Over-the-Counter Derivatives

Background:

As processors of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of over-the-counter (OTC) derivatives. Farmer cooperatives use swaps to help safely hedge risks associated with price movements in commodities, including (but not limited to) grain, milk, energy, and fertilizer. As market volatility increases, cooperatives use swaps to better manage their exposure by customizing their hedges and accessing risk management alternatives in otherwise illiquid markets. This increases the effectiveness and can reduce the costs of those activities. In addition, swaps give cooperatives the ability to offer customized products to producers to help them better manage their risk and returns and, ultimately, provide more predictable profitability. Some examples include:

- Providing customized hedging solutions to dairy farmers, allowing them to lock in margins to help ensure future profitability. The co-op will, in turn, offset that risk by buying financial futures on corn and soybean meal, while selling class III milk futures.
- A local elevator/co-op can offer a crop farmer a guaranteed price for future delivery of a specific volume of a commodity and offset that risk by entering into a swap with its larger cooperative.
- Large inventories of fertilizer are necessary to provide farmers with timely service as fertilizer is produced year round and there are only seasonal applications. Though there are no centrally cleared tools, there is a growing OTC market that helps co-ops hedge away inventory/price risk during volatile times.
- Customized solutions are developed at the co-op level to assist individual farmers with their fuel hedging needs as nearly all U.S. farmers do not have the fuel demands necessary to consume a standard 42,000-gallon monthly NYMEX contract.

The ability to provide those services to farmer owner-members is not only reliant on the ability of the local co-op to enter into a swap with its larger cooperative (or its subsidiary), but also for the larger cooperative to have affordable access to the OTC market with other commercial counterparties.

NCFC Position:

As the Dodd-Frank Act is implemented, it needs to be clear that end-users such as farmer cooperatives are not captured under the rules as a swap dealer or major swap participant (MSP). Not only is it important that farmer cooperatives are excluded for their primary business activities, but if a farmer cooperative were to be considered a dealer in swaps that are used to offset the risk of providing forward pricing to producers, additional regulatory requirements could make providing these services economically unfeasible.

In addition to not imposing margin requirements on end-users, margin/transaction costs need to be kept at acceptable levels. If initial and variable margin requirements are imposed in addition to capital requirements on uncleared swaps with dealers and MSPs, higher transaction costs will be passed on to end-users. Those increased costs will require additional working capital currently being used in other business activities and investments. Furthermore, if the costs are prohibitively high, the ability of farmer cooperatives to provide their producers risk management tools, such as forward pricing, will be diminished.