

# Clearing for Agricultural OTC Swaps

Commodity Futures Trading  
Agricultural Advisory Committee  
July 29, 2008

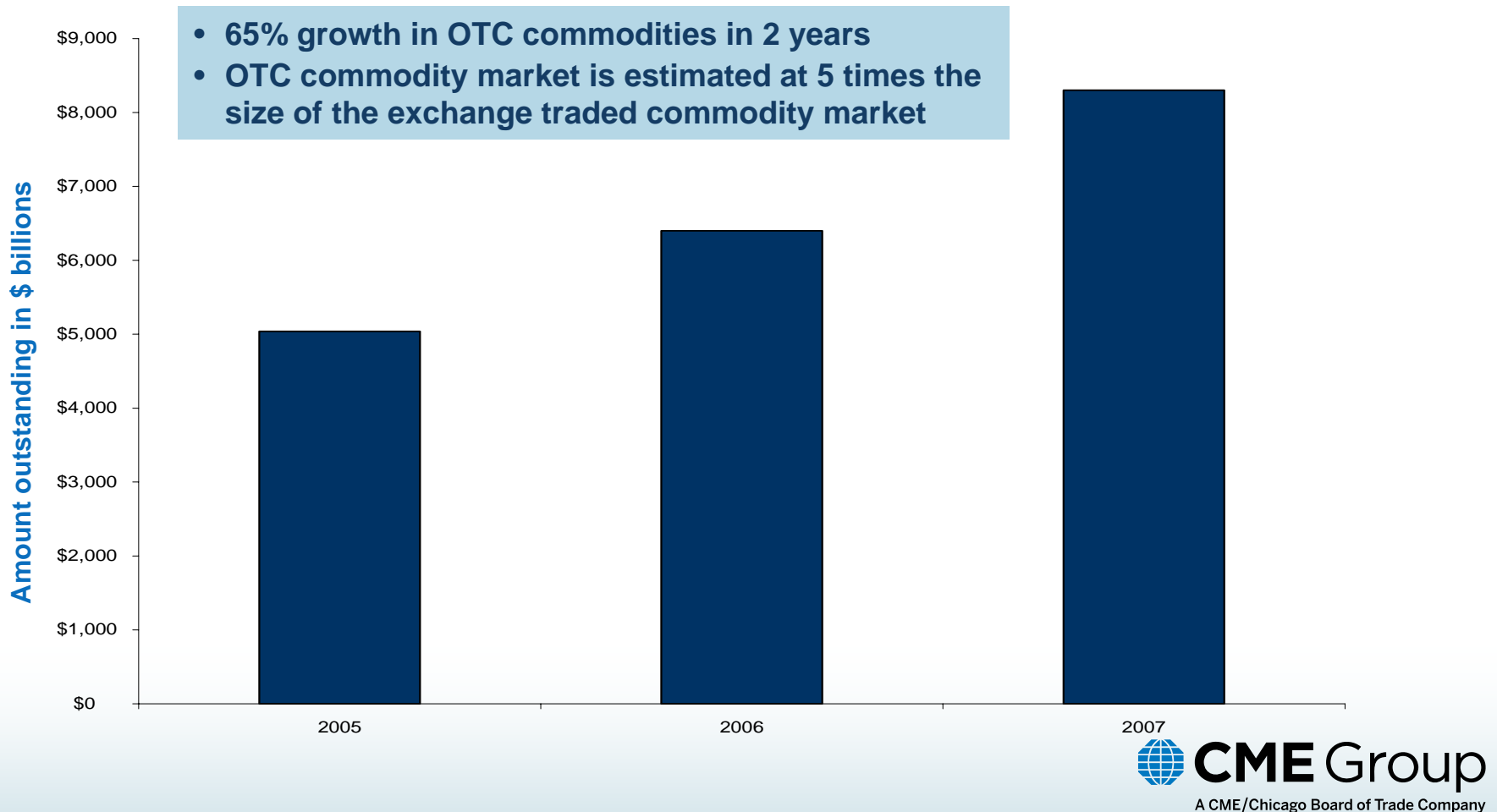
# Fundamental Changes in Commodity Markets

- **Basic supply and demand principles in commodity markets are resulting in higher prices and greater price volatility:**
  - Weather and disease limiting supply
  - Growing demand from developing countries
  - Falling U.S. dollar
  - Higher input costs related to increasing energy prices
  - Biofuel production increases
  - Limited additional farmland in the short run
  - Restrictive export policies from some major exporters
- **Agricultural markets are undergoing tremendous change, development, and adjustment. Traditional risk management tools have been forward-looking 1-3 crop years.**
- **Higher risk resulted in market participants looking toward additional price risk management tools and longer-term protection.**
- **Hedging needs have also become more individualistic and are not as easily satisfied by standardized futures contracts where contract terms are standardized and liquidity is concentrated within the first couple of crop years.**
- **Instead, some market participants have looked to specialized swap dealers in the over-the-counter (OTC) market.**

