AGRICULTURAL ADVISORY COMMITTEE MEETING

Sheraton Overland Park Convention Center
6100 College Boulevard
Overland Park, Kansas 66211

Thursday, April 5, 2018

MR. THORNTON: Good morning. Welcome to Kansas. My name's Charlie Thornton. I'm the designated federal officer for the Ag Advisory Committee. As the agricultural advisory Committee designated federal officer and acting chair of this committee, it's my pleasure to call this meeting to order.

First I would like to go around the table and ask the committee members to introduce themselves. We have several new members, four temporary members and 10 people participating remotely by phone. That's the sound you'll hear above beeping in and out.

So we'll start with Lynn. If you could state your name and your organization, I'd appreciate it.

MR. CHRISP: I'm Lynn Chrisp. All right. Thank you. I'm Lynn Chrisp serving as first vice president for the National Corn Growers Association. My farming operation is in South Central Nebraska.

MR. KOVANDA: I'm Joe Kovanda, member of National Cattleman's Beef Association and representing them today. I work for a company called Bartlett Cattle Company.

MR. HAWKINS: Garrett Hawkins. Deputy director of the Missouri Department of Agriculture representing the National Association of State Departments of Agriculture.

MR. HANDKE: Hello. Good morning. I'm Steve Handke. I'm the president and CEO of the Union State Bank in Everest, Kansas. We're a community bank in Northeast Kansas, Northwest Missouri. I'm honored to serve as the chairman of the ICBA's ag committee and representing ICBA today.

MS. MESA: I'm Jackie Mesa representing the Futures Industry Association. Tom Kadlec is our current representative on the Ag Advisory Committee. I'm honored to represent FIA today.

MR. KOTSCHWAR: Good morning. I'm Lance Kotschwar. I'm here representing Commodity Markets Council.

MR. HINES: I'm Matt Hines. I'm a licensed broker with Loewen & Associates, Manhattan, Kansas and Chairman of the Market Structures Committee for American Farm Bureau Federation. That's who I'm representing here today.

MR. PETERSON: Good morning. I'm Monte Peterson. I'm a farmer from Southeast North Dakota and director with the American Soybean Association and representing them here today.

MR. WILSON: TJ Wilson here representing Morrill & Janes Bank on behalf of the American Bankers Association.

MR. WANDS: My name is Hayden Wands. I'm representing the American Bakers Association (inaudible). I chair the commodity and agricultural policy committee for them and my company is Grupo Bimbo.

MS. GUETTERMAN: Jodi Guetterman and (inaudible). I'm here representing Guetterman Brothers Farms.

MR. ZACHARIAS: I'm Tom Zacharias, National Crop Insurance Services, Overland Park, Kansas.

MR. LANCLOS: Ken Lanclos, USDA Risk Management Agency, Washington D.C.

MR. BARKER: Joe Barker. I work for CHS and I'm here representing the National Council of Farmer Cooperatives.

MR. RINIKER: Paul Riniker, National Farmers Organization, farmer in Northeast Iowa. I raise about 500 acres of corn and feed about 1500 Holstein and feeder cattle.

MR. COYLE: I'm Patrick Coyle. I'm here representing the National Grain and Feed Association. I work with COFCO International.

MR. GALLAGHER: Good Morning. My name's Ed Gallagher. I'm representing the National National Milk Producers Federation, and I work with Dairy Farmers of America.

MR. BAKER: Good morning. I'm Dustin Baker with the National Pork Producers Council.

MR. STRONG: Morning. I'm Steve Strong. I work for Bunge North America and St. Louis, and I'm working with the North American Export Grain Association.

MR. ULLMER: Kim Ullmer here on Continental Marketing here representing R-CALF and United Stockgrowers of America.

MR. OWEN: I'm John Owen. I'm here representing USARice Federation. I'm a rice producer in Northeast Louisiana. I also produce corn and soybeans.

MR. THORNTON: Thank you. Also, before we get started, there are a few logistical items that I've been asked to mention to committee members and invited speakers.

First of all, if everyone here could put their phones on silent or turn them off, that would be greatly appreciated.

Also would you please ensure that your microphone is on when you speak? And I've just noticed that these microphones -- you have to turn yours off, so the next person can be able to speak. So make sure after you speak, turn it off, so we can proceed.

And please speak clearly because there's a webinar audience. They will -- for them to be able to hear you, you have to speak into your mic.

Also, please state your name and organization. We have a court reporter here and they need that for the record.

If you would like to be recognized during this discussion, please position your placard so that it sits vertically on the table or raise your hand. When you are finished speaking, please turn off the microphones. And then, as I explained, only one mic can work at one time.

For AAC members participating by webinar, please keep your phone on mute until you are ready to speak and identify yourself beforehand.

After each panel presentation, I will ask the moderator to unmute the speaking lines and you'll have the opportunity to ask questions.

Finally, please refrain from using any electronic devices during the meeting. We have a full agenda today, and we would like to ensure full participation by all members of the AAC.

I would now like to turn to Commissioner Behnam, the AAC sponsor, for opening remarks.

COMMISSIONER BEHNAM: Thanks, Charlie.

Good morning and welcome to the first CFTC Agriculture Advisory Committee Meeting of 2018. I am pleased to sponsor this meeting and thrilled to be able to host this meeting in Kansas. In addition to being home to a CFTC regional office, Kansas is home to America's heartland, where many of our nation's farmers and ranchers proudly produce the food and fiber that feeds our world's growing population.

Before we move into the substance of today's meeting, I want to thank Commissioner Quintenz and the soon-to-arrive Chairman Giancarlo for being here this morning and for their contributions to today's discussion.

I want to thank each of the panelists. We have gathered a distinguished group of speakers, and their willingness to participate is greatly appreciated and critical to today's discussion.

I would also like to thank Christa Lachenmayr. As a member of the CFTC's Division of Market Oversight, Christa's hard work, dedication, and knowledge of agricultural markets have proven, for many years, to be an invaluable resource to the CFTC, market participants, and stakeholders. Christa played an integral role in setting today's advisory agenda, and her skills will certainly be on display throughout the morning.

Finally, I want to thank Charlie Thornton, CFTC's Director of Legislative Affairs and this Committee's Designated Federal Officer. Charlie and I have worked together as staff on the Senate Agriculture Committee for several years. In selecting Charlie as the Committee's DFO, I considered his knowledge of agricultural policy and our strong working relationship. As sponsor of the AAC, it's important that I engage thoughtfully with the Committee's members and outside stakeholders. My goal is to lead discussions that will drive better policy and ultimately strong, transparent, safe derivatives markets. Charlie certainly will play a leading role in helping me -- and all of us -- to reach that goal.

In November 2017, shortly after being sworn in as Commissioner, I announced a listening tour for the first year of my term. Since then, I have been fortunate to visit many businesses across the country, including several here in Kansas City. Throughout my visits, I have been able to hear directly from members of the industry, market participants, end users, and the public. And, I've shared some of my own views. The meetings and conversations have allowed me to inform and formulate goals and ideas for my term that are grounded in real-world concerns and challenges. Today's panels reflect some of the more pressing concerns brought to my attention.

Today we will dive into two timely topic areas; crop insurance and agricultural block trading. First, crop insurance is a critical risk management tool for growers; its importance cannot be understated.

Having worked on the 2014 Farm Bill, I intimately understand the important role crop insurance plays in a producer's risk management and tool box. However, the fundamental role futures markets play to crop insurance is often overlooked. I am hopeful this morning's discussion will educate and inform the Commission regarding the intersection of the two and further the CFTC's active engagement with registrants, market participants, USDA, and agricultural stakeholders to ensure confidence in the crop insurance program.

Later this morning, we will discuss price discovery and the recent implementation of block trading in agricultural futures contracts. I am looking forward to hearing from both the panelists and the Committee membership on this important issue. Price discovery and liquidity are integrals to well-functioning futures markets, and the CFTC must ensure that market structure does not adversely affect either.

Finally, we are very fortunate to have staff from the Farm Credit Administration in attendance to share their insights on the state of the farm credit and the role risk management plays in a producer's ability to borrow capital. Farmers and ranchers place everything on the line at the beginning of the season, often needing to borrow significant capital to purchase machinery, seed, fertilizer, crop protection materials, and feed. That said, the well-hedged producer is a stronger borrower, and hopefully this will be the first of many discussions between the CFTC, FCA, and stakeholders to better educate borrowers and creditors about the futures market and the role it plays in risk management.

The agricultural economy has faced stiff headwinds for many years. Persistently low commodity prices, extreme weather events resulting from climate change, and trade policy are a few of the significant hurdles that made production agriculture more challenging every year. The CFTC has historically played a key role in helping producers discover prices and manage risk. As the Congress considers the 2018 Farm Bill, I am committed to ensuring that the CFTC plays a leading role in ensuring that the derivatives markets remain a desirable, cost-effective, and transparent risk management tool for all agricultural producers, including our new and beginning farmers. A healthy farm economy is a big part of a strong and vibrant rural economy, which is integral to our nation's prosperity.

This morning's AAC meeting, and the

first of its kind Ag Conference hosted by Kansas State University, are steps to fulfill that commitment and I look forward to the many important discussions today and tomorrow.

Thank you.

MR. THORNTON: Thank you, Commissioner Behnam.

Commissioner Quintenz.

COMMISSIONER QUINTENZ: Thanks, Charlie. Thank you for your work. Thank you, Christa, for your great work. Thank you to our Kansas City office and all of the CFTC staff for coming out, for the great work in putting on what I think is a fantastic event and which I'm very excited to participate in.

And thank you, Commissioner Behnam, for your leadership in hosting today's meeting. This is the second advisory committee meeting you've sponsored in the last two months and it's the second advisory committee you've sponsored in the last two months. So good work and thank you for your effort.

Today's meeting of the Ag Advisory Committee is actually only the second meeting that has occurred since 2015, which in my opinion is much too long of a time to have gone by without taking advantage of your input, quality, or expertise. While practice of the prior leadership of this committee was to hold one meeting a year, I'm hopeful that either with your leadership, Commissioner Behnam, or new leadership, once additional commissioners get confirmed, we can take much more frequent advantage of this important panel's significant expertise.

So I'm delighted to join all of you and the distinguished members of the committee, some of whom I've had the privilege of meeting in D.C. over the last year or so. Some of them I've actually had the privilege of meeting in your places of business around the country, talking with you directly about your concerns with our markets. For decades, this advisory committee has provided the CFTC with invaluable insights into the pressing issues of the day: agricultural trade options in the 1990s, the transition from pit to electronic trading in the 2000s, and current challenges involving the deliverable supply and convergence. I look forward to a robust discussion today about the state of our futures markets and their ability to serve as an effective price discovery and risk management tool for the ag community.

It is fitting that the AAC Committee is meeting today in Overland Park because the town was founded by William Strang in 1905. William Strang left home at the age of 15 and became an American railroad magnet, building railroads all over the country, including the Missouri and Kansas Interurban Railroad that ran through Overland Park and that was built along the historic Santa Fe Trail. And he was an avid believer in innovation and built the first self-propelled railroad motorcar in the world.

He was fascinated by progress. He also built the first -- or constructed an airfield here in Overland Park in 1909 -- only six years after the Wright brothers conducted their first flight -- so that locals could witness the novelty of so-called "flying machines."

I highlight those accomplishments because I believe that they were a reminder of what's possible if we follow our aspirations and how a pound of vision of one person can have a generational economic impact on a region. The railroads that Mr. Strang built, in conjunction with America's natural inland waterways, enabled cities like Chicago and Kansas City to become hubs of commerce and market for America's grain, produce, and cattle.

Today, of course, there are different challenges that must be overcome by modern vision, leadership and ingenuity. And as I'm going to discuss in more detail tomorrow, the challenges facing the agricultural industry today -- historically low commodity prices, intense international competition, and slimmer profit margins -- make it more important now than ever that the futures markets remain a trusted and effective tool for price discovery and risk management for America's farmers and ranchers.

Indeed, the need for futures prices to reflect supply and demand fundamentals impact even those who choose not to directly participate in futures markets. Crop insurance, an essential risk management tool for many farmers, relies upon futures prices to determine the expected income of farmers in the event a payout is made. Today, over 300 million acres of farmland is covered by crop insurance, with an insured value of over $100 billion. I am interested to learn more about how the crop insurance program is working today from our first panel and make sure that we all understand that any lack of convergence impacts not only risk management hedging, but also the effectiveness of the crop insurance safety net.

In addition, given the past several years of depressed commodity prices, many farmers are struggling with access to credit. According to the USDA's Economic Research Service in 2017, the farm sector's debt-to-income ratio, which measures a farmer's ability to pay down liabilities, rose above six to one. The last time we saw such a high debt-to-income ratio for farmers was the 1980s. I look forward to hearing from the FCA today about the various ways that they and the private sector can continue to meet the financing needs of farmers and ranchers.

From our final panel, we will hear from the CME about recent implementation of block trading in certain agricultural products. I'm interested to hear that panel's observations about how the expanded use of block trade in this space is impacting liquidity and price discovery.

Together, the futures markets and crop insurance are the cornerstones of the farm safety net. They work together to ensure that farmers don't lose access to credit in a very volatile industry so that they can continue to providing America and the world with high-quality, low-cost food.

Again, I commend Commissioner Behnam for hosting this meeting today, thank the staff for their hard work, and look forward to exploring with you how all of these issues are impacting the vitality of the ag community.

MR. THORNTON: Thank you, Commissioner Behnam and Commissioner Quintenz for your opening remarks.

As noted in today's agenda, our first discussion will cover risk management with regard to crop insurance. Our panelists are Kent Lanclos, director of Business Analytics at USDA's Risk Management Agency, Tom Zacharias, president of the National Crop Insurance Services, and Jodi Guetterman, a producer of corn, soybeans, and wheat from Guetterman Brothers Family Farm. Please begin.

MR. LANCLOS: Thank you and good morning. Let me begin with a little bit of information about the history of the Federal Crop Insurance Program. Federal Crop Insurance established in 1930s in the depth of the Great Depression and the Dust Bowl. However, it is only during the past 20 years or so that it has become the primary core safety net. It helps farmers recover from disasters and severe weather events, sustains local infrastructure to agriculture such as (inaudible), suppliers, community growers, and grain handlers and reduces the impact -- financial impact -- of disasters on rural communities supporting local businesses and jobs.

