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# Options trade to deepen commodity market

By Ashwin J Punnen Jun 14 2017 , Mumbai  
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Market regulator Sebi's decision to introduce options in commodities derivatives market is widely seen as a critical reform, which could further deepen the domestic commodity market as it is expected to provide farmers and other participants a new hedging tool in a more cost-effective manner.

The regulator this week laid out rules for trading of commodity options, while allowing bourses to start trading of option in one commodity on a pilot basis.

Options are derivative contracts that give the buyer of the option the right but not the obligation to buy or sell.

Under the framework provided by the Sebi, options would be permitted on those commodities that are among the top five futures contracts in terms of total trading turnover value over the previous 12 months, and their average daily trading volume should be minimum Rs 200 crore for agricultural commodities and Rs 1000 crore for others.

The underlying asset for the option would be commodity futures contract of a specified month in which the option will devolve into. Options would be European style, and the expiry day shall be decided by the exchange.

Sandeep Sabharwal, Group CEO, Sohan Lal Commodity Management (SLCM), "the launch of options will boost overall market participation and also complement the existing futures and make the commodities market more robust and efficient. The combination of futures and options can give market participants the benefit of price discovery of futures and simpler risk management of options."

All major global commodity derivatives exchanges like the Chicago Board of Trade and Tokyo Commodity Exchange have options contracts with futures contracts as underlying.

The volumes in the commodity derivative market which currently clock around Rs 26,000 crore, are expected to rise with the option trading.

"A hockey-stick effect is expected, with cannibalisation impact for a brief early period, followed by significant market growth driving earnings," Ashish Chopra of Motilal Oswal Securities said in a note.

The top five commodities on MCX in terms of trading volume are crude oil, gold, silver, zinc and copper. All of these have trading volume of Rs 100 crore and would be eligible for the launch of options. Most likely MCX launch options on gold or crude futures.

Experts say if the option market develops it will have a positive impact on the agriculture sector in the country as farmers would be able to hedge their produce in the options market before the growing season by paying a premium and buying a put option. This will provide them an option to sell produce at a pre-defined price on a future date by paying a fixed premium and ensure that the farmer gets a guaranteed minimum price for his produce.

"The option could become part of the financial inclusion if farmers and other smaller players are able to participate in the market. But, initially the product will be used by retail and HNIs," says Prathamesh Mallya chief analyst non-agri commodities Angel Broking.

Experts add that similar positive impact will pan out for manufacturers and consumers who have significant raw material risk.

Rollout of goods and services tax (GST) will also help with cross state trading and ease some of the capacity to manage physical delivery.

Overall this move will increase the depth of the market, provide more cost effective hedging options and ensure liquidity for various participants, including farmers and SMEs.

Vjay Singhania, founder, Trade Smart Online, "overall this move will increase the depth of the market and provide more cost effective hedging options and ensure liquidity for various participants. As In the financial year ended March 2017, the options-to-futures ratio stood at 5.1 times for equity markets in India due to the favourable tax structure for options. We expect commodity options to gradually outpace commodity futures market as the commodity transaction tax (CTT) would be on option premium instead of the notional value of the transaction"

The Sebi has fixed the hybrid mechanism for settlement of commodity options. Under this mechanism, options devolve into the underlying futures contract on exercise, but can be cash-settled by taking offsetting position till expiry. The conversion to futures on expiry will lead to increased transaction costs on final settlement (CTT on notional value, higher transaction fees) and higher margin requirements of a futures contract. Due to the higher round-trip cost, market participants will prefer to settle in cash before expiry of the options contract, analysts said.

Launch of options will improve the risk management alternates for market participants. According to analysts, the impact of commodity price volatility on different players would be very high in domestic market.

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