a whole is, in essence, acting as a massive speculator with its fate dependent upon the vagaries of weather.

India needs to inculcate an effective price risk management culture for three reasons: 1) India has moved beyond agricultural self-sufficiency; 2) the GoI supports a market oriented agricultural sector and economy; and, 3) modern national multi-commodities futures exchanges now provide the operational capacity to effectively accomplish the hedging, or price risk management function, of futures markets.

This section recommends extensive, and targeted, education and training initiatives. It sets forth a methodology for implementing broad-based education and training by harnessing the skills and outreach capacities of numerous Indian institutions that are now poised to assist the agricultural sector, and help inculcate risk management. Many institutions could help lead this effort to make the commodity futures markets deeper and more efficient, and benefit the agricultural sector.

This section sets forth criteria that should be applied to evaluate these institutions to determine which ones might be most effective. The evaluative process would identify institutional partners with the *mission* to assist the lives of Indian farmers; the *direct access* to farmers through a well organized network of employees and facilities across India; a large *professional staff* knowledgeable about agricultural sector issues; strong *institutional relationships* with entities relevant to training, such as farmers associations, agricultural cooperatives, rural banks; and a *willingness to act*. The objective would be an effective India-wide, large-scale and multi-faceted education and training program over a sustained period of time.

Increase Hedging

"*Increasing hedge participation is a major challenge for all exchanges. We are actively educating the agricultural sector on the merits and methods of risk management through commodity futures. We also need the Government to better use its resources to encourage risk management, remove certain legal impediments affecting futures trading such as making warehouse receipts negotiable, permitting banks and mutual funds to act in commodity futures markets, making mandis more transparent, and neutralizing tax policy. India's commodity futures markets growth potential is enormous.*"

P.H. Ravikumar, Managing Director & CEO, NCDEX, June 7, 2004. Remarks to USAID/FMI delegation, Mumbai.

IV. Operational Reforms in Commodity Futures Exchanges.

Commodity exchanges in India withered over the past forty years as various commodities were periodically banned from futures trading. The GoI decision to permit the formation of new exchanges that must operate in accord with demutualized ownership, electronic trading, advanced modern systems, and international best operational practices, has resulted in India having a “two tier” exchange system.

This section of the report presents survey information that details the nature of the two tier system, with major differences in exchange ownership, mutual or demutualized; trading systems of open outcry versus electronic; volume; number of contracts authorized to trade; margin systems; and clearing and settlement systems.

These differences require tailored regulatory approaches. For the national multi-commodity exchanges, the focus should be to develop hedge participation, ensure that futures prices remain aligned with the underlying physical prices, and improve liquidity through development tools such as contract design, and educational outreach. By contrast, for the regional exchanges, the regulatory emphasis should be on trading integrity and financial soundness.

For both tiers of exchanges, the regulator’s challenge is to focus on applying its regulations with three objectives foremost: market integrity, financial integrity, and customer protection. If an exchange fails to meet these regulatory tests, then the GoI should require remedial action, or close the exchange.

This section also highlights methods for improving the design of futures contracts, and outlines methods to gain substantial input from the agricultural sector hedgers, the producers and food-processors. The purpose is to broaden hedge participation and build futures markets liquidity, because liquidity is a magnet for greater liquidity.

V. Facilitating Issues: warehousing issues; standardization and grading of commodities; improving price transparency of *mandis;* authorizing institutional participation by banks and mutual funds in commodity futures markets; authorizing options trading; and adopting conducive tax policies.

Commodity futures markets have different requirements than do securities markets for facilitating trading, margins, settlement, and other aspects. For example, warehouses need to exist so that delivery on agricultural futures contracts can occur. A warehouse receipts system, with receipts formally serving as negotiable instruments, can assist farmers and payment transfers. Standards for grading commodities can assist hedging, and grading can provide confidence for delivery or provide a basis for discounts. Greater price transparency at *mandis* could offer farmers greater marketing alternatives and more information in order to better use futures markets. This section briefly outlines these commodity industry facilitating issues that, if properly addressed, would help develop the commodity futures industry and empower the farmer.

