

# Role of Banks in Commodity Market

\* *Jyoti*

## INTRODUCTION

After liberalization, the Indian financial system has been incrementally deregulated and exposed to international financial markets along with the introduction of new instruments and products. Financial sector reforms in the area of commercial banking, capital markets and non-banking finance companies have also been undertaken.

As a result of which, the financial health of the commercial banks has improved manifold with respect to capital adequacy, profitability, and asset quality and risk management. Further, deregulation has opened new opportunities for banks to increase revenue by diversifying into investment banking, insurance, credit cards, depository services, mortgage, securitization, etc. Liberalization has created a more competitive environment in the banking sector. The aggregate foreign investment (FDI plus FII) limit for the private sector banking has been raised to 74 percent in the central budget. The competition has increased within the banking sector (with the emergence of new private banks and foreign banks) as well as from other segments of the financial sector such as mutual funds, non-banking finance companies, post offices and capital markets.

Commodity market is another important constituent of the financial markets of the country. Commodity market is growing at a faster pace in the Indian scenario. The increase in the commodity market activity has fostered the expansion of the financial services industry and has led to tremendous growth in size and specialization of various intermediaries. Amongst all financial intermediaries, banking institutions have shown significant revolution. Procedures and practices adopted in the markets, and financial interrelationships are also parts of this system.

Banks have played a central role in the growth of commodity market. To understand and analyze the role of banks in the development of commodity market, there is need to define the concept of commodity and commodity market first.

## COMMODITIES AND COMMODITY MARKET

A commodity may be defined as an article, a product or material that is bought and sold. Forward Contract (Regulation) Act, 1952 defines “goods or commodity” as every kind of movable property other than actionable claims, money and securities. Commodities actually offer immense potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. Retail investors, who claim to understand the equity markets, may find commodities an unfathomable market. But commodities are easy to understand as far as fundamentals of demand and supply are concerned.

Future trading is organized in a way that commodities are permitted by the central government. At present, all goods and products of agricultural (including plantation); mineral and fossil origin are allowed for future trading under the auspices of the commodity exchanges recognized under FCRA.

Commodity derivatives (futures) market trade contracts for which the underlying asset is a commodity. It can be an agricultural commodity like wheat, rice, pulses, soyabean, rapeseed, cotton etc., or precious metals like gold, silver, etc. It is different from other financial derivatives in the sense that due to bulky nature of the underlying asset, physical settlement creates a need for warehousing.

The Commodity Market in India revived after the liberalization of the economy in 1991 when future trading in major commodities (barring few of strategic importance) was permitted in a gradual way from April 1, 2003. At present, there are 24 commodity exchanges operating and facilitating trade in different commodity derivatives. Commodity market is an extensive form of stock market where commodities are promised to be bought in future by fixing its value today. It is also a kind of contract market. In India, this market is at a nascent stage.

Today, very few institutions are supporting the commodity market. Here, commodity exchanges are facilitating selling and buying of commodity contracts. There are sixty to seventy types of commodities including the above-mentioned ones for which the trading takes place on 24 exchanges of India.

Commodity trading is nothing but “value” trading. It refers to buying or selling commodity contracts by deciding its value through estimation of expected price of the underlying commodity in future. For example, what would

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\* Assistant Professor, K.P. College of Management, NH-2, Navalpur, Agra-Tundla Road, Agra-283202, Uttar Pradesh.  
Email: jyotidb18@rediffmail.com