Crop insurance operates as a

public/private partnership. The program partners the federal government's financial capacity with effective private sector delivery. RMA develops and approves policies and procedures, provides regulatory oversights and is the primary reinsurer for the companies and the program. There are currently 15 private insurance companies that sell and service crop insurance. Mr. Zacharias can provide a bit more information and background on these companies and who they are.

Federal crop insurance has seen immense growth in the past 20-plus years. In 2017, we insured about 310 million acres of farmland in the U.S. as compared to only 100 million acres in 1994. Linkage to other farm programs in 1995 led to significant increase in insured acreage. Mandatory crop insurance participation was repealed in 1996, but most of the insured acres stayed in the program and since that point, insured acres has continued to grow.

In recent years, a big driver of the program has been insurance for Pasture Rangeland and Forage (PRF) introduced in

2007. Over 75 million acres of pasture has been insured by 2017. Insurance coverage is available for over 130 crops. Aside from PRF, we otherwise have limited product for livestock, however, and those products that we do have provide basically marketplace coverage. In 2017, these livestock market products accounted for about $550 million dollar in liability and about 18 million in (inaudible). They're not a large part of crop insurance portfolios. Truly crops are what we actually do with our program.

In terms of market penetration, about 9 percent of the (inaudible) major crops, primarily corn, soybeans, wheat, grains, et cetera is now insured by our program and the average coverage level is over 70 percent. The expected crop is insured by our program.

As mentioned, in 2017, federal crop insurance will cover about 106 billion dollars in crop value entering a total premium of about $10 billion. Of the 106 billion for crops, corn, soybeans, wheat, and cotton accounted for about 75 percent of that total. Pretty consistent with what we see year in, year out.

As you can see, however, the amount of insurance is quite variable reflecting the inherent variability of commodity prices. For example, in 2010, we insured about $78 billion in crop value. By 2013, the amount of insurance had increased to over $123 billion, so a rather large increase in just a very short period. Annually there are about 1.2 million policies earning the premium in our program purchased by some 550,000 policyholders.

Now, turning to the pricing aspects. For non-exchange traded commodities, the insurance prices generally reflect an estimate expected season average price for that commodity. For the most part, these estimates are developed by U.S.D.A. analysts based on consideration, supply and demand factors such as stock-to-use ratios, planting intentions, et cetera.

With few exceptions, revenue insurance is not available to producers with non-exchange traded commodities, though I can attest they would really like to have regular insurance for corn and soybean growers. But simply put, it is difficult to provide insurance in a sound manner absent [a price reference]. The advantages of a futures exchange [price] are not easily replicated by other methods of price discovery such as some type of a (inaudible) model or some other type of simulation approach. An exchange is an efficient aggregator of [supply and demand] information. An exchange provides an objective, unbiased, and transparent third-party source of prices.

Exchange values are forward looking, not backward looking, and they readily incorporate information as it becomes available. For crop insurance, the result is that insurance based on exchange values is much less susceptible to adverse selection.That is, people only buying insurance for (inaudible) also will buy exchange base revenue insurance, so there is much less risk of a pricing mistake inadvertently distorting the market. For example, inducing a large increase of acreage because the projected price is too high (inaudible) actual expectations.

Farmers have eagerly embraced revenue insurance where it is available. The first revenue insurance policies were offered in 1996. By 2007, revenue insurance accounted for about 80 percent of total program premiums and has remained at that level since this time. As noted before, revenue insurance is generally only available for those crops where there is a futures exchange for price discovery or in some cases where there is a derivative for an exchange-based commodity, so it primarily means corn, soybeans, wheat, cotton and rice, again with extension to other commodities.

For the crops with revenue insurance, the exchange values are used to project both the projected price, the volatility, and harvest prices. That way, we assure pricing consistency and minimize the potential for adverse selection amongst the insurance products.

How you use the exchange value on the projected and harvest prices is contained in the commodity exchange price provisions. The general process is as follows: For corn, the applicable exchange is Chicago Board of Trade.

In the Midwest the sales closing date for spring crops is March 15th. That is the date by which you must make a crop insurance purchase decision. For these states, the December CBT contract is the referenced contract. Our (inaudible) projected price 15 days in advance of the sales closing date, so about March 1. The intent with this date is to provide farmers with an opportunity to make an informed decision, but not so far in advance of sales closing that the price has become stale or been outweighed by subsequent events, so it's striking a balance between (inaudible) and currency.

The projected price itself is determined as the average of the daily values of the December contract for the month of February. For most states in the Midwest, the harvest price is determined as the average of the daily values of the December contract during the month of October. In the interest of transparency, [USDA/RMA] publishes most of this information - from deriving the projected harvest prices to the volatility factors - on our public website.

As shown here, this is Section 1 of the commodity exchange provisions. It provides definitions of terms applicable to all of these revenue -- exchange-based revenue products. The method for calculating the volatility is also available on the website.

Section 2 of the price provision provides the reference exchange, contract month, and projected and harvest price discovery period for each state and sales closing date. It's a little bit small here, but trust me. For example, for counties with January 31st sales closing date in Texas, the referenced contract corn is September CBT contract. The projected price discovery period, as stated in this document, is December 15th through January 14th, and the harvest price discovery period is August 1st through October 31st.

Also shown here is counties of Texas with a February 15th sales closing date, which would have its own set of terms as listed here as well as counties (inaudible). So for every state and every closing date for every commodity, you can find on our website all the materials about which contract, which pricing period is used for price discovery.

So how is the record contract determined? In brief, the record contract is the new crop futures contract at the end of the harvest period for the post-harvest contract for the crop in the area. As we've kind of seen already, the projected price discovery period dropping to a 30-day period, ending 15 days prior to sales closing. The harvest price discovery period is approximately a 30-day period that corresponds to when most farmers are actively harvesting the crop in the area.

We do impose certain threshold requirements to use the exchange values as described in the commodity exchange price provisions. In particular, there must be at least one full active trading day during the price discovery period for a full active trading date defined as any trading date with at least one open-interest contract available at the close of trading. The contract itself when traded at least once during the discovery period, that is at least one trading date equal to one. These threshold requirements are not fairly stringent, but still we must address the question: If the threshold requirements are not met, what then? That answer is also spelled out in the commodity exchange price provisions. Specifically, on the rare occasion that the threshold requirements are not met, you first look to a futures contract.

So if the threshold requirements are not met for December contract, for example, just average to projected price, we would then look to the September contract. However, that futures contract is also subject to the same threshold requirements. If the threshold requirements are still not met for the projected price, then revenue coverage will not be offered. Only real coverage will be available at a price determined by RMA. If the threshold requirements are still not met for the harvest price, that is a bit trickier because farmers have already purchased the revenue insurance coverage, so we can't simply say that once the revenue coverage is gone or not available. In that situation RMA will determine a harvest price to allow the companies to sell contracts, insurance contracts.

Thankfully we have only a few instances, primarily for rice, where we have to use a substitute futures contract to establish the price. It's a very rare situation. And as far as you can recall, we have not had a situation in which RMA has had to itself determine either the projected price or the harvest price, so the instances we've had have all been based on projected price and (inaudible) data, if you will, for publishing that.

With regard to volatility, the rating method for revenue insurance assumes that the price distribution is normal and that the [value] can be computed from an option-based volatility measure. The parameters in price distributions together with the assumed price correlation are used in a simulation procedure to calculate the revenue load, which are then charged to the farmer which is the revenue coverage.

RMA derives a measure of price volatility based on observed option contract prices for the underlying futures contract using the actual framework. However, we do not calculate the value ourselves; rather, we obtain those values. So go to a public source for those volatilities. We do apply a time adjustment to take (inaudible) into account the time difference between the expiration of the options contract and the time period the farmer uses to establish the harvest price.

Finally, volatility is the simply average of the time-adjusted volatilities for the last five days of the projected price discovery period.

As a quick example of how revenue insurance works and how it differs from straight yield insurance, consider the following illustration: In all these examples, the average yield is assumed to be 100 bushels, projected price is $4 per bushel and the coverage is 75 percent. So for revenue insurance to guarantee 75% of $400 dollars is equal to $300, the [product of] one hundred bushel average yield, $4 dollar projected price and the 75 percent coverage level.

For yield insurance, the guarantee is stated in bushels, so that is setting by bushels. (Inaudible) the actual yield is 65 bushels and the harvest price is $3 a bushel. So for yield insurance indemnities, simply calculate a product of the 10 bushel shortfall and $4 projected price, that's $40. For revenue insurance HPE, the indemnity's $105 obtained is the difference between the $300 dollar guarantee and calculate the harvest revenue of $195. That is the product of the 65 bushel actual yield and the $3 harvest price.

Now, in this illustration you see two revenue insurance products listed. Revenue insurance and revenue insurance HPE are harvest price exclusions. What is the difference? Standard insurance includes replacement cost coverage for lost production. That is, if the market price has increased at harvest, it pays off any lost production at that prior price. The basic idea is that if a farmer has already contracted to a grain manager to deliver a certain amount of production and subsequently sustained a significant production loss, the farmer still has to fulfill that contract and those bushels to that grain handler. So the farmer has to go to the market -- cash market -- and buy the replacement bushels.

In case of, like, some type of significant loss like in 2012, the market price will be a lot higher than what would have otherwise occurred. So he would pay a lot more above the price to purchase those replacement bushels. This feature of this revenue insurance provides coverage for that occurrence and helps compensate them for that type of situation. Now, revenue insurance HP simply excludes that replacement cost for the future.

Now, even though revenue insurance HP is offered, excuse me, to most farmers, 95 plus percent choose the standard revenue insurance policy that provides the replacement cost coverage. So the same illustration as before, only the harvest price is now increased to $5 a bushel. The yield coverage is unaffected by the price change. The indemnity is still $40 as before. The indemnity for revenue production HP is also $40. The indemnity for the standard revenue insurance, however, has increased to $50, reflecting the $10, 10 bushel yield loss and now a higher $5 price.

As mentioned before, revenue insurance is available for select crops and priced as a derivative [of another futures price].For example, revenue insurance for barley and grain is based off of projected harvest prices for corn. For sunflowers, prices are derived from soybean. All futures and organic pricing is derived from the exchange values for the traditional crop.

The way we approach that is that we derive a factor that reflects some historical relationship between the price of the reference crop and the price for the product or type of interest. How that factor is derived is specific for each crop. Organic corn and soybean compare prices of USDA, (inaudible), the CBT contract to drive that historical relationship. Organic cotton is obtained from proprietary data on organic cotton prices compared to futures prices for conventional cotton.

So basically, there is no standard approach or data to be used to develop these factors. We fill out and look at what's out there. And it's always been a hurdle that our pricing on organic commodities (inaudible), so we make do with what we have.

Now, as I stated before, (inaudible) transparent with our pricing methodology. And so on our public website you have a link shown there. We provide documentation how we establish these prices for these other crops and types.

That concludes my presentation. I thank you for your time. I am happy to answer any questions you might have.

MR. THORNTON: Thank you. Tom.

MR. ZACHARIAS: Thank you, Commissioners and the Committee Members here. It's a privilege and opportunity to be here today. I apologize in advance. I've got a little bit of a cold and a little bit of a cough, so I'll try to muddle through this.

That said, first I emailed yesterday for slides and I knew they weren't going to get in, so you're going to have to go unplugged here with me, but I think we'll be fine. Kent's slides provide an excellent overview, so I'm going to just basically peel off of that for my remarks.

This is the first time I have been here with this group, so we'll do a little introduction. Our organization, National Crop Insurance Services, is actually about four blocks down the street from here. We are the service organization for all the insurance providers that hold a standard reinsurance agreement with USDA's Risk Management Agency.

We also serve as the company's liaison for their state-regulated business, which is primarily hail coverage. In general, our organization provides industry training on the development of loss-adjustment procedures. We also administer a national agronomic research program that is used to develop the loss-adjustment procedures for farmers in the field with the adjusters. We are also responsible for industry outreach and industry communication activities.

A little bit about our membership.

As I said, we are comprised of those companies holding the standard reinsurance agreement that write both state and federally-regulated crop insurance. Our focus here today will primarily be on the federally-regulated segment of the business.

As Kent mentioned, there are currently 15 holders of the standard reinsurance agreement and that defines the rules of the road, the rules of engagement, the contractual obligations between the companies and USDA. Their top six riders hold about 75 percent market share, and this has been fairly stable over about the last ten years. Currently there are 15 carriers, and between 15 and 16 carriers have been a fairly stable -- I'm hesitant to use the term equilibrium, but that's where it's played out over about the last ten years or so.

These writers of insurance are in the U.S., both domestic and international capital. We have writers such as QBE out of Australia, Zurich, Great American Financial out of Cincinnati, Des Moines is The Chubb Company. Rain and Hail is a Des Moines company in Chubb.

And then most notably, one of our members is a family-owned operation, Farmers Mutual out of Des Moines, which just celebrated its 125th anniversary of writing crop insurance business. These guys used to ride around in bicycles, and their promotional activity was giving pink pencils to their insureds. So the crop insurance industry has a long history dating back to the early 1900s, late 1800s as well.

But the history has pretty much been hail. And as Kent mentioned, in the early '90s with the Reform Act of 1994, then that's really when the game started changing for federally-regulated crop insurance.

What are some of the attributes of crop insurance that has brought us to where we are today that has led to its farmer popularity and its political support? This isn't necessarily in order of importance, but these are some of the key things that have gotten us to where we are.

Crop insurance is contractually based. There's a policy between the insured farmer and the insurance company. The rules of the game are written down. There's the standard reinsurance agreement that defines the rules of the road between the companies writing the business and USDA. In addition, companies have contractual relationships with the agents writing this business as well, and then there's a portion of this business that is laid off in the private reinsurance market and that stuff is written down.

Okay. There are multiple levels of cost sharing in the crop insurance industry. The farmer pays about 40 percent of the risk premium. They also shoulder a deductible. The average deductible is probably about, oh, 20 to 25 percent nationwide. As you get to the corn belt, farmers are probably holding 80 to 85 percent coverage. So farmers are sharing not only in the cost of the premium, but they are also absorbing the first loss with their policies.

