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EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

EPFSF Briefing
"Commodity Trading"

Introduction

Commodity derivatives trading started to enable farmers to protect themselves from the risk of the value of their crop falling below cost of production. The industry has evolved to include a wide range of products, participants and functions. In recent years, higher food and energy prices have provoked considerable interest and a number of initiatives from regulators and politicians, including in Europe.

How and where are commodities traded?

A wide range of commodities are traded on wholesale markets, including

- **'Softs'**: agricultural commodities such as grains, coffee, cocoa, sugar, cotton.
- **Base Metals** e.g. copper and aluminium, and precious metals e.g. gold, silver, platinum.
- **Energy** e.g. electricity, gas, oil and other energy derivative products.
- **So-called 'exotics'**, allowing market participants to hedge risks linked with specific variables affecting costs/profitability in their business e.g. weather, freight costs.

These commodities are traded in two main types of contract:

- **Derivatives**: Commodity derivatives derive their value from changes in the value of the underlying commodity, index, or rate, transferring price risk from one counterparty to the contract to another. These may be settled by transfer of cash, or in some cases the underlying commodity.
- **Physical trading**: Trading of the physical commodity, often involving scope for physical delivery of the relevant commodity e.g. in 'spot' trades, involving immediate delivery of the commodity.

Commodity trading takes place on two principal types of venue:

- **On-exchange:** traded on exchanges' or on alternative electronic trading platforms, where standardized contracts are cleared and traded on a centrally regulated market. The vast majority of these trades are cash-settled futures and options.
- **Over-the-counter** (OTC), off-exchange, where bilateral contracts between counterparties can be customised according to the needs of the counterparties, or where the underlying commodity is not traded on an exchange i.e. the only liquid market is off-exchange.

1,684 million commodity contracts were traded on-exchange in 2007, up by over one-third on 2006 levels. Agricultural products accounted for 46% of this total, energy 35% and metals 19%.[1] The notional amount of OTC commodity derivative contracts outstanding was $9 trillion as of-end 2007[2] (although this amounts reflects hedging and offsetting contracts entered into to further reduce risk). The real risk (before netting, further reducing risk, had taken place) related to these contracts was between 4 and 8% of the notional volume.

What function does commodity derivative trading serve?

Risk transfer and management: The key function of all derivative contracts is the *transfer and management of risk*. In commodity derivative contracts, commercial market participants can mitigate risks posed to their business by movements in the price of important commodities.

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[1] *IFSL Research: Commodities Trading 2008, June 2008: http://www.ifsl.org.uk/upload/CBS_Commodities_2008.pdf*

[2] *BIS figures*

Thus, for example,

- Agricultural producers can 'lock in' a stable price for their produce;
- Energy producers can make necessary investments in infrastructure, content that these investments will not be undermined by falling energy prices making their business unprofitable; and
- Corporates can secure prices for supplies, protecting their cost base against price changes.

In this context, the role of non-commercial market participants in commodity markets is key. The presence of different types of non-commercial participant (e.g. banks, pension funds, hedge funds etc) in wholesale commodity markets adds diversity to the spectrum of ways in which dealers can then lay off their risk. This allows risks taken from hedgers to be dispersed more widely in a way minimizing the impact on market prices.

Portfolio diversification: Commodities trading can also offer a useful means of portfolio diversification. Fund managers and other 'non-commercials' use commodity derivatives on the basis that commodities behave differently at different times in the economic cycle to other financial instruments (e.g. shares or bonds). This is investment *responding* to market conditions however, with, limited impact in terms of 'amplifying' price changes (recent falls in commodity values underline that flows of capital into commodities cannot override the effect of demand exhaustion). It should be noted that pensions and UCITS funds are limited quantitatively in their investment in commodity derivative contracts.

What are the benefits of trading OTC and exchange-traded commodity derivatives, respectively?

In the OTC commodity derivatives business non-commercial participants can act as 'dealers', customising bilateral contracts with commercial participants to meet their risk management needs, and themselves taking on some of the risks that 'commercials' are exposed to in their core commercial activities. The ability to customise (e.g. in terms of delivery dates or locations, cash flows) is the real added value of OTC commodity derivatives – individual contract terms are altered according to the exact risk management needs of the counterparties.

Exchange-traded derivatives, on the other hand, offer the advantage of a central mechanism for real-time price discovery and valuation in liquid markets (meaning it is always easy to trade), standardisation, transparency, and capital advantages in terms of counterparty risk.

Exchange-traded commodity derivatives (and some OTC commodity contracts, including some energy derivatives) are traded as 'cleared' contracts, with a Central Counterparty becoming the intermediary in the trade and taking on the risk of counterparty default in return for clearing fees and the holding of margin submitted by the counterparties.

What regulations apply to commodity derivatives trading?

In Europe, financial institutions engaged in trading of commodity derivatives are subject to the 2004 Markets in Financial Instruments Directive (MIFID). Specific aspects of MIFID and of other EU financial services legislation (e.g. the Market Abuse Directive) apply to such firms to the extent to which they trade in commodity derivatives falling within the definition of MIFID financial instruments.[3] They are required to get authorization to provide investment services or activities, and are subject to the same requirements that apply to other regulated business, including obligations to act honestly, fairly and professionally. These firms benefit from a 'passport' for their activities across EU markets.

[3]Including commodity derivatives that may be forcibly settled in cash; physically-settled commodity derivatives traded on MTFs / regulated markets, physically-settled commodity derivatives not entered into 'for commercial purposes', and that are like other financial derivatives (e.g. they are cleared in clearing houses and subject to regular margin calls), and cash-settled 'exotic' (weather, freight, emissions allowances) derivatives and other derivatives cleared in clearing houses and subject to regular margin calls.

