The landscape of risk management for commodities in India

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Roundtable on "Commodity price risk hedging: Role of banks"
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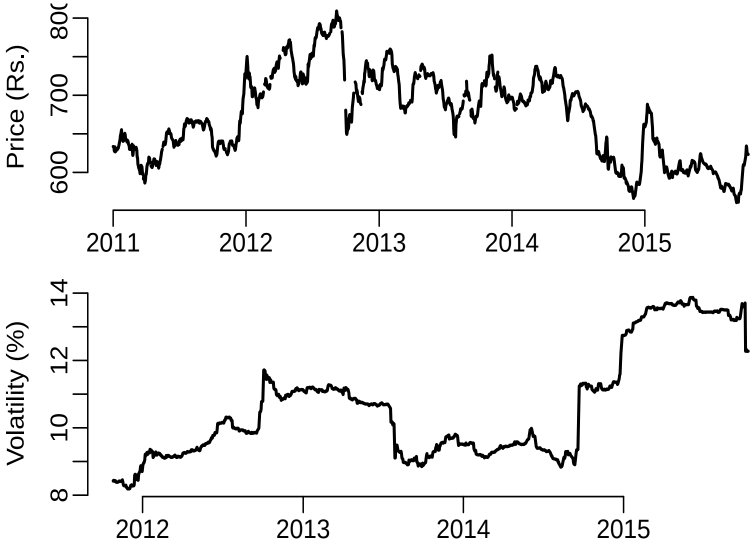
Outline

Some facts

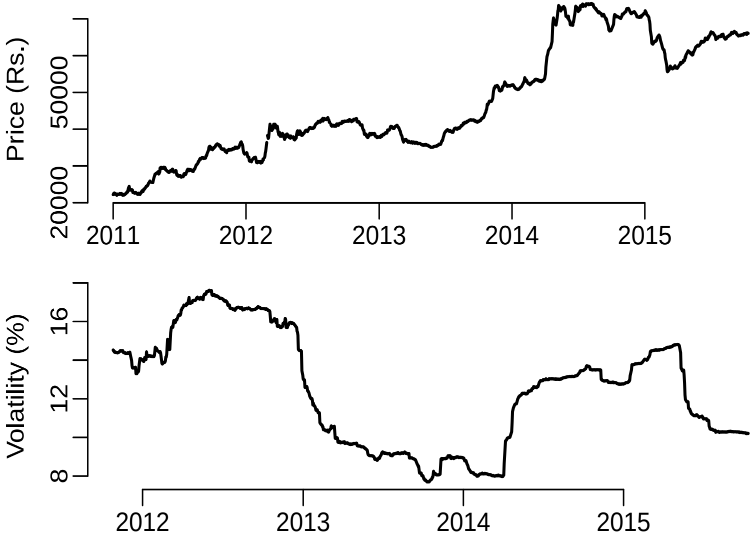
- 34% of India's GDP is commodity related. 17% is from agriculture.
- India has an explicit advantage in agri-commodities as producer and price-setter.
  India is one of the largest producers of wheat, rice, pulses, cotton, sugar, oilseeds and spices.
- In non-agri commodities,
  - In metals, India is one of the largest consumers of bullion – 11% of our imports.
  - Petroleum and petroleum products account for 35% of our imports and 18% of our exports.

