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ET in the Classroom –
How Introduction of Options Will Affect Commodity Markets

Commodity exchanges MCX, NCDEX and NMCE will be allowed to offer trading on options, once market regulator Sebi releases the framework for the same in the middle of January 2017. This is likely to result in the probable entry of new participants into the space, which may transform the commodity markets

1. What are options and what do commodity exchanges offer now?

Options are an instrument that give the buyer a right to buy or sell an underlie at a pre-set price on a future date. They are of two types: calls (right to buy) and puts (right to sell).

Sellers of options receive money, called premiums, from buyers.

Currently, exchanges, such as MCX and NCDEX, offer futures on commodities, such as gold, silver, crude, edible oilseeds and oils, sugar and wheat. Futures also facilitate purchase or sale of an underlie at a pre-set price

2. What's the difference?

Futures are riskier than options as the holder of the contract has to settle mark-to-market obligations on a daily basis. MTM is the end of day difference between a contract's market price and that at which it was purchased or sold . So, if you bought a sugar futures for, say, `100 a lot and the end of day price was `102, your trading account will be credited by `2 . But if the contract closes at `98, your account would be debited by `2. The losses and profits are magnified because you didn't pay `100 but a certain percentage of that, typically 5-7% to buy or sell the contract. If you paid `7 and earned `2, that would be a profit-loss of almost 30%.

In an option also, the premium paid to a seller is actually a fraction of the contract's cost. The premium is usually lower than the margin charged for a futures contract. In the above instance, if you paid `7 for a future, you would pay `3-4 for an option. MTM settlement is not done daily so loss is limited to premium paid but profits are unlimited . However, options have another drawback that futures don't: for every day that you hold an option, its value reduces due to time decay.

3. What's the reason to launch options?

These markets were set up to benefit farmers, but in reality, very few, if any, farmers participate on the exchanges. Options will open a window for them if an entity like a bank, which lends to them, aggregates their produce and trades on their behalf. Since the cost to trade an option is lower than futures and the loss is limited, this can be a good hedging tool for farmers.

4. What's the sticking point ?

Sebi has to take a call on whether options should be cash settled or result in delivery, like most futures contracts. It must also decide whether options should be settled on futures price or devolve into futures, meaning it would have to expire before the futures contract does.

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