

Looking into futures

By Samir Ahmed

What prices are going to be in the future? This million-dollar question, for ages, has bugged growers, producers and consumers in the same way. The proposition is not just of academic interest, but also of real economic value as ups and downs in asset and commodity prices play a cardinal role in keeping a business afloat or running it aground.

The uncertainty associated with future prices is a fundamental risk that all enterprises have to face and deal with. Just as this problem has been in existence since the advent of trading in the history of mankind, we also know of measures to counter risks attached to it. These measures, which have examples even from biblical times, are essentially the same as practiced today in the increasingly sophisticated world of modern trade and finance: agreeing and locking-in a price today of a commodity to be bought or sold at some time later. This concept is the essence of price hedging where anyone exposed to changing prices can lock in future prices, now, and protect from uncertainty and volatility. It is also termed as 'price hedging'.

The interchangeable terms of forwards and futures represent the same transaction as the one described above. (Technically speaking, futures are traded on exchanges and the same transaction when concluded between two parties directly is termed as a forward). Essentially, all higher order derivatives like swaps, options, and combinations of these are aimed at reducing uncertainty and hedging price movements.

Of all types of derivatives, futures and forwards are the most basic and simple. Even before the establishment of Pakistan's first futures exchange, forward hedging had been practiced by participants in various commodities. While often unregulated, they have nevertheless evolved their own trading protocols so as to protect future prices. We still see active examples of these transactions in sugar and cottonseed oilcake among many other commodities.

The primary purpose of commodity price hedging for a grower is to know at what price he will be able to sell his crop so that he can ascertain his return given his input cost. Same principle applies to any consumer of a commodity who is exposed to rising prices and may wish to lock-in his purchase price ahead of time so that he can better plan his consumption or business investment. Generally speaking, producer of a commodity hates falling prices in the same way a consumer abhors to see them rising. In trading terminology, the producer is referred to someone having a long position and the consumer is the one who has a short position. If both of them can agree with each other on a future date and price when the commodity will be ready for delivery, they will be able to offset their price risk. While this represents a very clean and perfect way to manage price risk, it has some practical problems when implementing in reality. And that is where the benefits of futures trading on exchange come in.

Every time two parties enter into a transaction, they face multiple risks. These include non-delivery of payment or asset, defects in the underlying asset or differences in quality

and issues of legal title. Most of these risks are classified under the heading of credit risk. Market participants normally counter these risks by trading with selected parties where they have built a good track record over a series of transactions. Often strong parties are in a position where they can exploit weaker parties on terms of trade and prices. While these risks are minimal in spot markets -- where both parties transact for immediate delivery and payment -- in forward transactions the risks become larger. It is inevitable that in a forward transaction, one party will be at a loss and the other will be in profit when the final time of settlement arrives. This leads to a huge incentive for one party to renege on the contract and lead to default. However, if all these transactions were done through a central, neutral authority which takes upon itself the task of ensuring settlement then most of these risks can be eliminated. Such a third party in forward trading is actually called a Futures Exchange. While essentially the transaction is the same as that entered into by two parties on their own, the mode of trading and fulfilling obligations is different. Both parties agree to the rules of the independent third party as the arbiter and regulator of trades between them. The Exchange guarantees financial settlement of all trades and in order to discharge this responsibility, employs a multi-faceted risk management scheme.

The difference between exchange and bilateral trading is the elimination of counterparty settlement risk as well as the assurance of minimum standards of quality for the delivered commodity. As the exchange is a centralised place for trading, a large number of participants can take part where strong and weak counterparties are treated equally thereby enhancing the efficiency of the marketplace. Exchange based futures trading is a tried and tested mode of price hedging, which has been in operation for over 150 years around the world and has proven its effectiveness for the improvement of market infrastructure.

Pakistan Mercantile Exchange (PMEX) is the country's only futures exchange and is striving to play its part in the reformation of commodity markets. Change will be gradual as most current practices are well entrenched over generations, but the path is clear: modern and reformed modes of hedging on the exchange will eventually lead to better price efficiency for all participants. The long journey on the path of overhauling the country's antiquated commodity market infrastructure has begun and 'futures hedging' is one part of this commodities' ecosystem. Slowly but surely, the success of futures trading on the exchange will result in efficient sowing, harvesting, investing and planning decisions by stakeholders.

The writer is CEO of Pakistan Mercantile Exchange Ltd.

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