

EEX Group - Deutsche Börse Group
Response

to the Commission's targeted consultation on
the role of the Euro in international trade of agriculture and food commodities

Frankfurt, 22 March 2019

1. Background

We welcome the Communication by the European Commission “Towards a stronger international role of the Euro” and very much appreciate the opportunity to respond to the consultations in that respect.

As a euro-area based integrated provider of financial market infrastructures, Deutsche Börse Group (DBG) covers a variety of products from agricultural and energy commodity markets to foreign exchange (FX) and their processing throughout the entire value chain from listing to clearing and settlement. In this context, DBG has followed with great interest the recent European Commission’s initiative to further strengthen financial integration and to explore ways to support the role of the euro at the international level.

Increasing the international role of the single currency may be done through different paths – directly, by increasing the trust and attractiveness of the currency itself; and indirectly, by supporting products and services denominated in euro. Given the complexity and potential cross-feeds of such dynamics, we welcome the European Commission’s approach to collect and gather feedback from a variety of sectors and actors to better understand the mechanisms at hand.

2. Introductory Remarks on the Consultation on the role of the euro in international trade of agriculture and food commodities

DBG’s services i.a. include the European Energy Exchange Group (EEX Group), which is the commodity branch of the group. As EEX Group runs markets in Europe, Asia and North America, we are home to different currencies. So questions with regard to whether DBG wants to launch a new contract denominated in euro or in another currency, are part of our everyday business decisions. The EEX Group offering comprises contracts for energy, agriculture, freight, metals and environmentals, including the EU Emissions Trading Scheme. The integrated group portfolio is completed by two clearing houses which ensure the proper clearing of these transactions, one of which is located in the US, Nodal Clear, and the second of which is located in Germany and called European Commodities Clearing (ECC).

The agricultural commodity markets represent one of the largest sub-asset classes in global exchange commodity trading. Our agricultural offering comprises financially settled derivatives contracts on dairy products and processing potatoes which are offered for trading and clearing.

3. Market dynamics and potential for more euro-denominated exchange products

As mentioned above, agricultural markets represent one of the largest sub-asset classes in exchange commodity trading globally. However, most of the agricultural future markets in Europe are still facing a situation of quite low liquidity, as it takes time to develop a functioning market. In the EU, futures markets that are relatively liquid are grains, oilseed, processing potatoes and softs. As is the case for most agricultural futures markets, trading in these contracts is typically based upon physical delivery of the underlying product. However, the futures markets on European dairy products and potatoes are more recent innovations launched by EEX, respectively Eurex, and use cash settlement as convergence mechanism rather than physical delivery. As the latter have existed for only a couple of years (liquid milk marked its launch in 2018), they are still in an introductory or growth phase.

From a global perspective, the majority of freely available agricultural benchmark prices (that are used as the basis of, or derived from futures contracts) are denominated in US dollar. As a result, international physical trade in these markets also tends to be priced in US dollar and once a contract is embedded in a currency, there is little potential to change this.

In Europe however, many agricultural futures contracts are denominated in euro. The EEX agricultural risk management offering currently includes futures on the underlyings European processing potatoes and dairy products, such as European butter, skimmed milk powder (SMP), whey powder and since 2018 also liquid milk. All of these contracts are denominated in euro. While this is an evident choice for agricultural goods that are generally produced and consumed locally (e.g. processing potatoes and liquid milk), it is less evident for agricultural goods that can be exported to the world market, i.e. butter, SMP and whey powder, which are also denominated in euro at EEX. In these markets EEX competes

with agricultural risk management markets in the US and New Zealand, which are generally denominated in US dollar and are referring with their instruments to underlyings from the respective region of the world.

It is noteworthy that, while for these dairy contracts the open interest as well as its share of production is much larger on US dairy contracts than the ones on EEX or in New Zealand, both open interest and share of production is slowly but steadily growing at EEX.

In light of the European Commission's consultation, we believe that in order to grow the amount of transactions in euro, the EU should not only support its liquid future markets which are already denominated in euro, but particularly focus attention on the new and illiquid contracts that have only just started to grow and for which the standard currency in global trade has not been embedded yet, such as those referring to European dairy products.

4. Regulatory framework required to achieve the aims of this initiative

The European Communication's Communication carefully notes that *"the decision to use a currency is ultimately made by market participants and there are good reasons why economic actors might wish to invest and hedge in different currencies. The objective is not to interfere in commercial freedom or limit choice, but rather to expand the choice for market participants by ensuring that the euro represents a strong and reliable alternative in all relevant ways."*

While we agree with this statement, we believe that the EU can play a vital role in creating a regulatory framework that (1) promotes new contracts denominated in euro and (2) fosters the liquidity in contracts that are already denominated in euro. Here below, we outline three key areas in which the EU can play such a role for agricultural commodities.

