Should Banks Be Allowed in Commodity Futures Trading?

India's Experience

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It may sound surprising to some people, but it's true that banks are not allowed to trade in commodities in India. The banks are allowed to trade in financial instruments (such as shares, bonds and currencies) in securities market but the Banking Regulation Act of 1949 strictly prohibits banks (both domestic and foreign) from trading in goods and therefore they are not allowed to trade in commodity futures market.

The Section 8 of Banking Regulation Act clearly states that no bank shall "directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realisation of security given to or held by it." However, banks are allowed to finance commodity business and provide fund and non-fund-based facilities to commodity traders to meet their working capital requirements. Banks also provide clearing and settlement services for commodities derivatives transactions. In India, banks can also own a stake in the commodity exchanges. For instance, several banks (e.g., State Bank of India and HDFC Bank) own a stake in the Multi Commodity Exchange (MCX). But banks cannot trade in commodities themselves.

The Growing Pressure

With the rapid liberalisation of Indian securities markets, pressure is exerted by big foreign banks — who have considerable international experience and expertise in commodity derivatives trading — to allow their entry in the commodity markets.

In the aftermath of the global financial crisis, the push for amending the Banking Regulation Act has gained new impetus. In a post-crisis world, big international banks are shifting their focus to Asian markets (such as India and China) which are considered to be the "new engines" of economic growth. For these banks, a largely untapped Indian commodity futures market offer enormous profit-making potential. In 2009, Bank of Nova Scotia sought permission to set up a wholly-owned subsidiary to trade agricultural goods and metals on the MCX and National Commodities and Derivative Exchange (NCDEX). But the proposal was rejected by the Reserve Bank of India (country's central bank) as per the provisions of the Banking Regulation Act.

Since January 2012, New Delhi is considering an amendment in the Banking Regulation Act so as to allow banks' entry into commodity futures besides providing similar access to mutual funds, pension funds, insurance companies and foreign institutional investors (FIIs) to participate in the commodity markets.

The Weak Rationale

The arguments supportive of banks' direct entry into the commodity trading are highly overstated and backed by very little hard evidence. The proponents argue that this move would enable banks to hedge their exposure to agricultural lending arising out of price fluctuations. In reality, banks in India lend money to farmers and commodity traders but they don't have any direct exposure to commodities.

By the same logic, banks have large exposures in infrastructure sector, should they get directly involved in building bridges, airports, highways and power plants? At best, banks are expected to advise their borrowers to hedge their price risk in futures markets rather than hedging themselves. By acting as a trader/broker in the commodity derivatives market, banks would be moving away from their core competence — lending money to individuals and firms.

Given the ground realities in the country where 80 percent of farmers are small farmers, not even 0.1 percent of farm borrowers in India trade in the commodity futures exchanges.

Further, there is no rationale for allowing non-banking financial players such as mutual funds, insurance companies and FIIs in the agricultural commodity markets since they have no direct exposure to farm loans and farming community in India.

The Current Regulatory Framework

Banks' entry into commodity futures trading could turn out to be a risky proposition for several valid reasons. To begin with, the commodity futures market in India is still in its nascent stage of development and therefore the existing regulatory environment cannot handle the sudden entry of big financial players such as banks.

Unlike equity markets regulator, the commodity trade regulator (Forward Markets Commission – FMC) is toothless and has weak regulatory powers to ensure fair trading in commodity exchanges. The FMC does not have any statutory power for compulsory registration of traders and brokers which makes it difficult to monitor and supervise traders. There are plenty of instances where the FMC failed to curb malpractices (such as parallel illegal trading) and prevent excessive speculative activities which distorted the price discovery and hedging function of commodity future markets.

In addition, the existing penalty provisions are grossly inadequate and not in tune with current trading volume in the Indian commodity derivatives markets. It may sound astonishing that FMC — regulating billions of dollars worth of commodity trade — has no powers to directly impose a financial penalty on the traders. At present, only a maximum penalty of Rs.1000 ($18) can be imposed on traders by FMC, and that too through court orders on conviction. A financial penalty of mere Rs.1000 (enforced through lengthy court process) does not act as a deterrent for potential offenders in the commodity markets.

Under the Forward Contracts Regulation Amendment Bill (2010), the government has allowed FMC to impose financial penalties to a minimum of Rs.25000 ($450) and in some offences (such as insider trading) up to Rs.2500000 ($45000). The proposed Bill is still under discussion. Given the fact that FMC is unable to effectively monitor and supervise the existing non-financial players, it would require considerable time, resources and technical expertise to deal with the high trading volumes which the entry of banks into commodity trading would bring about.

The Lack of Domain Knowledge

By and large, Indian banks (both public and private) lack market knowledge and expertise to benefit from trading in commodity futures. The RBI has also expressed concern on the risks posed by domestic banks that lack expertise and skilled manpower to deal with such risky trading instruments.

As pointed out by G. Chandrasekhar, Commodities Editor, The Hindu Businessline, "Given the lack of product knowledge and market knowledge among Indian banks and given the huge volatility of commodity markets, these institutions run the risk of losing money rather than safeguard it. Policymakers have to exercise utmost caution in allowing huge speculative funds to flow into the commodities derivatives, especially agricultural goods."

The real beneficiaries of this move are likely to be big foreign banks who have a competitive edge over domestic banks in dealing with such businesses. Already foreign banks dominate the financial derivatives market in India. Most of these products are financial in nature with no actual bank lending involved. However, banks make money on these products through fee income. The off-balance-sheet exposure of foreign banks (e.g., currency forward contracts, interest rate derivatives) is currently very high in India. The off-balance-sheet exposure of foreign banks as proportion of their on-balance-sheet exposure was 1860 percent in 2010-11.

Inflationary Concerns

Even though there are various causes of high food inflation in India, the role of futures trading has remained contentious. In 2007, New Delhi had suspended the futures trading in key agricultural commodities due to their alleged role in triggering rapid price hike. "Participation of banks, MFs and FIIs can potentially distort the market instead of advancing it, as too much money would start chasing commodities in short supplies and result in inflation. By allowing more money to flow into commodity market, there is the danger of rising prices without corresponding benefits flowing back to those in the farm sector," argues Chandrasekhar.

Other Policy Issues

Furthermore, this policy change is contrary to the positions India has taken at various international forums. Not long ago, India's former Finance Minister, Pranab Mukherjee, voiced concern at G20 over the growing influence of "financialisation" behind the increase in the level and volatility of global oil prices.

At a time when the Indian banks are struggling to raise fresh capital of Rs.4750 bn ($88 bn) before March 2018 to meet the Basel III requirements besides fulfilling mandatory financial inclusion and priority lending targets, such a move could divert resources from developmental banking to speculative trading activities which may weaken the otherwise stable banking system in the long run. For New Delhi, the first priority should be to remove structural bottlenecks in the agrarian economy and improve efficiency of the underlying spot markets in cooperation with state governments.

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