Commodity market regulatory pathways not yet chosen

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Abstract: Despite the extreme commodity price volatility of 2007-08, rules and enforcement practice governing commodity futures markets remain largely unchanged. Markets remain structurally vulnerable to speculation far in excess of the liquidity needs of commercial hedgers. Proposals to regulate over-the-counter (OTC, off-exchange, largely unregulated) trades and to apply position limits to the number of derivatives contracts controlled by any one entity and/or their affiliates during a trading period (i.e., aggregate position limits) are two regulatory pathways for commodity markets. Most of the financial services industry and many corporate derivatives end-users are resisting these proposals. This note explains some proposals, the resistance to them and possible consequences of continuing business as usual, albeit with higher market participant capital reserve requirements.

1. Despite the global transmission of commodity futures prices, there is no global economic governance of commodity markets. The technical committee on commodity futures markets of the International Organization of Securities Commissions (IOSCO) can develop best practice recommendations, e.g., on improving reporting of OTC trade data, as requested by the Group of 20.[1] But the member commodity exchanges are not obliged to implement those recommendations, much less require member governments to regulate OTC derivatives.

2. Nevertheless, the G-20 aspires to provide such global governance. The April 23, 2010 G-20 finance ministers communiqué states, "We will finalize our work to address excessive commodity price volatility by improving the functioning and transparency of physical and financial markets in both producing and consumer countries."[2] In an annex to the communiqué the ministers announced that they will welcome "contributions" from UNCTAD "as appropriate." These

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contributions would help the Financial Safety Nets Experts Group advise the G-20 finance ministers on how to finalize their work on excessive commodity price volatility. Of course, UNCTAD has already made such contributions, most notably in its discussion of the "financialization of the commodity markets" in the Trade and Development Report 2009 and subsequent related publications.[3] An UNCTAD secretariat paper informing UNCTAD (including G-20) member governments stated the situation clearly: "highly volatile commodity prices act as a serious distortion on the development process."[4]

3. During the past year, commodity and financial market regulators, particularly U.S. and EU regulators,[5] have debated how best to enable market participants to manage market volatility while ensuring adequate liquidity and market information transparency. Some regulatory issues, such as restoration of prudent capital reserve requirements, are relatively uncontroversial. Other issues, such as the regulation of OTC derivatives and the enforcement of aggregate position limits for all market participants, are very controversial. There is greater awareness of the market mechanisms of the "financialization of the commodity markets" and their effect on the risk-management capacity for commodity exports and imports. However, governments and market participants are not yet agreed on how to best regulate commodity markets, which are now exposed to even greater market volatility following the end of forward contracting in iron and steel, and the advent of a $200 billion metals derivatives market.[6]

4. The relation of position limits to commodity prices is relatively clear. Exemptions from position limits granted by the Bush administration Commodity Futures Trading Commission (CFTC) allowed financial institution speculators to move prices by their huge "weight of money" advantage over position-limited commercial hedgers. For example, position limit–exempted Goldman Sachs and Morgan Stanley commodity index fund investors controlled about 1.5 billion bushels of March 2008 Chicago Board of Trade corn (maize) futures contracts, while position-limited commercial hedgers controlled about 11 million bushels.[7] Index fund "weight of money" enabled the commodities bubble that burst in July 2008, when the insolvency of "too big to fail" financial institutions, exempted from capital reserve requirements, became aware to insiders.[8] Investigations by the U.S. Senate and the French Ministry of the Economy have determined that financial institutions drove futures contract prices in wheat and oil respectively far in excess of what could be explained by fundamental factors, such as supply and demand and logistical costs.[9] These reports confirmed both academic and non-governmental organization analyses

of excessive speculation in commodity markets that led to spikes in agriculture and energy import bills, particularly for developing countries.[10] Nevertheless, given the billions of dollars in fees and proprietary trading earned by financial institutions in a deregulatory environment, there is a very well-financed lobbying resistance to aggregate position limits. On the other side of the ledger are commercial hedgers and their commodity markets, such as the agricultural markets, which according to FAO, remain structurally vulnerable to non-agricultural market investments and regulatory decisions.[11] IATP, as a member of the Commodity Markets Oversight Coalition, has urged the U.S. Congress to include aggregate positions limits in new legislation.[12]

5. There is likewise great resistance in industry and their government allies to proposed U.S. legislation that OTC trading, otherwise known as "dark market" or "shadow market" trading, be pushed on to public and regulated exchanges or regulated derivatives clearing organizations. In the $600 trillion notional value OTC market (according to June 2009 Bank of International Settlements figures, the latest available), commodity contracts occupy just 1.23 percent. (Notional value refers to the face value of the offset derivatives contracts, not the value finally netted by investors and proprietary traders.) "Unallocated" contracts, of which mixed swaps between financial and commodity instruments (e.g., "hedging" interest rates with oil futures revenues) are a small fraction, amount to about 12 percent of the OTC universe.[13]

6. The Coalition of Derivatives End-Users includes transnational firms, such as Bunge, John Deere and Cargill that are both commercial hedgers and financial speculators.[14] The coalition has argued that OTC trades between financial institutions and non-financial institutions, such as the coalition members, should be exempt from the requirement to clear those trades on public exchanges. At least three reasons are given to justify the exemption. First, non-financial firms pose no systemic financial risk and hence they should not be prevented from "customizing" their interest rate, currency exchange, balance sheet and commodity risk in bilateral deals with financial institutions. Second, the higher margin requirements of trading on exchanges will pose huge cash-flow problems for coalition members. In the coalition language advocated in December to the U.S. Senate Banking Committee, non-financial derivatives end-users would be exempt from margin requirements, i.e., from having to maintain a certain amount of collateral with an exchange clearing organization in order to trade.[15] Third, if bilateral trades are pushed from the dark markets to exchanges or derivatives clearing organizations, trade risks will be concentrated

in such a quantity that these centralized clearing (trade processing) platforms will be unable to confirm and verify trades operationally.

