National Grain and Feed Association

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Testimony of the
National Grain and Feed Association

to the
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
U.S. Senate
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Presented by Thomas Coyle
Chairman

Good afternoon, Chairman Levin, ranking member Coburn, and members of the subcommittee. My name is Tom Coyle. I am General Manager of Chicago & Illinois River Marketing LLC in Chicago, Illinois, and I serve as the elected industry chairman of the National Grain and Feed Association (NGFA).

The NGFA is the national nonprofit association representing the grain, feed and processing industry and related commercial businesses. Our 1,000 member companies are geographically diverse; range from very small to very large; comprise privately held firms and cooperatives, grain handlers, processors, exporters, long and short hedgers. We estimate that more than 6,000 NGFA-member facilities handle, store, process and export well in excess of two-thirds of U.S. grains and oilseeds produced every year.

One common thread running through NGFA-member companies is that we rely on efficiently functioning markets in purchasing and merchandising the U.S. crop and in assisting producers with their marketing strategies. Futures markets that facilitate accurate price discovery and effective hedging are an integral part of those functions.

I appreciate the opportunity to testify today and I congratulate you on the recent publication of a very interesting and insightful report about the U.S. wheat markets. We believe this report examines futures market data and the views of futures market participants in a unique way that offers some fresh new perspectives on U.S. wheat futures markets over the past few years.

New Entry of Investment Capital into Agricultural Futures Markets

We began noticing the entry of investment capital into agricultural futures markets in larger volumes three to four years ago. At that time, participation of investment capital in our markets seemed more a matter of interest than of concern. We believed then, and we still believe today, that the attractiveness of agriculture as an asset class in investor portfolios is a positive signal about the vibrancy and future prospects of our industry.

However, over time and as the level of capital invested in agricultural futures has increased dramatically, we have become convinced that it has reduced the effectiveness of futures as a hedging tool for our members, the traditional commercial grain hedgers. The impact has been particularly dramatic on the Chicago Board of Trade wheat contract. As the subcommittee's report points out, "Commodity Index Traders" as defined in the weekly Commitments of Traders (CoT) report issued by the Commodity Futures Trading Commission (CFTC) currently hold about 55% of open interest in the wheat contract when spread trades are excluded – which we have said for the past year is the best way to represent investment capital's participation. Their share of open interest has remained at consistently very high levels regardless of price: from $3.42 in January 2006, through the February 2008 peak of $13.34, to the current market of $5.11. The latest CoT report shows Commodity Index Traders hold net ownership of 162,532 contracts, which represents 196% of the latest USDA estimate for U.S. 2009 soft red winter wheat production.

To date, positions held by commodity index traders have been mostly long-only, held for extended periods, and non-responsive to changes in price. We believe that this situation, in which a large portion of the crop is not for sale at any price for extended periods, has sucked liquidity out of the contract and has contributed to extreme volatility such as seen last summer in the soft wheat contract.

There is no doubt that other factors are at work, too. In recent years, large soft wheat crops and stagnant export markets, changes in domestic demand patterns, increased fuel and transportation costs, and other factors all have contributed to a changing marketplace. We believe strongly, though, that disproportionate participation of investment capital has been the significant contributing factor to a disconnect between cash wheat values and wheat futures prices.

It is important to note here that we have not seen evidence of efforts to intentionally manipulate the wheat contract or other agricultural futures contracts. The funds and institutional investors seeking exposure to agricultural commodities are investing on behalf of individual investors saving for retirement or college or any number of other goals. For this reason, our association has not historically supported limits on participation in futures markets; but our industry's recent experience has prompted the NGFA and its members to evaluate carefully how best to preserve the wheat contract's utility to commercial grain hedgers and their farmer-customers.

