Exchange Traded Forwards - Counterparty Risk

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Agreements and promises not backed by a regulatory or legal authority have a huge element of counterparty default risk and will always remain susceptible to nature's vagaries.

Forward Contracts, in giving or taking supply of a particular crop after a specified period, is also open to risks. Therein lies the critical importance of the authority and regulation of an exchange.

Sharp fluctuations in commodity prices can play havoc with incomes of individuals, profitability of companies & economies of a nation.

Long term Supply Contracts have been a time tested method. Though Forward Contracts help the two concerned parties lock in prices, yet a risk of any one of the sides defaulting remains to be addressed.

Off-market deals that are negotiated bilaterally, without the authority of a regulatory framework to penalise a defaulting party, has a higher risk of resulting in counterparty default.

The unorganised & fragmented structure of the physical market amplifies its possible occurrence, magnifying its impact in the physical market transactions.

NCDEX, India's leading exchange for agricultural commodities, has introduced Exchange Traded Forwards, which takes away the critical counterparty risk and defaults to a large extent by its margins mechanism and by providing its risk management services to the trading parties. In the event of a counterparty default, the participant is assured of a compensation guarantee to the extent of margin collected.

A participant makes an Initial Margin at the time of making a trade. Then, there is an Incremental Margin, similar to Exposure Margin that's charged in Futures Trading, to cover risks that may arise from unusual fluctuations in commodity prices.

If the participant fails to pay the Incremental Margin call, he is given two days grace time. If he is still unable to pay, the trade is deemed to be cancelled and the margin blocked amount is forfeited. Ninety percent of such amount collected from the defaulting party is paid as compensation to the counterparty and 10 percent is retained by the Exchange.

In addition, NCDEX provides arbitration services to settle any dispute arising out of or pertaining to its trades as per its bye-laws and regulations. Exchange Traded Forwards have potential to streamline highly fragmented physical market and enhance the confidence of traders.

The NCDEX Edge: • Reduction of Bilateral Agreement Risks • Flexible Contracts • Reduced Operating Costs • Access to National Market Place

<table>
<tr><th colspan="2">Initial Margin</th></tr>
<tr><th>Fixed Price Contract</th><th>Reference Price Contract</th></tr>
<tr><td>Up to 30 days – 7.5% of trade value each on buy side and sell side</td><td rowspan="2">5% of the trade value determined based on the Trade Price and Basis Price</td></tr>
<tr><td>30-60 days – 10% of trade value each on buy side and sell side</td></tr>
<tr><th colspan="2">Incremental Margin</th></tr>
<tr><th>Fixed Price Contract</th><th>Reference Price Contract</th></tr>
<tr><td>The Exchange shall intimate the Incremental Margins to be brought in on the outstanding obligations, based on the volatility and at a frequency determined by the Exchange.</td><td>It is recomputed every Monday and the Exchange would make a call for Incremental Margin based on price movement. In case the Linked Futures price has moved more than 3% from the day of trade, Incremental Margin would be recomputed earlier than the next Monday and if required, at greater frequency intervals.</td></tr>
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