# Benefits of Ag OTC Products

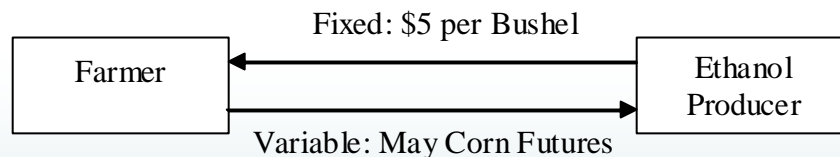
- Commodity forwards, swaps, and options are being transacted in the OTC space on a variety of enumerated commodities including corn, soybeans, wheat, dairy, and meat.
- Since OTC swaps are not guaranteed by centralized clearing, these market participants can be at risk for default. One potential solution to this problem is to have centralized clearing for these OTC swaps.
- Market participants are turning to CME Group and asking for central counterparty clearing for these types of OTC instruments in the agricultural sector.
- Currently CFTC Rules prohibit exchanges from clearing agricultural OTC swaps. If the CFTC grants exemptions to exchanges to clear agricultural OTC swaps, these tools can be available to more market participants without the risk of counterparty default.
- Introduction of cleared ag OTC products will provide market participants with new products to help them manage increasingly volatile basis risk, price exposure, and counterparty risk.

# Amounts Outstanding of OTC “Other” Commodity Forwards, Swaps, and Options (including energy)



# Definition of a Swap

- A swap is an agreement between counterparties to exchange cash flows over some period of time. The oldest and most popular swaps are exchanges of interest rates.
- A commodity swap is similar to an interest rate swap, but the parties are exchanging a fixed price for a commodity with a floating or variable price for the commodity.
  - Ethanol producer agrees to pay the farmer a fixed price of \$5 per bushel for corn. In return, farmer agrees to pay ethanol producer a variable price for corn. For example, the price of CBOT Corn futures on the day the swap expires.
  - Assuming the swap expires on April 30, on that day the ethanol producer will pay the farmer \$5 per bushel for corn and the farmer will pay the ethanol producer the settlement price on May CBOT Corn futures on April 30.
  - Commodity swaps are usually settled financially and there is no physical delivery.



Plain Vanilla Commodity Swap between a Farmer and Ethanol Producer

# Product Example: Corn Basis Swap Contract Specs (Northeastern Iowa)

**Clearing Unit:** 5,000 bushels

**Months Cleared:** Monthly

**Price Basis:** cents and  $\frac{1}{4}$  cents per bushel

**Last Day of Clearing** - The last day of clearing in Northeastern Iowa Corn Basis Swaps deliverable in the current delivery month shall be two business days prior to the first calendar day of the delivery month.

**Final Settlement Price** – The final settlement price shall be determined on the last clearing day. Final settlement shall be the average of the daily Northeastern Iowa corn cash price index minus the settlement price of the corresponding CBOT Corn futures contract over the last five clearing days.

**Daily Settlement** – Daily settlement other than settlement on the final settlement day (as described in Regulation XX42.03) or during the last five days of clearing shall be the preliminary Northeastern Iowa corn cash price index minus the settlement value of the corresponding CBOT Corn futures contract on that day.

# Exchange Product and Service Offerings

- **These products will continue to trade as OTC products with private negotiations between eligible counterparties or between a market participant and a swap broker. The OTC trades can then be brought to the CME Group for clearing.**
- **Pending an exemption from CFTC, CME Group will offer clearing services for the following OTC agricultural swaps:**
  - Corn, Wheat, and Soybean calendar swaps
  - Northeastern Iowa, Northwestern Iowa, Southern Iowa, Eastern Nebraska, Eastern South Dakota, and Southern Minnesota Corn basis swaps
- **The Exchange and/or CME Clearing will:**
  - Publish daily settlement prices
  - Distribute daily volume and open interest for all swaps listed for clearing
  - Adopt position accountability levels for single months and all months combined for these OTC swap contracts and establish reportable levels of 25 contracts
  - Conduct financial surveillance and oversight of FCMs clearing these swap contracts
  - Utilize SPAN margining system to establish margin levels
  - Perform daily and final mark-to-market on contracts