Importance of Efficient Futures Market Performance

Efficient performance of futures markets is critically important to grain hedgers and to U.S. agricultural producers who traditionally have relied on their elevator – the first-purchaser of their grains and oilseeds – to transfer risk and help optimize returns from the market. The subcommittee report provides a good example of a typical hedging transaction, but it may be useful to walk through a simple scenario to illustrate the importance of a properly functioning futures contract to grain hedgers and producers:

Often, when an elevator purchases grain from a producer, the parties enter into a forward cash contract under which the producer agrees to deliver a specified amount of commodity to the elevator at a specified future time and location. Such forward cash contracts come in many different forms to help serve the varying needs of producers; typically, the price ultimately received by the producer is based on a futures price.

When an elevator enters into a forward cash contract to buy commodity from a producer, the elevator usually hedges its risk by selling futures on a regulated commodity exchange. The elevator generally enters into this "short" futures position in a similar quantity as purchased from the producer, and in a futures contract that roughly coincides with the expected date of sale of the commodity.

As the futures contract nears expiration, the elevator relies on the relationship between cash and futures values – known as the basis – to converge. Convergence is a bedrock fundamental principle of futures markets on which hedgers have relied for decades. In the absence of a predictable relationship between cash and futures – i.e., lack of convergence – the elevator lacks a reliable benchmark with which to help establish a bid to the producer and to place a value on the commodity when selling it. It is just such a lack of convergence, coupled with historically large and volatile basis swings, that grain hedgers have been dealing with for the past two to three years.

This scenario makes clear several critical functions of futures markets: to help grain hedgers manage business risk (i.e., to hedge their price risk and inventory risk); to assist both producers and elevators in valuing their product accurately, whether buying or selling; and to facilitate risk transfer and marketing opportunities for producers as they utilize cash forward contracts offered by their elevators.

Last year's extreme volatility in wheat markets dramatically emphasized the disconnect between cash and futures values for soft red wheat. While cash markets continued to function well in providing accurate valuations of wheat at a given location and time – as cash markets must to facilitate efficient movement of commodities – traditional basis relationships between cash and futures seemed no longer to apply. Futures values ran up aggressively, becoming divorced from cash values that remained at levels based on supply and demand fundamentals.

As cash and futures diverged, grain hedgers were subjected to larger and larger margining requirements in order to maintain their short futures positions and their hedges. The result was extreme financial stress for grain hedgers, who were compelled to borrow several multiples of their normal needs just to maintain their futures positions. The borrowing limits of hedgers were severely strained, as was the capacity of lenders to respond. Our industry narrowly escaped a real tragedy in which many firms could have been forced out of their hedge positions and out of business. The agribusiness lending community responded well to the crisis, but the entire episode has led some lenders to question whether futures provide an effective hedge – and has generated continuing concern among hedgers about whether lenders would have the capacity to respond in a similar fashion if the situation was repeated today. The feedback we've received from the banking community says they would not.

As to the ripple effects for producers, many elevators were forced by financial constraints to reduce or even eliminate cash forward contract offerings that previously had been available to producers. Many hedgers simply were not able to take on the additional financial exposure that writing more forward contracts would have created. Extreme volatility compelled elevators to price grain purchases from producers more cautiously; far from producing an automatic windfall to the elevator, greatly increased risk and much higher costs to finance hedges forced such action. As a result, producers were frustrated in attempts to lock in favorable pricing opportunities at a time when their fuel and other input costs were escalating dramatically. Our member companies' traditional function as a conduit for efficient pricing to the producer was impaired as the wheat contract failed to provide accurate pricing signals. Although not the sole cause, we believe strongly that investment capital played a significant role in driving futures values to artificially high levels and threatening the viability of the wheat contract.

Potential Solutions to Re-Establish Cash/Futures Relationship and Convergence

The NGFA has been working actively for solutions to the performance problems of the CBOT wheat contract, and we deeply appreciate the CME Group's openness and responsiveness to our industry's concerns. The NGFA and the CME Group have maintained an ongoing dialogue about how best to enhance the contract's performance, a discussion that continues today. We initially hoped – and the CME Group may have assumed – that markets would correct on their own, as efficient markets tend to do over time. However, the extraordinary situation in the wheat contract has prevented the market from correcting in a timely way. As a result, some commercial grain participants have reduced their use of the contract as a business strategy due to reduced hedging efficiency. This is particularly true for the hedging of non-U.S. production. The result is even less "commercial short hedging" which further amplifies the impact of long-only participants.