The taxpayers share in supporting delivery expense and risk sharing with the crop insurance companies. The companies bear a portion of the delivery expense as well as risk sharing with USDA. Another advantage of crop insurance is that it can be individually tailored to meet the farmers risk management needs. As Kent mentioned, there's about 130 crops with alternative coverage levels. If you expand that to the number of counties that are included in the U.S., you can find about, oh, probably, at this stage, maybe 70,000 different crop combination ways to manage risk through the Federal Crop Insurance program today.

In practice, the changes to the policy can be managed by the agency. Crop insurance does not require direct legislative action to change and update the features of the program. Sometimes this is done, as was done in the 2014 Farm Bill, but crop insurance can, in some sense, run along by itself. It has its own enacting legislation, so things can keep running.

If you notice during the government shutdowns that we've had a couple of times, crop insurance companies are still required to pay and manage claims with their insureds during these down times.

So the efficiency of the private

sector and the private sector's ability to interface with USDA and interface with the farmer to deliver this program is one of the features that has led to its popularity. If you look at the efficiency of delivery in 2012, Under Secretary Scuse was quoted as saying, when we went out to the field --

(Interruption in proceedings.)

I used to teach at LSU and people would leave the class, so... Kent knows about this.

Anyway, back to 2012. Under Secretary Scuse went through the country and he handed out his card and he said, “if you've got a complaint about crop insurance, give me a call.” His staff was not crazy about that, but I don't think anybody ever called him.

Also, in terms of regional disasters, if you look at the situation in 2011 where you had a regional drought in Kansas, Texas and Oklahoma, those claims were handled by the private sector as well, in addition to the flooding in the Midwest along the Missouri and Mississippi rivers. So efficiency of private sector delivery complements this.

And lastly, crop insurance is bankable at the individual level. Both the lenders and the farmers know what their risk is ex ante, before, prior to, planting the crop and they know what crop insurance will indemnify the farmer for in the case of a loss.

All right. So as Kent has demonstrated, revenue exchange-traded products, primarily RP, revenue protection with corn and soybeans is very popular, has broad participation. So from the insurers' perspective, what makes this desire, what makes a risk insurable? So I'm going to go at sort of a high level here.

Okay. It's easy in these conversations to talk about what can be covered. From an insurer's perspective, it's just as important to talk about -- can the claim be adjusted? Can the claim be adjusted fairly? Can it be adjusted accurately? In the case of revenue products, can the pair be defined clearly? And I believe the answer is in the affirmative with respect to this. We know what the spring prices are; we know what the harvest prices are; farmers know what these prices are. And so the claims adjustment process becomes very straightforward.

On the production side, Kent mentioned the yield coverage part of it. Yield coverage has been around since about 1980 with federal crop insurance services. Those procedures are well understood. There are individual situations where people -- I'll use the vernacular sometimes the adjuster has to hold the farmer down to what he wants. A farmer may not always feel that way, but it's a little bit of a joke.

Moving on. All right. But basically, we can understand the loss and how it works. The coverage is clearly defined both in production risk and price risk. In terms of actuarial targets, crop insurance -- a broad metric is that crop insurance has come under and met its actuarial targets in terms of losses relative to premium. If you look at this over the long run, the long-run loss ratio is in the range of about 1/100th, okay, premiums equaling losses. And crop insurance has met that actuarial target, so we're collecting the right amount of money; we're rating it correctly.

So let me turn to that from the insurer's perspective and ask a couple of questions there. Is the rating process transparent? If you go out to RMA's website, you can find documentation with respect to how it's rated? I don't think anyone can actually take that document and go get a bunch of data and duplicate their stuff exactly, but I don't think that's a necessary condition. The companies writing this business have confidence in the rating methodology. There is a process. If we believe our academics as Well, if there are concerns with the rating methodology, that those can be addressed and as he demonstrated those are publicly available. You can have a conversation about those.

Is the data public or private? In the case of the exchange-traded markets, the price data is publicly provided, publicly available through the exchange. I think this is a big attribute for a major feature that shouldn't be or should be emphasized and credit should be given for that.

There are technical issues from time to time that show up. Kent mentioned the volatility factors. There's been a discussion on that. And I would say, in general, in terms of a rating methodology, which if we're going to have private sector capital in this market, they have to have confidence in the rating structure; they have to have confidence in the underwriting.

And so in terms of a methodology, I would say a couple of things. If the farmers believe the rates are affordable and they have confidence in them, they're purchasing the product and the methodology produces a rate that also generates an adequate return for the insurers. I think that's about as good as you're going to get and we should accept that.

Now, does everything work like we expect or want? Obviously not. I have the privilege of sitting on an international board and primarily folks from the European community and they have an insatiable desire to have a revenue program in Europe. There is a demand for revenue coverage and it meets the farmers' needs. Farmers tend to like it. All right.

Revenue coverage works best when there's lots of data and lots of trading. Now, when those conditions don't hold, then we do have problems. The example Kent mentioned is probably the one in terms of rice where there has been limited data. It is a thin market. I would say to that that RMA has done a good job about getting out in front of that and defining what to do in the case when that's not met. Now, has that met everybody's satisfaction in every case? Probably not. But in general, there are procedures in place to deal with the problems of thin markets, and so I think that's an important aspect of this.

There are also situations -- Kent mentioned the extension of revenue coverage beyond futures-traded commodities -- and there have been some attempts to offer coverage there and there have been some breakdowns. But these can be worked through with the agency, with the private sector and the farmers, and I think this can be resolved.

And I will have to be quite honest: if people don't understand these rules or don't agree with these rules, then we go to legal and then we go to the Secretary of Agriculture for some formal resolution on this. But there is a vehicle to fix these problems as they come up.

So in closing -- in general, I would say the experience from the industry's perspective with the exchange-traded crops, the revenue protection has been quite favorable. Farmer participation has been high. It's met its actuarial target, can be underwritten and clearly adjusted.

With that, I will conclude my remarks and appreciate the opportunity to have been here today.

MR. THORNTON: Thank you. Ms. Guetterman.

MS. GUETTERMAN: Okay. I was asked to come and talk about how we, on our operation, have used crop insurance in the past. I'll just give you a quick overview of our operation. We're a 100 percent no-till farm and we are located just south of Overland Park here about 15 miles in Bucyrus, Kansas. Our operation supports five families and three full-time employees. Here's my husband, his dad, and his three brothers that the operation supports. We are primarily dry land and our crops are waxy corn, Amos corn, soybeans, and winter wheat.

And so how do Guetterman Brothers utilize the futures in our operation? First I had forward contracting, but as of yesterday that changed. We use it as an element of surprise and excitement in our household. As I was in the shower yesterday morning, my husband yells, something must have happened overnight. Well, soybeans were down 50 cents. So we use it as an element of surprise in our operation, too.

But the first is forward contracting. Another way we utilize the market is through options and the third way is -- and this is a way that you don't think of in most times -- but it's also through crop insurance.

So just briefly on forward contracting. Usually our operation forward-contracts about 30 percent of our anticipated crop prior to harvest. Usually during the spring and summer months we try to take advantage of any planting scares and/or any, you know, midsummer scares.

We sell another 20 percent usually by January just for cash flow purposes, and then the remaining 50 percent is sold in the spring and summer months following harvest after January, hoping to take advantage of any rallies that we may have. We do have on-farm storage so this allows us to go ahead and store.

Another way we utilize the markets in our operation is through options. Most of the time ours are primarily through utilizing puts. Since we do have the on-farm storage, we usually put some puts on and hope for the best, but make sure we have that floor in, if the prices go down.

And the third way is crop insurance. And why do we have crop insurance on our operation? The first and foremost is risk management and the safety net that it provides for us. Our fixed and variable costs are high -- they're not going down -- and it gives us a baseline to budget our year off of and manage those costs from.

And as a disclaimer, in the 20 years that I've been involved in the operation, I looked back and there are very few years that we actually get back our premium. But the one or two years that we have, it was essential to keeping our operation functioning and we don't buy it with the intention to actually use it. You don't buy your car insurance with the intention of wrecking your car.

It's required by our lender. Our working capital we do have to get from a lender the funding for that. And our crop insurance is the collateral for our lender. And it also allows us marketing flexibility. We know that we can safely market up to a percentage of our APH and be covered.

So how do the markets affect our crop insurance coverage? Crop insurance revenue products are essential, and to not just covering the loss of the bushels, but to cover the revenue also. And 2012 was a -- on our operation was a -- huge year that really made you a believer in the crop insurance system. And the markets, when they truly reflect the supply and demand, it's crucial for our survival.

Here's what we look like coming in the spring. We're not in Iowa. Our average APH, our average yield, is about 120 bushel an acre. The spring price for crop insurance in 2012 was $5.68. So that's a gross that we're expecting to bring in on an average year of $6.81 and then $3.53 worth of just input expenses. That's just seed, chemical, fertilizer, cash, rent. That doesn't include paying our employees, paying for equipment, paying our liability insurance, regulatory expenses or living expenses.

So then the reality of 2012 hit and our corn averaged 44 bushel an acre. At that point, the fall price did go up, but our gross income was significantly reduced. If you can see, it's not even covering our inputs. It wasn't covering the seed, chemicals, fertilizer -- what our crop actually yielded -- let alone paying our employees, let alone paying for the equipment, let alone paying for our own living expenses.

So when crop insurance kicked in in 2012 -- and it's hard to see -- but the spring price was $5.68. That was the price determined in the spring. But by the fall, in the October discovery period, it increased by $7.50. The market did its job. Supply was low throughout the United States and the market went up.

So if we would have just had the spring price, our operation -- as you see at the bottom on the gross profit, our operation probably would have been okay; we might have had to restructure some things. But with the option of having that harvest price and the market going up because supply was down, we were able to operate, not restructure, and continue going. Yes, it ended up being an average year. It wasn't a bumper year, but we were able to sustain and keep going.

So the bottom line for us is the markets do affect our operation when we have grain to sell, but they also affect our operation when we don't have the grain to sell.

MR. THORNTON: Thank you. And thank you all for your presentations. I now open the floor for questions or discussion.

Mr. Gallagher.

MR. GALLAGHER: Question for Jodi. I'm in the dairy industry. So the revenue insurance programs are relatively new for us. Trying to figure them out to help our members. So in 2012, where you had your revenue insurance policy— did you also manage your risk using forward contracts and futures and options as well? Tell us a little bit about that.

MS. GUETTERMAN: (Inaudible). Well, we usually do forward -- like I said, we usually do forward contracts. In any given year, it's a difference between 30 to 50 percent of our crops. We had forward-contracted some prior to the market going up. So in that sense, not only did we not have the bushels, but didn't get to take advantage of it when the market did go up.

So with the revenue coverage, that helped offset some of that loss on the bushels that we didn't produce. On the bushels that we did produce, the 44 bushels that we did produce, we had to fulfill those contracts at the lower price.

MR. THORNTON: Mr. Owen.

MR. OWEN: Thanks. I'd just like to make a couple comments. You know, crop insurance works really well when prices are high because you can utilize it as a subsidized put option, and when prices are low it is not as effective. And also, it's really important that the futures markets are converging properly for crop insurance to work properly because -- and particularly during a harvest price discovery period that's generally when the bins are full and full, you know -- in times of abundance basis generally will widen, and so the contracts need to be structured in the delivery territory to promote convergence. Because with a lack of convergence, it's very easy, particularly in rice, for the futures price to be above the indemnity trigger, but the cash price the farmers receive is below the indemnity trigger. So you should be receiving an indemnity, because business is bad, but you're not getting it because of a lack of convergence between cash and futures.

MR. THORNTON: Thank you. Mr. Ullmer.

MR. ULLMER: One of the major problems in South Dakota is we have a problem with the packer concentration on the livestock side, but it's much worse on the elevator side. They just united two more elevators. When I bought the farm, there was five choices for elevators; now there's one. They are taking 25 percent out of your check. You aren't calculating that in when you go in there. If [If] you look on the regions where there's still competitive elevators, you're dealing with 4, 6 or 8 percent. They're taking 20 to 25 percent out of our checks. It's not worth even trying to put a cash crop in because they take 25 percent (inaudible).

Now that there's only one elevator left for the entire northern region of South Dakota, now they've got heavy discounts; now they've got whatever price they want to price for the fertilizer. We've got to go just pay it. We've got no competition. We can't call anybody. They raise their prices up, so the elevators are raising their prices and they're building million-dollar elevators and taking 30 percent away from us and that’s before we even start and so we have to go to a feed crop.

Then you go to a feed crop and you go to your insurance agent and say, we want to put in a feed crop and make an attempt with cattle because we can't make money with cash grain, then they won't insure the feed crop. So there should be a way to insure feed crops, because they're afraid of feed crops because they can't find a valuation of it turning into cash because you're going to feed it through the system.

Well, if you're going to let them take 20 to 25 percent out of our checks on the cash side and that doesn't even come close to working, at least try to help us insure our feed crops, because we're sitting there setting up 1,800 acres trying to set it up so 100 percent is fed, because you can't -- if somebody's going to take 20, 25 percent out of your check when you are making a cash crop, you aren't even remotely calculating that into your crop insurance prices. They're taking it.

They just join together. It doesn't matter what they set their prices at; we have no choice. They’re the only company out there. So it's a major problem.

MR. THORNTON: Paul.

MR. RINIKER: I've had Federal Crop Insurance since about prior to '93 for sure, maybe after the '88 dry weather in Iowa, they call it. The government was pushing us farmers to go in the federal crop and over all of those years, like Jodi, I probably collected maybe two years. Not the 2012 because we had rain and our disaster was 180 bushels of corn; last year was 245.

So talking about this low revenue Coverage, since corn was so low, I've got a real high APA, it’s over 200. I'm not sure exactly, but I think I'm covered at about $7.50. Again, my expenses, just under rent, are more than what you guys are paying for everything, Jodi.

I look at crop insurance. Like my dad said, it was just something to have, to hold the operation together. It isn't something to make money on, and the guys are making money on it are the guys that are wrecking their cars and it isn't long before the insurance company gets involved and there's fraud and all those kind of things involved.

