1st Consultative Forum on Coffee Sector Finance
27 September 2011
London, United Kingdom

Summary report on the 1st Consultative Forum on Coffee Sector Finance

Background

1. At its 106th Session in March 2011, the Council decided that the topic to be addressed at the ICO meetings in September 2011 should be 'Managing the risk of green coffee price volatility'. The Council also decided to establish an Ad Hoc Working Group to assist with preparing a statement of problems or issues related to this topic (see paragraphs 23 to 28 of Decisions and Resolutions adopted at the 106th Session of the Council, document ICC-106-19).

2. A report on the work of the Ad Hoc Working Group containing the statement of the problem was circulated in document ED-2118/11. A copy of this statement was attached to the convocation for the 1st Consultative Forum on Coffee Sector Finance (CFCSF) contained in document ED-2121/11[1].

3. The 1st Consultative Forum took place on 27 September 2011 during the 107th Session of the International Coffee Council, chaired by Mr Michael Wheeler of Papua New Guinea. The objective of this Forum was to discuss 'what mechanisms, tools or strategies exist, or could be developed or improved, to help small- and medium-sized producers manage the risk of green coffee price volatility' and 'what are the challenges for each of the mechanisms, and how can those challenges be overcome to make the tools/strategies more accessible and useful for small- and medium-sized producers?' The texts of all the presentations made at the Forum are available on the ICO website (http://dev.ico.org/documents/wsiteenglish/forum-10-e.htm).

[1] *The terms of reference for a Core Group for the Consultative Forum were subsequently circulated in document ICC-107-18.*

SUMMARY REPORT ON THE
1st CONSULTATIVE FORUM ON COFFEE SECTOR FINANCE

1. The Executive Director a.i. welcomed participants and said that this 1st Forum was a significant step in advancing the process of consultations on topics related to finance and risk management in the coffee sector, with a particular emphasis on the needs of small- and medium-scale producers, as provided for in Article 31 of the Agreement. The Forum was an innovative feature of the Agreement, which would enhance the ICO's efforts to promote sustainable expansion by engaging market-based principles to promote the betterment of all participants in the world coffee sector.

2. The Chairman noted that market-based risk management tools for mitigating the effects of volatility were available but were largely inaccessible to smaller coffee growers due to barriers such as lack of knowledge, lack of scale, regulatory and institutional obstacles, and financing possibilities. This Forum would explore a number of potential strategies or tools that could enable small- and medium-scale growers to overcome these barriers as well as other means to help these growers better manage risk associated with green coffee price volatility. It would also explore the role of differentials in price volatility. Four leading experts, coming from a range of backgrounds and experience, had been invited to make presentations on important aspects of managing risk to mitigate coffee price volatility.

Presentations

Oscar Schaps, Managing Director, Global Soft Commodities, INTL Hencorp Futures LLC

3. Most of the available financial instruments for managing price risk in the coffee market are accessible to larger players in the industry. For smaller producers, attempts to support prices through cooperatives, direct sales and minimum price structures have proven difficult, mainly because of a lack of information. Gaining a better understanding of how the market operates was a major challenge for these producers. The main issue currently affecting the coffee market was not the unprecedented situation of tight supply, but price volatility. Today, only two tools exist to transfer risk: futures contracts on terminal markets and structured products (usually made by combining existing contracts, such as options and futures). Although much attention had been focused on the behaviour of differentials, the most important determinant of prices for producers was the absolute levels of terminal markets. While the levels of specific differentials measure real coffee availability, no risk management tools are currently available to transfer differential risk since the lack of complete transparency of how the differential market operates not only constitutes a

psychological obstacle, but also creates an actual barrier to creating an instrument that would be appropriate. However, the operation of the natural gas futures market on the New York Mercantile Exchange (NYMEX) could provide a possible model for building a reliable and trustworthy settlement instrument for coffee, providing a number to which stakeholders in the coffee market could use as a benchmark for prices at the end of the life of the differential contract. This could be, for instance, a certain volume of coffee and the FOB differential. Over-the-counter (OTC) coffee differential contracts could be traded anonymously through brokers on the OTC market and subsequently be cleared at the Inter-Continental Exchange (ICE) to ensure accountability. Roasters could go through the same process. It would be relatively easy to create smaller contracts, say for 50 bags, which would mirror the ICE and Liffe contracts and could allow access to hedging for medium and smaller players. For the smallest participants, cooperatives and/or associations could facilitate access to this instrument. It was vital, however, to inform these stakeholders about these instruments so that they could be given choice within a free market.

Edgar Cordero, Executive Vice President, Colombian Coffee Federation, Inc.