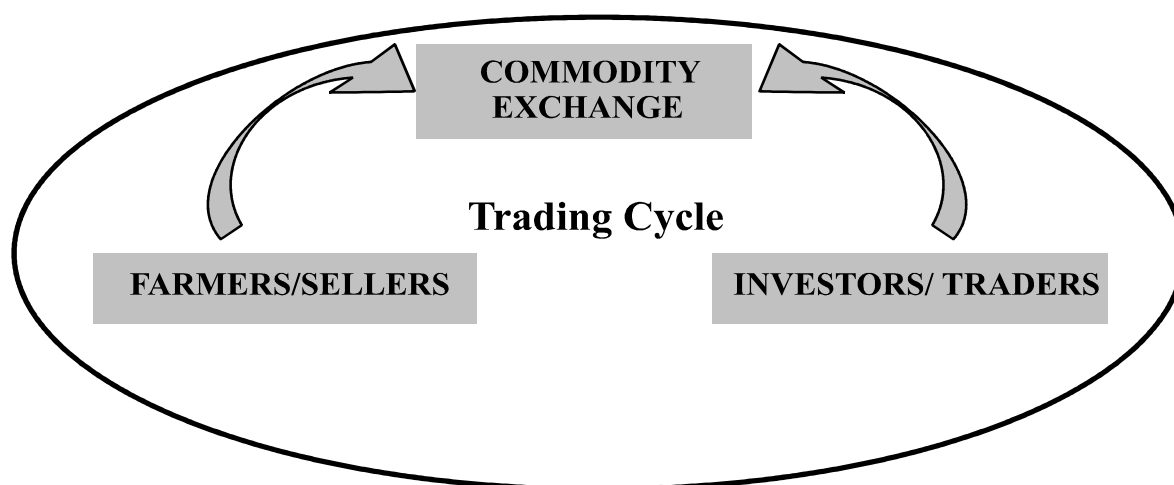
be the price of wheat after six months would be a question that has to be considered to find out the “value of a contract” for which the underlying asset is wheat.

The commodities market exists in two distinct forms- namely Over the Counter (OTC) market and the Exchange based market. Also, as in equities, there exists the spot and the derivatives segment. The spot markets are essentially over the counter markets and the participation is restricted to people who are involved with that commodity say the farmer, processor, wholesaler etc. Derivative trading takes place through exchange-based markets with standardized contracts, settlements etc.

## TRADING MECHANISM

The exchange generally maintains a Central Order Book, which matches the trades on a pre-defined matching algorithm, and confirms the execution of trades to the members on an online real-time basis. It has an integrated Surveillance and Settlement System. Exchange members located across the country are connected to the central system through VSAT, Leased line, Internet or any other mode of communication as permitted by the Exchange.

**Figure 1 : Trading Cycle**



Traditionally, this process used to take months to complete the transaction and possession. Now, with the support of online settlement system, the farmers, sellers, investors and traders settle price and value online. This is also called as the future trading because the crop will be ready some time in future but the price is decided in the present, and based on this price, the contract trading is completed. The most important benefit of such a market is that on one side, farmers do hard labour to grow better crops for a better price; and on the other hand, the traders or investors earn profit by simply promising to buy the crop without buying it.

In India, there are three main commodity exchanges. Two of them are operating in Mumbai and one in Ahmedabad. They are:

- Multi-commodity Exchange, Mumbai
- NCDEX, Mumbai
- NMCEX, Ahmedabad

**Table 1: Commodity Exchanges In Various Countries**

EXCHANGES	SPECIAL COMMODITY
NewYork Mercantile Exchange	Crude Oil
London Metal Exchange	Aluminum, Copper, Tin, Lead
Tokyo Commodity Exchange	Silver, Gold, Crude Oil, Rubber
Malasian Derivative Exchange	Rubber, Soya Oil, Palm Oil
Chicago Board of Trade	Soya Oil, Soybean, Wheat
Chicago Board Auction Exchange	Energy Products

Source: <http://indiabudget.nic.in>

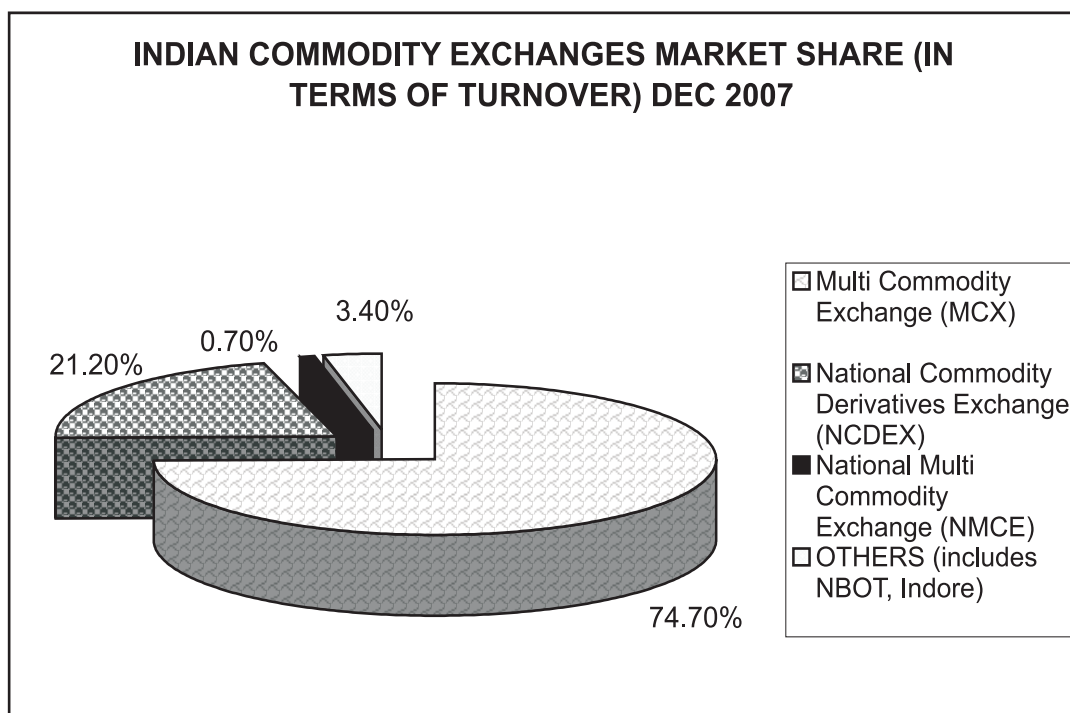
Besides these, National Board of Trade, Indore and other commodity exchanges are also operational. Commodity trading is at its growth peak in some of the foreign countries. The famous commodity exchanges in various countries are shown in Table1.

