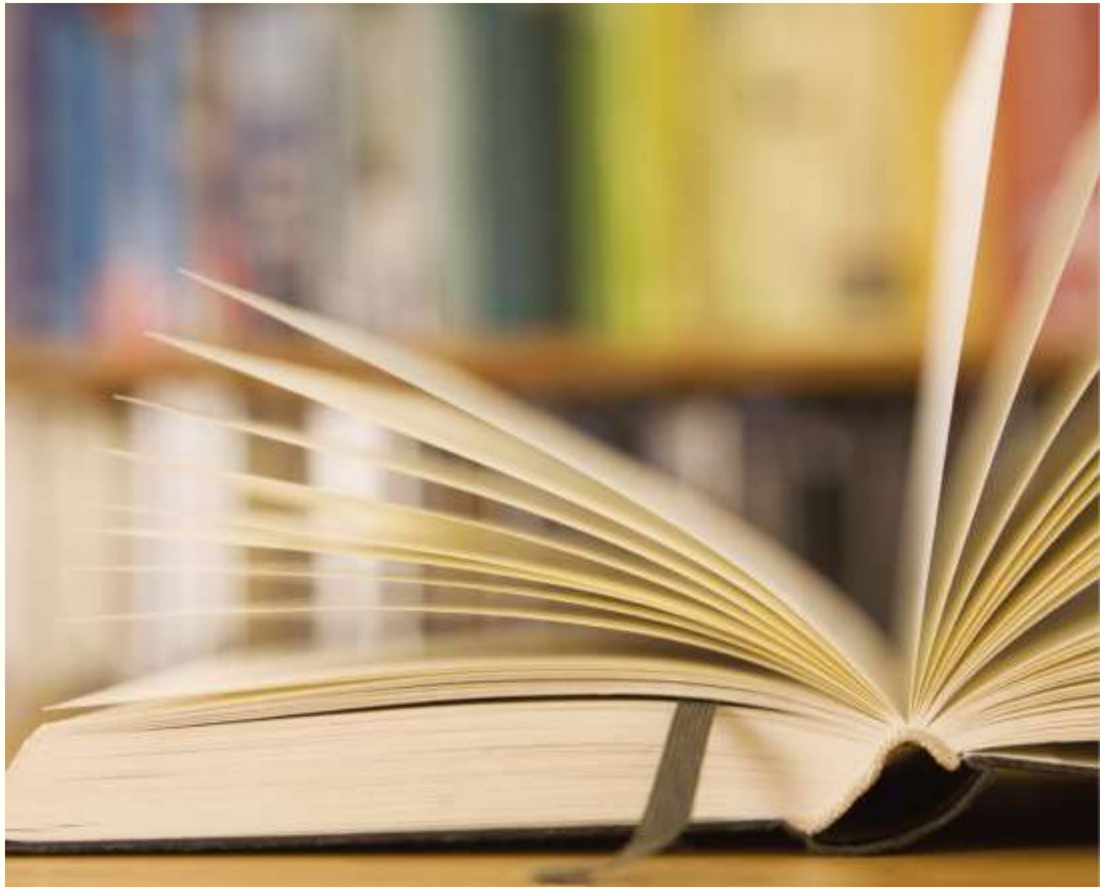
FINANCIAL MARKETS

SYBBI- SEM III



Unit III -Commodity Market

Meaning and Definition

- Any merchandise that can be used for commerce or an article of commerce which is operated on an authorized commodity exchange is known as commodity. The article should be movable of value something which is brought or sold and which is produced or used as the matter or barter or sale.
- Forward contracts (Regulation)Act (FCRA) , 1952 defines goods as every kind of moveable property other than actionable claims money and securities.

Commodity Market

- Commodity market refers to markets that trade in primary rather then manufactured products. It is a physical market place for buying, selling and trading primary products.

Objectives of commodity market:

- ➢ **Hedging with the objective of transferring risk related to the possession of physical assets through any adverse moments in price.**
- ➢ **Liquidity and price discovery to ensure minimum volume in trading of a commodity through market information and demand supply factors that facilities a regular price discovery mechanism.**
- ➢ **Maintaining buffer stock and better allocation of resources as it augments reduction in inventory requirement.**

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- **Price stabilization along with balancing demand and supply position.**
- **Flexibility, certainty and transparency in purchasing commodities facilitate bank financing. Predictability in prices of commodity would lead to stability, which in turn would eliminate the risk associated with running the business of trading commodities.**

Benefits/Role/functions of commodity market:

- **Price discovery**: Based on inputs regarding specific market information, the demand and supply equilibrium, inflation rates, Government policies, market dynamics, buyers and sellers conduct trading of future exchanges. This transforms in to continuous price discovery mechanism. The execution of trade between buyers and sellers leads to assessment of fair value of a particular commodity that is immediately disseminated on the trading terminal.
- **Price risk management**: Hedging is most common method of price risk management. It is strategy of offering price risk that is inherent in spot market by taking an equal but opposite position in the futures market. Future markets are used as a made by hedgers to protect their business from adverse price change.