4. The Colombian Coffee Growers' Federation (FNC), which is a private non-profit organization established by Colombian coffee growers to improve their living standards, aims to promote a competitive and sustainable coffee sector. The coffee regions are regarded as vulnerable communities: 89% of Colombian coffee growers have farms smaller than three hectares. The FNC acts as the administrative agent of the National Coffee Fund, which uses resources from contributions by growers and coffee sales to: guarantee the purchase of coffee; provide warehousing, sorting, processing and packaging of coffee beans; provide domestic and international commercialization of coffee beans and freeze-dried coffee; provide public goods and institutional services, including technical assistance to farmers, enforcing quality controls, worldwide marketing, promotion and advertising, and research and development. It also invests in the development and competitiveness of the domestic coffee industry. The purchase guarantee is operated through a network of cooperative purchasing points to ensure that growers find buyers for their coffee at a transparent and socially responsible price. In the international coffee market the FNC normally uses the New York 'C' contract as a benchmark for prices of Arabica coffees. This involves determining the differential, which is the substitution price, expressed in premiums and discounts, of one type of coffee for another. Differentials are the result of constantly changing global arbitrage markets, acting as an 'independent machine' within the market. Global arbitrage markets are subject to manipulation and all the endogenous and exogenous forces to which any market is subject. Currently, there is no way to hedge the differential. The FNC uses straight futures contracts to hedge risk, since this is a relatively straightforward way of managing risk. Options on futures are becoming increasingly

popular, but hedging strategies (such as the use of the Black Scholes formula to calculate the value of call options) are complex and difficult for small producers to understand. This means that there are fewer hedgers involved in the options markets, creating lower liquidity and higher costs. The Forum should debate ways to encourage greater participation by hedgers in the futures and options markets, either individually or through institutions like the FNC, and means of finding financial resources for promoting this increased participation. It could also discuss the possibility of establishing a Global Coffee Fund, financed by a global coffee tariff, to intervene in markets and establish price floors and ceilings

David Browning, Director of TechnoServe

5. TechnoServe, a non-governmental organization established to help emerging entrepreneurs in poor areas of the developing world, has worked with smallholder coffee farmers for a number of years. Experience in this field showed that coffee price volatility was driven by market fundamentals. Global stocks are at low levels and are continuing to decline. The producer stock-to-use ratio for crop years since 1980/81 showed a similar pattern, even though Brazil had been producing bumper crops in recent years. This was because demand is exceeding supply: domestic consumption in Brazil is growing rapidly, as is demand in China. There is also growing demand for other agricultural commodities from emerging markets, while the amount of land under cultivation is not growing. The supply of Mild Arabicas has been flat for 30 years. This imbalance between supply and demand creates volatility in coffee markets, which is exacerbated by increased trading from outside the coffee industry. Coffee has been a very attractive investment for speculators. The behaviour of the Dow Jones Global Equity Indexes shows that investing in equities is not as safe as formerly. The instruments to protect farmers already exist, but for these to work, buyers and sellers for these instruments are needed and often lacking. Since the world coffee price floor is above the cost of production, 'put' options can provide insurance. In addition to 'put' options, there is a 'collar' option strategy that can be used to limit the range of risk. Fixed price contracts are another option, however, these are subject to default by the seller when the market price exceeds the contract price. In fact, this is what is currently taking place in the market and deterring the offer of instruments that act as insurance against price volatility. To address this, parties to contracts would need to have confidence that the other party will meet its obligations. This would require commitment at origin to provide recourse, such as arbitration, that would engender the trust that is needed. Education is also needed to help producers and other stakeholders at origin understand the risks of volatility and the value of hedging. Regulatory frameworks should be examined to identify hurdles that might be inhibiting hedging from being offered to small- and medium-scale producers. Short-term measures include: an improvement in the quality and timeliness of information that can reduce volatility; and a better understanding of

techniques that can have the same effect as hedging or reduce hedging costs (e.g. selling part of the crop early to cover production costs and selling options later). The ICO could play a role in developing a vision of a desired end state and disseminating information on pragmatic tools to mitigate volatility risks.

Professor Christopher Gilbert of the University of Trento, Italy

6. Coffee prices have risen strongly over the past decade and are now three times their levels during the ‘coffee crisis’ period. In real terms, however, prices are not exceptionally high compared to their 1995 peak levels: Arabica prices are around 75% and Robusta prices around 40% of 1995 peaks. Spot price volatility has remained relatively stable at around 30% since 1995, though the volatility of Brazilian Naturals has been consistently higher than that of Other Milds and Robusta. There has been a rapid rise in Arabica prices since 2010. Problems with contracts are much more the result of rising prices than volatility. These do not arise from the standard ‘price-to-be-determined’ coffee contracts but from the exporter’s price fixing option, since this entails performance risk on forward delivery in which prices have already been fixed. Exporters are essentially looking at the fixed contract price as an options price. A tentative suggestion for dealing with these problems is that the coffee contracting system could be adapted, using settlement prices based on monthly averages, along the lines of the averaging system for price-to-be determined contracts in the non-ferrous metal industries traded at the London Metal Exchange (LME). Average prices are significantly less variable than daily prices and also less vulnerable to manipulation. Margin finance is a problem when prices rise significantly since banks are cautious in providing finance to importers if they see potential exporter default. Improved contracting can therefore provide partial relief for margin finance. Margin finance requirements shift the balance of competitive advantage away from small niche players and towards the large multinationals. Prices have fallen sharply in recent weeks in response to growing concerns for the future of the Euro zone and the prospect of a second recessionary dip. Coffee prices are likely to fall further over coming weeks. In this new context problems of default and margin finance become less urgent.