Outline

Soy Oil

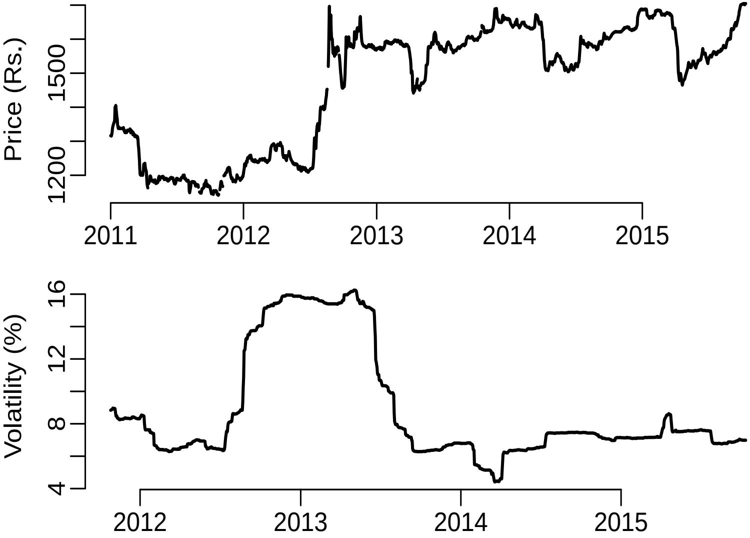

Price (Rs.)
600
700
800
2011
2012
2013
2014
2015
Volatility (%)
8
10
12
14
2012
2013
2014
2015

Pepper



Price (Rs.)
20000
50000
2011
2012
2013
2014
2015
Volatility (%)
8
12
16
2012
2013
2014
2015

Wheat


Price (Rs.)
1200
1500
2011
2012
2013
2014
2015
Volatility (%)
4
8
12
16
2012
2013
2014
2015

Outline

Entities affected by high commodity price volatility

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  1. Food credit
  2. Non food credit in the form of
     - 2.1 Collateral financing
     - 2.2 Working capital loans
  3. Priority sector lending

Outline

Sector-wise gross bank credit

	As % of gross bank credit		
	Aug '13	Aug '14	Aug '15
Food credit	1.44	1.42	1.28
Non food credit			
Agri	11.74	12.65	13.11
Industry	44.92	43.92	42.59
Food processing	2.32	2.51	2.50
Sugar	0.62	0.61	0.59
Edible Oils	0.34	0.33	0.29
Tea	0.06	0.05	0.05
Others	1.30	1.52	1.57

High exposure to agri-credit.

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Instruments to hedge risk

- **Markets**: OTC, Exchange traded
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     - CME • DCE • ZCE • LME • ICE

Rules governing participation in domestic exchange traded commodities markets

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- Currently, domestic FIs are not permitted to participate:
  - Mutual funds, insurance and pension firms not permitted.
  - **Banks – not permitted by RBI (Banking Regulation Act, 1949 – Section 8).**
- Participation subject to position limits.
- Large public sector organizations like FCI, STC, MMTC etc. do not participate.
- Large oil companies or GoI take positions in offshore markets due to lack of depth in domestic markets.

The RBI circular of May 2015

Banks – no means to hedge the indirect commodity price risk exposure.

Recent RBI circular:
"With a view to developing strong risk management capabilities to manage agri- commodity price risk, it is felt that banks should encourage hedging by the agri- borrowers by creating awareness amongst them regarding the utility and benefits of hedging through agri-commodity derivatives. At the same time, banks must keep the sophistication, understanding, scale of operation and requirements of their agri- borrower in mind while advising on the availability and use of these instruments."

Which could imply
– Banks educate the borrowers about derivative instruments.

– Banks provide financial advisory services to borrowers for hedging.

Outline

Liquidity of the domestic commodities markets

	Liquidity costs (%)			Depth (Rs.)	
Commodity	Spread	IC_{250K}	σ_{IC}	Best prices	Best 5 prices
Castor	0.02	0.06	0.02	62,665	836,255
Chana	0.14	0.32	0.08	52,240	392,350
Dhaniya	0.07	0.09	0.04	113,855	686,240
Guarseed	0.04	0.07	0.02	58,902	588,342
RMSeed	0.03	0.06	0.02	70,150	587,700
Soybean	0.03	0.07	0.02	55,140	661,145
Reliance Futures	0.01	0.02	0.01	333,040	3,215,518

Outline

Open questions

1. How can banks facilitate hedging by agri commodity borrowers?
   - Increase awareness? Incentives?
   - Financial advisory services?
   - Inventory financing?
2. How feasible is it for agri borrowers to hedge using the domestic markets?
3. What are the other issues that an agri borrower faces in hedging using these markets?

Thank you.

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