

# Better resource allocation through commodity futures markets

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# Presentation Structure

- The economic purpose
- A strategic picture for the commodity futures ecosystem
- Translating into tangible public administration

# The economic purpose



June

October  
*(Harvest)*

March  
*(Peak price)*

Decision:  
Land for  
p1 vs. p2

June

October  
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Decision:  
Storage for  
p1 vs. p2

Decision:  
Land for  
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Futures  
price

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Decision:  
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Decision:  
Land for  
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Futures  
price

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Decision:  
Storage for  
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Futures  
price

# Who makes these two decisions?

- Who allocates land (and labour and water and ...)?  
The farmer.
- Who allocates storage?  
The hoarders: Storage specialists or cash-and-carry arbitrageurs.



# The prime function of the futures price: To guide resource allocation

- These two impacts upon allocative decisions ride through *the price*
- This is visible in the newspaper
- Even if no farmer and no arbitrageur directly uses futures markets, their actions are shaped by them!
- The futures price is a public good

# Auxiliary functions

- Support risk management by farmers
- Support risk management by lenders.

# What do we require in order to achieve sound prices?

- ① *Speculative price discovery*: The price formation should be dominated by people who look into the future and speculate about what the price might be.
- ② *Arbitrage*: Pricing efficiency results when there is ample skill and capital doing frictionless arbitrage.

## Can we please leave some myths behind

- There is something bad if farmers are not using futures markets.
- There is something bad if the dominant use of futures markets are not hedgers.
- Hoarding is evil.
- Speculation is evil.
- Arbitrage is evil.
- There is something morally wrong when a speculator in Taiwan is trading in futures on Guar Gum that's made in Bikaner.

# A strategic picture

# Identifying and addressing the market failures

**Market abuse** Market abuse is the falsification of information emanating from the futures market about prices or liquidity.

**Micro-prudential regulation** Exchanges / clearinghouses must work correctly when taking in and giving out money or goods.

**Consumer protection** All users of the market should be entitled to certain protections; unsophisticated users should be entitled to more protection.

# How to achieve a liquid and efficient market?

- ① A government that identifies and addresses the three market failures.
- ② Low entry barriers through which speculators and arbitrageurs from all over the world can easily get started with participation.
- ③ Identify and repeal all rules/laws that interfere with the above.

## Building up organisational capital

- Speculation and arbitrage can be done by lone individuals
- It is done better by organised teams of individuals: Firms
- *What we require most in India is for formal, sophisticated firms that build up organisational capital.*
- Every ban kills organisational capital, and then we have to start all over again. Therefore: Do not ban things.



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- *What we require most in India is for formal, sophisticated firms that build up organisational capital.*
- Every ban kills organisational capital, and then we have to start all over again. Therefore: Do not ban things.
- How to create an environment where there is leaning-by-doing?
- How to create an environment where managers invest in IT systems, process maturation, and a complex web of contracts that interlink firms of various kinds?
- We must give owners and managers of firms a long-term perspective.
- They should have the confidence that they are in a stable business, where government will not shut them down or mess up their business.
- When the private sector anticipates weird actions by the government in the future, they will hold back on investment.

# Convergence between securities and commodities

- There are enormous economies of scale and scope between the mainstream securities business and one subset of it, the commodity futures business.
- Organisational capital will get built by harnessing the commonalities.
- Every sophisticated securities practitioner or firm is a potential commodity futures practitioner or firm.
- Towards this:
  - 1 Remove artificial barriers.
  - 2 Harmonise policy between SEBI and FMC
  - 3 Harmonise operations (standardise software, data formats) to reduce costs

# Internationalisation

With many agricultural commodities, India is one of the top producers or suppliers

The world price can be made on Indian commodity futures markets

# Applications

## Retail financial products

- ① An agricultural loan that bundles a futures contract
- ② A retail financial product that judiciously blends weather derivatives and commodity derivatives and debt.

## For government

- ① In most cases, society does not need the government to do agricultural risk management.
- ② If this has to be done, the lowest cost strategy is for the government to hold commodity derivatives.

