

Financialisation of the agricultural commodity markets – the role of legislation

Myriam Vander Stichele
Senior Researcher, SOMO
for
Expert Group on
agricultural commodity derivatives and spot
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Focus of this contribution

- The principles
- Deregulation of commodity derivatives and financial markets
- Challenges of current regulation: new trends
- EU regulation in different laws and processes
- The current political economy of regulating commodity derivatives markets

Some fundamental principles for commodity derivatives regulators

- How socially and economically useful?
- Useful for whom? Cf. context of CAP reform and context of banks & financial market reforms
- Public interests vs. private interests
- Effectiveness and efficiency vs. compromise among EU members
- Strictness vs. (fear of loosing) competitiveness
- EU specificity vs. international decision making (G-20) or advice from global bodies (FSB, IOSCO, UNCTAD, FAO, OECD, ...)
- In case of doubt: no action vs. precautionary principle

Challenges of lack of transparency



- Lack of data on e.g.
 - OTC commodity derivatives,
 - Hedge funds activities (AIFMD: hedge fund reporting obligation starts July 2013) : who, how much, in what commodity derivatives ? how much leverage and what impact i?
 - How non-financial participants assess market movements/fundamentals vs. speculators behaviour;
 - Spot prices (e.g. contango or backwardation) and private prices
- Mixed academic evidence
- Lack of full guarantee of independence of academic and expert researchers
- Lack of information about market and product innovation
- Financial players' arguments and strategies vs. other stakeholders

Objectives in context of financialisation

- Integrity of price formation and price discovery
 - Integrity of 'bona-fide' commodity hedging functions
 - Integrity of function as price benchmark for production and consumption (in the EU or around the world ?)
- Insurance in a speculative way:
 - but not to result in too much contango or backwardation
- → efficient and effective legislation without loopholes

The role of deregulation

- In US:
 - 1999/2000 deregulatory process
 - but still position limits in the US that affect financial players
- Deregulation of capital flows
- Deregulation of foreign entry through treaty obligations: GATS-WTO and free trade and investment agreements (FTAs) in financial services & their providers:
 - Third country issues (MFN, NT);
 - Prudential carve out;
 - Prohibitions in regulation ('market access' and 'domestic regulation' rules');
 - Full automatic entry of all new financial products (GATS Understanding).

New trends in financialisation

- Close connection between financial parties/speculative positions and bona-fide hedging parties/positions: Blurring? Circumvention?
- New generations of commodity investment products: new indexes, actively managed weighing of indexes and roll-over period, total return swaps, ...
- New risky and short term speculative strategies: HFT, profitable returns in one day, 'turbo's', financial engineering with collateral.
- Commodity hedge funds' strategies/computerized programmes: increasingly aggressive, innovative, short term and HFT, speculation on rolls and ETFs, ...

Challenges of new trends

- Overall: increasing number of (very) speculative/financial players vs. hedgers who want confidences in commodity exchanges ?
- More traders not based on fundamentals of physical supply and demand and aiming at very short term results
- Likely to lead to more OTC derivatives
- Increasing but underestimated interconnectedness of financial players and financial markets
- Increased correlation between commodity markets and financial markets

Regulation at EU level: diffuse legislation

- MiFID II / MiFIR”
- MAD
- EMIR
- CRD-IV / CRR and other bank reforms
- UCITS VII?
- PRIPs
- Benchmarking/indices
- Related legislation:
 - competition,
 - FTAs and ISA,
 - ...

MiFID-II, MiFIR and EMIR: Preventing loopholes and ensuring effectiveness



- Mandatory limits on financial participants : net positions vs size of position, individuals vs/and class of traders, cash and physically settled contracts , all months and/or sport months
- Position limits set by ESMA/EU level or national authorities
- Position controls/checks on non-financials
- Purpose of position limits
- Exemptions : e.g. treasury finance
- No limits on OTC derivatives trading ?
- Mandatory clearing and trading on exchanges of standardised OTC derivatives

MiFID-II, MiFIR and MAD: Ensuring effective supervision

- Reporting of full breakdown of positions on request vs. automatic detailed real-time position reporting to competent authorities
- Based on weekly report by the exchanges with the aggregate positions ?
- Resources to check claimed bona fide hedging vs blurring.
- Consultation vs. close cooperation with physical market authorities vs. CFTC-model
- Mandates of supervisors to supervise and intervene: sufficient resources?

MiFID-II and MiFIR: Ensuring effective reporting

- Loophole by exemption for report below certain benchmark ?
- Weekly central reporting of all EU commodity markets in EU?
- Public reporting: min. 1x per week; aggregate but meaningful and accessible for all stakeholders ?

NB:

! ? Better reporting of diverse commodity positions in accounts of financial and non-financial companies ?

! ? standardisation of valuation of derivatives in accounting needed?

UCITS, PRIIPs and indices regulation

■ UCITS VII?:

- Review the scope of assets and exposure eligible for a UCITs fund: more commodities?
- Which investment strategies allowed?
- Which exposure to non-eligible assets !?

■ PRIIPs:

- product design rules ?
- strict investor protection rules?

■ Regulation of indices and benchmarks: in process

Bank reforms: assessing and limiting commodity derivative risks



■ Capital Requirement Regulation (CRR) :

- Counterparty credit risk
- Own funds requirement for commodities risk

■ Basel Committee on Banking Supervision:

- Fundamental review of trading book capital requirements
- Analysis of risk-weighted assets in the trading book (regulatory consistency of risk-weighted assets for market risk)

■ ‘Liikanen report’ on structural bank reforms:

- No separation between basic banking services and derivatives trading for clients and proprietary trading and/or market making?

■ Banking union:

- Financial market operations of banks will be supervised by ESMA who will communicate with ECB: how efficient?

Additional regulatory processes

- Competition policy: better tackling of concentration?
- Safety and efficiency of other price insurance mechanisms and physical market stability instruments
- Continuous FTA negotiations (including EU-US FTA):
 - Further “disciplining regulations”
 - Further liberalisation of OTC derivatives trade
- Transparency in accounting in company annual reports
- Transparency of spot markets : beyond AMIS
- ...

Current political economy of regulating financialised commodity derivatives markets

- Fear of regulatory arbitrage and loosing competitiveness
- Lack of balance of input by different kind of stakeholders
- Difficult balance between costs of free markets vs. regulation vs. supervision
- Lack of balance between public and private interests

**Thank you
and
looking forward for your
comments and questions**

Background information on EU regulatory processes, analysis of financial parties in commodity derivatives markets, etc., see: <http://somo.nl/themes-en/financial>