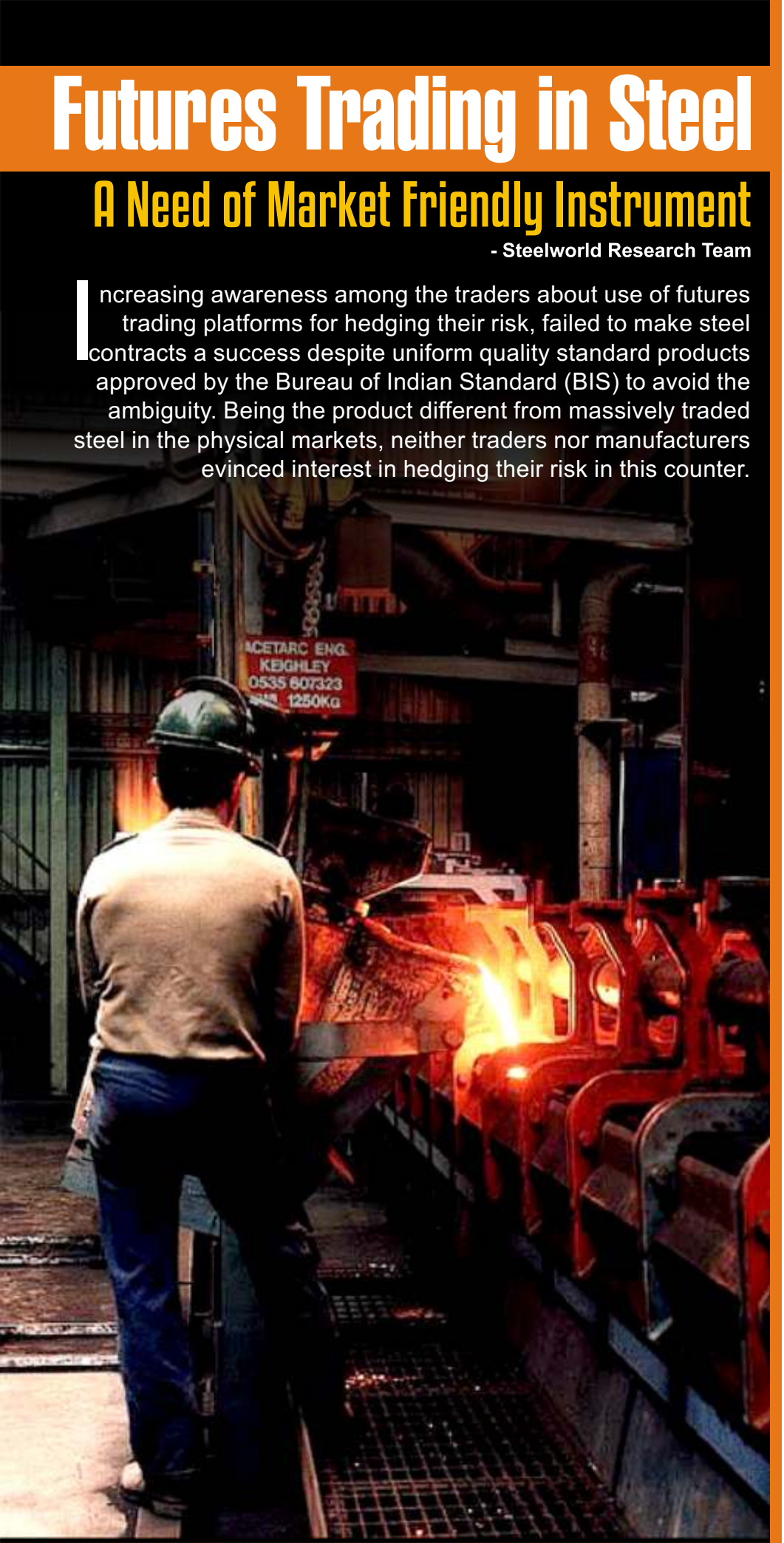
Futures Trading in Steel

A Need of Market Friendly Instrument

- Steelworld Research Team

Increasing awareness among the traders about use of futures trading platforms for hedging their risk, failed to make steel contracts a success despite uniform quality standard products approved by the Bureau of Indian Standard (BIS) to avoid the ambiguity. Being the product different from massively traded steel in the physical markets, neither traders nor manufacturers evinced interest in hedging their risk in this counter.



Contract Availability

After about two years of suspension, both Multi Commodity Exchange (MCX) and National Commodity & Derivatives Exchanged (NCDEX) introduced mild steel / billet contracts on their platforms in November 2013. Since then, virtually no click took place either on MCX and NCDEX. Interestingly, the contract was highly liquid with some corporate participation was seen before suspension. Traders remained totally absent from this contract. According to Ashok Mittal, CEO of Emkay Commotrade, a Mumbai based commodity broking firm, the quality of the mild steel / billet though adhering to BIS specifications yet not friendly to spot market. Currently, NCDEX is offering trade in steel contracts for forward months.

