EVENT REPORT

EUROPEAN CAPITAL MARKETS INSTITUTE

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Following up onto the last year publication of the Report on "Price Formation in Commodities Markets: Financialisation and Beyond", ECMI-CEPS hosted Professor Craig Pirrong's presentation of a report on the "The Economics of Commodity Trading Firms" and how they manage commodities risks. The following panel of experts discussed the policy and regulatory challenges raised by an increasingly complex interaction between commodities physical and financial markets and the potential systemic importance of commodity trading houses.

Session1: Presentation of the *Report on "The Economics of Commodity Trading Firms" by*

- **Craig Pirrong**, Professor of Finance, Bauer College of Business, University of Huston
- **Diego Valiante,** Head of Capital Markets Research, CEPS and ECMI [Discussant]

Session2: The impact of developments in global commodities market structure on risk management and trade: prospects and challenges

Panelists:

- **Edward Lucas**, senior editor, The Economist
- **Peter Caddy,** Global Business Development Director, Argus Media Ltd
- **Valérie Ledure**, Policy Officer, DG Internal Market and Services, European Commission
- **Christophe Salmon,** Chief Financial Officer Europe, Middle East and Africa, Trafigura

John Llewellyn, Partner, co-founder Llewellyn Consulting, [Moderator]

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IMPORTANT NOTICE: The views expressed by the speakers are their own individual views and do not necessarily reflect the views of their companies or institutions. The content of this event report is not a transcription from the speeches delivered by the speakers and should instead be understood as the interpretation of their views by the author. This report was authored by Cosmina Amariei and Jan-Martin Frie. Contact ecmi@ceps.eu with any comments or questions.

John Llewellyn (Llewellyn Consulting) introduced the topic and underlined that the commodities markets have undergone significant changes. Moreover, the recent growth in size and reach of commodities houses has raised questions about the soundness of risk management procedures involved in complex operations across diverse commodities physical and paper markets.

Craig Pirrong (University of Huston) discussed the findings of his recent report on "The Economics of Commodity Trading Firms", indicating that their main business is of physical nature, with profitability driven by volumes and margins. Their financial activity is for risk management purposes. Most CTFs do not speculate on movements in the levels of commodity prices. Instead, they use derivatives to exchange flat price risk for basis (spread) risk, i.e. the value differential between the physical commodity held and the underlying commodity to the financial instrument. Supply or demand shocks drive the relationship between flat prices and volumes/margins. Crucially, most CTFs are agents of transformation: in space (transportation), in time (storage) and in form (processing). However, the business landscape of the CTFs is very heterogeneous: they vary in size, asset classes, type of transformations they undertake, financing, and ownership. His research further points out that the asset intensity (fixed assets/total assets) of CTFs varies widely and that the assumption of an asset heavy sector uniform trend is not supported by data. Some (but not all) firms are getting more asset intensive. Different risk management strategies in relation to possible hold ups in the value chain ("transactions costs economics") and different ownership structures can help explain the asset intensities of the CTFs. In this respect, public ownership works better for large, asset-heavy firms, while the private ownership model is well-adapted to asset-light traders. While there are better incentives under private ownership, this limits the ability to raise capital and limits the ability of owners to diversify. Nonetheless, some private firms manage to tap public capital markets by using hybrid financing strategies, such as issuing some form of perpetual bonds or selling equity in asset-heavy subsidiaries. Moreover, trading firms that are asset heavy tend to be less heavily leveraged. On the issue of the adequate regulatory framework and the potential systemic importance of CTFs, Mr. Pirrong considers that a "too-big-to-fail" approach is neither necessary nor appropriate. CTFs are analogous to industrial firms rather than banks as they do not engage in the same maturity transformation activities, are not major suppliers of credit and are less leveraged and are generally not as big. CTFs' balance sheets are structured differently from banks and are far more robust. In general, short-term assets are funded with short-term debt and long-term assets with long-term funding. For many commodities, especially the most important ones, there is relatively little concentration among commodity trading firms. Unlike many financial institutions, CTFs under financial distress can still function and redeploy their assets. Most importantly, they are less vulnerable to economic downturns as falling price levels have little effect on volumes traded and margins. On the follow up to G20 commitments, he argued that the trading obligation for the execution of commodities derivatives is unnecessary, while the central clearing requirements will reduce counterparty risks but have the potential to trigger further liquidity problem. With regard to the manipulation of prices, he indicated that targeted sanctions have more deterrence and disapproved prescriptive/preventive regulatory approaches.

