Role of Banks as Intermediaries in the Commodity Derivatives Market

Role of Banks

Sectors like energy and agriculture are highly susceptible to the price of the underlying commodities. An useful tool to counter this volatility is by using derivative products. Banks, with its variety of credit facilities and grassroot level reach, can play an important role here.

- **Advisor to Customers:** Despite the presence of several derivative products, many small traders remain exposed to price volatility. Lack of awareness and the complexity of these products can be inferred to be the cause. Banks with its reach to such borrowers can create awareness among them about the potential merits of using derivative products.

- **Intermediaries for smaller parties:** Small players like farmers are highly susceptible to commodity price volatility. Banks can play an important role here as intermediaries by providing know-how and proper risk management solutions to these farmers to improve income.

- **Counterparty for Traders:** Banks often provide support to trading concerns by providing necessary documentation that facilitates commodity contracts, e.g. warranties, letter of credit, etc.

Types of Intermediations

- **Transactional Trade Finance (TTF):** Short-term commodity financing. The goods serve as collateral. The sales proceeds are used to repay the loan (self-liquidating).

- **Structural Trade Finance (STF):** Advance or interim financing (tolling) of goods yet to be produced, especially useful for developing or emerging countries. Banks usually model the performance risk under this type of financing. The timeframe is medium to long.

- **Commodity Risk Management (CRM):** Enable industry to either reduce or convert their exposure, through to Direct or Structured Investment. Banks usually structure deals at all levels of complexity and provide liquidity during, and outside, exchanges times.

- **Commodity Indices (CI):** Banks facilitate exposure to multi-generation indices. Some of the well known indices are the GSCI (Goldman Sachs Commodity Indices) and UBS Indices.

- **Liquidity Source :** Financial Intermediaries dampen the negative effects of commodity price volatility.

Banks – Products and Services

With extensive financial capabilities and risk-management techniques, banks offer several commodity-linked solutions to its customers. These institutions can help customers manage risk from fluctuating commodity prices through implementation of effective financial hedging strategies.

1. **Derivative Products**
   - Commodity Swaps
   - Commodity Options
   - Commodity Collars
   - Commodity Structures

2. **Financing Services**

   Banks offer structured financing solutions to commodity producers as well as consumers.

3. **Research and Analytics**

   Banks often provide detailed research and analytics on domestic as well as international commodity markets that help traders in making informed decisions.

Risk Management

Uncertainty over the future price of commodities is a major concern to traders, small and big alike. This volatility increases the chances of default for borrowers. The risk is even more pronounced in cases were the borrowers have not hedged the underlying commodity price risk.

Two commonly offered solutions to this volatility are ***Swaps*** and ***Options***.

Commodity Swap (or Futures):

A swap ensures that the client receives a fixed price or agreed upon prices even when the commodity price rises or falls below a certain level. This certainty helps in planning as well as proper budgeting.

Produce: 100Kg
Expected Sale Price: Rs. 250/kg
Sale Date: 30 DEC 2017

Without Swap Contract: Sell at a Loss

With Swap Contract @Rs250/kg : Sale at expected price

Price on 30 DEC 2017: Rs. 240/kg

Commodity Options:

Options provide the opportunity to benefit from favorable price movements, in addition to providing protection again commodity price volatility.

In an option transaction between a trader and the Bank, the former has the right but not obligation to buy/sell a commodity at a strike price on an exercise date, for a premium. Depending an the intention to sell or buy a commodity, a trader may purchase a put or call option from the bank.

In options, the risk is minimum as option holder is at most liable to loose the premium and as such is more suitable for conservative participants like farmers and small entities. These transactions are settled in cash only and no physical delivery of the underlying commodity takes place.

A Win-Win Scenario for Both

NarnoliaVelox
Generating Superior and Consistent Risk Adjusted Returns

For Traders/Commodity dealers:

- Banks provide planning and risk management solutions to traders to improve effective returns.
- With its extensive research base, banks provide solutions to limit the exposure to commodity fluctuations, thereby providing more control to traders.
- Provide tailor made solutions to traders by offering appropriate protection as per different business needs.

For Banks:

- Owing to globalization, business expansion of banks have led to high commodity exposure on their part. Increasing exposure in hedging based products will mitigate some of this risk.
- The participation of banks in such derivative based products will also add to their sustainable growth.

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