The new steel long contract launched by the exchange is based on BIS 2830 grade. With the production of billets and ingots expected to converge to the BIS 2830 grade in the main and secondary steel sectors, the contract will aid the price discovery and facilitate hedging amongst the entire steel production chain. It will also facilitate the migration of the secondary steel sector towards early adoption and production of BIS 2830 grade. Deliverable at seven key steel production/consumption centres across India, the contract would help the producers and consumers to lock into a forward price with the added benefit of the counter party risk mitigation provided by the exchange. NCDEX would also facilitate the physical delivery of steel at exchange approved warehouses. The contract provides flexibility for settlement of the trade either through direct delivery or from the approved warehouses of the bourse and the prices under the contract would be discovered locally.

The contract Steel Long IS 2830 has the base centre at Mandi Gobindgarh with delivery centres at Mandi Gobindgard, Ghaziabad, Mumbai, Raipur, Hyderabad, Jaipur and Kolkatta. It will follow a warehousing model plus direct delivery mechanism. For the contract, the direct delivery mechanism will help traders bypass the warehousing mechanism and thus reduce the various costs associated with storage and logistics. Clearing and settlement of contracts will commence with the commencement of Tender Period by compulsory delivery of each open position tendered by the seller on T + 2 to the corresponding buyer matched by the process put in place by the Exchange. Upon the expiry of the contract all the outstanding open position shall result in compulsory delivery. Earlier, NCDEX had a steel long futures contract which was discontinued due to insistence of BIS mark and related issues.

MCX Suspends Trading

The Multi Commodity Exchange (MCX), India's largest commodity derivatives trading platform, has decided to withdraw Mild Steel / Billets contract from its platform April 2014 onwards due to the lack of liquidity. Launched on December 9, 2013 for the current year, Mild Steel / Billets contracts failed to attract traders' attention due to difference in the quality largely traded in spot market and approved specifications by the Bureau of Indian Standards (BIS). Mild Steel / billets shall not be made available for trading from April 2014 futures contract onwards. Further contracts shall be made available for trading by the exchange with due notice, an exchange official said. Interestingly, Mild Steel / Billets contracts were very liquid until August 2012 on the National Commodity & Derivatives Exchange (NCDEX) which was offering trading in non-BIS standard of steel. But, in September 2012, BIS introduced quality specification and ordered commodity exchanges to adhere to the same. The quality introduced by BIS is neither produced by any steel mills, nor traded. Hence, this quality steel differs from the popular steel traded in spot market. This is the reason for traders' lack of interest in steel contracts. Traders on the MCX will have options to square off position in the two live forward month contracts i.e. February 2014 and March 2014. Contracts thereafter will not be available. "There was no trading interest on Mild Steel / Billet contracts despite being the quality of traded steel adhering to the BIS. Hence, we decided to discontinue the contract for paying attention on the liquid contracts," said the official.

Quality - A Matter of Concern

There are thousands of types of steel products available in India. Quality of steel varies depending upon product mix used at the time of manufacturing. Even small variation in the raw material mix, changes the quality of steel.

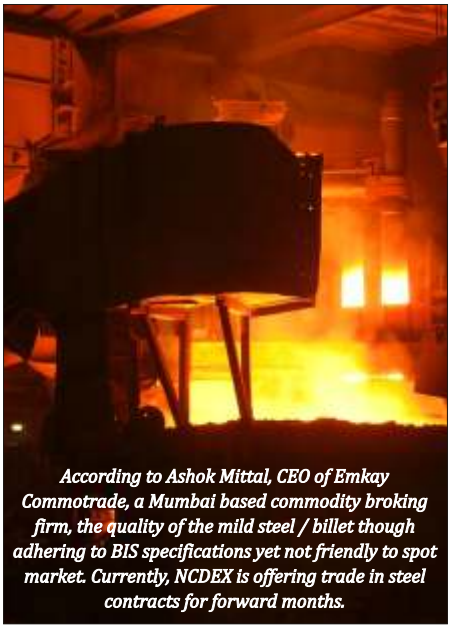
Hence, every lot of steel and its products has a change in its specification depending upon the requirement of customers. Neither the government nor the industry has set any uniform standard of steel for mass consumption. "This is the reason why the standard introduced by the BIS for futures trading was unsuccessful," said a trader.

"But, products should remain available for the markets to adapt. Even for a opportunistic trading or one spot trading for a diverse mix for traders would bring high liquidity in steel contracts," said Ramesh Iyer, product – head (Steel) at NCDEX.

Way back in March 2005, NCDEX was first in the world to launch futures contract in steel. However, the contract had to be discontinued after the government's body Bureau of Indian Standards (BIS) mandated steel quality norms last year.

A True Mechanism for Price Discovery

India is a leading producer of steel with a production of 90 mn tons per annum and targeting 142.3 mn tons by 2017 as per 12 Five Year Plan target. However, analysts point out that the target may not be achievable due to the slowdown being faced in the industry as many leading players have deferred their expansion plans. India's steel capacity addition has slowed down due to various reasons such as procedural delays in Greenfield and brownfield projects, environmental clearances, land allocation, securing raw material linkages etc.