Specialist commodity firms (e.g. oil firms, food producers - not part of a bank group - engaging in commodities derivatives trading to manage commercial risks) can currently benefit from exemptions from the MIFID and from the Capital Requirements Directive. However, they do not benefit from a 'passport' for their activities in the EU. This is reflected in varying approaches to regulation of commodity firms' wholesale trading in the EU (e.g. the UK requires many commodity firms exempt from the scope of MIFID and the CRD to apply for a license under the OMP and EMP[4] regimes).

The major exchanges trading commodity derivatives in Europe (e.g. ICE, EEX, LIFFE, Nordpool, LME) are regulated markets under MIFID and as such are subject to rules governing management and operating requirements, admission of instruments and participants to trading, and pre-/post-trade transparency.

It should be mentioned that regulated markets are given considerable responsibility by regulators in policing market behaviour. Regulated markets must report transactions in MIFID commodity derivatives traded on exchange to regulators. The Market Abuse Directive applies to all commodity derivatives traded on regulated markets (or linked to instruments traded on regulated markets), and charges regulated markets with watching for signs of abuse.

Another tool available to regulators is competition policy. The European Commission's recent Energy sector enquiry revealed a number of concerns about competitive conditions in gas and electricity markets, particularly excessive market concentration, inadequate levels of unbundling between network and supply interests, and market mechanisms favouring incumbents. While some issues were tackled in the 3rd Energy Package, more vigorous application of competition policy to these market structure challenges would address many of the problems that prompt political figures to query the benefits of commodity trading.

What regulatory initiatives are under way dealing with commodity derivatives?

Fluctuating food and energy prices have placed commodity derivatives trading in the spotlight.

There is considerable evidence to suggest that these rises were largely the result of altered and more sophisticated patterns of supply and demand in recent years, in particular

- Greater and more diverse demand for food and energy from developing economies such as China, India, Brazil, Russia;
- Trade and export constraints in many countries, limiting supply;
- A failure to invest sufficiently in years past in energy infrastructure, and recent investment in energy sources which reduce food supply (biofuels);
- A natural 'lag' in the ability of energy and food producers to meet accelerating demand.

Nevertheless the activities of commodity 'speculators' have attracted political and regulatory interest.

The Commodity Futures Trading Commission (CFTC), which regulates commodity derivative trading in the US, has looked at this issue throughout 2008, concluding (as part of an Interagency Task Force) in June 2008, that higher crude oil prices were due to altered supply and demand. A September CFTC 2008[5] report on the activities of swap and index traders (types of 'non-commercial' participant in markets: index traders[6] in particular have been much blamed for driving prices up) that increases in net notional value of commodity index business in crude oil futures, were due to *"an appreciation of the value of existing investments caused by the rise in crude oil prices and not the result of more money flowing into commodity index trading."* Nevertheless, the report proposed changes including a change to the classification of swap dealers for reporting purposes, more detailed reporting for large futures traders, and reduction of scope of 'hedging' exemptions (from regulation) for swap dealers. This report came after considerable pressure from the US Congress. Political pressure also led the CFTC to impose US-style regulatory reporting on an EU Exchange on threat of excluding trading screens from the US.

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[4] OMP - Oil Market Participant, EMP – Energy Market Participant.

[5] 'CFTC Staff report on Commodity Swaps Dealers and Index Traders with Commission Recommendations', Sep2008:http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf

[6] Traders (including pension and endowment funds) that seek exposure to commodities through passive long-term investment in commodity indexes

In the EU, the European Commission published a Communication on food price rises in June 2008[7], laying the blame on supply and demand, but pledging to watch developments in commodity-related financial markets. An October 2008 report on oil markets by the French Presidency (assisted by the European Commission) , came to similar conclusions, ascribing higher prices to changes in supply and demand, but adding that *'financial markets are…likely to have played a role in more recent volatility.'*

So are EU regulators considering greater regulation of commodity derivatives trading?

The exemptions from MIFID and Capital Requirements Directive are under review, although there appears to be some regulatory support for the principle that commodity firms participating in these markets for commercial purposes, and who do not deal with retail investors (who do not typically participate directly in these markets), should continue to benefit from exemption. A report (for consultation) outlining policy options, is expected from the European Commission in December 2008.

The boundaries of regulation of wholesale and electricity and gas trading are also the subject of review by financial and energy regulators, working with the European Commission, in the context of the 3rd Energy Package. This review is assessing the case for new record-keeping, market abuse, transaction reporting and transparency rules for physical and derivative markets in electricity and gas, and requires close cooperation between the European Commission Directorates-General for the Internal Market and for Transport and Energy, in view of the potential overlap of financial and energy regulation.

Lastly, the EU Market Abuse Directive (MAD) is also under review by CESR. A consultation document is expected in the coming weeks, and may broach issues including the scope of commodity derivative instruments covered by the MAD, as well as the operation of current commodity-specific aspects of the Directive, such as the definition of inside information for commodity derivatives.

Conclusion

Commodity derivatives play a vital, but often misunderstood role in commodity markets. The core purpose of commodity derivatives is helping market participants to manage important business risks.

It is tempting to blame price volatility on speculation in commodity markets, but there is evidence that recent price rises are largely the result of an imbalance in the relationship between supply and demand for many commodities, resulting from changing global economic and demographic patterns, and in many cases, government intervention. The role of supply and demand in these price changes has been recognised by many international and national regulatory or quasi-regulatory organizations.

Regulatory interest in these issues is justified, given the impact of commodity price changes in ordinary peoples' lives. It is important, however, that regulators take decisions based on sound economic assessment, in order to avoid any possibility of unforeseen and unintended consequences negatively impacting producers, manufacturers corporate users and consumers alike.

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[7] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0321:FIN:EN:PDF

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