SEBI Bans Derivative Trade in Agriculture Commodities

For Prelims: Capital Market, Derivative Trading, Inflation, Options, Futures, Forwards, Swaps

For Mains: Reasons for Derivative trading suspension and its impact, Significance and concerns related to Derivative trading.

Why in News

Recently, the **Securities and Exchange Board of India (SEBI)** has banned the derivative trade of seven agricultural commodities on the future's platform of **National Commodities and Derivatives Exchange (NCDEX)** for a year.

- The regulator has banned derivative contracts trade in **chana, wheat, paddy (non-basmati), soyabean and its derivatives, mustard seed and its derivatives, crude palm oil and moong** for a year with immediate effect.
- The commodity derivatives market **has been prone to such sudden suspensions of trading in agriculture items** ever since it was introduced under the erstwhile **Forward Markets Commission (FMC).**

SEBI

- It is a **statutory body established on 12^{th} April, 1992** in accordance with the provisions of the **Securities and Exchange Board of India Act, 1992.**
- The basic functions of the SEBI is to **protect the interests of investors in securities and to promote and regulate** the securities market.

Key Points

- **Reasons for Ban:**
  - **To cool off Food Inflation:**
    - **India's retail inflation** rose to a three-month high of 4.91 % in November from 4.48 % in the previous month primarily because of **a rise in food inflation to 1.87 % from 0.85 % over this period.**
  - **Double Digits WPI:**
    - **Wholesale Price Index-based inflation** has remained in double digits for eight consecutive months beginning in April, mainly because of surging prices of food items.
    - In November, the wholesale price-based inflation surged to a **record high of 14.23 %** amid hardening of prices of mineral oils, basic metals, crude petroleum and natural gas.
  - **To insulate future Price Shock:**

        - In view of **Rabi Output** that might be affected morbidly because of fertiliser shortage faced in many parts of the country.
        - By banning future's trade, the government is trying to insulate any price shock the market might feel in the days to come in case the production is not up to par.
- **Impact:**
    - The suspension comes ahead of the rabi crop, sown in winter, hitting the markets in a couple of months. With no reference price, **traders will be clueless on future sentiment.**
    - Importers, who hedge on the derivative market to safeguard themselves from price moves, may be more **vulnerable.**
    - Impact on prices initially, the outlook will be bearish **as traders rush to square off open positions on derivatives.**

Derivatives

- **About:**
    - Derivatives are the instruments which include security **derived from a debt instrument share, loan, risk instrument or contract** for differences of any other form of security and a contract that derives its value from the price/index of prices of underlying securities.
    - In the finance field, a derivative is a contract **that derives its value from the performance of an underlying entity.** This underlying entity can be an asset, index, or interest rate, and is often called the **"underlying"**.
- **Types:**
    - **Forwards and futures:**
        - These are financial contracts that obligate the contracts' **buyers to purchase an asset at a pre-agreed price on a specified future date.** Both forwards and **futures** are essentially the same in their nature.
    - **Options:**
        - Options provide the buyer of the contracts the **right, but not the obligation, to purchase or sell the underlying asset** at a predetermined price.
        - Based on the option type, **the buyer can exercise the option on the maturity date** or on any date before the maturity.
    - **Swaps:**
        - Swaps are derivative contracts **that allow the exchange of cash flows between two parties.**
        - The swaps **usually involve the exchange of a fixed cash flow for a floating cash flow.**
        - The most popular types of swaps are interest rate swaps, commodity swaps, and currency swaps.
- **Significance:**
    - **Hedging Risk Exposure:**
        - Since the value of the derivatives is linked to the value of the underlying asset, the **contracts are primarily used for hedging risks.**
        - In this way, **profits in the derivative contract may offset losses** in the underlying asset.
    - **Underlying Asset Price Determination:**
        - Derivatives are frequently **used to determine the price of the underlying asset.** For example, the spot prices of the futures can serve as an approximation of a commodity price.
    - **Market Efficiency:**
        - It is considered that **derivatives increase the efficiency of financial markets.** By using derivative contracts, one can replicate the payoff of the assets.
        - Therefore, the prices of the underlying asset and the associated derivative tend to be in equilibrium to avoid arbitrage opportunities.
    - **Access to unavailable assets or markets:**
        - Derivatives can help organisations **get access to otherwise unavailable assets or markets.**
        - By employing interest rate swaps, a company may obtain a more favourable interest rate relative to interest rates available from direct borrowing.

- **Issues:**
  - **High Risk:**
    - The high volatility of derivatives **exposes them to potentially huge losses.** The sophisticated design of the contracts makes the valuation extremely complicated or even impossible. Thus, they bear a high inherent risk.
  - **Speculative Features:**
    - Derivatives are widely regarded as a **tool of speculation.** Due to the extremely risky nature of derivatives and their unpredictable behaviour, unreasonable speculation may lead to huge losses.
  - **Counterparty Risk:**
    - Although derivatives traded on the exchanges generally go through a thorough due diligence process, some of the contracts traded over-the-counter do not include a benchmark for due diligence. **Thus, there is a possibility of counterparty default.**

National Commodities and Derivatives Exchange

- NCDEX is **an online commodities exchange dealing primarily in agricultural commodities** in India.
- It is **a public limited company**, established on 23rd April 2003 under the **Companies Act, 1956.**
- The exchange was **founded by some of India's leading financial institutions** such as ICICI Bank Limited, the National Stock Exchange of India and the **National Bank for Agricultural and Rural Development**, among others.
- These include 25 contracts for agricultural products. NCDEX is run by an independent board of directors with no direct interest in agriculture.

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