Discussions and issues

7. The presentations were followed by an exchange of views among Panel members and discussions with all participants on the issues raised, with delegates from several ICO Members contributing to the conversation. Issues raised by ICO Members included additional risk management challenges posed by climate change, the need for additional financing in the coffee sector, difficulties faced by small farmers in gaining access to information about risk management tools and the need to ‘translate’ complex topics

associated with risk management and finance for coffee farmers, producer associations and their role in facilitating access to risk management tools, minimum price guarantee programmes, difficulties posed by language barriers and lack of access to technology, the extent to which speculation versus market fundamentals are driving prices and volatility, and successful programmes for informing producers about risk management tools. Each of the four panellists made concluding remarks in which they concentrated on their priorities for future discussion and exploration. The main points raised are summarized below:

- **Strategies to combat limited knowledge and awareness of market-based and other instruments to mitigate risk:**

  Strategies are needed to help small- and medium-scale farmers to better understand volatility risks and the value of hedging and other risk management tools. This would help facilitate these farmers' access to existing risk management tools. Consideration could also be given to developing the use of new technology, such as hand-held communication tools or mobile devices, to provide information on transactions by small- and medium-scale producers and facilitate communications on market developments.

  There is a need for capacity building in financial literacy for public sector personnel involved in financing to enable them to understand risk and mitigation opportunities.

- **Developing new and improving use of existing risk management instruments:**

  Further consideration should be given to opportunities for direct and longer-term contracts between producers and roasters/importers, including challenges posed by defaults when the market prices rise above or fall below the contract price. Further consideration should also be given to insurance type instruments such as 'puts' and 'collars' and how they could be made more effective. Countries need to invest in institutions to promote the use of risk management instruments and the state and other entities could have an important role to play in providing access to hedging instruments for small- and medium-scale producers under government programmes. Initiatives taken by a number of producing countries could be explored, for example the mini contracts developed by the Colombian Coffee Growers' Federation (FNC) and the financing of options contracts for small producers developed by Mexico.

  One possible avenue to be explored is the use of multi-day averages as a price reference in order to attenuate the effects of volatility.

- **Producer aggregation into cooperatives or associations:**

  Producer cooperatives and rural producer organizations can be used as a means of pooling risk as well as improving farmers' understanding of, and access to, risk management tools. These institutions could also manage credits and increase guarantee funds. Producer organizations with government support, as necessary, could coordinate these activities on behalf of farmers, bearing in mind that producer aggregation reduces costs and facilitates dissemination of information. Quasi-centralized marketing systems could act as a shock absorber in mitigating the impact of market fluctuations.

- **Other challenges:**

  The divergence between physicals and futures markets is a matter of great concern to producers that requires further consideration. While tools that might be developed or applied to manage differential volatility are of potential interest to actors in the physical market, they are likely to be of less interest to speculators whose emphasis is on the futures market. Non-commercial players and speculators have become increasingly involved in the coffee market. Commodities in general are regarded as a new asset class and coffee has become an attractive investment whose price movements are not closely related to those of equities and other financial instruments. While speculative interest is needed to support trade interest in the coffee market, these recent developments could have significant effects on future coffee price volatility.

Summing up by the Chairman

8. The Chairman noted that the Consultative Forum was designed to operate as an evolving process. This Forum had identified a number of issues and problems requiring further exploration in the light of the general discussion among Panel members and participants. Priorities for future discussion and exploration included:

- Measures to be taken to meet the need to raise small- and medium-scale growers' understanding of, and access to, risk management tools, and the institutions or mechanisms that should be engendered or improved to develop the activities required.

- Further study of mitigation mechanisms, particularly those supported through producer associations and government action. The Governments of Mexico and Brazil, who had taken measures to mitigate price volatility, had undertaken to provide information on their experiences in this area. The experience of producer associations in countries such as Colombia and Guatemala should also be taken into account.

- Identification of specific mechanisms or tools that may warrant more in-depth analysis and serve as topics for focussed discussion in future Consultative Forums, including potential instruments that could help small- and medium-scale producers to protect themselves against the effects of challenges such as climate change.

Thanks

9. The Chairman thanked the Executive Director a.i. for organizing the 1st Forum and thanked the invited speakers for their valuable contributions to the Forum. The debate had been a significant development in the evolving process of consultations on topics related to finance and risk management.

10. The Executive Director a.i. expressed special thanks to the Brazilian Coffee Exporters Council (CeCafé) which was one of the sponsors of this 1st Consultative Forum.