But I think it's really well regulated the way it's done. It's not perfect by no means, but it's like all insurances: It is something as kind of keep you from going broke in one year's time. If you lose a crop and there's a lot of dollars invested, it doesn't matter if you have 500 acres of corn like myself or whatever you guys are raising for crops. It will literally devastate you, set you back 10, 15 years and in default with your lender if you're not carrying crop insurance.

And I carried it long before it was popular simply because at the time USDA or FSA was pushing that even with their -- when we did have a hail claim one year and our accounting was over 20 percent and they went ahead and made an extra -- it was not a loan, it was kind of free money for the folks that had federal crop -- and that was in '09. So my situation, those premiums are not too bad in our area, but boy, it can be hell if you don't have coverage and something happens. Thank you.

MR. THORNTON: Mr. Gallagher.

MR. GALLAGHER: Kent, I think you said 90 percent of the major crop acreage was insured.

MR. LANCLOS: Yes, that's correct.

MR. GALLAGHER: How much of that is on a revenue insurance program?

MR. LANCLOS: In terms of premium, about 80 percent of the premium in the program is revenue insurance product. In terms of liability, it's about 75 percent or so, so... I did put a number -- I don't have it right here for all of the programs, but you kind of extrapolate that. It's going to be very high up there for these crops.

MR. GALLAGHER: So to compartmentalize this -- there's traditional crop insurance, which is just insuring against loss versus revenue insurance. So has the market, then, kind of shifted kind of away from that to the revenue insurance products?

MR. LANCLOS: Yeah, it definitely has in terms of the farmers' purchase decisions, yes. I mean, in 1995 there was no revenue insurance coverage, so the market share was zero. And basically, a decade later it's, basically, 80 percent of the business for the major crops, if you will, is revenue insurance.

So definitely it has embraced by the farming population and we constantly -- for the non-major crops, crops that don't have a type of futures exchange or easy extension, if you will, non-GMO corn or something like that -- we're constantly being approached by farmers to develop a revenue insurance product for them. So the farmers of these non-exchange traded commodities, many of them feel they're at a competitive disadvantage because they don't have that revenue insurance option. So we're constantly getting approached. But as I described, it's very difficult to develop revenue insurance. So how do you? The market does that. The exchange is that good at extracting that information for price discovery. After that we're kind of at a standstill.

MR. THORNTON: Mr. Barker.

MR. BARKER: Gentlemen, and lady, I think you did a great job explaining the key points of crop insurance. I would say, from my perspective, and as a committee, could you give us some explanation as to the prevented planting components that are built in the crop insurance? That gets very confusing from a price discovery perspective as to how the different regions have prevented planting and sometimes they can take a plan on this commodity and plant another, and that gets very confusing to market participant.

MR. LANCLOS: Let me first say they are very confusing. I do apologize. I didn't (inaudible). Prevented planting is a situation where, let's say, the river overflows its banks and so that the land --

MR. THORNTON: Can you speak up just a little bit? Thank you.

MR. LANCLOS: I'm sorry. Prevented planting is a situation where, for example, the river or the stream, whatever, overflows its banks and the ground becomes flooded and therefore the farmer can't get in there, in that ground, in a timely manner and plant the crop. And we do have dates set in the policies that say that the crop must be planted by a date certain in order to receive the full guarantee. Most crops have a late planting period.

For each day beyond this we would reduce your guarantee by X amount, just recognizing that, if you will, the optimal planting window is passed. You're more likely to have an early freeze, something like that, whatever the conditions are.

So you do have that option there, but if you still are unable to plant, you are eligible for most crops to get a prevented planting payment that is basically -- I want to say it's 50-55 percent of the guarantee. Our senior actuary is back there, he’s not in sight, so I know I’m in good shape.

But basically, 55 percent of the guarantee that we will pay the farmer in order to prevented planting situation.

So basically, if your guarantee would have otherwise been $300, you would get paid $150, $165. Something like that would be what your payment would be. Just because you incurred expenses, to get the ground ready for plant if you can plant, so therefore it's compensation for those expenses. There is a -- again I’m forgetting -- there's a 1st crop/2nd crop option where you can -- you can forgo --you can forgo the prevented planting payment on the 1st crop, plant the 2nd crop and then – I will admit I'm a little bit fuzzy right now, but...75 percent at that point for you to do the 1st crop/2nd crop option. But it is complex.

MR. ZACHARIAS: I would say, with respect to preventative planning, replant --

these types of features in the crop insurance policy, the benefit of the private sector delivery in terms of a good relationship with the crop insurance agent. Because these are you -- as you stated, these are region specific and crop specific. And so for the farmer to have a working relationship with the agent and to know the terms and conditions of the policy are what's essential. We have people in our office that spend a lot of time -- quote, unquote -- on prevented planting coverage refining it and improving it.

But it's not -- as you saw with Kent and I, you've got to go back and read the book to get it right, and so that becomes the value of the agent and the adjuster and the farmer having confidence in them to help manage his policy and manage his risk.

MR. BARKER: If I may follow up. I guess my point in asking the question [is that] it is confusing for me. When we talk about the impact on price discovery, the data flow of what the prevented planting acres are and you get a report at 7:31 Monday morning, and then on Wednesday you get a report from a different agency that has different numbers. It can be quite confusing to the price discovery mechanism of the future market.

And so as a committee member, I guess my point in asking the question or to raise the issue was to say if we want to think about the impact of crop insurance on price discovery, it would be nice to have improvement in that data flow.

MR. THORNTON: Thank you. Take two more questions here and then we'll go to the participants remotely and see if they have any questions.

MR. KOVANDA: Jodi, thank you for your presentation. You mentioned that crop insurance allows for marketing flexibility. I wondered if you might expound on that a little bit further. In particular, how much of your cash transactions are negotiated transactions that you do the day that you ship the product or within seven days? And how do you think that your propensity to when you transact the cash commodity influences the issue that was raised about cash and futures convergence?

MS. GUETTERMAN: I guess I'm not

understanding the question on within seven days pricing.

MR. KOVANDA: I guess, a simple example of it would be how many of your bushels that you sell to an elevator, you bring them to the elevator and you price them as (inaudible). Or you sell them seven days and then ship them?

MS. GUETTERMAN: At harvest?

MR. KOVANDA: Not necessarily at harvest, but perhaps in April -- on April 1st you transact 5,000 bushels and by April 3rd you ship the product. What percentage of your production would be transacted in that way?

MS. GUETTERMAN: So you're saying we'd sell within -- okay. The 50 percent that we sell after harvest, probably 40 -- well, 40 to 50 percent of that would be selling it to deliver within 30 days. And the remainder would be to deliver within two to three months on our operation. We do have the capability to store, so we don't have to usually sell for storage issues because we do have the capability to hold it.

MR. KOVANDA: So does that impact

your experience in convergence (inaudible)?

MS. GUETTERMAN: We are very close to the Kansas City market, so that supply and demand that you may have out in Western Kansas where you're dumping wheat at harvest, we don't experience wide swings in basis in our area.

MR. THORNTON: Thank you. I'll remind folks here today, if you can state your name, your organization for the folks remotely participating, you can speak.

MR. HANDKE: Thank you. This is Steve Handke, Independent Community Bankers. We're a large agriculture lender in Northeast Kansas and on the Missouri side, so I guess I have two points to make, anecdotally. First an amazing success of crop insurance, though an amazing success, but also in a small way an amazing failure in prevented planting. Let me talk about the amazing success. So I'm a third generation farmer. I've never seen any cases where your crop insurance, your production cost -- our farmers are generally about 3,000 acres in Missouri bottoms and we generally count crop insurance loans in 500,000 Units (inaudible). More importantly a lot of a million-five (inaudible) in crop earnings. So I'm going to guess

Jodi -- I'm going to guess she probably is rolling one-million, one-million five of operating inset settlement for her farm.

Every year exposed to weather and you're dead on. That gives assets a lender the collateral to finance those and to have a reset with them if there is a crop failure. An amazing success through the 2000s.

Also, and it's really, really odd year, so in my whole farming career history, I never saw a year like 2015. Northeast Kansas could not get planted; Northwest Missouri could not get planted. About 60 percent of the acres got planted, so then you're trying to figure out the prevented planting rules. From a banker's position, it was an absolute disaster.

And the part of -- and luckily it's not a big part of your program. Maybe it happened one in 30 years, but it was regionally significant. And what our operators were faced with is trying to figure out if the time had melted away in July, do I plant or do I not, the crop insurance prevented planting keeps rolling away from them. The ones that decided to plant beans on the 25th of July did much better than those that took prevented planting and the main reason for that is the tremendous cost in maintaining idle acres. So there wasn't any really discount. They actually had to keep the --

MR. THORNTON: Can you please speak into the microphone?

MR. HANDKE: I guess if there's only a small retooling it would be of prevented planting. That for 90 percent of what you do, I think is basically successful.

MR. THORNTON: Thank you. I'll ask the operator to unmute the lines to see if we have anybody on remote, participants who would like to ask some questions.

Okay. Thank you. I'll turn to the Commissioners and Chairman. Start with Commissioner Behnam, if you have questions.

COMMISSIONER BEHNAM: No questions. But thank you for your participation. Thank you.

COMMISSIONER QUINTENZ: Yeah, no questions for me either but I found it very informative. Thank you very much for your presentations.

CHAIRMAN GIANCARLO: I want to

apologize for arriving late. I was able to inform the Federal Reserve District President that the CFTC actually exists here in Kansas and we're doing some unique things here. The first Ag Advisory Committee meeting in some time, the first one outside of the beltway in some time. And the first ever ag commodity futures conference will start later on today.

And I don't say that really to pat us and all of you on the back as much as to say the CFTC is very, very focused on our ag commodity futures markets, making sure these markets serve all the people that you serve and farmers like yourself so the message is that we are very, very focused on making sure these markets continue to serve all of our nation's producers and the world as well as they possibly can, because these markets are vital national and international interests and that is what we hope comes out of the next 48 hours of meetings just like this one. Thank you all for your participation and involvement (inaudible).

MR. THORNTON: I would like to thank the panel and open for any closing remarks that you may have.

With that, I thank you. We will now be taking a five-minute break and we will resume at promptly 10:35 for our second panel. Thank you.

(Recess taken.)

MR. THORNTON: Everyone please take their Seats. I would like to call the AAC meeting back to order and begin our next panel in which staff from Farm Credit Administration will discuss risk management. Our panelists are Mike Duffy, Credit Specialist Program Manager in the Office of Examinations, and Steve Koenig, an economist in the Office of Regulatory Policy. Please begin.

MR. DUFFY: Thank you and thanks for the opportunity to speak to the Committee this morning. My name is Mike Duffy. As Charles said, I'm the Credit Specialist Program Manager in our Office of Examinations. We're the federal regulator, regulatory agency for the farm --

MR. THORNTON: Could you speak up just a little bit into the mic?

MR. DUFFY: Sure. Just a little bit

about myself. I'm based in Bloomington, Minnesota in our Office of Examinations. Grew up on a grain and livestock farm in Northeast Iowa in Paul’s part of the world. I have been lucky enough to remain involved in our farming operation, so I have some perspective from that side of the business as well.

But we're here to talk about risk management and financing and risk management in the Farm Credit System. Steve will give an overview of current conditions in the Farm Credit System, and then I'll talk a little more specifically about what lenders look for when they're financing risk management and some of the things they expect from borrowers in that area. So with that, I will turn it over to Steve.

MR. KOENIG: Thank you, Mike. And welcome everybody, this morning. Again, my name is Steve Koenig. I'm with the Office of Regulatory Policy in our McLean, Virginia headquarters. A little bit about my background. I have been in the farm credit industry since 1981, but Through the 1980s as a credit system lender and later on at USDA and then more recently with the Farm

Credit Administration.

I want to start out this morning with a little introduction of the cooperative Farm Credit System for those who are not familiar with it. The system is currently comprised of -- the system is currently comprised of six direct lending associations and they are served by four regional banks, funding banks. Those 69 associations have over a half-a-million borrowers, about 1.5 million in loans. Those loans total about $259 billion at the end of the year. To give you some idea of the size of the Farm Credit System, it's assets, total assets are about $330 billion, nearly a third of a trillion. If it was a single entity in the commercial banking system, it would be about the seventh or eighth largest bank in the United States.

This next slide is a little bit confusing, but it shows a system of the territories. Those 69 associations, and the point I want to direct you here is that there's some very large associations and there's some very small associations. We have some associations with portfolios with just 100 million and we have some with portfolios over 20 billion. So we have a range of credit policies, a range of sophistication, a range of geographic location, and so that can be sometimes a little difficult to characterize activities in the Farm Credit System and those in respect to credit underwriting procedures and the price and risk management tools that our borrowers use.

This next slide shows a little discussion about the system's financials. They're very strong right now. Loan performance is historically very good. Under one percent of loans are not performing. The system has had very good earnings in recent years. It had 5 billion -- over 5 billion in earnings in 2017, that enabled it to grow its capital again. You can see on that chart that capital is at the highest level since the great recession. So asset quality is good; earnings are good. Overall, things are performing quite well.

Who supplies farm debt? Who's the suppliers? Well, system provides about 40 percent, commercial banks provide about 40 percent, and then there's a selection of other lenders. I was at a conference just last week. Most -- actually all of the lenders are reporting actually very good performance in their loan portfolios. Loan indemnities are down. Losses are low. USDA’s direct farm loan program are performing better than they had expected, given the difficulties some farmers have had in the last few years.

This next chart shows the system's portfolio. It's broken down by commodity. It's a very diverse portfolio. But if you look up there, you will see the cash grains and cattle constitute a little over a quarter of the portfolio. I think that is important to this group in that those are two of the enterprises where risk management tools can be often more critical than some of the other commodities that are under contractual arrangements.

This next slide shows some price trends. This group is very expert on that. But from a lending perspective, I wanted to include this to show if you look at the figure, the green particularly in the last decade, we've had a rising price situation and more volatility particularly on the grain side. But recent years we're kind of trending back to the previous decade where we had more -- less volatility, more consistency --. And so my point is, I'm not sure where we're going, but those marketing tools, those risk management tools, perhaps might be even more important.