## COMMODITY MARKET IN INDIA

In India, 94 commodities were traded in the commodities futures market as in December 2006 as compared to 59 in January 2005 and these included major agricultural commodities (rice, wheat, jute, gur (jaggery), cotton, coffee, major pulses like urad, arhar, chana, edible oilseeds like mustard seed, coconut oil, groundnut oil and sunflower), spices (pepper, chilies, cumin seed and turmeric), metals (aluminium, tin, nickel and, copper), bullion (gold and silver), crude oil, natural gas and polymer, among others. Gold accounted for the largest share (31 per cent) of trade in terms of value, followed by silver (19 per cent), guar seed (11 per cent) and chana (10 per cent) (mcxindia.com, 2007). A temporary ban was imposed on futures trading in urad and tur dal in January 2007 to ensure orderly market conditions. During 2007, a variety of agricultural commodities, spices, metals, bullion and crude oil were traded on commodities futures market.

An efficient and well-organized commodities futures market is generally acknowledged to be helpful in price discovery for the traded commodities. Here future trading takes place at MCX, NCDEX and NMCEX and other regional exchanges. Multi- Commodity exchange features amongst the world's top three bullion exchanges and top four energy exchanges. The growth in the volume of trading has been primarily propelled by Multi Commodity Exchange, Mumbai (MCX) and National Commodity Derivatives Exchange, Mumbai (NCDEX), with these two exchanges accounting for a large share of the number of contracts traded (Figure 2).

**Figure 2: Indian Commodity Exchange Market Share**



Source: [www.indiabudget.nic.in](http://www.indiabudget.nic.in)

The growth in the commodity derivative trading witnessed in 2005-06 continued during 2006-07 and 2007-08. The total volume of trade in the commodity futures market rose from Rs. 34.84 lakh crore in 2006 to Rs. 36.54 lakh crore in 2007, notwithstanding the suspension of trading of wheat, rice, urad and tur.(Table 2).

## THE PRESENT SCENARIO

Despite the ban on trading in a number of commodities (like soya oil, rubber, *chana* (chickpea) and potato in May extended till November), high inflation and political hurdles, commodity futures market showed an impressive 40% surge in 2008.

**Table 2 : Turnover Of Commodity Futures Markets  
(Rs. Crore)**

Years	2005	2006	2007
MCX	633324	2025663	2730415
NMCX	12107	111462	25056
NCMDX	883209	1243327	774965
NBOT	50889	73691	82272
OTHERS	57816	30342	41779
Total	1637345	3484485	3654487

Source: <http://indiabudget.nic.in>

The total turnover of various commodity exchanges at the end of November 2008 totaled to Rs. 46,65,295 crore which was expected to grow to Rs. 50 trillion as compared to Rs. 36,53,895 crore in the year 2007.

One major development in this market during last year was the entry of new players like R-ADAG, Kotak Mahindra Group, Indiabulls group, MMTC Ltd., etc. MMTC and Indiabulls formed a joint venture to set up a fourth national commodity exchange. Reliance Money picked up a stake in the National Multi-Commodity Exchange of India Ltd (NMCE) and Kotak Mahindra Group picked up a stake in the Ahmedabad Commodity Exchange.