1. Promotion of risk management tools in the EU Common Agriculture Policy

First of all, DBG supports the EU's ambition to have a more market oriented Common Agriculture Policy (CAP), as laid out in the European Commission's proposals for a post-2020 Common Agricultural Policy published on 1 June 2018¹. However, greater market-orientation also means that farmers will be increasingly exposed to price risk. In addition to greater market-orientation, also climate change and associated frequency and severity of extreme weather events will lead to risks of price volatility and hence a greater desire for risk management tools.

The report from the Agriculture Markets Task Force, published in 2016², explains that there are two types of risks:

- a) Risks related to agricultural production which are caused by environmental factors and weather induced events;
- b) Risks related to agricultural market prices. These risks may inter alia be affected by inter-linkages with other commodities and financial markets and other macro-economic factors which influence dynamics on both the supply and the demand side.

The European Commission's Communication on the "Future of food and farming" from 29 November 2017³, rightly states that there is need for a robust framework to ensure appropriate risk management. The 2013 CAP reform already introduced a comprehensive set of tools helping farmers to prevent and manage risks, from direct payments and market intervention to post-crisis compensations and income stabilization tools. However, as the Agriculture Market Task Force rightly points out in its report, the uptake of these tools by Member States is limited and, in addition, more focus is needed on the risk management tools offered by the private sector, such as future markets. Futures markets, such as EEX

¹ https://ec.europa.eu/info/food-farming-fisheries/key-policies/common-agricultural-policy/future-cap_en

² https://ec.europa.eu/agriculture/sites/agriculture/files/agri-markets-task-force/improving-markets-outcomes_en.pdf

³ https://ec.europa.eu/agriculture/sites/agriculture/files/future-of-cap/future_of_food_and_farming_communication_en.pdf

agricultural markets, offer farmers an additional tool for risk management and carry the potential of usefully underpinning a market-oriented agricultural policy, particularly when the use of traditional public market measures is reduced.

However, there is a lack of awareness of the existence of risks and the actual need for pro-active risk management by farmers. The latter has been recognised by the Task Force's report as one of the most important reasons for limited use of futures by farmers. DBG therefore supports the European Commission's proposal to increase awareness and knowledge of risk management tools through rural development training, knowledge transfer initiatives and the inclusion in the farm advisory service. However, these measures should include risk management tools offered by the private sector, such as future markets. As been recommended by the Agriculture Markets Task Force, Member States should be encouraged to make funding available under their rural development programmes for practical training for farmers and cooperatives on how to use futures.⁴ This will contribute to the European Commission's objective of having a stronger international role of the euro.

2. Make the financial regulatory framework fit for commodities

As the farming community faces limited knowledge about future markets, the same is true for the financial community and policy-makers in the field of financial regulation about commodities, and particularly about agricultural commodities.

With its entry into force, MiFID II has fundamentally changed the landscape for commodity markets in Europe. While it has been one of the objectives of the G20 Pittsburgh Summit in 2009 to better oversee and regulate commodity futures, the one-size-fits-all approach adopted in MiFID II has had a couple of adverse effects on commodity markets. The failure to sufficiently take into account the specificities of certain commodity products have particularly hampered the uptake of new and nascent markets, including EEX euro-denominated agriculture contracts. In the below, the three most important adverse effects are listed:

a) The MiFID II position limits regime

With the entry into force of MiFID II, every commodity derivative contract in Europe has become subject to a position limit on the size of a net position that a person can hold at all times in this contract. The limits, which aim at preventing market squeezing, are set as a percentage of the deliverable supply available in the underlying physical market with regards to spot month contracts and a percentage of open interest with regards to contracts expiring in all other months. Furthermore, Article 15 of RTS 21 has introduced a specific regime for new and illiquid contracts whereby a fixed limit of 2,500 lots is set for all months in contracts not exceeding 10,000 lots of open interest. In addition, contracts between up to 20,000 lots of open interest are eligible for a higher percentage limit of up to 40% of deliverable supply in spot month and open interest in other months.

While EEX agricultural commodity derivative contracts have not yet come close to the threshold of 10,000 lots, DBG is concerned that when they do, the absolute limit of 2,500 lots will be too restrictive to allow for further development of the contracts. This is because the number of active trading firms is typically limited in a developing contract.

Particularly from the view that, as long as the underlying index is sufficiently robust, DBG does not believe that market squeezes are likely to occur/or are easy to engineer in cash settled contracts, we encourage the European Commission to review the MiFID II positions limits regime so as to ensure it does not impose a barrier on the development of new and nascent products, as intended by MiFID II. Generally, we believe that a proportionate and efficient position limits regime should concentrate on a limited number of benchmark contracts, similar to the way the U.S. has developed its position limits regime.