One important component in this discussion is enhanced transparency in futures markets. In early 2007, the CFTC introduced additional detail into the CoT report that our industry found very useful. Reporting on positions of Commodity Index Traders in the CoT report aids commercial grain hedgers in determining whether markets are moving in response to fundamentals of supply and demand or other factors. Chairman Gensler has announced that additional enhancements to the report will be made, including disaggregating positions of swap dealers and managed money funds. We believe that information will be helpful. We would also recommend that the Commission consider providing the same level of detail in the "lead month" – the contract month with the largest open interest – along with the total open interest for each commodity in the CoT report to further enhance transparency. While this reporting would not necessarily improve convergence, the information gained would assist commercial grain hedgers in their decision-making and would also assist the Commission and public policymakers in evaluating participation of various types of traders.

With regard to re-establishing convergence, we are hopeful that contract changes being implemented now by the CME Group – a seasonal storage rate, additional delivery locations, and changes in vomitoxin specifications – will move the wheat contract back toward convergence and preserve the contract's utility for its traditional users. These changes are significant, and we acknowledge that the exchange has moved quickly by historical standards. While the changes may not go as far or as fast as many in our organization would prefer, we believe the CME Group is committed to restoring the contract's performance.

We can appreciate the CME's desire to proceed carefully to avoid creating other problems, but we have expressed our view that they must be prepared to move quickly on additional measures to fix the contract if the current changes don't have the desired effects. We understand the CME Group is looking closely at a Variable Storage Rate concept that we believe holds promise. We have also suggested to the CME Group a Modified Compelled Loadout element that we believe, if added to the contract, would restore convergence. We have urged the CME Group to lay the groundwork now for additional changes, if needed to re-establish convergence, and we believe they will be prepared to act. If the CME Group moves to adopt either of these concepts or other changes, it will be critically important that the CFTC is prepared to move contract improvements through its approval processes expeditiously. I would be happy to provide more detail on these concepts.

Historically, the NGFA has been a very free-market organization. We would much prefer to see the wheat contract come back into balance with minimal intervention as we work with the CME Group on constructive contract changes. However, if that doesn't occur soon, and if the changes being implemented by the CME Group do not prove sufficient, other measures could prove to be necessary. Among these options is a concept release published recently by the CFTC that would revamp the process by which hedge exemptions are issued by the Commission and phase out over time the no-action relief from speculative position limits that has been granted to two index funds – concepts similar to recommendations in the subcommittee's report. The NGFA has advised the CFTC that a reappraisal of these policies may be timely. At this time, we do not advocate a complete end to hedge exemptions for commodity index traders and swap dealers, but we have advised the Commission of our notional support for a re-examination of its policy on hedge exemptions and, potentially, tighter regulatory standards for hedge exemption eligibility.

I would provide just a few words of caution as I conclude. At a certain level, risk and volatility in markets is necessary, and a good thing. Some amount of volatility always has been inherent in agricultural markets as we are so dependent on the vagaries of weather, supply and demand around the world and other factors. Our member companies and the producers with whom we work so closely have learned over the years to manage these risks and to capitalize on a reasonable amount of volatility. We would not want to see markets legislated or regulated so firmly as to remove producers' and hedgers' opportunities for favorable returns in a well-functioning marketplace; nor would we want to see a return to the days of constant surpluses, with large stocks hanging over markets and damping down opportunity for producers and elevators. The challenge is to find the right combination of changes to contract terms and appropriate public policies that will ensure the CBOT wheat contract serves its original purpose: to provide price discovery and risk management to their traditional users.

To that end, we look forward to continuing a close and open dialogue with the CME Group, the CFTC and the subcommittee. I would be happy to respond to any questions.