Finally, in line with the equity markets, the government on January 30, 2008 allowed 26 percent FDI and 23 percent FIIs in commodity exchanges. The decision to allow up to 49 percent foreign investment in commodity bourses is likely to bring global trading practices and strategic investment policies to the Indian commodity market. This will not only improve the efficiency of exchanges, but also make trading more transparent.

## **ROLE OF BANKS**

The financial sector, especially the banking industry in most emerging economies like India, is passing through a process of change. As the financial activity has become a major economic activity in most economies, any disruption or imbalance in its infrastructure will have a significant impact on the entire economy. By developing a sound financial system, the banking industry can bring stability within the financial markets. Banks are not only supporting commodity market by acting as an intermediary, but also by exposing their investment to this market. Their role can be analyzed from the following three perspectives.

- Creator or Promoters
- Intermediary
- Institutional Investor

## **BANKS AS PROMOTERS**

Indian banks and financial institutions have played a vital role in establishment of various commodity exchanges in India. Few of the examples are as mentioned further.

- **Multi Commodity Exchange** has been established with the support of Financial Technologies (I) Ltd., State Bank of India and its associates, National Bank for Agriculture and Rural Development (NABARD), National Stock Exchange of India Ltd. (NSE), Fid Fund (Mauritius) Ltd. - an affiliate of Fidelity International, Corporation Bank, Union Bank of India, Canara Bank, Bank of India, Bank of Baroda, HDFC Bank, SBI Life Insurance Co. Ltd., Merrill Lynch and Citigroup.
- **National Commodity & Derivatives Exchange Limited (NCDEX)** is a professionally managed on-line multi commodity exchange. Promoter shareholders are Life Insurance Corporation of India (LIC), National Bank for Agriculture and Rural Development (NABARD) and National Stock Exchange of India Limited (NSE). Other shareholders include Canara Bank, CRISIL Limited (formerly the Credit Rating Information Services of India Limited), Goldman Sachs, Intercontinental Exchange (ICE), Indian Farmers Fertilizer Cooperative Limited (IFFCO) and Punjab National Bank (PNB).

## **BANKS AS INTERMEDIARY**

In commodity market, brokers and sub-brokers act as intermediaries amongst the investors. Nowadays, banks have also started performing the role of brokers or sub-brokers. They provide a platform for trading and charge the commission or brokerage for the same.

Banks also act as mediators between cultivators and FMC to discover better prices for their produce. Certain technical difficulties for farmers in approaching the commission can be resolved with banks' entry into the market.

Banks, as mediators, are required to be technically sound to enter into such complex market. All branches of the bank are needed to be fully equipped with technical know-how and also should be capable of adopting the innovative technologies. Presently, ICICI bank is providing the facility of commodity trading with the help of ICICI Direct.com. Besides this, Indiainfoline.com, Motilaloswal.com, Sify Securities, Karvy commodities Ltd. etc., are also giving this service to their clients. Public sector banks are still lagging far behind in the implementation of new technologies for all their branches, especially rural ones where even essential infrastructure is not available. Due to this reason, it may take a long time for these banks to enter into this market. Banking sector in India is still not fully computerized.

The second Rangarajan Committee constituted in 1988 drew up a detailed perspective plan for computerization in banks and for extension of automation to areas like fund transfer, electronic mail etc. Based on these recommendations, RBI has set up different level of communication which has become the backbone for interconnectivity among bank branches. They are BANKNET, INFINET (Indian financial networks), S.W.I.F.T, EDI (Electronic data interchange), EFT (Electronic funds transfer), MICR CLEARING, ECS, and ATM NETWORK. These initiatives may push up banks for profound involvement in upcoming markets like commodity market.

## **MODUS OPERANDI –TRADING IN COMMODITY MARKET THROUGH BANKING CHANNEL**

To get into this market through banks, the investors need to open three accounts in the bank- Trading account, Demat Account and Savings Account. Margin money is deposited in the demat account. An investor fixes the "trade value" of a commodity online. That commodity is booked in his/her name and the value (amount) is debited to the investors' savings account. If this trade is completed with the help of a broker (who is not settling the trade online), the deal takes time and the value of the commodity starts deviating. Banks are providing online trade facility with the support of innovative technologies to eliminate this effect.