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- **Management of risk**: This is most important function of commodity derivatives. Risk management is not about the elimination of risk rather it is about the management of risk. Commodity derivatives provide a powerful tool for limiting risks that farmers and organizations face in the ordinary conduct of their businesses.

- **Efficiency in trading:** Commodity derivatives allow for free trading of risk components and that leads to improving market efficiency. Traders find commodity derivatives to be more attractive instrument than the underlying security. This is mainly because of the greater amount of liquidity in the market offered by derivatives as well as the lower transaction costs associated with trading a commodity derivative as compared to the costs of trading the underlying commodity derivative as compared to the costs of trading the underlying commodity in cash market.

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- **Speculation**: This is not the only use, and probably not the most important use, of commodity derivatives. Commodity derivatives are considered to be risky. If not used properly, these can leads to financial destruction in an organization.
- **Price stabilization function**: Commodity Derivatives market helps to keep a stabilizing influence on spot prices by reducing the short-term fluctuations. In other words, derivative reduces both peak and depths and leads to price stabilization effect in the cash market for underlying asset.

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- ➢**Improved product quality**: The existence of warehouses for facilitating delivery with grading facilities along with other related benefits provides a very strong reason to upgrade and enhances the quality of the commodity to grade that is acceptable by the exchange.
- ➢**Useful to the producer**: Commodity trade is useful to the producer because he can get an idea of the price likely to prevail on a future date and therefore can decide between various competing commodities, the best that suit him.

Participants in Commodity Derivative market:

Hedgers. • Speculators • Arbitrageurs • Investors

- **Hedgers:** Hedgers are participants who use commodity derivatives instruments to hedge the price risk associated with the underlying commodity asset held them. Hedgers are those who protect themselves from the risk associated with the price of an asset by using derivatives. A person keeps a close watch upon the prices discovered in trading and when the comfortable price is reflected according to his wants, he sells futures contracts. Speculators: Speculators are those who may not have an interest in the ready contracts, etc. but see an opportunity of price movement favourable to them. They provide depth and

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- **Speculators**: Speculators are those who may not have an interest in the ready contracts, etc. but see an opportunity of price movement favorable to them. They provide depth and liquidity to the market. They provide a useful economic function and are integral part of the futures the market. It would not be wrong to say that in absence of speculators the market will not liquid and it may at times collapse.
- **Arbitrageurs**: Arbitrage refers to the simultaneous purchase and sale in two markets so that the selling price is higher than the buying price by more than the transaction cost, resulting in risk-less profit.
- **Investors**: investors are participants having a longer term view as compared to speculators when they enter into trade in the commodities market. Ex. Farmers, producers, consumers etc

Ways to Invest in Commodities

- **Direct Investment**
- **Futures contracts**
- **Commodity funds**
- **Exchange traded products**

Growth of Commodities market in India

- **Drastic change in Indian Market (because of Coal and Metal)**
- **Trade with standardized manner because of MCX and NCDEX (Multi commodity exchange. National Commodity and derivatives exchange Ltd.)**
- **Precious Metal and other(Gold, Silver, Platinum Nickel, Aluminum, copper, Crude oil, natural Gas, oilseeds-groundnut, mustard, sunflower)**
- **Multi commodity**
- **Forward Market commission**

Forward market Commission

- **Central Government has formed a body called Forward market Commission under section 3.**
- **It develops powers from the Act.**
- **Function of FMC are elaborated under section 4(50)**
- **The recognized association cannot carry out trading without the approval of FMC.**

The office of FMC is distributed into 3 broad divisions

- **Commodity Division**
- **Enforcement Division**
- **Administrative Division**

Commodity Exchange

- It regulates the trading of commodity futures in the United States. Passed in 1936, it has been amended several times since then. The CEA establishes the statutory framework under which the CFTC operates. Under this Act, the CFTC has authority to establish regulations that are published in title 17 of the Code of Federal Regulations.
- In other parts of the developing world a commodity exchange may act in a broader range of ways in order to stimulate trade in the commodity sector.

Commodity Exchage in India

MCX- Multi commodity Exchange
NCDEX- Multi commodity and Derivatives exchange
NMCE- National Multi- commodity Exchange
ICEX- India commodity Exchange

2,000 members operations through more than 4,68,000 trading terminals, spanning over 1,900 cities and towns across India.

Unit IV Derivatives Market

Risk Management System and Procedures

1. Understand the nature of various risks
2. Describe a risk management policy for the organization and quantifying maximum risk that organization is willing to take if quantifiable
3. Measure the risks if quantifiable and compute otherwise.
4. Build internal regulator mechanism to control and monitor all the risks.

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