

## **Financial Reform: Will It Impact Commodity Price Discovery Through The Futures Market?**

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As Congress struggles with the issue of financial reform, many in the agricultural sector are asking, “What is the impact of proposed legislation on agricultural commodity markets?”

The Senate Agriculture Committee passed a financial reform bill last week as a first step towards overhauling financial regulations. One of the major objectives of this financial reform movement is to finally regulate and bring transparency to derivatives trades, especially the credit default and currency swaps which played a big role in the recent near collapse of the U.S. financial system. The Ag committee has responsibility in this area since it oversees the Commodity Futures Trading Commission (CFTC), the government's regulator of futures exchanges.

### **Derivatives**

Part of the proposed legislative package would place a limit on investment banks trading in derivatives. A derivative is simply a financial instrument that 'derives' its value from something else, some underlying asset. The value of the derivative is tied to changes in the value of the underlying asset. Some common underlying assets are stocks, bonds, commodities, and currencies. Derivatives are usually used to hedge against price risk, but they can also be used for speculative purposes. Speculative trading in derivatives such as credit default swaps

(tied to the booming housing industry) by large investment banks led to the near collapse of the U.S. financial system.

While some financial swaps are traded through clearing houses, these financial instruments are typically traded in what is commonly referred to as the “over the counter market.” These trades are concluded privately and bilaterally (between two or more parties). The actual asset rarely changes hands, and the two or more parties settle the trade with one or a series of cash payments, depending on price movements. For example, there are large pools of financial swap on interest rates, allowing one party to “swap” a liability or asset that is attached to a floating interest rate against a fixed one.

These financial swaps have become incredibly complex and since most are privately transacted, they are almost impossible to regulate and monitor. For example, during the recent financial crisis, American International Group (AIG) Inc. almost failed by trading in derivatives related to mortgage securities. The company wasn't required to hold significant cash in reserve for the swap contracts and couldn't meet its obligation when the housing market collapsed. If AIG had failed, it would have had major implications to the entire financial system associated with them. This potential problem prompted a federal bailout.

### **Commodity Futures and Options**

So, a credit default swap is a type of derivative, but so are futures and options. A futures contract is a derivative traded on an exchange that gives the buyer the right to pay today's price for a specific asset to be delivered at some point in the future. But, unlike trading in financial swaps, futures trades are conducted in open markets where buyers and sellers must deposit collateral in margin accounts that serve as performance bonds. All gains and losses are accounted for on a daily basis by the Exchange Clearinghouse, which serves as a middleman

between buyers and sellers. Trade in commodity options, give the right, but not the obligation to buy or sell futures contracts, and operate in the same way.

Part of the U.S. regulatory reform efforts would force most or all standardized swaps to trade through exchanges and clearing houses in order to bring greater transparency to the market. These trades would require collateral deposits as are currently required in futures and options trading.

As a result, the financial reform underway may not have a major impact on agricultural futures markets as a place to hedge price risk or as a price discovery tool because trading in the futures market already meets the over-all objectives, in terms of trading in derivatives, that the reform hopes to implement. The reform may actually help reduce a potential repeat of some of the calamity caused by previous wide futures price swings.

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