Diego Valiante (ECMI and CEPS) put the findings of Mr. Pirrong in the context of the ECMI-CEPS report on "Price Formation in Commodities Markets: Financialisation and Beyond", i.e. in the three narratives that describe the change of global commodities markets in the last two decades: international trade, market infrastructure developments, linkages with the financial system and monetary policies. He indicated that high nominal and real prices have inflated the revenues of trading houses and that the distinction between trading houses and commodity firms has become increasingly blurred. Moreover, the vertical and horizontal integration processes shaped different business models. He challenged the point made by Mr. Pirrong that there is no uniform trend in terms of asset intensity of trading houses showing that the absolute value of investments in fixed assets were substantial over the past 5 years and may deem certain CTFs as being "too-physical-to-fail". The "too-physical-to-fail" concept involves three potential risks stemming from: conflicts of interest, market power, and supply security. Investments in physical assets have led some commodity firms to become major (regional) players in production, trading and storage of commodities. Consequently, conflicts of interests among different functions and market power can have harmful effects on physical flows (e.g. regional bottlenecks, temporal disruption, such as the LME aluminium queues) and market competition (e.g. market power and anticompetitive behaviours) may arise. Furthermore, he challenged the notion that assets are always easily redeployable/marketable, especially if the company gets into a short-term

liquidity crisis. He agreed though that this does not necessarily mean that CTFs exhibit the same type of systemic risk as banks or other deposit-taking financial institutions. Mr Valiante also discussed about the increasing interaction of commodities markets with the financial system over the last decade, commonly referred to as *'financialisation'*. Multiple circumstances, including the growth of international trade and cross-border interaction among physical markets, easier access to international finance and credit, expansionary monetary policies, market infrastructure developments, have increased co-movements between commodities and financial markets, as well as the opportunities for financial participants to enter these markets and for CTFs to use pure financial leverage and letters of credit to expand their physical interests. As it is documented in the ECMI/CEPS report, returns from commodities were increasingly pooled with returns from pure financial assets (a 'pooling effect'). The growing interconnection between financial and non-financial assets, and between regional physical markets, has amplified the reaction to market shocks. Even if CTFs are very resilient to exogenous difficulties, the crisis has shown that a shock from the financial sector can spill over to the commodities side and create volatility peaks in the short term. He also acknowledged the difficulty to draw a line between speculation and investment or to come up with a definition of speculation. On the latter, he referred to Grossman and Stiglitz's definition of speculation as vital to keep the balance between 'informed and uninformed trading' and indicated that regulators and policy-makers should be less concerned with the particular use of a product or technique as such but focus on the way in which information circulates and generates advantages on a discretionary basis. On the most appropriate regulatory approach, Mr. Valiante emphasized that regulation should focus on the services or function provided by the entity and not on the nature of the entity itself.

Edward Lucas (The Economist) stressed that conflicts of interests may arise, in particular, when financial and non-financial activities are combined in the same entity. Market manipulation in the underlying physical commodities market is likely to affect the derivatives markets. A trader could, in theory, send false information to a price-reporting agency in order to move a price for another purpose, such as making money on a derivative trade. He argued that the Market Abuse Directive (MAD) has not given enough sanctioning powers to deter manipulation in several areas, including commodities benchmarks. He underlined the importance of transparency for the overall functioning of the markets, their smooth interaction and ultimately the convergence between futures (forward) and spot price. The distinction between reality and perception in the physical and financial markets creates opportunity for wrongdoing and this should be addressed by relevant regulation.