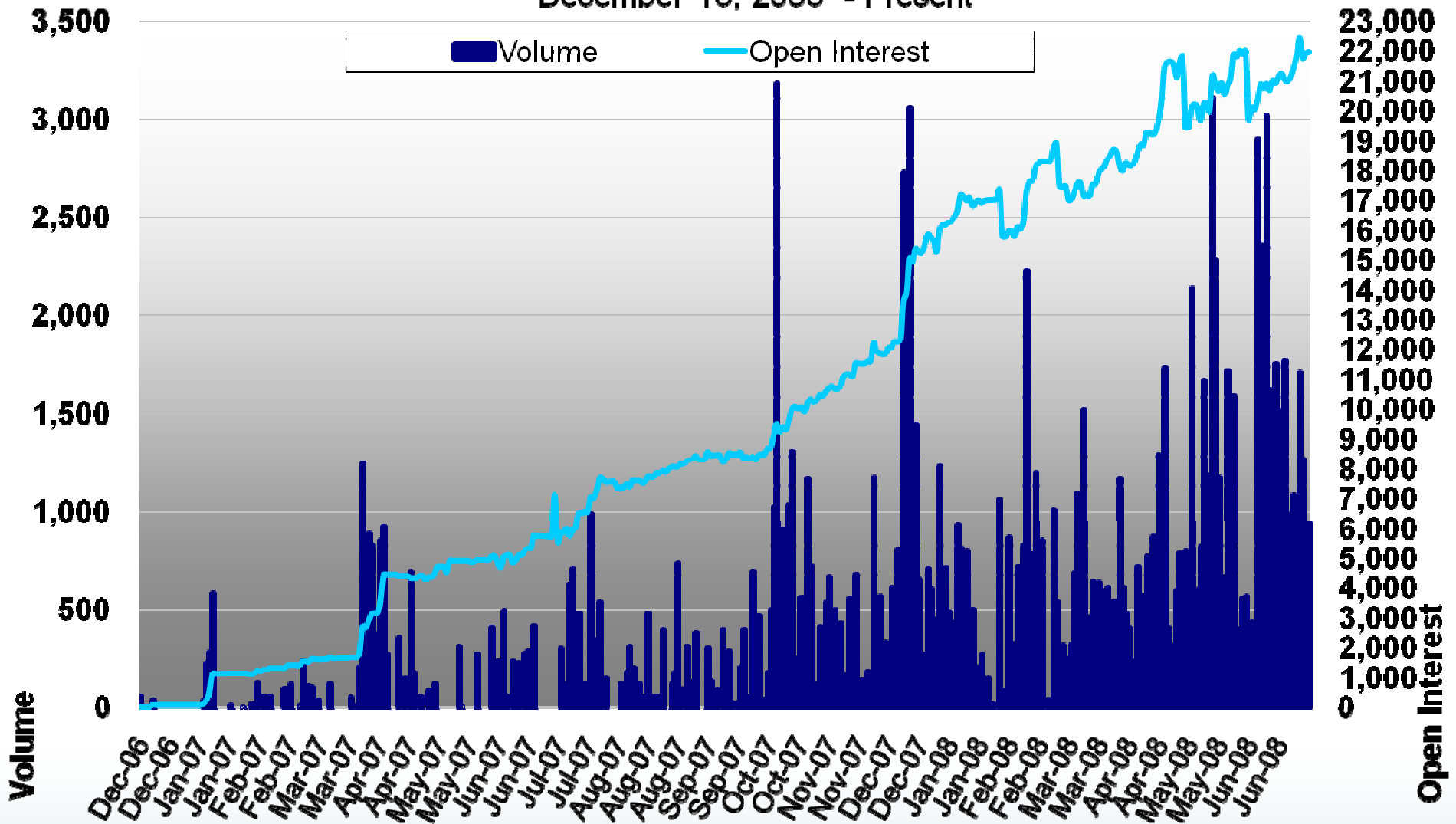
# CME Clearing Guarantee

- CME Clearing will act as central counterparty for all swaps submitted to CME for clearing.
- CME Clearing will guarantee performance for cleared swap products, and will utilize mark-to-market and the establishment of clearing level performance bond requirements (“margin”) as key risk management tools to underpin its guarantee services.
- CME Clearing intends to maintain flexibility in offering clearing services for cleared swap products, and, depending on the structure of clearing services for particular cleared swap products, plans to provide the following services:
  - Multi-lateral netting
  - Post trade give-up
  - Real time trade confirmation
  - Risk offsets against other highly correlated products as a part of its service offering
- **Total financial safeguards package available through CME Clearing is over \$4 Billion.**



## Daily CBOT Ethanol Swaps, Volume and Open Interest

December 13, 2006 - Present



# Benefits of Cleared Ag Swaps

- Bridge unregulated OTC markets with regulated Exchange-traded markets
- Increased transparency through public reporting of volume, open interest and settlement prices
- Enhanced market surveillance of OTC activity by requiring position accountability and reportable levels of 25 contracts
- Increased safety and soundness of the markets since CME Clearing eliminates counterparty risk
- Added margin benefits to customers who can offset with existing futures positions held at CME Clearing
- Enhanced risk management for agricultural commodities since basis risk can be managed in addition to flat price risk
- Improves capital efficiency through daily mark-to-market margin process
- Provides benefits of centralized clearing for bespoke OTC products that are too small to support an efficient, liquid exchange-traded futures contract