It's easy to make money when prices are good. It's not as easy when prices are not. And we're potentially in a situation where we are right now where profit windows are relatively short, not deep. And so decisions need to be made at a much finer level.

In the grain sector side, farmers continue to struggle with that cost price squeeze we’ve see in recent years. It just shows the red line is prices paid. It is sticky, land prices, land rents. Seed costs are very fixed as opposed to commodity prices which are more volatile. And so we have a lot of our producers that are facing this and have been for several years. How do you close that gap? And that appears to be a continuing problem.

This next slide shows business income from the USDA, the latest forecast in February. I included it to show that the pricing situation, at least from the USDA's perspective, is likely to continue. The red numbers there are the major commodity groups that lenders finance and USDA’s calling for declines in that cash farm income across the board.

Some few observations on borrowers' financial positions. Farmers balance sheets have been held up pretty well-- with resilient farmland prices. That's enabled a lot of producers to restructure, rebalance their balance sheets, right-size them whatever terminology you want to use, work with their lenders in that respect. A lot of farmers came into this downturn, particularly on the grain side, some very strong balance sheets and they’ve been able to weather the tighter margins I just showed in the previous slide.

Again, working capital is declining, though, and that is a concern. USDA is forecasting another double-digit decline in working capital for 2018, again on its February forecast. So with less cash, there's more need for borrowing. You see the operating credit demand go up in recent years, and that's going to be the case this year as well.

So, credit use is rising, interest rates are rising, too, as we all know.

That is going to be a stress

going forward, I believe. There's roughly 375 billion dollars in farm debt outstanding. In the system, about half of the system's farm debt reprices at least on an annual basis. So those costs, interest costs will translate into borrowers' financial statements relatively quick, and we're talking big numbers here. We're talking probably billions of dollars in interest cost over the next coming year.

Farmers continue to work through cost adjustments and that will be ongoing theme, I think, unless commodity prices turn around soon.

And I want to close by pointing out the farm safety net has helped in this whole process for sure. When I talk farm safety net, I talk about crop insurance and the farm programs, ARC and PLC. I think was mentioned by someone earlier. Those tools are probably going to be less important going into 2018, just the way the formulas work on them in terms of price and so on. So with that, I'll turn it over to you Mike.

MR. DUFFY: Thanks, Steve. With

that, I'll touch base on a few of the specific areas that lenders look for in financing risk management activities. And first, I would say, as a regulator and certainly the lenders and as a credit program manager, I would say everyone is in agreement that financing -- borrowers, farmers should have reasonable risk management practices and lenders should finance them. It's the sound business practice to do that. And I would only emphasize the reasonable risk management. Once it goes beyond that, lenders become much less Comfortable. As you move into margin enhancement and maybe on the speculative side, lenders become much less interested in financing that type of activity. But risk management itself, lenders can and should be involved in financing that.

As Steve already mentioned, volatility and shorter profit windows really create the need for better risk management. I don't think the last week -- you probably couldn't have a better example than, I think, markets were almost limit up Thursday with a surprise on the planet acreage intentions, and then yesterday morning with some of the trade discussion going on, 40 cent or 50 cent move down in soybeans. The volatility and the need to move quickly on markets is increasing, if anything.

I'd say, as a personal aside, we finished up our old crop soybean sales Monday, felt pretty good about it yesterday morning and then I think they got about half that back since yesterday morning, so by next week we might wish we wouldn't have sold it all, but that's just the nature of the markets here lately.

One other comment on -- just on financing side -- . There are a number of basic tools that are very common, particularly on the grain side, with forward pricing, hedge to arrive contracts, that don't require cash outlays, don't need borrowing to do those. Typically done through local elevators or ethanol plants in my part of the world. So there's a fair amount of risk management that can be done without financing. As you move into more sophisticated activities in hedging, obviously financing is required.

Just a few of the basic things that

our lenders would say is, they need to understand the risk management strategy to finance it. If a borrower wants to come in and get financing, they need to be able to explain their plan in terms that the lender can understand and get comfortable with.

Another thing, without exception, the system lenders would say they need to be the primary operating lender to also finance risk management strategies. Split-financing in that situation is just too difficult to track, and so if they're not the primary operating lender, they would not finance some other risk management strategies separately.

And then the final bullet: Exceptions exist, but the ideal scenario is a customer that knows the cost of production, has a written and executable marketing risk management plan. And, like I said, there is going to be exceptions. Strong borrowers, smaller loans and certainly competitive pressures will result in some loans when they don't have that,

but I think the lenders that we talked to, more than anything else, they emphasize producers need to know their cost of production to have a good risk management plan. If you don't know the cost of production, it's very hard to lock in a profit.

And, I would say, five years ago, a lot of grain farmers probably didn't know their cost of production, but a lot more of them know it today. I think they've gotten that message a lot over the last few years, as margins have been squeezed and much more conscious of that in the current environment.

A couple of things. When a lender gets a request to finance risk management, they need to decide on a couple of things. Will they do it as part of the operating loan or will they set up a standalone hedge account or a standalone hedging loan? And then also how much they'll provide. And typically, if it's a fairly small portion of the total operating needs, they'll keep it within the operating loan, particularly on smaller borrowers and with fairly basic hedging or risk management strategies. As the dollar amounts go up and the hedging activities get more complex, then typically it will be in a standalone loan.

And, I would say, in particular on the livestock side, when operations are hedging both their input cost and the production, those would more typically be in a standalone hedging account rather than combining with the operating loan, just for tracking purposes and to keep things clear of what's going on in the accounts.

I wanted to mention just one thing, and getting a little bit more technical here, but if it is a standalone, hedge loan, three-way brokerage agreements are now very common with the system and this would be probably an outcome from the MF global situation a few years ago. Now the lender, borrower and broker would sign an agreement where funds would flow automatically between the hedge loan and the brokerage account and back. There would be cash sweeps on a daily basis on larger accounts to avoid situations where there's a lot of margin money sitting in that brokerage account.

And as some of you I'm sure would

recall, in an MF global situation, when they filed bankruptcy there was a lot of customer money in those accounts that was tied up. I think eventually all of the money did go back to the borrowers, but -- or the farmers that were hedging, but it took a long time. And so one of the things that has come out of that is three-way brokerage agreements to avoid that situation. And as part of that, the lenders can get, you know, in some cases, real time brokerage position reports, they can go in at anytime to see what the hedge account looks like, and so that's definitely an advantage for lenders and something they look for as risk management strategies get more sophisticated.

A few things that we would consider red flags for lenders in brokerage reports. Three-way option trades. And again, getting a little technical, but probably I’m way down the curve from some of the folks in this room, so I'll throw it out. In this case, it's fairly common to, for instance, buy a put and sell a call to cheapen it up, get part of that premium back.

If you get into situations -- and certainly some brokers will encourage it: Buy one put -- sell two calls, get even more of the premium back. When you start to do that, you're taking some risk on the other side and lenders get more uncomfortable as you get into those more complicated options or any other trades that would result in some risk to the borrower versus risk management.

Another sign is frequent placement and lifting up positions. Again, fairly common on the brokerage side to encourage customers to take some profits, maybe get back later. From a lender perspective, they'd rather see the borrower lock in a price, hopefully a profit, and stay with that hedge until the production is sold. So frequent in-and-out transactions are a flag for lenders.

And then also, activity that differs from historical norms or the size of the operation. If they're buying more futures contracts than they have production, that obviously is a flag that they move beyond risk management into the speculation side, so that would also be a flag for the lenders.

As I said earlier, lenders are committed to financing risk management and valid hedging, but they want to stay away from speculation. And obviously, there's not always bright lines between hedging and margin management and margin enhancement, which is a common term, and speculation. So I think that's something that they continue to monitor transaction reports for and ensure they understand the borrower's plan to make sure that is not going on or at least they're not financing it.

And as I think most would agree in any industry, lenders don't like surprises any more than anybody else, and so transparency on what -- and communication on what's going on in the hedging activity is very critical to the financing piece.

Just a few things I wanted to mention. Strength, challenges, and opportunities, I guess, in this area. Some livestock producers are very active margin managers, and from our perspective and what the system lends to with the swine industry is probably a great example of that. There's been a lot of consolidation in that industry, obviously, but with some very tough years in swine a few years back, a lot of the larger producers have really focused on locking in both the input and the production side and managing the margin, and they have been very successful at it in the swine industry.

It's been more difficult in the cattle industry, locking in fears that at profitable levels with what prices were particularly a few years after the drought conditions.

And it's been very difficult in dairy. I don't think I need to tell anybody in this group that. You probably know it better than us. You know, I think there's various discussions about why the basis is much more volatile and tougher to track on the dairy side. Not as actively traded, obviously, is one of the things that has been brought up. It's much more difficult, for system borrowers at least, to do as much margin management on the dairy side.

Another strength, I guess, in this case, would be a challenge. Particularly in the grain industry, producers are reluctant to go beyond cash sales and forward contracts. Basically, what they can do through their local elevator or maybe, like I said, local ethanol plants in some areas...

We talked to some of our lenders in the last few days. They indicated probably 10 to 20 percent of their grain borrowers actually have hedging accounts. Otherwise, most go through their local elevator cooperative. And that would be by number, not necessarily by volume. Because some of the larger borrowers certainly are more active hedgers, but most farmers are not as comfortable in the grain side in actually having the hedging accounts themselves, concerned about margin calls, things like that.

And so, you know, I think we would say continued education, information about what's available and what they can do is important. I think the lenders in the system have tried to do that with some of their borrowers -- get them more familiar with the tools that are available, but there's probably still a ways to go there.

The final bullet on this slide that lenders need to understand the impact of hedging on financial statements. As you get into larger accounts, certainly comprehensive income, unrealized gains and losses have a huge impact on the financial statements of the borrowers and a big impact on whether or not they're meeting their covenants. So understanding how those hedging gains and losses are being accounted for is also very important and sometimes difficult to sort out.

And again, a challenge, and I mentioned it earlier, knowing a cost of production from a lender's perspective is key to having a good risk management strategy and good financial records or high quality financial records are very important. And I think most lenders, and at least the system lenders we talked to, would say a lot of borrowers are still probably don’t have their financial records where they need to be to truly know their cost of production and do risk management.

So again, a case where the system institutions encourage borrowers to improve their financial records, some have offered accounting systems. I think there's a new one that's kind of a QuickBooks-type product that one of the institutions is offering now to try to get the records up to a higher level, particularly on smaller customers again, so they can more effectively manage risk.

And I think I comment -- a question that maybe was brought up before we came in today was in a more stressed environment when borrowers probably need risk management the most, what can lenders do? And, you know, what we would say in that case is they probably need to focus on less cash-intensive strategies. Lenders are not going to be as comfortable extending a lot of new money for hedging accounts to a borrower that's struggling. But options, contracts with buyers, hedge to arrive, forward contracts, still all very available options and those borrowers would need to do more of it, so lenders would continue to encourage risk management. They just probably wouldn't be as willing to extend as much cash to a distressed borrower in that situation.

One other challenge, again getting a little bit technical, on contracts that may not require delivery do create challenges for lenders. One example I throw out, that I'm familiar with, is a cash plus contract that some elevators would offer where they're buying the old crop at a certain price and then also throwing in a premium based on selling a call option, and if, you know, if that option expires worthless, the seller, the farmer, keeps that premium. If not, then it would convert to a hedge to arrive contract in the fall. In a situation like that, the farmer doesn't know for sure if he's got crops sold for the fall. So, you know, that uncertainty, I think optionality is a term that gets thrown into it sometimes. That creates some discomfort for the lenders because then the farmer may or may not have crops sold, won't know until later, and if they don't then price may change in that time frame. So those types of contracts, where delivery is not certain, is a challenge and makes lenders uncomfortable.

One last comment. I know we're about

up on our time. I want to leave some time for questions.

You know, lenders and borrowers need to stay committed to using the risk management strategies that are in place. Once everybody's agreed this is a strategy we're going to finance, they need to stay with it. And we have, you know, a couple examples I'll throw out from the system in recent years where that was effective. We talked with one lender; the hog prices spiked in 2014. A lot of their borrowers had production contracted or locked in at around $100 per cwt, went up to about $132 in a very short time frame. They stayed with those borrowers. In about a three-month period that particular larger hog lender increased their financing about $500 million. In another three months the market stabilized, the production started to go to market and they got that $500 million back. But they have to be in a position and willing to ride those markets up once the production is hedged and it is a true hedging strategy.

Another example, going back a little bit further, was in 2008. I'm sure most can recall as ethanol started to enter the picture, grain prices spiked dramatically in that summer. In some of the agribusinesses with production locked in, had huge margin calls as grain went up dramatically and a few of the big lenders, they needed to get participations both from other system lenders and commercial banks to continue to fund it. It went into the billings in that situation and they were able to stay with those customers and finance the hedging activity through that sharp run up. It's not the high prices as much as the change in prices that really increase the need for financing, and having lenders that are willing to finance that and understand the hedging activity is critical in that situation.

I did want to mention, too, I think it's of some interest to folks, for what is typical hedging loans on hog prices, a typical hedging account for a hog operation is probably $20 per head is what some of our lenders would throw out. On the grain side, a dollar to a 1.25 per bushel on corn is a typical hedging account, a loan for hedging account, and $2.00 a bushel on soybeans in case people are interested in the more specifics as to what a typical hedging loan would be for different commodities.

With that pretty quick overview, but for the sake of time, I will stop there and certainly be glad to take questions.

MR. THORNTON: Thank you for your presentation. I’ll remind folks, when you do have a question, press the mic to speak. And then if you engage in conversation, you have to turn your mic off to let them speak and vice versa. So I'll open the floor for any questions.

Seeing none, I will -- oh. Paul and please state your organization.

MR. RINIKER: Just a short question for you, Mike. You didn’t mention cattle, but you had the dollars per cwt. for hogs. Which was it on hogs? Like $20? Per cwt? Okay. On cattle?

MR. THORNTON: Please turn on your mic.

MR. DUFFY: I didn't have a rule of thumb on the cattle side. I'm sorry. I didn't get that. I best not throw one out because I might be off base on what some of our lenders would say.

MR. THORNTON: Mr. Ullmer, please state your organization.

