Option Contract in Gold: A New Investment Mechanism in Indian Commodity Market

* Prof. (Dr.) Raju Agrawal

Abstract

A Gold future is simply a deal to trade gold at terms (i.e. amounts and prices) decided now, but with a settlement day in the future. That means you don't have to pay up just yet (at least not in full) and the seller doesn't need to deliver you any gold. The settlement day is the when the actual exchange takes place- i.e. when the buyer pays, and the seller delivers the gold. Its usually up to 3 months ahead. Largest commodity bourse Multi-Commodity Exchange of India Ltd (MCX) launched India's first commodity options in gold. It was launched by Union Finance Minister Arun Jaitley. The gold futures contract will have bi-monthly duration. The option will also have the existing gold kilo futures contract as its underlie.

Options in Gold

Options are an instrument that gives buyer right to buy or sell an underlined at present price on a future date. They are of two types: puts (right to sell) and calls (right to buy). According to market experts, options are also a much better hedging instrument as compared to futures for hedgers.

The launch of gold options is one of the major reforms SEBI has taken for the commodity derivatives market. Earlier in June 2017, SEBI had allowed options trading in commodities to deepen the market but permitted each exchange to launch options on futures of only one commodity initially. SEBI is going to put strict eligibility criteria and options could be launched on futures contract of only those commodities that are among the top five in terms of total trading turnover value of previous 12 months. It also has stipulated necessary guidelines with regard to the product design and risk management framework to be adopted for trading in options on commodity futures.

Features of Gold Options

1. MCX's Gold Option contract is European-styled Gold options with Gold (1 Kg) futures as underlying asset.

2. These options are hedge-friendly and physically settled. It means that on exercise at expiration options position develops into corresponding underlying MCX 1 KG Gold futures position at strike price of exercised options.
3. The options product is unique and first of its kind which gives buyers right to buy or sell underlying asset but no obligation, at a specified price at expiry. Thus, for buyers, risk is limited only to premium paid to option seller (i.e. Option writer)

The launch of commodity options in gold denotes one of most significant reform measures since modern commodity derivatives trading started in 2003. It will give stakeholders new set of financial instruments to hedge their price risks. Moreover, introduction of options gives strong impetus towards systematic development and transformation of commodity derivatives market in India, ushering in new era in price risk management in response to stakeholder expectations.

*** Director**
S. S. Jain Subodh Management Institute
Jaipur (Rajasthan)

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