According to FMC, the commodities market regulator and some banks have already started providing finance to commodities that are hedged on commodity exchanges, so the banks' role should be increased in Futures trade. Federal Bank has financed up to 85 per cent of the price of some of the plantation commodities hedged on exchanges ([www.commodityonline.com](http://www.commodityonline.com)). The bank is planning to finance up to 90 per cent. If banks can take this view — of giving finance with liberal margins for hedging commodities — it is a logical follow up for them to hedge the commodities themselves on commodity exchanges. FMC is promoting the idea of aggregators for helping small farmers to hedge their crops on commodity exchanges. Aggregators act on behalf of farmers who are not comfortable in hedging their crops on exchanges either for want of knowledge or because the quantities are small. Banks will be asked to provide credit to the aggregators who will in turn handle the margins and mark to market, enabling hassle-free trading for farmers.

## **BANKS AS INSTITUTIONAL INVESTORS**

Besides the capital market, banks have steadily increased their exposure to some extent in the commodity sector also. On the participation of banks, traders in the commodity market would bring more liquidity and better practices into the market.

The Government has recently allowed banks to trade in commodity derivatives. As a result of which, previous years have seen few banks as institutional investors for commodity trading. ICICI Bank has shown immense interest in this market (change from 2004-05 to 2005-06 is 196.7%) as compared to other banks as shown in following table (Table 3).



**Table 3 : Investment By Banks In Commodity Market  
(Rs. Crore)**

<b>Public Sector Banks</b>	<b>2005-06</b>	<b>2004-05</b>	<b>% Change</b>
Corporation Bank	335.42	319.57	5
Punjab and Sind bank	82	131.68	-37.7
UCO Bank	810.12	755.26	7.3
<b>Private Sector Banks</b>			
Bank of Punjab	0	40.32	-
ICICI Bank	2984.9	1006.1	196.7
J & K Bank	147.26	91.35	61.2
<b>Foreign Bank</b>			
DBS Bank	31.64	14.73	114.8

Source: [www.rbi.org.in](http://www.rbi.org.in)

Total exposure of Scheduled Commercial Banks to the sensitive sectors was 20.4 per cent of aggregate bank loans and advances in 2006-07 as compared to 18.8 per cent in the previous year. The investment in commodity sector is 0.6% which has increased in 2007 (increased from level of 0.5% in 2006 (Table 4)).

**Table 4 : Lending to Sensitive Sectors by SCBs**

<b>Sectors</b>	<b>March End</b>			
	<b>2006</b>	<b>2007</b>	<b>2006</b>	<b>2007</b>
	<b>Rs. Crore</b>		<b>Percent of Total</b>	
Capital Market	22303	30637	7.8	7.6
Real Estate	262053	370689	91.7	91.9
Commodities	1413	2206	0.5	0.6
Total	285769	403532	100	100

Source: <http://indiabudget.nic.in>

Banks can insist that their borrowers, who deal in commodities or agri products, should enter into forward contracts, in order to hedge against losses due to spot price fluctuation. This will, in turn, protect banks from losses arising out of exposure to commodities.

Commodity derivatives will enable banks and other institutional investors to gain exposure to alternative investments. Specifically, exposure to commodity-linked products will increase a portfolio's risk-adjusted returns because of lower cross-correlations that stocks and bonds have with commodities (B. Venkatesh, 2005). Besides, these institutions will provide liquidity to the commodity derivatives market, enabling the hedgers to efficiently control their price risk.

Banks can use commodity derivatives to control inflation risk of their bond portfolio besides deriving benefits from portfolio diversification. Importantly, such an exposure can be used as a hedge against loan-assets. Credit risk in the agriculture sector is typically a function of the quality/quantity of the harvest and the price that the produce fetches in the wholesale market. This essentially means that a poor harvest or lower price for the produce can lead to higher credit risk for the banks because farmer-borrower is then more likely to default. Banks can take a suitable long or short position in commodity derivatives to hedge their credit risk. Such a hedge runs a high basis risk. Besides, this hedge will only work to the extent that the farmer-borrowers do not default deliberately.

At present, banks are not fully allowed to hedge exposures. Preventing banks from taking hedges leads to preventing them from taking precaution against price fluctuation but the development of the commodities market

and introduction of products like options may permit it. Banks can lessen their risk by buying options. Banks' role was limited due to the regulatory restrictions. Banks should be given more autonomy and should be favoured to trade in commodity markets. For this, the Forward Contracts (Regulation) Act, which governs the commission, should be amended.