# Translating into tangible public administration

## Setting: The existing FC(R)A

- We live in a world of the FC(R)A and not the Indian Financial Code.
- FCRA is not SCRA
- There is a real economy connection
- There are two levels of exchanges:
  - 1 Recognised Association
  - 2 Registered Association
- There are two kinds of commodities:
  - 1 Commodities that have been notified
  - 2 Other commodities

# Building FMC

- Re-work organisational design as per powers and functions under FC(R)A
- Implement regulatory governance principles from IFC and *FSLRC Handbook*

## Mandate: More powers, capacity

- 1 FMC should have additional regulatory powers
- 2 FC(R)A permits Central Government to delegate most powers to FMC - S.26, FC(R)A
- 3 Additional powers to be delegated:
  - Grant of recognition and registration
  - Superseding governing body of recognised associations
  - Withdrawal of recognition
- 4 Start building capacity - presently less than 80 staff



# Bound by Regulatory Governance Principles

Regulator is a “Mini-state” - requires clear demarcation of functions

- 1 Legislative function: process of making regulations
- 2 Executive functions: business permissions, inspections, investigations, prosecution
- 3 Judicial function: Suspension of members, withdrawing recognition

# Organisation Design - Structure

Legal functions/powers dictate organisation design

One function = one department:

- Regulation-making: Framing regulations to be approved by the Commission
- Supervision: Approvals, inspections and investigation
- Enforcement: Recommendations for prosecution, suspension orders, withdrawal of recognitions
- Information management: collection and collation of all information required to be collected

# Organisation Design - Accountability

- ① Performance measures against legal functions/powers to be clearly stated in rules
- ② Examples:
  - Regulation-making
    - Ex-post cost-benefit analysis as far as possible
    - Ex-post estimation of extent to which regulation addressed market failure
  - Business permissions and supervision
    - Time taken to process applications
  - Inspections and investigations
    - Number of inspections
    - Number of violations detected per inspection
    - Number of adjudicatory decisions on basis of investigative reports
- ③ Accountability measures also be clearly reflected in RFD of FMC

# Regulatory Governance

## Commission

- ① IFC mechanisms for selection and appointment of members - rules required
- ② One member with legal expertise to oversee only prosecution proceedings and judicial functions.
- ③ IFC mechanisms to be followed for all Board meetings.

## Legislative Functions

- ① Initiation and finalization of regulations at Board level.
- ② Effective public participation - IFC mechanisms for regulation-making.

# Regulatory Governance

## Executive Functions

- ① Business permissions
  - All conditions to be in regulations
  - All rejection of applications to be reasoned
  - All decisions to be time bound
- ② Inspections and investigations:
  - Duty of regulator to inspect based on risk and oversight
  - Recording of reason for special investigation
  - Requirement to keep investigation private
  - Legal member to sign off on furthering findings of investigation to appropriate authorities

# Regulatory Governance

## Judicial Functions

- 1 Judicial functions: Suspension/ withdrawal of recognition
  - Based on result of investigation process
  - Legal member on Commission to be supervisory authority signing off on all judicial matters
  - Affected party to be heard before final decision on prosecution
  - Detailed reasons to be recorded for final decision

## Outcome

- 1 FMC performs clear statutory functions effectively
- 2 Capacity and resources to match/exceed SEBI
- 3 Uses IFC principles on regulatory governance
- 4 Implements rule of law and prevents fraud and abuse

# Tangible steps

- Step 1: Fix procedures related to Board.
- Step 2: Frame detailed objectives and strategies for every function.
- Step 3: Re-engineer internal organization.
- Step 4: Strategic resourcing: Identify priorities, determine required capacity and existing strengths.
- Step 5: Simultaneously, frame and publish Handbook compliant internal bye-laws on:
  - Regulation-making;
  - Registration and recognition processes;
  - Issuing notices;
  - Investigations;
  - Collection of information;
  - Enforcement
- Step 6: Create staff performance measures.
- Step 7: Strengthen accountability through better reporting

## Step 1: FMC Board related procedures

Pass resolution to adopt IFC mechanisms for Board meetings (*inter alia*):

- Pre-publish detailed agenda of Board meeting along with decisions to be taken;
- Record and publish immediately after the meeting:
  - List of attendees;
  - Quorum;
  - Voting records.
  - Resolutions.
  - Legal instruments FMC will prepare pursuant to the Board meeting, if any.
- Release minutes within 6 weeks of meeting. Minutes to contain details of deliberations.



