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Commodity options will help bring offshore business back to India: Samir Shah, NCDEX

By *Nandini Sanyal*, ETMarkets.com | Updated: Nov 07, 2016, 02.46 PM IST

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Options promise to revitalise the domestic commodities market, by bringing back business from offshore markets. But it will require time to educate market participants about this new instrument and ensure that there are enough option writers for market making to keep the contracts liquid, says ***Samir Shah,*** *Managing Director & CEO,* ***NCDEX*** *, in an email interview. Edited excerpts:*

Introducing options trading in India will incentivise market participants, who have been forced to hedge offshore because of the lack of options trading opportunities in India.

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When are you expecting to launch options trading?

Sebi recently paved the way for the launch of options trading in commodities and we will initially start with one agri and one non-agri commodity. The details are being worked out in terms of the kind of commodities being suggested, the product structure, contract specifications, option style, settlement procedure and trading cycle. NCDEX is in discussion with Sebi on these issues. Time would be required to educate market participants about the new product and ensure that there are enough option writers for market making so that the contracts remain liquid.

Can you explain a bit about options trading in commodities and how it will impact the market?

Options have been a long-pending demand and by allowing them SEBI has sent out a clear signal that it wants to take these markets ahead and make them hedger / user friendly. Options give hedgers a form of insurance determined by the strike price of the option. Since options carry virtually no downside risk, such risk-management products are much-needed instruments in a diversified emerging economy like India with a preponderance of small stakeholders who are risk averse and who need these products the most. A combination of options and futures – both risk management tools – can give market participants the leverage of futures with the safety of options.

With addition of liquidity through commodity options, various associated benefits such as lowering of impact cost, improved market stability, lowering of volatility, reduction in risk of market cornering and improved price discovery can be seen. It is expected that its

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existence would boost overall market participation, especially the hedging community. It will also complement the existing futures contracts and make the commodities market more robust and efficient.

The biggest beneficiary though will be the farmers, for whom options will be a game changer. It would help them to sell their produce in the derivatives market and thereby get the benefit of price protection in case the price falls below their cost of production and also derive the benefit of any rise in the price.

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In which products do you plan to launch options trading?
The exchange is considering some agricultural commodities most suited for options, based on liquidity and participation in the underlying commodity. Soyabean, soya oil, mustard seed and guar seed are some of the commodities being considered. Sebi will take the final decision on it.

What are the advantages of options trading over futures trading?
Both futures and options are derivative instruments that derive their values from an underlying commodity. However, there is a fundamental difference between the two instruments. In futures, while both the buyer and the seller have the obligation to fulfil the contract, in options, the buyer has the right but no obligation to fulfil it. So, for an option buyer, loss is limited (to the premium he pays for the contract) while profits are unlimited. This feature makes it an ideal hedging tool for small participants.

There are some advantages compared with futures. One, the initial outlay is much lower in options. While the initial and volatility margins that an investor pays could vary, the premiums on options are much lower than the initial margins paid on futures contracts.

Two, compared with the M2M daily margin payments in futures, there is no further outgo after the initial payment for option premium.

Three, losses in options are limited to the premium paid whereas a trader who uses futures faces unlimited losses. It is hence less risky than futures.

Will options help increase depth to the commodities market?
Introducing options trading in India will incentivise market participants, who have been forced to hedge offshore because of the lack of options trading opportunities in India, to bring their business back to India's bourses. While the introduction of options can help increase liquidity, market depth will come with increased participation by allowing banks and other mutual funds to participate in the commodity market.

Since commodity is cyclical, how safe are options for investors? Are options a safer product for investor in the commodity market compared with futures?
The cyclical nature of commodities is one of the reasons for the price risk being faced by market participants. While a futures contract can enable price risk management, the combination of futures contract with options contract can add to the effectiveness of a combined derivatives position.

There are two parties to an option contract — a buyer and a seller (also called the writer). The buyer of an option is the one who by paying the option premium buys the right to exercise his option on the seller. The seller of a call/put option is the one who receives the option premium and is thereby obliged to sell/buy the asset if the buyer exercises his right.

So, clearly, the risk is higher if you are a seller in an option contract - as your profit is limited to the premium amount, but the loss is unlimited. But for all hedgers – be it farmers or commodity users who will be buying put option or call option – the risk is limited to the premium. If prices are not favourable to them, they can let the contract expire.

Hence for buyers, options are more flexible than futures and less risky. This makes options akin to insurance, because the cost can be limited to the cost of the option. They are riskier for sellers, but they add income to investment portfolios, provided appropriate risk mitigation measures are undertaken.

What do you make of the effect of global trade winds on the Indian commodity market? Are we insulated from developments like cross-currents in the Chinese economy and Brexit?
The network structure of international trade implies that development in other economies are not just restricted to the immediate trading partners, but have higher round impacts. The commodity markets in India emulate global trends in many ways and India is no longer insulated from developments such as happenings in China or the Brexit. It is a matter of time to see the long term impact. But one thing is certain - the risks have increased for businesses and with it the increased need for risk mitigation measures.

Of late, in agriculture there has seen a paradigm shift from cereals to pulses and cash crops. Even the PM has been exhorting farmers to make the switch. Will that have an impact on the commodities trade?
The shift in acreage is a function of supply and demand and the prices that farmers have fetched in the preceding season. What is important however, is to ensure that there is a vibrant market structure and supporting ecosystem for farmers to get fair prices and an increased share of the consumer prices. Options can play a very important role here, since farmer can use the tool to lock in a minimum price for his produce and in the event the prices go up can choose not to exercise the option.

For example, a farmer growing maize can buy a put option to sell 10 MT of maize at Rs 1,500 per quintal, five months from now. Two scenarios can play out for him. If the price of maize goes down to Rs 1,300 per quintal, he can exercise his option, making a profit of Rs 200 per quintal. This will offset the notional loss he will incur when he sells the product in the physical market. In the event of the price of maize going up to Rs 1,600, he can choose to not exercise his option.

In the context of monsoon and an expected bumper harvest, will there be an impact on commodities exchange?
NCDEX offers a robust platform for transparent price discovery and hedging. The trading and prices of commodities are a function of fundamental supply demand in the underlying commodities. One cannot predict the impact of monsoon and bumper harvest on trading.

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