This section also addresses ancillary policy and legal issues that could facilitate the development of commodity futures markets. These issues include authorizing options trading on commodity futures; authorizing institutional participation in commodities futures markets by certain banks and mutual funds; authorizing foreign participation in the commodities futures markets; adopting conducive tax policies; and broadening the legal definition of "commodities" that may be subject to futures trading.

This section illustrates that the recommendations in this report could not only transform commodity futures markets practices, but also have a far reaching impact on the physical commodity markets. These beneficial impacts could include: 1) making spot markets more efficient for agricultural producers, end-users, consumers, and traders; 2) integrating spot and futures markets players; 3) developing support institution efficiencies in the food handling system, making agriculture a globally competitive sector as required under a WTO regime; and 4) removing regulatory and logistic bottlenecks to improve farmers' price realization and reduce overall costs of raw materials.

Warehouse Receipts Innovation

"The National Multi-Commodity Exchange (NMCE), the Punjab National Bank (PNB), and the Central Warehousing Corporation (CWC) launched a warehouse receipt financing program for the farming and trading community. Under this scheme, a farmer or trader can deposit an agricultural or non-agricultural commodity in a CWC facility and obtain a warehouse receipt. The farmer or trader would then enter into a forward sales contract with a NMCE broker or member and receive a copy of the order execution form. With the warehouse receipt and order execution form, the farmer can approach one of four PNB branches and obtain a loan of up to Rs. 2 lakh at Below Prime Lending Rate (BPLR).

This scheme will improve institutional credit to the agricultural sector, and in the long run through more than 4000 PNB branches across the country, will help bring down the indebtedness of marginal farmers. Farmers and growers who often rush to borrow funds from high interest private moneylenders are now being given a better alternative."

Kailash Gupta, Managing Director, NMCE. Excerpt of remarks at the FMI/NFA Training, August, 16, 2004, New Delhi.

Course of Action

This report outlines a recommended course of action in each of these five areas in order to achieve a comprehensive and integrated commodity futures market development program.

Adopting this program will mean a serious commitment of resources, both capital and human, by the GoI and the affected private sector stakeholders. Such a commitment means that the GoI policy makers and private sector commodity futures leaders will need to agree upon a program that is *consistently pursued* in the years ahead.

The GoI must remain resolute on its adoption of a market-based, internationally competitive, agricultural sector. This will mean that, unlike in the past, when a calamity befalls the agricultural sector, policy makers must remember that price volatility is usually reality-based, caused by supply and demand conditions. The historic urge to ban commodity futures as the putative solution must be resisted.

India is well positioned to take advantage of the many regulatory and operational advances that developed elsewhere while India's commodity futures markets languished. International standards for the legal, regulatory, and operational "best practices" are today refined and established. India has adopted them operationally with the three leading national multi-commodity exchanges. India needs to vigorously address the issues highlighted in this report to ensure that its commodity futures development potential is reached, and that the economic benefits of commodity futures are realized for its agricultural sector.

End Past Interventions

"GoI policy on commodity futures was premised on fear and misunderstanding for decades. If the vagaries of monsoon left no rain in Gujarat and groundnut prices shot up on futures markets, then the Government's response was to ban groundnut futures so as to stop those speculative profiteers.

When I was Chairman of the FMC in the 1980s, one year the rains were lean and in August the futures markets prices for gur in the months ahead were accordingly going up. The Minister of Civil Supplies called me to Delhi to inform me that he was very worried that with the festivals of Ganesh Chaturthi, Navratri, and Diwali all coming up, that we simply could not have high gur (jaggery) prices. As Chairman of FMC, I was to, somehow, make jaggery prices go down."

Venkat R. Chary, Chairman MCX, IAS (Retd.), Advocate, High Court, Mumbai. Excerpts of remarks at FMI/NFA Training Program, August 11, 2004, Mumbai

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