7. These objections merit a more detailed response than can be given in this short paper. However, indicative responses can be sketched. First, while no individual non-financial firm poses a systemic financial risk, aggregate OTC trades with financial firms can pose a systemic risk, particularly if financial firms continue to be exempt from position limits. Furthermore, the degree of customization is slight in the copyrighted and therefore highly standardized contract language. Whether trades are accepted by exchanges as clearable should be the trading standard, not whether they are standardized or "customized." Second, exchange margin collateral requirements are usually 4–8 percent of the value of a trade. While posting such margin may occasionally result in cash-flow problems for corporate OTC derivatives end-users, reduced use of such derivatives is a small price to pay for ensuring the financial integrity of derivatives markets, particularly given the size of the public bailouts of market failure. Third, as bilateral trades move to exchanges and derivatives clearing organizations, their increased capitalization will enable improved infrastructure to confirm and verify trades. Aggregate position limits, if enforced, should also enable exchanges and derivatives clearing organizations to process the formerly bilateral trades.

8. U.S. Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler contends that if proposed end exemptions to clearing OTC derivatives remain in the final version of U.S. reform legislation, up to 60 percent of OTC trades will remain outside effective regulatory purview.[16] With so much of trade data still bilateral and dark, it will be impossible to set position limits with confidence and enforce them uniformly. In August 2009, the CFTC had sent to the Senate a polite but firm critique of the OTC provisions in the U.S. Treasury proposed financial reform bill that reflected Wall Street positions.[17] This was perhaps the first step in a major U.S. interagency confrontation on the future of commodity derivatives, although commodity contracts are only a small percentage of the broad array of derivatives used by transnational firms. As of this writing, the final form of U.S. financial legislation is still being debated. IATP has stated its clear preference for a version of OTC derivatives reform passed by the Senate Agriculture Committee that would allow exemptions for the clearing of derivatives only for commercial hedgers in position-limited contracts.[18] But what might happen under legislation that would allow most OTC derivatives to remain in dark markets, thus preventing regulators from having timely access to all trading information, a prerequisite for effective derivatives regulation?

9. In January, Goldman Sachs advised its clients, "we do not recommend a strategic allocation to a commodity futures index."[19] Given the technical analysis that accompanies this recommendation, it might be taken as the sign of a market self-correction, following past institutional over-allocation in index funds. However comforting this belief in market self-correction through improved transparency, IATP does not find it any more convincing than the April 23 promise of the G-20 finance ministers to reduce excessive price volatility through non-binding recommendations to increase transparency of trade data reporting. Data transparency is a necessary but insufficient condition for market participants to discover prices through a process in which all market participants contribute price information on a daily basis that all participants and regulators see on a daily basis. The unfair competitive advantage conferred by the OTC trade data reporting delay not only impedes price discovery but makes it exceedingly difficult for exporters and importers to manage price risks and investments, as UNCTAD has noted. If developing countries continue to spend a high portion of hard currency reserves for food and energy imports, while their rate of return in commodity investments remains unpredictable, the "distortion of development" will intensify, resulting in a widespread political instability that certainly will not self-correct.

10. In response to a CFTC request for comment on whether the agency should consider applying position limits to agricultural "softs," such as cocoa and coffee futures contracts, IATP replied in the affirmative.[20] We noted that such position limits would complement in the futures market the negotiations for a successor to the International Cocoa Agreement under UNCTAD auspices. Once this agreement is implemented successfully, it will fulfill in part the G-20's April 23 call for more transparent physical commodity markets that function better for commercial hedgers. However, if the financial markets remain fundamentally unreformed, the contribution of the Cocoa Agreement and similar agreements to revenues for the development of producer countries will likely be diminished by excessive speculation on tropical commodities from consuming country firms. As IATP stated in our CFTC comment, the continued inducement by financial institutions of price volatility in commodities of import- and export-dependent developing countries may lead not only to food and energy price riots, but to broader political instability. Surely, such instability is too high a price to pay for the sake of continued deregulation of the financial services industry to ensure its excessive profitability.

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[4] "Recent developments in key commodity markets: trends and challenges," UNCTAD secretariat, January 12, 2010, at 11. http://www.unctad.org/en/docs/cimem2d7_en.pdf

[5] http://www.tradeobservatory.org/library.cfm?refID=106910

[6] David Oakley and Javier Blas, "Iron ore swaps could grow to $200 bn," *Financial Times*, March 30, 2010.

[7] "A big move lies ahead," *The Brock Report*, May 23, 2008.

[8] "Commodity Market Speculation: The Risk to Agriculture and Food Security," Institute for Agriculture and Trade Policy, November 2008. http://www.tradeobservatory.org/library.cfm?refID=104414

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[11] "Food Outlook: Global Market Analysis," Food and Agricultural Organization, December 2009 at http://www.fao.org/docrep/012/ak341e/ak341e00.htm

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[15] http://www.tradeobservatory.org/library.cfm?refID=107145

[16] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-26.pdf

[17] http://www.tradeobservatory.org/library.cfm?refID=106665

[18] http://www.nefiactioncenter.com/PDF/cmoc_ltr_2010apr23.pdf

[19] Sharman Mossavar-Rahmani et al, "Commodities: A Solution in Search of a Strategy," Investment Strategy Group, Goldman Sachs, January 2010 at 11.

[20] http://www.tradeobservatory.org/library.cfm?refID=107255