## Step 2: Framing Objectives and Strategy

- 2.1 Map functions from FC(R)A: Regulation-making, Supervision, Enforcement, Information management.
- 2.2 For each, FMC to define measurable objectives for short-term and long-term.
- 2.3 Identification of method by which FMC will achieve its objectives with resources, including measures to augment resources in short and long-term.

## Step 3: Re-engineer internal organization

- Internal organization has to follow legal mandate.
- Present organization: 9 Departments/Divisions
  - 2 Market Divisions
  - 1 Monitoring and surveillance division
  - 1 Intermediary division
  - 1 Planning and Co-ordination division
  - 1 IT division
  - 1 Legal Affairs Division
  - 1 Vigilance and enforcement division
  - 1 Administrative division

## Step 3: Re-engineer internal organization

- Many divisions do not flow from legal mandate
- Displays lack of clarity on organisational priorities.
- Re-organize as:
  - 1 Regulation - making division
  - 1 Supervision division
  - 1 Enforcement division (Prosecution + Adjudication)
  - 1 Information-gathering division
  - 1 Administrative division (include vigilance, IT, HR)
- Assess skills required within each division - starting point for assessing capacity requirements.

## Step 4: Strategic resourcing - Prioritise objectives

- 4.1 FMC, like any regulator, has multiple objectives to pursue - Trick is to prioritise and balance. For example,
  - Increasing information collected may be a long-term objective
  - Has to be balanced in short-term with necessity to investigate complaints and regulation-making.FMC Board has to decide what functions to prioritise.
- 4.2 Determine kinds of skills required: legal drafting, record keeping, market research, data management etc.

## Step 4: Strategic resourcing - Measure strengths

- 4.3 Measure skill sets and strengths of existing staff.
  - Current workforce is 80.
  - Identify, on a per-person basis, skills and strengths of existing staff.
- 4.4 Assess gap between skills and capacity required and existing skills and capacity.
- 4.5 Augment capacity - Develop independent hiring policies.
- 4.6 Incorporate strategic workforce planning practices.

## Step 4: Strategic resourcing - Augment capacity

- Other regulators do it - U.S. Commodity Futures Trading Commission (65,370 registrants)
  - No. of employees: 435 (FY 2006)
  - Expected usage of staff-years: 710 (FY 2012)
  - Requested budget to cover 1015 staff years. (FY 2013)
- FMC should also compute capacity required in terms of man-hours.

## Step 5: Frame Handbook compliant bye-laws

- Internal bye-laws set internal rule of law.
- Regulator becomes transparent, predictable, by minimising discretion.
- **5.1 Regulation-making:** Board should pass resolution adopting IFC regulation-making process for regulations, guidelines, bye-law approvals.
- **5.2 Transparency:** Board should pass resolution stating all past and present regulations, and also all records of Board meetings to be published on FMC website.
- **5.3 Other bye-laws/internal manuals:** FMC Board should approve the following manuals:

## Step 5: Frame Handbook compliant bye-laws

- *Notices*: Incorporate IFC provisions on circumstances and types of notices, and minimum content of notices.
- *Investigations*: Incorporate IFC provisions on prior notice before investigations (with exceptions), information that can be sought etc. e.g. SEC has detailed enforcement manual also covering investigative procedures.
- *Enforcement*: Incorporate IFC provisions on administrative law members, decision orders, information-sharing obligations, and proportionality while imposing penalties.
- *Information collection*: Incorporate IFC provisions on how information should be collected, what information may be collected, confidentiality obligations, etc.



## Step 6: Staff Performance measures

- How to incentivise performance while increasing accountability.
- FMC should have power to hire independently and set individual goals in line with its own objectives.
- This will give FMC flexibility to hire the best talent and ensure that employees aid FMC in meeting its objectives.

## Step 7: Reporting

- Reporting should measure performance against defined objectives
- MoF should write reporting rules as per IFC
- FMC Board should mandate that staff collect performance data on ongoing basis
  - Data/ knowledge management systems should enable easy aggregation and extraction of data

# Conclusion

- The futures market is essential to sound allocation of scarce resources in production and in storage.
- This shapes a strategic picture about how we create an efficient commodity futures ecosystem.
- The tangible tool for achieving these objectives is : A properly structured Forward Markets Commission with the right:
  - Organisation chart
  - Process manuals
  - Staff training.
- We can go 75% of the way without requiring the IFC enacted as law, by voluntarily living by the IFC.

# Thank you