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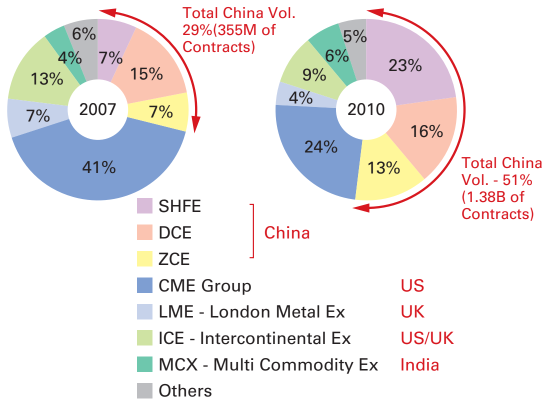
Chinese commodity futures markets' promising future

Nomura Research Institute, Ltd.

In 2010, China was the world's top-ranked commodity derivatives market by trading volume, although volume has since decreased drastically in response to a series of guidelines issued in November 2010 by the State Council in the aim of curbing frenzied speculation. Nonetheless, the recent authorization of investment advisory services and ongoing discussions about legalizing CTA and offshore brokerage services hold promise for the market.

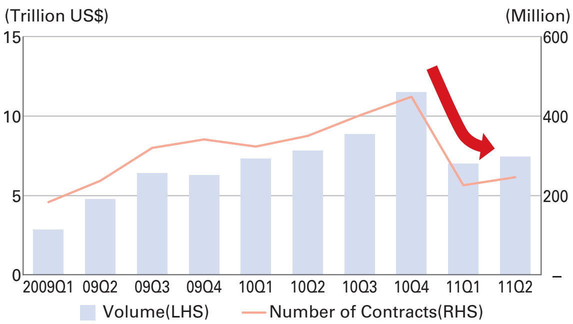
China being the world's largest exporter and second-largest importer, its commodity futures markets are rapidly growing to meet the needs of its industries that are closely related to commodities consumptions and trading. While China earned the title of the world's largest commodity derivatives market in 2010 (Exhibit 1), regulators tightened regulation of the market in November 2010 out of concern about rampant speculation. In response, trading volume fell some 50% in the first quarter of 2011 (Exhibit 2).

Exhibit.1 Global Commodity Derivatives Market Overview



Note: Global top 20 exchanges. Based on number of contracts.
Source: NRI America, based on Futures Industry Association Annual Volume Survey

Exhibit.2 China's Commodity Futures Market



Source: NRI America, based on SHFE, DCE, and ZCE data

Better off under tighter regulation

Commodity futures trading in China dates back to 1990, when the Zhengzhou Commodity Exchange[1)] (ZCE) was launched. Within a few years, 38 exchanges had sprung up. They collectively offered some 50 products traded by around 500 futures brokers subject to little regulatory oversight. The resultant redundancy and misallocation of resources prompted regulators[2)] to engineer a massive wave of consolidation and restructuring through 1998. Today only three commodity exchanges remain: the Shanghai Futures Exchange (SHFE), Dalian Commodity Exchange (DCE) and ZCE. The SHFE is predominantly a metals futures exchange while the DCE and ZCE mainly offer agricultural commodity futures. Industry consolidation ultimately reduced the population of futures brokers to around 100 and the number of tradable products to six. These numbers have since increased to 163[3)] and 25, respectively, as of August 2011. Market participants are mostly corporates (commercial hedgers), retail investors and underground hedge funds[4)] (speculators/arbitrageurs).

In 2010, commodity trading activity intensified. Surging prices and heightened volatility alerted regulators to commodity speculation's potential risks to producer and user industries. Since November 2010, the regulators have responded with a series of measures to tame commodity futures markets, drive out hot money and restore the markets' price discovery function.

Measures to deter short-term trading

Exchange commissions were increased for most products. Commission rebates from exchanges and discounted commission rates for day traders were discontinued. To stimulate trading activity, exchanges had been rebating commissions to futures brokers with the most trading volume. Brokers in turn reduced their commission rates to attract more volume. Such arrangements indirectly encouraged short-term trading and led to unhealthy price competition in recent years.

Measures to curb retail speculation

Margin requirements for most products were increased to 10-12% from 5-7% previously. Contract size will be increased to RMB200,000-300,000 per contract. These measures are intended to reduce market liquidity and curb speculation. For instance, the fuel futures contract size was increased from 10mt to 50mt. In the global market, by contrast, the trend is moving in the opposite direction. The London Metal Exchange (LME) and Singapore Exchange (SGX) recently co-developed new 5mt contracts for copper, aluminum and zinc. The new contracts are smaller than the LME's standard 25mt contracts and therefore make the market accessible to a wider range of investors.

New services should revitalize the futures industry

Despite this recent regulatory clampdown, the commodity futures industry is rolling out promising new services.

Investment advisory services, legalized by the China Securities Regulatory Commission (CSRC) in May 2011, allow futures brokers to differentiate themselves by providing risk management consulting, customized research, and hedging solutions, mainly to corporate customers. As of August 2011, 14 large futures brokers had already obtained investment advisory licenses. The authorization of investment advisory services will diversify futures brokers' revenue sources away from simple broking. Regulators, together with industry organizations, are organizing training programs and qualification examinations to prepare professionals to be investment advisors.

In the eyes of industry insiders, investment advisory services presage the advent of **commodity trading advisors (CTA)** in China. Unlike in Western countries, where CTAs are asset managers specializing in commodities derivatives trading, Chinese CTAs will be futures brokers that manage commodity investment funds. Given the risk of hot money inflows causing needless market volatility, allowing retail investors to invest in CTA funds may dampen speculation in Chinese commodity futures markets. Details are still under discussion but the CSRC is already conducting a feasibility study. Meanwhile, the China Futures Association and three exchanges are working to educate futures brokers and investors in preparation for increasing future demand for advisory services.

Another topic related to Chinese commodity futures markets is **offshore brokerage services**, which would offer domestic investors access to global commodity markets. Regulators, however, are hesitant to grant such access out of fear of increased cross-border currency flows and risks posed to still immature domestic commodity futures markets. Domestic corporates currently have access to only the 25 listed futures contracts available in China. Hedging of overseas exposures is therefore still beyond their reach. To participate in global commodities market, a domestic corporation must obtain a license[5] from the State Council or set up a subsidiary in Hong Kong. Institutional investors are still prohibited from trading commodity derivatives domestically or offshore, with the exception of six QDII[6] funds recently approved by the CSRC. These QDII funds are permitted to invest in overseas commodity derivative funds. Many expect offshore brokerage services to be legalized to meet domestic investors' substantial trading needs. As of August 2011, however, regulators have yet to take any concrete steps to do so. Concerned parties are anxiously awaiting the regulators' next move.

In light of regulators' cautious approach to promoting the sound development of the commodity futures market, we anticipate the advent of a well-built platform offering a broad range of products and services.

(Abstract by Hidenori Sueyoshi)

Note

1) Originally named the Zhengzhou Grain Wholesale Market.

2) The CSRC has been approving new products and brokers every year.

3) Most commodity futures brokers are backed by domestic securities brokers or nonfinancial corporations. Only three are joint ventures between foreign and domestic brokers: JPMorgan Futures (JP Morgan), CiticNewedge Futures (Newedge), and Galaxy Futures (RBS).

4) Unregulated investment companies that serve high-net-worth individuals.

5) As of August 2011, 31 state-owned enterprises had been granted licenses.

6) A QDII (Qualified Domestic Institutional Investor) is an institutional investor permitted by the CSRC to invest in foreign securities.

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