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OPINION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Capital Market & SEBI

Recently introduced options trading instruments on commodity trading platforms are expected to be low-risk hedging tools for traders and farmers, while helping improve overall growth in trading volumes in the derivatives market.

However, the type of options contracts introduced are European in style, which allows “right to exercise” only on the day of expiry. This is strikingly at variance compared with options contracts traded on global commodity exchanges, which are American in nature, allowing an option holder to exercise his right to buy or sell the underlying commodity instrument anytime during the option’s life term.

When futures trading on national-level commodity exchanges was launched in 2003, it was projected as a platform where farmers can foresee a trend of prices of the commodity they are going to produce and take appropriate cropping decisions. However, the futures contracts launched have a maximum life of six months and their trading volumes reach reasonably high levels only when they are close to one month from expiry.

The distant month contracts are not well integrated with spot market prices, leaving farmers with price forecasts for only one month. But crops sown in India are of longer duration. For instance, in Punjab and Haryana, wheat sowing starts in October and harvest commences in April, meaning farmers need at least five to six month of active futures month contracts with fairly high volumes in September/October itself so that they can have reliable price forecasts.

For processors, too, having advance price forecasts helps in better planning of procurement and sales operations, while reducing uncertainty in income. This is more pronounced in globally traded commodities where long-term sale purchase deal-making is very common and such advanced domestic price forecasts help importers (of commodities such as edible oils, pulses) and exporters (of rice or cotton) in making pricing and hedging decisions.

For instance, in the case of *tur* (pigeon pea), when there was a shortfall in domestic production in 2015-16, the average import price (CIF, or cost, insurance and freight) for the November 2015 to March 2016 period was 8,200 per quintal, which was sharply lower than the average price of 9,100 in the Gulbarga market of Karnataka during the same period. In contrast, a year later, when there was a sharp rise in domestic production, the import price, as well as the Gulbarga market price, remained almost the same at 4,600, forcing importers to sell at losses.

This has happened as everyone, including the government, failed to see the prospect of a steep fall in domestic prices. Importers who had contracted months before, having no mechanism to see domestic price forecasts, ended up with losses. Had there been an efficient futures market to give long-term price forecasts, they would have either hedged positions, or would have appropriately priced their import contracts. However, in reality, farmers, processors and the entire hedging community are deprived of such an advantage.

Further, in the case of kharif or summer-sown crops, the only reliable information available for trading purposes are crop sowing data and monsoon rainfall data that are used for predicting (and sometimes for wildly guessing) the quantum of crop production to be arrived at during the harvest months starting October, and which can be verified months later. However, the same information is used even for trading in contracts that are set to expire in June to September.

Importance of volatility for option price calculation

The volatility of underlying asset price, which helps in measuring the speed of achieving a certain targeted price, is a key factor in deciding premium values for options contracts. When volatility is high, options premiums are relatively expensive as there is a high chance of underlying asset prices going through the exercise price; and when volatility is low, options premiums are relatively cheap.

Commodity prices that are determined by the pure interaction of supply-demand dynamics can exhibit different levels of volatility in different years due to differences in supply-demand balances. Inter-annual volatility may also differ due to seasonal differences in supplies and demand, which might cause different commodity futures contracts even within a calendar year to have different volatility levels.

Once an investor decides to buy or write an option on a futures contract, he may need to have an appropriate, volume-driven volatility value to arrive at a premium price for the option, which can be calculated if we have enough high-volume traded data for that particular futures contract. However, due to the short life of existing futures contracts, appropriate premiums values may not be calculated.

Introduction of long-maturity futures contracts, with a life anywhere between 24 and 36 months, and eliminating all contracts that face expiry during the respective crop growing season while reducing total contracts to less than four per commodity per calendar year may help.

It is American options that provide greater flexibility to farmers, processors and other hedgers who need to take long-term risk decisions, by allowing the early exercise of option contracts. American options are also found to better reflect market conditions like high volatility in underlying asset prices, the requirement of a longer duration for the maturity of the contracts, compared with currently traded European-style option contracts.

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Comments are welcome at theirview@livemint.com

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