MR. ULLMER: Kim Ullmer here on Continental for R-CALF and United Stockgrowers.

I did a survey, went through all kinds of meetings, cattle meetings. And, 672 people so far have participated, one of the questions is, do you feel the CME board is a safe risk management tool for producers? Three percent yes; 97 percent no. When you look at: Do you think each trade should be backed by an asset with delivery options? Ninety seven percent say yes; three percent say no. And then when you ask, is it gambling or is it futures trading? Ninety percent of it is -- 90 percent of the people think it's a gambling format instead of a futures contract.

And so the request from these people is they would like to see you guys change it back from a commodity casino to a futures option with an asset and a delivery because it's the number one problem in the livestock industry that we have to face. So our request is also some help to set up the American

Mercantile Exchange that will be asset-based and delivery, and my question would be would you help fund that? Because you have a lot of producers going out of business. We lost 9 out of every 10 hog producers and now there's thousands of livestock producers going out of business. So we need help on the funding side and we need help getting it asset-based with delivery so it's a safe risk management tool. I provided all of the information in studies for you guys with the same stuff I got.

MR. THORNTON: Thank you for your comment.

Matt.

MR. HINES: Thank you for presenting to us today. Just a couple quick questions.

Do you have a measure of track for denials for renewal or increases to credit lines? Is that anything that you track in the past few years? There's been some concerns specifically over this past year just on the increase in credit like you had mentioned, if renewals are still happening or if increases are taking place.

And a second question would be, are

you seeing more standalone hedge marketing notes or lines in the past couple years?

MR. DUFFY: Thanks. I'll take a shot at this one.

We do look at denials and change in activity. Certainly it's up somewhat, but definitely increases in lines. Borrowers, you know, in some cases the line was out there. They weren't using it, and now that they are advancing on it a lot more than they were for a few years, it's surprising how many farmers had operating lines and didn't even use them for a number of years, and that certainly has changed in the last few.

As far as hedging activity, I'd say over time it's increasing because farmers are getting larger. On the livestock side definitely we're seeing separate hedge lines. Not as much as on the grain side yet.

And, like I said, a lot of the more typical or traditional farmers really are not as interested in setting up a standalone hedge account and doing their own hedging. They're more comfortable going through the local elevator and not facing the margin calls, which I think is part of it. So large grain farmers, I'd say, are doing it; most traditional ones are not. Livestock definitely you see more standalone hedge lines.

MR. THORNTON: Thank you. I'll ask the operator to un-mute the line for any questions from the remote participants.

Any questions? Thank you.

I thank this panel and in the interest of time -- sorry, Chairman.

CHAIRMAN GIANCARLO: I do have a question for Mr. Duffy. I found your presentation very compelling for would-be lenders to producers for their risk management practices. My question is for the past decade with the consolidation of lenders, and certainly the lack of new formation of small banks in agriculture sectors, whether lenders today have sufficient knowledge about farm economics to be able to actually get comfortable with making the kind of lending that we're talking about for risk management purposes?

MR. DUFFY: I would say, you know I hate to say bigger is better, but in our experience, the larger institutions probably have the scale where they can have the people on staff, and I think we have some institutions, very strong risk management folks very familiar with markets and hedging.

Some of the smaller institutions, with very small staffs, I think struggle to -- as we get into more complex marketing strategies, probably don't have as much expertise on staff to do that. And so I think it varies by size of institution in our situation.

CHAIRMAN GIANCARLO: That's very helpful. I just wanted to make the point.You do many things with the CFTC. One thing we're not charted to do is provide lending, so we're not a funding institution. Just for your information there, you mentioned funding some new exchange. That’s one line that this agency is not statutorily set up to do.

COMMISSIONER QUINTENZ: I just have one quick follow-up for Steve.

You had mentioned that half of some amount of debt in the farm sector reprices every year. Is that total farm debt? Is that a specific category of farm debt?

MR. KOENIG: That was referencing to the system's repricing of its loans of roughly

50-55 percent of the loans reprice in less than a year, so that’s largely because of the production credit side but there's -- you know, that's the whole system's portfolio. There's a lot of lending that's also to cooperatives and that's off on a short-term basis.

So I have to be a little careful on that and characterizing that with farmers, but I’m talking about the whole portfolio of the Farm Credit System.

MR. DUFFY: And I would just add on the real estate side, obviously, there's a lot more fixed; it's a much lower percentage. It's operating and the cooperative credit where the shorter term financing comes into play where the funding would reprice annually. On real estate loans it's a much longer term and it's a much lower percentage that reprice.

COMMISSIONER QUINTENZ: Okay. Thank you. I think it's an important opportunity for some of us to keep in mind as we have continuing conversations with Federal Reserve presidents and governors. I just want to make a quick point that on a number of my farm visits around the country in Kansas, Missouri, Mississippi, Louisiana, Arkansas, I've heard that access to credit for margin payments is an issue. And I think you've done a great job of describing both the interest in providing or ensuring that farmers are appropriately hedged in that capacity, but also some level of discomfort with practices around that that can create questions. I think that's an interesting area to keep exploring and to try to either further resolve or get more answers to or more education around, so thank you for your presentation.

MR. THORNTON: The last question. Mr. Paul Riniker from National Farmers Organization.

MR. RINIKER: Just for clarification, the 55 percent number, is that on farm credit loans that are looking to refinance, or did I hear you wrong?

MR. KOENIG: That's the repricing of loans outstanding in the system. So it's not farmers looking to reprice; it's just what the portfolio looks like at the end of 2017.

MR. RINIKER: Thank you.

MR. KOENIG: Again, a lot of the credit is short-term. That would be true with commercial banks, too, of course. Commercial banks fund off deposits so the deposits tend to be short-term in nature. Actually, commercial banks are the largest provider of production credit and the system is the largest provider of real estate credit, so that would be very true for commercial banks as well. A lot of their loans are repriced on an annual or less basis.

MR. THORNTON: Thank you, Commissioner Behnam.

COMMISSIONER BEHNAM: Quick comment and echoing Commissioner Quintenz' comment and question that the Chairman had. I'm very happy that you agreed to come out here. I think this is a relationship that probably has not existed between the CFTC and farm credit at all, so we're very encouraged and open to continuing a dialogue with you because I think it can benefit everyone at this table. Definitely something we hear about and it's one element of the larger challenges that growers are facing is the credit issues. And I think with more collaboration and above all else education, we can serve our constituents well. So thanks again for coming out and really appreciate your presentation.

MR. THORNTON: I'd like to thank this

panel for their presentation.

In the interest of time, we will move directly to our last and final panel, Block Trading in the CME Agricultural Products.

Thank you. So this is our third and final panel. Price Discovery: Block Trading in CME’s Agricultural Products. Our panelists are Tim Andriesen, Managing Director of Agricultural Products and Alternative Investments, Business Line Management. Fred Seamon, Executive Director of Agricultural Products, Commodity Research and Product Development. And Andrew Vrabel, Executive Director and Global Head of Investigations, Market Regulation Department.

I would please welcome your presentation.

MR. ANDRIESEN: Thank you. And thank you to the Commission, the Commissioners and this group to give us an opportunity to share with you what's been going on.

Let me just make sure you can hear me better.

I January 8th of this year, we implemented in agricultural products relationship based trading which is blocks and crosses. This is something that we have in virtually all of our other products, and most commodities have these capabilities as well. We know that it's a change for our agricultural customers, and what I wanted to do today is walk through a little bit of why we did this and share a significant amount of data with you around what we're seeing in the marketplace subsequent to that. I'd also like to hand it off to Andrew to talk about --

MR. THORNTON: Can you bring the mic a little closer? It's hard to hear.

MR. ANDRIESEN: And then I'd like to hand it off to Andrew to talk a little bit about our oversight activity around blocks, so...

The first thing that I want to do is reaffirm that our goal is to provide an additional tool for users of our markets. Our expectation is that our central limit order book markets will always be the primary execution facility and the primary venue for price discovery. Before I kind of dig into this, I want to clarify for some people what exactly relationship-based trading is.

There are essentially two things that we implemented. Both of them are relationship-based trading. It's called that because what it facilitates is a broker being able to go source the liquidity for a transaction. So if a customer can't execute a transaction, looks at the book, doesn't see the depth they need or for whatever reason, they can engage a broker who will go around and have discussions with other market participants, market makers, et cetera, around price, direction, and quantity to execute that trade, so to find the liquidity to help the customer execute that trade.

There are two types of relationship-based trading. One are crosses. Crosses are a market type that is executed on Globex, essentially, in a cross the broker goes and finds the two parties for the trade; they submit that trade into Globex; that trade goes into the central limit order book. It can be improved by other participants in the central limit order book and then the trade is executed.

There is no requirement for a customer, type of legal status for a customer. If you have a futures account, you can execute a cross. There are no thresholds or minimum size requirements of crosses as well.

Blocks, on the other hand, are slightly different. Blocks are transactions where a broker goes and sources the liquidity for the transaction. They find both sides of the transaction. They execute the transaction and then they submit it to CME predominantly through the ClearPort for clearing. Participants who are using blocks are -- have to be eligible contract participants. There are a minimum threshold for blocks, so there's a minimum transaction size for you to execute a block. And there is a time requirement that it has to be reported to the market by, so we want to ensure that that block transaction is seen by the market in a timely fashion.

One of the questions is why relationship-based trading? We have very deep and liquid markets, for the most part. But there are times when we have customers who have said to us: Listen, we can't get the volume done; we can't get a particular strategy done; we can't get done what we need to do. Typically, it's more likely in the back end of the curve or in less liquid products and

over the last years we've looked at additional -- several different approaches to addressing this. We've had market-making programs to encourage liquidity provision at the back end of the curve and other things. We believe that this is part of the solution for that problem.

Number 2. Recently, more recently, we've had customers who have come to us saying, I need to be able to execute larger transactions. I'm trying to roll my hedge book and we're looking for bigger -- the ability to execute bigger transactions to roll our hedge book.

And thirdly, in some less liquid products, particularly nascent products, it's very hard to build initial liquidity and what we've found, and some examples of this most recently, is our new Black Sea Wheat contract. Having a market where you have IDBs, independent dealer brokers promoting the product, sourcing the liquidity get to build that initial liquidity. I can tell you we have struggled when we have launched just pure CLOB-based products. We come up with a new product. It's very difficult to get that initial liquidity. We've seen more success in trying to use a model where we have brokers who are out drumming up the liquidity for that product. So those are essentially why we have gone down this path.

Now, one of the big questions we have had from customers is, well, wait a minute. Is this taking transparency away from the market? Is it creating another market? And The reality is, there has always been a second market in the agricultural space; it's an OTC market. I spent a significant part of my career in the OTC market. This is a market where you do swaps or options. It's a market, obviously, perfectly legal transactions, but they are predominantly done on a bilateral basis between two firms. They have an ISDA agreement in place to facilitate that. They tend to be much larger firms, and these transactions are not reported in an exceedingly timely manner to the marketplace. I think the requirements are they have to be in a suppository two hours after the transaction.

One of the things we believe the block market will do is hopefully bring some of these into that market where they can be seen more readily by market participants.

A second element we think is important, in terms of providing transparency to the marketplace, is the reporting period. The most liquid products we have, have a reporting period requirement of five minutes, so you will see that reported in a price feed within five minutes of the transaction. Interestingly enough, one of the things is a lot of times people will say, well, hey, I see something going on in the market; I don't understand why it's happening. In some cases in the past, that could have been an OTC transaction that people were hedging. In this case, if you see that activity you can look at a block ticker and see if maybe it was a block transaction that was getting executed.

And then the other thing we would

point out is that most of the block transactions are typically done between a market participant and a market maker. Those market makers then, in turn, turn around and hedge that into the marketplace. So they may not hedge it directly in the sense that, I've done something in the back of the curve and I'm going to put it all in the same contract. They may spread it around. But the flow from that activity is, for the most part, coming back into our market, so market participants are having an opportunity to interact with that. So we think that this is something that in specific cases will be beneficial to our customers to help them execute.

What I'd like to do is walk through some of the data around blocks and crosses just to give you a sense of what's going on. This data is based on all the trade activity between introduction on January 8th and on March 23rd, which is the week before last.

So if we look at the number of transactions that have occurred during that time frame, and we have broken this down by our major, major products. In that window there were 34 million transactions took place on CME within these products. Of that 34 million contracts, 220 were blocks and 1667 were crosses. So if you look at the numbers, quite frankly, it's a very, very small percentage of the activity that took place. You can see that, you know, for the most part it's just extremely small.

I think what we also want to do, though, is look at the volume that that accounted for, not just transactions but contracts. So again, if we look here, we can see that during that time period we traded 86 million contracts. Of that, 128,000 were blocks and 209,000 were crosses. So of the volume during that period, blocks represented .15 percent of our volume; crosses represented .24 percent of our volume.

And when we first started talking to the industry, and as we looked at other products, we said, you know, if you look at CME products, in general, blocks where it's established in the market generally account for 2, 3, 4 percent of the volume. So right now we're well, well, well below the numbers that we see in our other products.

If we look, more specifically, the largest product where we're having blocks is in corn. It's .28 percent, so slightly over a quarter of a percent of the volume there. Obviously, you go down to feeder cattle where none were traded. If you look at crosses, you know, the biggest number there is soybean meal where we saw three-quarters of a percent of the volume there.

Let's also look at a bit more breakdown, in terms of the difference between options of futures and crosses and blocks. What this chart shows you -- it is a little hard to read from here -- but there's two bars for each commodity. If you look at corn on the left, the first bar is blocks; the second bar is crosses. The dark blue portion of the bar represents futures; the light blue portion represents options. So you can see of the .28 percent of the volume that was done of blocks in corn, roughly half of it was futures; roughly half of it was options. If you look at all of those, what you'll see is that, for the most part, cross volume tends to be options and there are kind of a mixed story with futures.

If you look at corn, Kansas City wheat and soybean oil, you see there's a bigger percentage of futures than options. On the other hand, if you look at soybeans, it was very much different. So, we’ve seen a bit of a mix in terms of what's being done. We’d also like to look at livestock the same way. You can see in livestock it has a very interesting pattern. Options are almost -- almost all crosses are options, and a vast majority of the blocks are futures.

