

Improving the transparency and stability of commodities markets



This document was drafted by Eurofi with input from its members. It does not engage in any case the French Presidency of the G20 or the French financial authorities.

Executive summary

Commodities markets have become an easily accessible asset class for investors, with the strong development of derivatives and index funds. This has favoured stronger correlations among the different commodity markets and with other asset classes such as equities and other derivatives markets.

Many commodity markets have experienced strong volatility and price rises since 2006, which has led the G20 to require to “improve the regulation, functioning and transparency of financial and commodities markets” and to increase the consistency of commodities markets regulation on a global level. Most economists explain these evolutions by physical, and economic factors related to changes in supply, demand and inventories as well as political and seasonal reasons.

Although the growing presence of financial investors in commodities markets is undisputed, identifying causality links in price evolutions between financial and physical markets is a complex issue. Some economists believe that the growing financial positions in commodity markets may have amplified short term price evolutions, particularly in markets with a tight balance between supply and demand, in which a relatively minor reduction in quantity of supplies or herding behaviours in a context of low inventories can result in large increases in price. The lack of comprehensive data on physical and OTC financial markets introduces however a strong element of uncertainty. This is further complicated by the fact that physical markets have different features.

The different ways financial players operate in the market also need to be taken into account in these analyses. Hedge funds which are generally active investors may use leverage and take both financial and physical positions. Index investors are on the contrary mostly passive investors (many of them are pension / sovereign wealth funds) using no leverage and with a longer term perspective, meaning that they are not likely to have a strong impact on volatility, although some index investors – particularly retail – may introduce some irrationality in the market due to limited familiarity with commodity markets.

There is generally a consensus among regulators that the transparency of commodities markets as well as their supervision and coordination on a global level need to be developed, illustrated by the proposals recently made by IOSCO. This requires improving the data available on physical markets (e.g. by strengthening the cooperation among the relevant bodies and adjusting the methodologies and processes for collecting data) and on OTC derivatives markets with the projected implementation of one or several trade repository(ies) (which will complete mandatory clearing and trading, when appropriate, of sufficiently standardized contracts). Extending position reporting is envisaged for on and off-exchange markets. The powers and tools of supervisors also need to evolve in many cases to ensure better coverage of physical and OTC commodities derivatives markets. Research and an on-going monitoring of markets are moreover needed in order to develop a better understanding of price formation processes, sources of volatility and interactions between the physical and commodity derivatives markets.

Specific measures to improve the integrity and efficiency of commodities markets are currently being examined in different regions of the world.

The regulatory requirements of investment firms operating in the commodity markets are being reviewed in the US and the EU (e.g. authorization, capital and liquidity standards...).

Market abuse rules also need to be adapted for commodity markets in particular to avoid cross-manipulations between financial and physical markets.

Position limits are a more contentious issue. Proposals have been made in the US following requirements of the Dodd-Frank act to extend position limits, which currently exist for certain agricultural products, to other commodities in order to limit market manipulation risks and avoid excessive speculative positions. Such tools are also being considered in the EU in addition to the introduction of position reporting, particularly when there are risks to the overall stability of physical commodities markets.

CFTC Commissioners have recently put forward concerns with regard to the feasibility of position limits, due to the lack of reliable data, and doubts as to their capacity to prevent excessive speculation. Many industry players also consider that a cautious or more focused approach to such tools is required, arguing that inappropriate blanket limits could result in reduced market liquidity and consequently impairing price discovery and that regulatory arbitrage should be avoided.

Position management systems, which are more focused than position limits and by which regulators are bestowed with powers to instruct a particular trading party to explain a position and possibly close or reduce it are an option worthwhile considering, in the perspective of improved market data. The EU Commission has proposed in the MiFID review consultation document (Dec. 2010) using such mechanisms. Some industry players have also proposed to better coordinate and improve the consistency of position management processes currently utilized by certain exchanges for dealing with market manipulation risks. An alternative could be for regulators to resort to position limits on a temporary basis e.g. when markets are exposed to specific threats or instability.

Strong coordination is needed by the G20 (Finance Ministers and Governors) in this perspective to enable an effective implementation of the measures proposed by IOSCO to improve transparency of physical and OTC derivative commodity markets and ensure that measures for preventing market manipulation and avoiding excessive speculative positions are defined in a consistent and appropriate way internationally (e.g. the definition of tools such as position limits or position management processes). In addition the G20 should monitor efforts to improve the understanding of pricing dynamics in physical and financial commodity markets in order to fine-tune the rules defined.

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