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Unveiling the new contract, JSW Steel Ltd Joint Managing Director and Group CFO Seshagiri Rao said "The steel futures introduced by NCDEX will help all stakeholders in the industry. We will be happy to use this platform for price discovery and hedging." There is a huge scope for industry to benefit from this futures trading platform as the government aims to raise the country's steel production to 300 million tonnes in the years come. Presently, India produces 80-90 million tonnes, against the capacity of 100 million tonnes, he added. Echoing views, JSPL Steel Deputy Managing Director and CEO V R Sharma said that such a platform was very essential for the industry for discovering the right price. Currently, the country manufactures 36 million tonnes of steel long.

Why is it Needed ?

Futures contracts are needed as a financial risk management tool that enable companies to hedge their price risk exposure by agreeing to buy or sell a particular volume of product for delivery on a fixed future date at a price agreed today. Markets have different forms of risk, and while some participants wish to avoid risk, others deliberately want to a acquire it. The risks depend in part on the market for example; interest rates rising and falling, currency rates changing, fluctuations in equity prices, raw material prices changing, energy costs fluctuating, etc. Futures contracts are exchange-traded risk products that hedge the risk levels. Other risk management tools, such as forward contracts or swaps may, and have historically been offered by individual companies.

A futures contract provides an understanding of price risk and a mechanism to reduce it. Many steel mills already hedge currencies and energy sources, whilst others just hedge some or all of their raw materials purchases, such as zinc, tin or nickel. The possibility of hedging would be open to all in the industry - mills, traders, stockists and end-users. One definition of hedging is "The offsetting of perceived risk in one market by the deliberate assumption of an equal and opposite risk in another market"

The exchange expects trading of atleast one per cent of the total output on its platform by next year, thereby improving its total trading volumes.

Trading on Global Exchanges

The London Metal Exchange launched steel futures contracts in April 2008, trading billet in the Far East and the Mediterranean region. These were merged into a single global billet futures contract in July 2010. The New York Mercantile Exchange (NYMEX) division of CME Group began trading hot rolled coil futures in October 2008. The contract is settled financially against a published price for the US Midwestern market. The Shanghai Futures Exchange began trading futures contracts in Chinese rebar and wire rod in April 2009. As a consequence of its unique price collection and calculation processes, The Steel Index provides independent, accurate and fully verifiable weekly steel reference prices that can be used as the settlement prices for financially-settled steel futures contracts or other Over-The-Counter (OTC) forward price risk management products.

Advantages

Through futures trading, price risk exposure can be managed and controlled. Transparent prices will facilitate external and internal negotiations with other market influencers, such as unions and governments. Futures contracts increase price transparency. As they are traded on an open exchange and acknowledged as the most transparent price, there is no one market maker (in theory) who can influence the price. The Experience in

other markets (e.g. oil and aluminium) shows that there is a high correlation between spot prices of different related products. In the case of steel products this could mean that a futures contract for one product, e.g. HRC could be used as a reference quotation price for other products such as cold rolled coil or slabs with a premium or discount. For similar reasons, the management of raw materials relationships could also be made easier – e.g. iron ore contracts could be linked to the price for HRC on an exchange; hence protecting margins. Decision making on capital investment can be more objective. Knowing the future revenue streams – say for a period ultimately up to five years ahead means that producers should be able to better plan capacity. Such planning and more certain cash flows should also reduce the cost of borrowing or capital.

Banks charge higher interest rates for businesses which they view as being more risky. If a producer can show that his future cash flow risks are less with a hedge of futures contracts, a bank is likely to lend cheaper money, or in some cases even to lend money when previously it would not. In addition, smaller companies who currently cannot borrow could be able to by use of steel futures. A risk management tool such as futures contracts would, therefore, is healthy for the industry by potentially increasing the capital available and also reducing the cost of capital and thus improving profitability.

In certain industries the introduction of a futures contract has increased the opportunity for sector/specialist consolidation. This is because the open exchange price and related transfer pricing (e.g. a premium between CRC and HRC) make vertically integrated businesses less risky. Additionally the open exchange price allows the whole industry to share the risk. Thus if steel futures are a success we could see some companies becoming specialist slab or billet producers, as others strengthen their downstream operations. It will therefore be easier for companies to specialize in what they are good at.

Disadvantages

If companies do not use futures contracts, i.e. there is a lack of liquidity or traction in the market the concept will simply fail. However, the underlying asset value of the global steel industry is large – estimated by some people as being $440bn, compared with about $130bn for the base and precious metals industry. Plus the annual turnover of the steel industry is massive; between $200bn and $300bn. Thus it is likely that liquidity will develop, but not certain. There is a fear that too few steel companies would use a futures' market. In this case, could some traders corner the market? – in theory, yes. But if the contract is appropriately structured, and the exchange is well regulated this is unlikely. This is possible if there is speculation or too little liquidity. Cornering the market could lift the futures price, and leave the spot market behind.

Conclusion

While future trading is needed for hedging risk of producers, traders and users, the contract available on futures platforms should be market friendly to attract liquidity. Uniform standardization in the production will take some time for traders and users to adapt, the futures platform will be used by all types of participants sooner or later.