Moreover, there should be an accurate reflection of the underlying physical markets. For example, the position limits regime should include a liquidity provision exemption, as has been included in the ancillary activity exemption regime. A liquidity provision exemption, as outlined in Art. 2(4) of MiFID II, is particularly necessary for new contracts that need

⁴ It goes as far as recommending that Member States should mobilise funding for designing new futures markets meeting the needs of stakeholders.

financial entities to incentivise trading in the contract. Also the Agriculture Markets Task Force recognizes that commodity exchanges should be encouraged to put in place liquidity provision programmes so as to stimulate liquidity in the early days of a new futures contract.

b) The pre-trade transparency regime

DBG and other European exchanges have long argued that the MiFIR pre-trade transparency regime in its present form is not fit for purpose for commodities. It may prevent pre-arranged trades from being submitted to exchanges, thereby limiting the ability of market participants to hedge their commercial exposures. Moreover, if market participants are no longer able to submit pre-arranged trades to exchanges, i.e. what we call “trade registration”, they may be forced to move trading activity to the non-cleared OTC space. This will limit transparency and undermine the price discovery process as well as limit the possibility of physical delivery to take place under the exchange / clearing house rules, hence going against the spirit of the G20 reforms. This is because, compared with other financial instruments in Europe, almost all agricultural commodity markets are less liquid. In order to achieve execution, market participants often trade via brokers organizing transactions through a pre-arranged agreement rather than in a central order book where a satisfactory execution would be less likely.

It is important to realize that because of trade registration, more and more traders find their way to the central order book. Trade registration has been and still is essential to – as a next step - bring more volumes to the central order book. This is why we believe that the pre-trade transparency regime should be better tailored to commodities, including agricultural commodities, and allow for a more natural move to central order book trading.

c) The hedging exemption

Both the pre-trade transparency as well as the position limits regimes include exemptions for market participants pursuing hedging activities as per Art. 8(1) of MiFIR and in Art. 57(1) of MiFID II. However, both articles limit the availability of the exemption to non-financial entities only, thereby rendering the exemption unviable to investment banks or commodity trading houses which are in many cases providing smaller commercial players, including farmers, with access to commodity derivatives markets and hence engaging in genuine hedging activities.

Therefore, the hedging exemption does not achieve the intended objective of ensuring that farmers can use regulated venues to manage their risk, and additionally worsens the problem of having an inappropriately designed pre-trade transparency regime and disproportionate position limits.

In order to strengthen the international role of the euro it is crucial that the underlying financial regulatory framework for agricultural commodity price risk management instruments trading takes into account these commodity-specific issues and creates a competitive environment for euro-denominated agricultural commodity contracts to grow liquidity.

3. Increase transparency on prices

In its report on “The Future of Food and Farming”, the Agriculture Markets Task Force further recognizes that one of the key issues for developing future markets in agriculture is the lack of information about the physical market, in particular lack of price transparency which is necessary for cash-settled contracts.

Benchmark prices are generally derived from either futures exchanges or PRA published prices. For example, international trade in corn will often be priced basis the CME contract and international trade in raw and white sugar will often be priced basis the ICE contracts – with all of these being US dollar-denominated. In addition, the recently launched Platts Black Sea Wheat index is also US dollar-denominated and is becoming a popular benchmark for trade in the region.

To increase use of the euro in international trade, similarly, euro-denominated agricultural commodity benchmark prices should be developed within the EU. For example, the European Commission collects euro-denominated prices and other information for a wide range of agricultural commodities produced by Member States. The current turnaround time

between collection and publication makes it challenging to use these prices as a basis for commercial pricing and hedging (e.g. raw milk). The Commission, in cooperation with Member States, could introduce an initiative to enhance the collection, publication and dissemination of these numbers. A further objective would then be to encourage private sector participants – traders, exchanges etc. to utilise this data as the basis of international commercial transactions and new agricultural futures contracts.

To conclude, DBG and its entities would like to welcome once again the European Commission's approach to collect and gather feedback from a variety of sectors and actors to better understand the mechanisms which underpin the use of the single currency. DBG very much hopes that this response will serve as first step to provide a holistic understanding of the various factors at play in the field of agricultural commodities.

In this context, DBG and its entities will continue to follow with great interest the European Commission's initiative to support the role of the euro at the international level. We stand ready to further support the European Commission's objectives to strengthen the European markets and Europe's financial ecosystem in this context, including creating competitive agricultural markets. DBG remains available for any questions and additional feedback on potential future propositions.