What's also useful is to look at the size of the trades that have been executed. So what we have here is a whisker chart. For those of you who aren't familiar with it, a whisker chart shows volumes. But, it also shows the distribution within that volume.

So if you look at corn, for example, you can see that from the bottom of the line to the top of the dark blue, to the bottom of the dark blue box represents the first quartile trades, the dark blue box the second quartile, the light blue block the third quartile and the top line is the largest trade.

So you can see, if you look at corn, the median trade has been about 1,000 contracts. It's important when you look at these, because there's one outlier trade - there was a 20,000 contract corn trade. It's important to understand that the way we're counting this is if it's a spread. It's a 10,000 contract spread, that counts as 20,000, so you're counting the legs. In some cases, you could equally, if you had a multi-legged spread, you could count all 3, 4, whatever other legs you might do, if you had a butterfly or something like that.

Again, looking at the distribution, in Live Cattle, the median live cattle trade was a little over 350 contracts. The median -- excuse me, that's 150 contracts; the median Lean Hog contract was about 200 contracts.

I'd like to walk you through just a couple trades, to give you some examples of how we see customers using this and how we think this is beneficial for customers.

February 28, 2018, there was a block

of 250 September Soft Red Winter Wheat futures done at 522 and a half. At the time that this was executed, the top of the book was 43 contracts deep. So if you were looking to execute this at the market, you would have gotten 43 at the top of the book and then had to go through the book. The block was done at the second level of the book. So, in other words, one tick off the top of the book. Had that gone into the marketplace, it would have gone through 10 levels of the book.

One of the pieces of feedback we get from customers is we see these movements around that we don't understand why that's happening. In some cases, our analysis has shown that there's liquidity holes where there might not be a -- there might be holes in the liquidity where if you go through a couple of levels, you don't see a lot of buying. This essentially has shifted some of that away from pushing through those liquidity holes to a market maker who is now going to spread that out and try to create a bit more orderly market.

Second example, March 9th. There is a block of 250 July-Dec Corn calendar spread options. It was a minus 10 even call spread done at a quarter. This is a contract that our commercials have told us is very important. They want to be able to do options on the spread. It's also a contract we have struggled to get liquidity for.

So, you know, prior to that trade, for the whole year up until March 9th, only 419 of these were traded. So, in this case, a broker was able to go out and source the liquidity for this customer to do 250, where, you know, we would guess that it would have been very difficult to try to do that in the central limit order book.

March 14th, 2018, a block of 300 July Corn futures traded at 399 and a half. You know, people kind of looked at this trade and said, well, wait a minute, July Corn futures? There's liquidity there. We don't understand why this was a block. At the time the top of the book showed 326 contracts. What you didn't see is that this was one leg of two legs of an ethanol crush. The other leg of that was 107 NYMEX ethanol futures. We had a customer who wanted to lock in an ethanol crush and he did it through the block market. And then finally, the week before last, July 27th, there was a block of 2,000 Sep Corn 290 calls against March 9, 210 calls. This was kind of an interesting trade and you actually -- somebody immediately says, well, wait a minute. You know, there's liquidity in the front end of that. If you would have put it in the pit, I would have easily done the Sep leg. Well, it wasn't a Sep contract; it was a spread.

On the board at the time there was 1100 contracts deep, but there was absolutely no bids or offers in the second leg of that. So a broker was able to go out, find market makers who were willing to take on that risk and facilitate that trade for the customer.

So when we see these, these are exactly the sort of things where we think that blocks can help the customers execute transactions to create more orderly markets and can help them manage risk more effectively.

Real quickly what I'd like to do is go through commodity by commodity. And I'm doing this because several people have said, well, you know, where's the liquidity? Where are these blocks and crosses taking place? So what we did is we looked at this data again. We looked at it by contract month by contract month. So if you made a spread, we could look at what legs, what contracts the legs of that spread were in.

So if we look at Corn, for example, where is the distribution of the transactions across the curve? The percentage that you see there is the percent of the total volume in that contract. So in the first case there you're looking at March of '18, and you can see that it's .22 percent of that contract. So if we look at Corn, we can see that there indeed has been, you know, some volume being done in the front end, but as well as we see the volume spread out beyond the curve.

The second question and a concern, of course, is are we -- you know, what impact is this having on liquidity? I can tell you that it's impossible to isolate something like this in terms of overall liquidity for the marketplace. But what we would tell you is that if you look at liquidity -- and what this chart shows -- is the top of the book and the top three levels of the book, the corn market actually is more liquid -- and this is comparing Feb of this year in the light blue to Feb of last year in the dark blue -- so we can certainly see that the corn market has significant liquidity.

If we look at soybeans, again, soybeans tell a very different story. Blocks have not had the uptake in soybeans. You can see that while the blocks are in the front end of the curve, they're fairly minuscule in terms of the size, you know, three-hundredths of a percent and two-hundredths of a percent. Again, liquidity overall in the market is better than it was last year.

Clearly, those are our two most liquid contracts. As we start to roll into things that maybe have a touch less liquidity, let's look at soft red winter wheat. Here we can see that actually most of the block activity took place in the September contract and it was spread pretty much across all of the contracts. Again, in the front end of the curve good liquidity, back end of the curve, it's more or less what it was a year ago.

Kansas City wheat, this is a contract that again is -- you know, probably has a bit more

liquidity challenges than some of the other ones. As you may know, we acquired KC in 2012. This has been growing significantly, but if you look at the distribution here what you see is clearly this is a market where there has been less liquidity in the back of the curve and you are seeing the block activity there as well, and the biggest majority of the block activity there is in the Dec 18 and the March 19 contract, so this is exactly what we would expect to see in a contract like this.
Again, if you look at this, you'll see there's a little less liquidity at the back end of the curve compared to other contracts.
Soybean oil, you know, a bit of a split.
There's clearly some activity in the front end, but then you go all the way back to the December contract and we're seeing that as where the vast majority of the activity is taking place.
Again, liquidity is a little bit better in some places and a little worse in others.

Soybean meal, again, a spread, but we're seeing the majority of the block activity taking place there in the August, Sep, and Dec contracts.

You also see maybe a little bit less liquidity back there in the back end of the curve.

Live cattle. The uptake on cattle has been -- and livestock has not been significant. I would point out we had crosses since 2002 in these markets. So actually, introducing crosses isn’t new to these markets. We see kind of the spread across the curve in terms of live cattle in the nearby I think that's -- is that five percent or nine percent? .009 percent. And it's pretty much spread across the board, and liquidity is reasonably on par with a year ago.

And lean hogs we see a pretty outstanding pattern here. The May contract has always kind of struggled with liquidity, and what we've seen is block activity that has made up for that with the rest of the liquidity or the rest of the activity spread.

So, you know, what we see is we see a market developing. Certainly these are new. We're looking at them closely. As I said before, our goal is to ensure that the central limit order book will always be the primary venue for risk management and price discovery and, you know, we will continue to watch these, look at these numbers and, you know, ensure that that's the case.

I'd like to turn things over to Andrew and he can talk a little bit about how exactly how we are watching the marketplace.

MR. VRABEL: Thank you. Thank you. Once again, my name is Andrew Vrabel. I'm the head of investigations in the CME Group’s Market Regulation Department. I haven't met many of you, so I'd like to take a moment to introduce what Market Regulation does for CME Group’s markets. I'll spend a little bit of time talking about the data we rely on and then specifically how we look at block activity.

We have approximately 160 employees in market regulation. Those are predominantly located in our offices in Chicago and New York. The staff has as diverse a background as I think you'd want to get in this type of industry. There's 2,000 former brokers, merchants, traders, HFT developers, and people who have traded their own money, people have traded others' money. And a healthy number of data scientists who are working across five primary functional groups in order to monitor activity in the market and work with market participants to be in best compliance with our rules.

We have a rules and regulatory outreach team, and their primary function is writing rules and advisories. They also spend a significant amount of time working with participants to educate them on our rules to ensure that they can come into compliance and not have to interact with myself or my staff.

We have a technology team within Market Regulation. This is a team of data scientists who build analytical tools that we need in order to do the surveillance that we need. I should add that outside of the technology team within Market Regulation, we have our IT department where we have almost 60 dedicated IT resources just for developing regulatory systems. We have a market surveillance team, and their primary function is to prevent market manipulation. So they spend a considerable amount of time looking at positions of participants, how those positions relate to the rest of the market and attempt to prevent any future manipulation that may happen.

My teams are investigations and data investigations, and we are looking at all market activity trying to find trade practice violations and/or data anomalies.

And finally, we have a team of attorneys that will prosecute the cases that my team or the market surveillance team refers to them.

There are two important keystones I think everyone needs to appreciate about Market Regulation because of what enables us to do what we do so well.

First, we're completely independent from the business of the organization. While Tim, Fred, and I may work on initiatives to improve the integrity of the markets, everything that we do in Market Regulation is within Market Regulation. No one outside of our department knows what we're investigating, who we're investigating, decisions we're making. They have no opportunity to opine, provide input. Everything we do is from the regulatory perspective making sure that we can preserve the integrity of our markets and also comply with any regulations that are out there.

We are overseen by an independent panel of our board which is called Market Regulation Oversight Committee. We're one of the first D.C. arms of the United States that have a dedicated oversight committee at a board level responsible for ensuring that we have the resources we need and that we can operate independent of the rest of the organization.

The second component relates to confidentiality, and this is critical in order to obtain information from participants. Any information that we obtain during the course of fulfilling our regulatory duties is maintained in confidence. That allows us to go out to the grain elevator or to a farmer or trading firm and ask them questions about what they feel is happening in the market and/or obtain from them more intimate information about their own strategies. That information stays within Market Regulation and goes to nowhere else.

The lifeblood of what we do in Market Regulation is highly dependent on having data and tools at our disposal. With every single order message that's submitted into Globex, we have real time access to that data. To put this in perspective, across all exchange products on a daily basis futures and options we take in 750 million to a billion order messages. The ag markets are a very small portion of that. If I look at corn futures. On an average day we may see 500 million order messages -- sorry, 500,000 order messages. So it's a small piece of the total amount of data that we're pulling in. But when we receive this order messaging data we then enrich it with other information that's necessary for us to do surveillance.

Tim mentioned before that in the period they looked at, mostly Q1, there were 34 million trades that happened in that group of ag products. So we, in Market Regulation, have information on every single cleared trade, including the ultimate owners of the positions that were acquired through those trades, whether those were given up from one firm to another or executed directly through the account for the owner. And this includes information on all deals submitted for privately negotiated trades, which is block trades.

So when a participant logs into ClearPort and inputs all the information, we have access at our fingertips to every single thing that goes into that system. And this is what a deal sheet would look like for a block trade where that information is readily available to any of the 160 people in market reg.

Our market surveillance team is collecting position data from any account that that has reportable positions. This information flows into all of our regulatory systems as well.

I mentioned the enormous amount of order messaging data this makes up the market data that is flowing out to the public. We spend a lot of time visualizing this enormous amount of data in order to get it into a format that's actually consumable. This visual here for Live Cattle spreads likely included a half a million rows of data. In order to take that much data and put it into a visual is extremely impactful for us.

We have tools that we developed ourselves in order to find specific types of violations. So for block trade, we have a suite of tools that allow the investigators to look for particular types of trading infractions.

Into our systems, we take feedback from participants. Last fall we introduced a self-reporting portal where block participants can self-report their late trades. And when we created this, we had this dropdown for explanations -- and this is based on kind of our informed history of doing block trade reviews -- on the reasons this was provided for having a late report. But then we also added a free form text field.

All of that information whatever is inputted into this flows into our other regulatory systems. So if we identify a late reported block, we also know whether the participant was proactive and self-reported that.

So specifically related to blocks. We have a dedicated team within investigations that's responsible for looking at block trading activity, and they perform five major functions which I'll run through quickly.

So they perform pricing analysis because any block trade by rule is required to be done at a fair and reasonable price, so our team is running analytics on block trades to determine if the pricing is fair and reasonable. We do that in a number of ways. We look at Globex was trading and a range around that time. We look at other block trades executed around that time and then we also do a cost-to-fill analysis. Questioning what portion of the block could have been executed in the order book. If 100 percent of the block could have been executed in the order book, it gives us reason to go then look at the pricing to determine whether that pricing was in line with where the market was trading.

We run a timing analysis, not only looking for blocks that are late reported, but also looking for block trades that may have been misreported. So, for example, if a firm reports a block as though it was done timely when, in fact, it wasn't. We look for prohibited pre-hedging activity, which while we allow pre-hedging, there's still certain limitations on the type of pre-hedging that can be effected in the market and by whom.

We look for standardized trade violations such as money pass activity and wash trades, wash trades that can be used or effected through block trades.

And then the last, is the sixth area we view, is the team performs analysis on every complaint received from participants related to block activity. So on an annual basis, we take in hundreds of complaints. A very small portion in that relates to block trading activity. But every complaint we receive, we analyze it and we provide feedback to the complainant on what their observations were. Either, yes, we have a problem with this and we’ve opened an investigation, or no, we do not have a problem and this is what our observations are, obviously without revealing any of the confidential information we may have or strategies of participants.

So just an example. I had this visual up before showing – you likely can’t read the upper portion. It's a live cattle futures spread market. The green line denotes the price traded on Globex at a particular time. I know that at 9:10 in the morning a block trade was executed for 75 contracts. I know, again, if you can see that purple dot, that it was executed at the existing trade price that was being executed in Globex. But then I also know from our data and our analysis, that had that been executed in the public market, it would have traded through at least three price levels.

This is the type of analysis the team is doing on a regular basis for every block trade that's done that would hit one of our flags either for timing, pricing, pre-hedging, money pass, wash trades or is the subject of a complaint.

If we identify violations, we generally have two courses of action. We have a summary finding process, which we use for reporting or recordkeeping violations. If we determine that the violation is egregious or there are repeated issues, we can refer the investigation to our enforcement team where they can pursue a sanction in front of our business committee.

This example up here is not in an ag market, but it was from last month where a firm was sanctioned $60,000 for a series of late-reported blocks. We take this very seriously, not only in how we are monitoring the markets, but the actions we take in order to get better compliance from markets.

Happy to take any questions.

