



## European exchange-traded futures and OTC derivatives on agricultural commodities

### 1. Scope

FEDIOL represents the EU oil and protein meal industry, a primary processing sector, which is central to the food and feed chain. Over 35 companies supply a large variety of vegetable oils and fats as ingredients for further processing to the EU food and non-food industry. Meals and other products derived from the crushing and refining activity are delivered to compound feed industries.

The oil and protein meal industry processed in 2008 about 26 million tons of EU produced rapeseeds, sunflower seeds and soybeans, and some 17 million tons of oilseeds or soybeans from third country origin. Our industry also processed 12.7 million tons of crude oils, derived from either oilseeds or tropical oil fruits such as palm and coconut.

In the context of the revision of commodity derivative markets (OTC proposal and upcoming revision of the MiFID Directive), which will also have an impact on the future regulation of agricultural derivative markets, FEDIOL would like to present its preliminary views

Futures markets provide a forum through which buyers and sellers of commodities can transact today what they intend to execute at some date in the future. Through this process, futures markets serve two primary economic functions – price discovery and price risk management. Both of these functions are vital to maintaining a highly efficient value chain that links farm production to consumer goods in food, feed and fuel. For farmers and cooperatives, the price signals from the futures markets enable them to make planting decisions based on demand signals. For grain handlers, processors, millers, and food manufacturers, futures markets provide a mechanism to secure protection against adverse moves in price and enable them to significantly reduce volatility in the pricing of consumer goods.

Futures on agricultural raw materials are financial instruments that usually involve physical delivery of those agricultural raw materials. Their publicly available prices form (through convergence) an inseparable part of the price setting mechanism for physical goods, as used by the operators in the supply chain.

Today, the instruments of European futures on agricultural raw materials are used by food chain operators (producers, traders, first-processing industries) as well as traditional financial actors (such as banks, hedge funds, insurance companies, etc.). All actors are essential to bring liquidity and well-functioning to futures exchanges as long as they do not distort the price discovery function of a futures exchange.

Considering the linkage to the food chain, the price of agricultural commodities is an issue that has direct impact on farm income as well as on food prices for the European consumers. Efficiently functioning exchanges, as well as OTC derivatives to cover specific needs, are therefore needed in order to offer reliable price signals to farmers in line with the direction in the CAP towards more open markets and to support all actors in managing volatility in agricultural commodities effectively and efficiently.

We therefore further agree that more transparency of trading, better market oversight and public perception of the integrity are essential elements to the viability of those markets, as long as reporting requirements remain manageable.

## **2. Transparency of trading**

For futures-traded agricultural commodities (rapeseed) on EURONEXT, there is already trade transparency information available for the exchanges to share with regulators.

We consider that futures-traded agricultural commodities on EURONEXT carry sufficient pre- and post-trade transparency through the available instruments (open interest, offer and bid, last traded price, closing price).

FEDIOL is however prepared to assist in defining what would be realistic and workable reporting requirements, without creating an additional operational & financial burden on operators.

We would be ready to look further into a periodic reporting by categories of players, as per the US system of reporting, in which companies that hedge their physical goods position are classified within the "commercials" category.

We prefer the trade transparency reporting to be a system of post-trade reporting by the exchange and to be amalgamated by categories of players.

## **3. Market oversight and integrity**

### **3.1. Transaction/Position reporting to regulators**

We believe that the Regulators and the Exchanges should develop such a periodic reporting of transactions and net positions by category of operators (to be defined, as described above).

With today's electronic means, the Exchanges should be capable of providing this periodic reporting on transactions and positions by category of operators without any additional administrative burden on the operators.

FEDIOL is however prepared to assist the Exchanges and/or the Regulators in the definition of what should then be made publicly available, for as long as the information is amalgamated by categories of players.

### **3.2. Position limits**

Futures-trading has already inherent limits (price movement limits, pre-delivery open position limits) as set by the Exchanges.

We are opposed to any arbitrary additional position limits imposed by the Regulators on the "commercial" category as they might endanger the liquidity and the well-functioning of the exchange trade in agricultural raw materials (with the subsequent negative impact on the physical trade).

Instead, we believe that the legislative focus in order to prevent unjustified speculative price movements should be on convergence rather than on position limits.

Via futures, commercial operators have an instrument to manage the difficulties of the fluctuation/volatility resulting from the seasonal nature of agricultural markets. Well designed futures contracts function in a way where futures contract values come together with cash market values as the futures contract approaches expiration. This "convergence" is a core test of whether a futures contract serves its primary function as an effective risk management tool and price discovery vehicle. While position limits play a role, the most critical issue is contract design. When exchange contracts exhibit routine convergence between futures and cash markets, the risk of a misalignment of the pricing of a grain or oilseed in Europe versus its fundamentals is very low.

Convergence is therefore a measure for the operating effectiveness of a futures exchange.

Impediments to delivery are a primary cause for illiquid markets and non-convergence. The mechanism of delivery is therefore an essential force that drives convergence and ensures definite price relationship between cash and futures markets. Deterrents to delivery must therefore be removed.

## **4. OTC Derivatives**

### **4.1. Increased standardization of OTC derivatives and central clearing**

Although in principle increased standardization might be a positive goal, it might trigger unwanted consequences:

- higher costs for hedging through OTC derivatives;
- basic needs of companies, which cannot be covered by standardized futures & OTC contracts, might be left unconsidered. Individual companies would no longer be able to cover specific/unique risks with affordable solutions.

### **4.2. Increased collateralization for OTC derivatives**

Moving towards imposing capital requirements and/or margins for OTC derivatives (which are today not covered by margining) would have substantial and negative effects on the primary processing industry from a capital requirement perspective.

We therefore urge that, before making any proposal for increased collateralization, an extensive impact assessment be conducted in order to understand the implications for the agri-food sector.

## 5. Conclusions

This paper on the MiFID review deals primarily with European exchange-traded futures on agricultural raw materials.

These European exchange-traded futures on agricultural raw materials markets should keep their initial purpose of price discovery and hedging as tools to cope with price volatility of the underlying physical agricultural raw material.

We therefore suggest that Regulators and Exchanges cooperate to increase trading transparency, improve market oversight and public perception of the integrity of the exchange-trade as these are all essential elements of the well functioning and the viability of those markets.

If this would require a clear separation in categories of operators, primary processing companies of agricultural raw materials should be clearly ranked in the "commercial" category.

If any additional reporting by the exchanges (beyond what already exists today) is desired on transactions and positions, we would be ready to consider potential amalgamation by categories of players.

With respect to concerns about impacts of speculative activities, we suggest that the legislative focus go beyond position limits for speculators and include an assessment of convergence between futures and cash markets.

We are concerned about potential increases in capital requirements for OTC derivatives and ask for maintaining a flexible margining requirement based on a risk assessment process.