## **SIGNIFICANCE OF COMMODITY MARKET**

Commodity market is a win-win market. All the participants, whether they are traders, farmers, investors or godown owners gain something from this market. Farmers are saved from selling their crops at a low price, banks can earn a good amount of brokerage, investors earn returns without buying the commodities and godown owners get the benefit in terms of rent.

A well-developed and effective commodity futures market, unlike physical market, facilitates offsetting the transactions without impacting on physical goods until the expiry of a contract. Futures market attracts hedgers who minimize their risks, and encourages competition from other traders who possess market information and price judgment. While hedgers have long-term perspective of the market, the traders, or arbitragers as they are often called, hold an immediate view of the market. A large number of different market players participate in buying and selling activities in the market based on diverse domestic and global information, such as price, demand and supply, climatic conditions and other market related information. All these factors put together result in efficient *price discovery* as a result of large number of buyers and sellers transacting in the futures market.

Futures market, as observed from the cross-country experience of active commodity futures markets, helps in efficient price discovery of the respective commodities and does not impair the long-run equilibrium price of commodities. The system of futures markets will also improve cropping patterns. For example, if we think there will be a shortage of wheat tomorrow, the futures prices will go up today, and it will carry signals back to the farmer making sowing decisions today.

The brokerage rate is 0.06% to 0.15%. Once farmers get an idea about an estimated value of their crops, they can invest accordingly to prepare the crops and also can search for the buyer at the same price. Traders can book the orders on finding future rate of commodity suitable for him and can be benefited through arbitrage process.

For example, Mr. X has booked 100 gm gold at the rate of Rs. 9000 per 10 gm. After three months, the rate increased to Rs. 9500 per 10 gm. So he sold it and gained a profit of Rs. 5000. Mr. X has only booked that commodity (gold); not bought it.

The lack of proper infrastructure facilities, like godown facility to store the food items, harvested and processed crops makes it difficult to operate commodity market efficiently. Due to this reason, million tonnes of grains remain under the open sky without any care. Farmers are dependent on government godowns. There is need for private godowns.

One can establish his own godown in villages and get it certified from NCDEX. One can also utilize the grading system facility and get connected online. The graded goods can be considered as security for bank loan and other facilities for the farmers.

## **CONCLUSION**

Banks are an essential part of the Indian financial system and have several roles to play to construct a well-developed economy. Inception and development of commodity market is one of them. Commodity futures markets are a part and parcel of a program for agricultural liberalization. Many agriculture economists understand the need of liberalization in the sector. Futures markets are an instrument for achieving that liberalization.

Indian fields have enough capacity for producing good quality crops but success lies in motivating the farmers. The banks can play a very important role to encourage them by acting as a broker or sub-broker for the commodity exchanges and promising a better price for their commodities.

Direct participation of the farmers in the commodity futures markets is somewhat difficult at this stage as the large lot size, daily margining, high membership fees, etc., work as a deterrent for farmers' participation in these markets. Farmers can directly benefit from futures market if institutions such as banks and insurance companies initiate to act as aggregators on behalf of the farmers. Even commodity exchanges are taking initiative as social responsibility to educate and encourage farmers. For example, Multi Commodity Exchange in its continuous

effort to reach as many farmers as possible entered into agreement with IOCL in March 2008 to disseminate price information of commodities among farmers. Then the banks, especially the public sector banks which are deep rooted in various parts of India through wide network of branches in small villages can definitely reach to farmers by a long way. State Bank of India, Punjab National Bank, Canara Bank, etc. are having their presence in almost every corner of India. If these banks start providing the service of commodity trading, then Indian farmers would be rich farmers and will surely receive the adequate value of their labour.

Banks are involved since the inception of commodity market. Their role and responsibilities need to be enhanced by providing them more autonomy and facilitating and equipping those (especially public sector banks) with recent technological innovations. Ensuring stable conditions in the market is the responsibility of policymakers, regulators as well as market participants like banks. This may call for the banking sector to broaden the geographical outreach and may stimulate their participation in development of commodity markets in India.

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- ❖ New attractive and innovative schemes should be introduced according to the requirements of different types of clients.
- ❖ PSCBs should prepare a model scheme for granting loans. This scheme should include each and every aspect, which the bank is normally expected to look into while processing loan applications.

## CONCLUSION

The public sector commercial banks in India play an important role in deposit mobilization and lending to needed people. From this analysis, one can easily understand that the functions of PSCBs are efficient and profitability is good.

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