MR. THORNTON: Thank you very much.

Let's start with Patrick Coyle from the National Grain and Feed Association.

MR. COYLE: Thank you. Andrew, on that price analysis that you've done, did you come across any instances where the trades were executed in the market and based on your analysis that could it have easily been done in the central order book? A lot of your examples have shown that had it gone into the central order book, it would have dramatically impacted prices?

MR. VRABEL: Yes, there are. There are examples where, particularly, and Tim pointed out, in corn where you have a fairly deep order book, both in outright and spreads where the block trade could have been executed, at the first price level of the book. When we see those instances, that's when the pricing becomes most important because if the block is, you know, off market. It really questions why the participant would have chosen to go through the route of blocks rather than putting it in the central limit order book.

Further to that, my team is committed

to doing -- we call it a post Q1 analysis of the block activity. And we will be making recommendations based on the activity that we see including potentially some of these observations for some of the more deep markets where the block activity likely could have been executed in the order book.

MR. COYLE: Just a quick response. That wasn’t ultimately the goal I think of blocks -- to take trades that could have been done in the central order book with liquidity away from the central order book, correct? That would be something would get a red flag of why a participant might go and use the block?

MR. VRABEL: It may or may not. The example that Tim noted where there was a corn and futures trade is a leg of another spread. They traded ethanol, I think it was. There are a lot of examples that we see where even the block size and block trade may have been able to execute in the central limit order book at the time. It doesn't necessarily negate or discount where that threshold is set. But it's something we're looking very closely at.

MR. THORNTON: Thank you.

Mr. Ullmer from R-CALF.

MR. ULLMER: Kim Ullmer here on Continental R-CALF on behalf of Stockgrowers of America.

This is a one-page contract is the way cattle are handled, that’s block trades a private treaty. Now, here's the 19-page result book that people in the livestock industry are supposed to try to understand. So we see all this stuff about regulation. Who's regulating these guys? They write a 19-page rule book and the real actual system works with the one-page system. That's the live cattle then on the feeder cattle they don’t even have a delivery. Here's a simple one-page private treaty contract that happens every day of the week and they take the total delivery out and create a four-page rule book. Let's work on regulating these guys. They're creating a false system that you can't even use. How many farmers on earth could take and figure out their 19-page rule book when the system works like this? Ninety million sell a year and we do it this way? We need help regulating these people.

MR. THORNTON: Thank you.

Mr. Hayden Wands, American Bakers Association.

MR. WANDS: So just a question on the block trades because a lot of our constituents are in the deferred markets. They’re incredibly illiquid. I won't even mention Minneapolis Exchange. So just a clarification. Let's say that we had orders in to buy, I'll say, March of '19 wheat at $5. Could a block trade trade at that level or less than that level we would be executed in the central -- You see what I'm saying?

If somebody wanted to do 2,000 contracts at 499 and three-quarters and I had an order in there to buy 10 at $5, could that block trade essentially trade through my order and we didn't get filled or could it trade at my order and we still didn't get filled?

MR. VRABEL: And so block trades do not elect stops that are resting in the central order book. One observation about blocks, separate from our block trading team, we have a team that's looking at disruptive trading activity in the marketplace. And the best example is looking at live cattle where a 75 lot market order in live cattle can cause significant price movement. And often when we see those large price movements, the market price deviates from the mean and then we'll revert back to where it was.

I can't tell you the number of complaints we got from commercial end users on their stop being elected and all of a sudden being significantly out of the money because it was elected when the market was in the reversion pattern. So I think that's one of the very important reasons why we don't want blocks to be electing stops. In other words, you are not going to get a fill if your order is on Globex and there's a block that's priced at or through them.

MR. THORNTON: Thank you.

Joe Kovanda, NCBA.

MR. KOVANDA: Yes, Joe Kovanda, National Cattlemens Beef Association.

In general, if you observed over a period of time the blocks or the crosses exceeding that level that you see in non ag commodities 3, 4 percent on a routine basis, what are the levers that you have to address in such a situation?

And then the second question, maybe more towards Andrew is, does the existence of blocks in the question just before incent users of the central order book that frequently use -- I don't know what other term you use -- but icebergs where the size is not displayed explicitly, does the existence of blocks incent those users to do less use of those types of orders?

MR. ANDRIESEN: Let me take the first question, and I'll hand it off to Andrew for the second one.

So there are two levers that we have in terms of increasing or decreasing participation of the block market. One is the threshold, so the transaction has to exceed a certain threshold to be able to be block eligible. So in theory, if you increase the threshold, then you're going to take more transactions away from the block, from their ability to execute as blocks.

And the second are fees. It is more -- it costs more to execute a block, so there is an economic disincentive to execute a block if you can execute it in the central order book.

MR. VRABEL: Is your second question, Joe, on whether blocks have an impact on displayed order sizes of the book? I haven't analyzed it. I can say anecdotally speaking to participants in other markets who have said, I would have traded at that price for that size. And my question back was, did you have that size displayed in your order book? And they say, no. I say, well, maybe you want to. So there is that possibility that people will change their passive order activity in order to attract more of that volume away from blocks.

MR. KOVANDA: Just a follow-up. The reason I ask that question, Andrew, is because in my experience, in talking with market participants, there's an increased use of those types of orders. And while the participant has intentions to get a fill on the entire volume, the way that they display it creates counteractions by aggressors in the market.

For example, looking at the market depth and saying, there's not enough there to execute what I want to and then they substitute with potentially a block trade.

So it seems to me that this is, just in my experience in discussing it with the market, this is a potential issue of users of the market that use these iceberg-type orders.

MR. THORNTON: Mr. Barker, NCFC.

MR. BARKER: Thank you. As I interact with our customers -- in my day job I'm the chairman of an FCM -- our customers are frustrated by this because the feeling is what Mr. Wands explained. You can get traded through and not get filled and the feeling in the country is there's one set of rules for people who enter five lots, and there’s another set of rules for people who enter 500 lots.

And I understand your argument is we're talking about less than one percent of the market, but from a hedger's perspective, deliveries in a lot of cases are less than one percent of the market, but they're essential to the price discovery function and the hedging functionality of our markets.

So I don't know that I have a question, but that's the sense in the country -- is that you created two different markets where it may only trade at the top of the book, but I had an order in there and didn't get filled and somebody else did because they're trading larger quantities. So I just want to express the sense I’ve gotten from my membership.

MR. ANDRIESEN: If I can respond to that very quickly.

Again, there is an OTC market today where people, a very small number of people, who have ISDAs with other counterparties can do that. And your customers don't ever see those transactions. Our goal and our hope is that actually implementing blocks at least brings those into a transparent market where they can see those transactions.

MR. BARKER: Respectfully, that argument somewhat falls on deaf ears, because you're the CME and you control Globex and Globex is transparent. And so when I have an offer out there at 10 on a spread, you expect to have an opportunity to get filled and the same entity that controls Globex and controls that is allowing a tiered system where a 500 lot could trade and I wouldn't get any of it.

MR. THORNTON: Thank you.

Mr. Hines, Farm Bureau.

MR. HINES: Thank you, gentlemen, for coming and presenting today. Matt Hines, American Farm Bureau. Two questions.

Within blocks and crosses we talked a

lot about where it hits in the book, is there a price requirement where that has to be filled at or put in within like an EFP, if I'm going to exchange with another participant we can take a look at the daily range, and pick a price in between there. Is there any type of price requirement on a block or a cross?

MR. VRABEL: There is a price limitation. The trades have to be executed in the daily range.

MR. HINES: Thank you. Just wanted everybody else to kind of hear that also because it wasn't mentioned today.

As far as difference between Globex and ClearPort, for instance, a quote system that I use it's a FCM derived quote system or a DTN Prophet X, it's concerning from a participant's point that I can go back and look at time and sales on Globex and see every single trade, but the block trade I have to go to a separate system in ClearPort to see that trade. there a way or somethingIs talked about in the future to bring those two and put them together so that I can see all of that in one?

MR. ANDRIESEN: So it's my understanding that all of the block information goes out with our data feed, so if you have a -- I don't know each individual data system, obviously. But the systems that we understand and particularly CME Direct, which is our system. You can bring up a window to look at block information just as you bring up a window to look at any other information that comes out in the data feed. How you see that is going to be a function of the system you have in front of you and whether or not it is designed to provide you with that information.

MR. THORNTON: Mr. Gallagher, National Milk Producers Federation.

MR. GALLAGHER: So the trades that have been happening with the blocks and crosses, do you know, are they trades that would have happened otherwise without it in the swap market, OTC market? Or are these new executions that are happening because you’ve made this change of using blocks and crosses?

MR. ANDRIESEN: I'm not sure there's a way to answer that question because each trade is different and what would have motivated the customer to do that would be different. I can't answer that question.

MR. GALLAGHER: But you know who participants are that are transacting - can you go back and do a survey and ask them that question. I think it would be kind of interesting to know. Is this bringing liquidity from somewhere else or is it generating new liquidity?

MR. VRABEL: So I do know who has executed every block trade. I can tell you that I have done some analysis and that there are participants who are active in the block market who are not in our markets Q4 of 2017 or the same time period at Q1 2017.

I don't know if those participants would have come to our market just to trade blocks or if they were coming to our market anyway and they started trading blocks. You're right though; the only way to truly find out is to send each of those participants an inquiry letter, which, you know, often causes some participants to get a little edgy when market regulation is sending inquiries.

MR. THORNTON: Thank you.

Mr. Strong, North American Export Grain Association.

MR. STRONG: Thanks. Maybe just a comment. Maybe Not a question, but a comment for everybody in this room and the Commissioners. This issue of block trades has some major reservations with the NGFA Risk Management Committee. And it is new and we're working through it and trying to see whether it really is good or bad for the market, but there are many who -- there are some on the committee who -- take exception that the level to enter block trades excludes the small consumer of futures needs or the farmer that might need to hedge, so an IB with a book of small business is just totally excluded from this.

There are -- while we generally get the fact that another side of a block is probably going to come back and re-hedge themselves in Globex, we are certainly skeptical of that. At least specifically in my firm, people are calling us all the time because they know that we are naturally a, you know, either short or long in different commodities so they're just looking to pair us up with somebody else. And I doubt that that -- I doubt once they can find a natural long and short, I wonder how much that volume does come back to Globex.

So some of us think that it is taking order volume off the central order book, which we don't think is good. We don't -- many of us don't -- want to go to an outside broker to do a block simply to execute a larger quantity, which is maybe not the topic of blocks for today, but it is a frustrating market occurrence which we've had many discussions on. We understand it comes from the K algorithm, but it is really frustrating to see 20,000 spreads on a bid or an offer and you go to lift 1,000 and all of a sudden it gets cut down to eight, and by the time you do your second thousand you've taken the market bid.

We don't really want to go to a broker that then would say, oh, this commercial is now rolling their whole soybean or corn book at these particular prices. We'd rather be able to operate that -- be able to operate and execute on the Globex in this anonymous way that we're used to right now and we don't really want to pay a higher fee since we're already members of the CME.

We saw some of these slides at the NGFA risk committee or -- excuse me, I'm sorry, at the NGFA convention in Scottsdale and some - Tim and Andrew, some subsequent conversation within the risk committee. We're wondering if the charts you put up that showed the very small percentages -- That's over a period of January 8th through March 23rd, I think, so it really smooths out the data, and a lot of us wonder if on specific days where blocks are more active than others, is it a heck of a lot more percentage of daily volume? I don't know if you have that data and can answer or not, but that's a question –- and you can get back to us if you want, but that's a question a number of us have had.

And I guess I would -- I guess I would again suggest that maybe the CME could consider increasing the clip size, so that, so that commercials – so that people can execute bigger quantities without using a block.

Other people at the NGFA convention came up to me when I suggested it at the committee meeting that they also agreed and thought that that would help the, let's say this annoyance problem where you get bids and offers that vaporize because they would have a much more risk of being lifted.

So anyway. I think that sums up my comments. I don't know if I was looking for anything specific, but I wanted everybody here to know that there are some in the group that really, I think the jury is still out with us whether blocks are a good thing or not.

MR. THORNTON: Thank you. And in the interest of time, because we are now 15 minutes over, I will turn to the Commissioners and Chairman for any -- quickly, for the call if there's anybody that needs a question.

Any questions? Thank you.

Now I'll turn to the Commissioners and Chairman for any questions or closing remarks.

CHAIRMAN GIANCARLO: Thank you all. This has been terrific. This is a great example of all of your determination to address many of these issues and get these issues right. And I think It is similarly reflected in the Commission's intention to work with you and bring our focus on these issues. So thank you all for your participation and look forward to many of you that will join us in the conference that begins in a little while. Look forward to seeing you there.

COMMISSIONER QUINTENZ: Just to add to the Chairman's point. This is my first ag advisory committee meeting. I found it incredibly useful, informative. I think it's -- these meetings provide an opportunity for education and discussion and feedback not only for us, but for you, our members, and for our panelists and I felt that that was demonstrated in spades today. So thank you for bringing your expertise to bear on all of these issues.

And I just wanted to reiterate how much I learned about how important the futures markets are to the effective operation of the entire farm safety net system. And I think that that's something that I will carry with me throughout my meetings with a lot of diverse market participants and up on the Hill. So thank you.

COMMISSIONER BEHNAM: A quick thank you to the speakers on all three panels. Thank you for all of the Committee members for being here, some local, some traveling. A lot of questions answered, a lot of questions unresolved. And we're going to stay focused. I know the three of us are very engaged on these issues; we care about them very much.

We have a lot to look forward to in the next day and a half. This was a special meeting for I think the Commission to be outside of D.C. and have an ag advisory meeting outside of the Beltway, like the chairman said, but especially here in Kansas.

I certainly want to thank Charlie and Christa for all of your hard work, the Chairman for being here, Commissioner Quintenz, as well. And again, to all the committee members, we appreciate your engagement. You inform us of what we need to be thinking about, how we need to be thinking about it.

And as always, as we've always said, speaking on behalf of Commissioner Quintenz and the Chairman, our doors are always open and we're always willing to hear your stories, so we can help resolve issues and looking forward to the rest of the event. Thank you. Thank you for attending this AAC meeting; the meeting is now adjourned.

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