Peter Caddy (Argus Media Ltd) underlined that differences in the functioning of physical and financial markets. This means that there needs to be a fundamentally different approach to the regulation of financial markets and physical markets. In this respect, he highlighted the difficulties of assessing benchmarks for physical commodities under regulation designed for financial markets. Financial market regulation is often based on assumptions about high volumes of transactions and ease of transfer of the asset. Such an approach within the EU to commodity price identification would have serious detrimental consequences for the functioning of commodities markets and induce companies to use benchmarks which are outside the EU jurisdiction. Reliable benchmarks are essential to manage the security risk. New infrastructure is constantly being built in order to eliminate inefficiencies down the supply chain. He noted that the physical infrastructure, including storage and delivery systems, determine the nature of the contracts that are traded. He warned that an unintended consequence of ill-thought out regulation could be that standardized spot contracts could be replaced by obscure structured contracts including optionality clauses. He also pointed out the differences between European oil markets, which are seaborne and where pricing is around specific dates of delivery and the US oil markets, which are pipeline based with and which consequently have many more transactions.

Valerie Ledure (European Commission) emphasized that commodity markets are no longer a suppliers/end-users market but have effectively become a destination for investment flows that might have triggered short-term price volatility. This change must be addressed by specific regulation and self-regulation is not an option. She highlighted that transparency in any market is key to arrive at a reliable market price, prevent market abuse and achieve overall market stability. Answering to market practitioners, Mrs. Ledure argued that EU regulations, such as MIFID II or EMIR, envisage preserving physical trading activities via exemptions for non-financial entities from being authorised as a MiFID investment firm if their financial activities can be regarded as ancillary to their core business, from the clearing and the trading obligation and from the position limits regime if the transactions are entered

into for hedging purposes. The agreement of 14 January also establishes additional transitional arrangements with regard to physically settled oil and coal derivative contracts traded on trading venues which provide additional relief from the clearing obligation under EMIR to ensure a smooth transition (42 months that can be extended once by 2 years and once by 1 year). The MiFID compromise text, which is now with the EP to be adopted, will impact the commodities derivative markets mainly by improving trade transparency, introducing of a trading obligation on multilateral trading venues and establishing position limits on commodity derivatives. MiFID II will most likely enter into force at the end of June and into application at the end of 2016. Mrs. Ledure also explained that this delay of 30 months is due to the need for ESMA and the Commission to develop Level 2 measures, the European Parliament and the Council to possibly object, 6 months for Member States to transpose provisions enshrined in a directive into national law and 6 months for the industry to adapt. ESMA will shortly start a public consultation on the development of the future technical standards (end May-beginning of June). The use of primary markets to manipulate financial markets or v*iceversa* falls under the Market Abuse Directive/Regulation (MAD/MAR). The new MAR prohibits and criminalises market manipulation (including benchmarks). A recent draft EU directive (2013), however, will regulate the work of price-reporting agencies (PRAs), entities that produce financial and commodities benchmark prices from transaction or market data and sell them to subscribers. In her view, much more work has to be done in these fields so that benchmarks will reflect more the economic reality and be used appropriately.

Among the services of trading houses that create more value added, **Christophe Salmon** (Trafigura) indicated storage, the on and off shore transit from supplier to final buyers, and risk management services. He pointed out that the growth of trading houses is mainly due to the growth of the overall market for commodities, i.e. increased demand from the emerging markets, and less to increased financial activity *per se*. Some commodity firms, such as oil companies, have retrenched their activities to focus on their core business, upstream in the value chain (exploitation, manufacturing). The resulting gap was filled by trading houses. Lastly, greater access to financial markets has increased the possibility to hedge risk, which favoured growth of trading house activity. In his view, most trading houses are confronted with the decision to choose between taking flat price risk or basis risk. However, he mentioned several other risks that need to be managed, such as operational risk, contract performance risk, market liquidity risk, funding risk, compliance risk and reputational risk. Mr. Salmon also referred to Basel III requirements, as most of the trading houses have access to bank liquidity through big credit lines and letters of credit benefit from either exemption or lower risk-weighing percentage. Furthermore, he indicated that privately held commodity firms are following the trend to increase transparency and have started to disclose their annual reports. On a final note, he encouraged the cooperation amongst market participants, policy-makers, regulators and supervisors.

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