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**Lunch presentation: The potential role of commodity
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**The development of commodity derivatives
markets in Africa**

CONTRIBUTION

from

The Government of Kenya

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THE ROLE OF COMMODITY EXCHANGE AND INTEGRITY OF CONTRACTS IN THE GLOBAL VALUE CHAIN

A commodities exchange is an entity, usually an incorporated non-profit entity with some responsibility for regulation of its members (self-regulatory organization), that: determines and enforces rules and procedures for the trading of commodities (in the spot market) and where applicable related derivatives commodity trading, such as commodity futures. Commodities exchange also refers to the physical center where commodity trading takes place.

- ❖ Example of a commodity spot contract: a maize producer agrees to a sale of a specified amount of maize at an agreed price to a maize miller for cash settlement within two days.
- ❖ Example of a commodity future contract: a maize producer could purchase maize futures on a commodity exchange to lock in a price for a sale of a specified amount of maize at a future date, while at the same time a speculator could buy and sell maize futures with the hope of profiting from future changes in maize prices.

As stipulated in the Capital Markets Master Plan (CMMP), Kenya's financial markets have reached the level of sophistication from which it can move to the next stage with the introduction of derivative markets (both financial and commodity derivatives).

Kenya can develop active agricultural and minerals derivative products but, first, Kenya needs to improve the spot markets for agricultural products which would improve prices for farmers and improve food security. Within the lifetime of the Capital Markets Master Plan, there may also be opportunities to create markets (both spot and derivative) in the products of mining and in power.

The CMMP also recommends the identification of products where Kenya has the opportunity to be an international price formation center (as palm oil is in Malaysia). It recommends that a study be undertaken where Kenya has such an opportunity to be the international price formation center (e.g. Coffee could be a candidate).

The CMMP notes that commodities markets in Kenya presently consist of the Mombasa Tea Auction and the Nairobi Coffee Exchange. It is observed that these markets, however, operate

as private clubs and information on the market prices achieved do not reach farmers on account of the opaque marketing systems that characterize both markets. It is suggested that there is clearly a need for more open, efficient and adequately regulated commodities markets covering a wider range of products.

Warehouse receipt system (WRS) and spot commodities exchange for agricultural products and metals is recommended. The development of a WRS, combined with an organized market in which to trade them can provide huge benefits, including mobilizing credit for agriculture, smoothing market prices, improving food security, and improving the market power of small producers.

Warehouse receipts system and financing has the potential to improve the supply of rural finance by directly easing collateral constraints and simultaneously enhancing the risk profile of farmers by fostering improvements in output markets that can lead to higher farm incomes. The system revolves around warehouse receipts (WRs), which are issued as evidence that specified commodities of stated quantity and quality have been deposited at particular locations by named depositors. The WRs may be issued to farmers, traders, exporters, or processors as well as individuals or corporate bodies. Warehouse operators or collateral managers, who issue the WRs, guarantee that a bona fide holder of the receipt can take delivery of the underlying commodity. They further warrant that they can make good any value lost through theft or damage by fire and other catastrophes – this is often underpinned by insurance. The guarantee is critical to the credibility of the WR system as it allows for the receipt to be pledged or transferred to trade counterparties.

The CMMP further suggested that the required infrastructure (warehousing and market place) can be provided by Government, donors, private initiatives or a combination of these. Most important at this stage is to provide a facilitative environment.

These spot markets, which would provide accurate price signals, are also essential for the development of associated commodity derivative markets, which add important opportunities to producers and consumers to hedge their exposure to often volatile prices.

The CMMP made the following recommendations in respect of spot commodities exchanges -

- (i) Promote WRS schemes across the country. Trading of warehouse receipts, which are financial instruments, needs quality regulation, just like any other market. The CMA is best placed to become this regulator due to the skills it has and its experience in regulating other markets.
- (ii) CMA to be appointed regulator for spot commodity markets.
- (iii) The necessary rules and regulations to allow for the development of spot commodity exchanges should be provided.
- (iv) Develop a commodity derivatives exchange for the commodities traded in spot commodities market.

Regulatory Risk Management - key component to transparency and integrity of commodity exchanges:

While managing the risks of commodities exchanges, regulators focus on the following key regulatory aspects (Mezui & al, 2013);

- I. Market integrity regulation: to ensure that the prices on the exchange properly reflect the supply and demand conditions of the underlying physical (or asset) markets.
- II. Prudential regulation: to ensure that commodity exchanges and the other parties that form part of the exchange system (brokers, clearing banks, etc.) are financially sound and able to meet their market obligations. This includes capital rules, internal controls, qualifications of key staff, inspections, etc. The regulatory process should also provide the regulator with information necessary to identify potential problems early on.
- III. Business conduct regulations: to protect consumers, especially retail clients. This includes risk disclosures, staff training requirements, etc.
- IV. Market stability protection: ensuring that commodity exchanges and related parties do not cause a systemic risk for the rest of the economy. The exchange regulator may share this responsibility with the Central Bank.
- V. Business growth; Growth and development of commodity exchanges, including by promoting innovation, permitting new markets to develop, and representing the interests of the exchanges and their stakeholders towards other parts of the government. This requires the regulator to be responsive, and its regulation has to be appropriate