SPOT Commodities FAQ's

Frequently Asked Questions of the Spot Commodities Market in Kenya

CAPITAL MARKETS AUTHORITY

Promoting the Integrity and Growth of the Capital Markets

BACKGROUND

In view of the challenges faced by smallholder farmers, especially due to existing value chain inefficiencies, the Government of Kenya embarked on an initiative to establish structured commodities trading in Kenya. Structured commodities trading is characterized by the development of a robust Warehouse Receipt System and Commodities Exchanges that link farmers to the market value chain to facilitate better access to markets and financial opportunities, helping them maximize their returns in a transparent market. In view of this, farmers are likely to be encouraged to increase production, which further supports the realization of the national priority of food security set out by the Government.

Frequently Asked Questions

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What is a Spot Commodities market?

This is the marketplace where commodities are traded. The marketplace may be a physical location where traders meet to conduct business or an electronic platform. The core function of the marketplace is to ensure fair and orderly trading and the efficient dissemination of price information for any trading on that market. The term "spot commodity" refers to a commodity that is being sold with the intention of being delivered to the buyer fairly immediately—either presently or within only a few days.

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What is a commodity exchange?

Commodities exchanges are the central location/physical centre where commodities are traded. It is a legal entity that determines and enforces rules and procedures for trading standardized commodity contracts and related investment products. Traders can either meet face to face at the exchange and communicate buy and sell orders through hand and verbal signals (open outcry method) or use electronic trading platforms.

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How do farmers benefit from the Spot Commodities market?

i. Enhanced price discovery process due to greater access to the market by local and international participants;
ii. Farmers/sellers are safeguarded from payment defaults as mechanisms are put in place for collateral management and settlement guarantees;
iii. Timely payments using direct settlement systems;
iv. Enhanced price stability using forwards and futures contracts;
v. Enhanced access to relevant trading information using Market Information Systems;
vi. Efficient and effective dispute resolution.

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What commodities should farmers expect to trade at the exchange?

Conventionally, Commodities are understood as the output of the primary sector of an economy. In other words, they are the output that comes from activities such as agriculture, extraction, mining, etc. Normally natural capital like agricultural crops, wheat, rice, pulses, spices, Minerals, Metals, Crude oil, etc. are referred to as commodities. But the raw output is not tradable. Every raw output goes through a minor process to become tradable. This process depends on the nature of the commodity. A basic product like cleaned and packed wheat has a minimum process applied. However, a commodity like sugar goes through a detailed production process and still qualifies as a commodity. To make the product or produce a tradable commodity, there must be some sort of process applied. But at the same time, it should not lead to creating a unique identity.

One of the major tasks that the exchange must do is to define the commodities that will be traded on the exchange platform. The selection of the commodities is a very specialized job, and it is after detailed research that the commodity is selected for the trading based on factors such as quality and standardization, trading and market capacity, and price movements and risk assessment.

Some commodities currently being traded in centralized market platforms include tea and coffee. Other potential commodities include Maize, Wheat, Sorghum, Millet, Peas, Beans, etc.

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How will a commodities contract be executed?

Typically, the exchange will facilitate the trading of commodities through standardized contracts which specify various commodity information such as quantity, quality, etc. to enable buyers to make an informed decision on what prices to bid. It is important to understand that the physical commodity is stored in a warehouse and that buyers entirely depend on the information disclosed in the contracts to make bids.

The trading platform facilitates the bidding process, normally accepting the highest bid for the Lot on sale. A lot is the minimum number of units that can be bought on an exchange e.g., 50 Kgs. Typically, the buyers of these contracts agree to accept delivery of a commodity, and the sellers agree to deliver the commodity.

Once the bid is accepted, the buyer is expected to make payment for the purchase within a specified time. Once this is done and verified by the exchange, the proceeds are channelled to the seller whilst the owner of the commodity is transferred to the buyer within a specified timeframe. The buyer can then plan for the commodity to be transferred from the warehouse to their preferred destination.

If disputes arise in relation to discrepancies between the information provided in the commodity contract and the characteristics of the physical good delivered, the exchange provides a robust recourse mechanism to address the same, within specific timelines.

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Who are the intermediaries/firms who will execute the contracts?

The key actors in the process include the producer, warehouse operator, commodities broker, commodities exchange, and the warehousing receipt system central registry. A brief outline of their key responsibility is outlined below.

i. The producer will deposit goods in a designated warehouse;

ii. The warehouse operator will issue the depositor with a warehouse receipt, register the receipt with the warehouse receipt system central registry, and store goods in the required manner;

iii. The warehouse receipt system central registry will certify and validate to issued receipt;

iv. The farmer will commission a commodities broker to sell the goods at the exchange;

v. The commodities broker will prepare a sales catalogue, in consultation with the exchange, to provide for sale at the auction;

vi. The exchange will administer the auction, clear trades, and facilitate settlement;

vii. The warehouse central registry will change the title of goods from depositor to the buyer;

viii. The warehouse operator will release goods to the buyer upon presentation of a receipt.

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Who are the regulators of the Spot Commodities market?

The Capital Markets Authority is mandated to regulate spot commodity markets in Kenya via the Capital Markets Act Chapter 485A of the Laws of Kenya

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How will the farmers and investors be protected?

i. Reduction in post-harvest losses due to proper storage and warehousing;
ii. Reduction in price volatility of commodities through forwards and futures;
iii. Guaranteed settlement of proceeds through a safety net mechanism;
iv. Price transparency through fair and orderly trading;
v. Access to market information;
vi. Availability of effective dispute resolution mechanisms;
vii. Increased quality and product standardization.

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Clarify the difference between the Settlement Guarantee Fund and Investor Compensation Fund and the rationale for both fidelity funds.

The settlement guarantee fund is a fund set up by the commodities exchange to honor commitments of the exchange arising from settlement defaults when members of the exchange fail to meet their settlement obligations arising from transactions executed in the exchange to ensure that settlements of trade transactions for participants are executed as scheduled.

The investor compensation fund is established to pay compensation to investors who suffer pecuniary losses because of failure or malpractice of a licensed intermediary in relation to commodity exchange-traded products.

It is important to have both funds to ensure that market participants, including investors, are safeguarded from counterparty risk as well as the failure of intermediaries.

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Please explain the warehouse receipts system in the context of the Spot Commodities market?

Warehouse Receipt System (WRS) is a process where owners of commodities (Farmers or Traders) deposit their commodities in a certified warehouse and are issued with a document of title called a Warehouse Receipt as proof of ownership. The Warehouse Receipt is transferable and negotiable meaning the receipt can be traded in a commodities market or used as collateral to secure loans from commercial banks.

Warehouse receipts are important because they serve as proof that the commodity is in the warehouse and that the proper documentation has been verified. They also prove that commodities have met specific quality standards to be traded and are verifiable by third parties. These characteristics increase investor confidence in their credibility. The warehouse receipt, therefore, provides the exchange with documentation that the goods authorized for sale are available for transfer to a buyer.

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What are the risks of a Spot Commodity market?

i. Price risks: These arise because of adverse movements in the prices of commodities that are determined by macroeconomic factors;

ii. Quantity Risk: Quantity risks arise due to changes in the availability of commodities;

iii. Cost risk: Cost risks are a result of an increase in the costs of commodities;

iv. Regulatory risk: When laws and regulations have the potential to impact the prices or availability of commodities;

v. Speculative Risk: The commodities markets, just like the bond or stock markets, are populated by traders whose primary interest is in making short-term profits by speculating whether the price of a security will go up or go down. These traders can impact market prices if there are more in the market than commercial users;

vi. Fraud: Although the regulatory bodies do a decent job of protecting investors from market fraud, there is always the possibility that you will become a victim of fraud

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What will likely determine how commodities prices are tracked?

i. Demand and Supply Factors - The principles of demand and supply influence commodity prices, based on trader behavior. When buyers outnumber sellers for a given product, the price of that commodity rises, and vice versa;

ii. External Conditions - Other elements, such as weather, might influence demand and supply. If there is a drought, for example, the cost of the commodity may increase due to limited supply;

iii. Eco-Political Factors - Price variance in the commodities market is influenced by a country's politics and economics. Political/economic instability could affect commodity prices, especially in circumstances where most of this commodity is produced in the jurisdiction;

iv. Speculation - In commodity trading, speculators invest on the assumption that a commodity will be profitable or not. This causes some commodity prices to fluctuate.

There are also several resources available online and at the various commodity exchanges to track commodity prices depending on your interests.

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Will there be a derivatives Commodities market and how will it work?

Since the prerequisite for an efficient derivatives market is a strong spot market, commodity derivatives will be introduced after the spot market is fully operationalized. Kenya already has a functioning derivatives market and commodity derivatives are anticipated to be introduced within the same framework.

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