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How Financialisation Influences the Dynamics in the Food Supply Chain

Discussion paper for the workshop

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Colophon

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Introduction

This paper provides a brief analysis of the financialisation of the food supply chain and its impact on the agricultural sector. The growing interlinkages between the financial sector and the agri-food sector have shaped to a large extent the prevailing dynamics of the latter, from land ownership to food retail. The different parts of this paper describe the different ways and means, and ever further levels of financialisation.

First, financialisation has led companies in the agro-food sector to prioritise financial profits and the interests of financial stakeholders over those of other stakeholders. Second, the financial sector increasingly influences how the food supply chain is structured and how decisions are made at various points along the chain. Third, the financial sector itself has increasingly used the agri-food sector as a basis to expand its financial business by developing and offering, often speculative, financial instruments and services that cause and further deepen financialisation. The agricultural derivatives markets are a typical example. Fourth, some agribusiness themselves offer financial services or act as the financial industry.

The agricultural sector and the food industry are attractive to the financial industry for a number of reasons. Expectations of long-term growth in food demand and increasing food scarcity make food-related companies attractive investments. Moreover, the inherent uncertainty and risks involved in agricultural production are appealing to financial players, as the greater the risk and volatility, the higher the potential returns. A wide variety of financial players are involved in the agri-food sector, such as individual investors, institutional investors including pension funds, commercial and investment banks, insurance companies, hedge funds, private equity funds, stock exchanges, agricultural exchanges and other trading venues for agricultural commodity derivatives, fund managers, financial advisors, etc.

The dynamics resulting from this financialisation of the food supply chain is distorting the main function of the agri-food sector, which is to provide nutritious food to as many people as possible in an environmentally and socially sustainable way. To restore this function, an important step to be taken is to expose the ways in which the financial sector's growing influence is having a negative impact on the agri-food sector. The following step is to hold financial players accountable for the distortions they cause. In addition, other ways must be found outside the financial sector to support and finance a more equitable distribution of income along the food supply chain, the provision of food for all members of society, and healthy food consumption.

1. Prioritising short-term financial profits: The dynamics of the stock market

One element of the financialisation of the food supply chain has been the growing focus and prioritisation on financial profits by companies and other operators (including farmers) in the agri-food sector. This pursuit of profits has put aside the prioritisation of the right to food to all, social and environmental sustainability, and healthy food consumption, which is ultimately the main function and purpose of the food and agricultural sector (Anderson, 2009).

Many companies that produce, trade and distribute seeds, inputs, agricultural produce and processed food have chosen to list on stock markets. By selling their shares on a stock exchange, these companies subject themselves to pressure from shareholders to increase the value of their share prices and dividends. There are 'walls of money' from individual and institutional investors whose sole aim is to achieve high returns. This kind of investor is not interested in socially and environmentally useful investments whose profitability they consider uncertain. This has led to listed companies prioritising short-term profits, as this is what is reported to their shareholders. There are no legal requirements for listed agri-food companies to report on the impact their activities have on farmers or other stakeholders, nor on the environment – these costs are externalised as much as possible. The constant pressure to boost shareholder value also occurs as a result of financial players (e.g. financial advisors for institutional investors) and the companies themselves constantly comparing a company's shareholder value with that of its peers. Companies know all too well that when their share value fails to live up to shareholders' expectations, they become susceptible to being acquired by competitors.

The emphasis on short-term financial profits and the fear of being acquired have spurred companies to pursue a business strategy of expansion. The larger the company, the more bargaining power it has to squeeze the weakest links in the agro-food supply chain on either the buyer or the seller side This in turn can initiate a vicious cycle of ever more integration, concentration and large-scale production, processing, trade and retailing (McCarthy e.a., 2014).
In the food processing industry, for instance, this has led some agro-food companies to move their production to cheaper sites or to outsource production to agricultural producers that are not unionised or not organised in cooperatives (van der Wal, 2008). In their efforts to expand market share and financial profitability, food processors have also been known to implement strategies targeting children through deceptive advertisements to make them addicted to sugary, salty and fatty (cheap) processed food (Isakson, 2013). Another strategy employed by large food processors is to buy up their smaller-scale competitors. The targeted companies include those that offer more innovative socially and environmentally sustainable products (MacDonald, 2011). By acquiring these companies, the financial strategies of the large food manufacturers are putting the long-term viability of such production methods at risk.

In the case of food retail companies, the larger and more concentrated they become, the more they can use abusive buying practices and make it difficult for small farmers and small food suppliers to find outlets for their products. Indeed, the cheaper their food products are – with cheap pricing (in particular in the fruit section) often used as a marketing strategy to attract clients – the more clients they acquire, leading to more market share and profits (Vander Stichele, 2006). The growing introduction of private labels – products offered under a supermarket's brand and manufactured by a company chosen by the supermarket – enable retailers to switch food producers easily, resulting in insecurity for producers and removing the little bargaining power they might have. This leaves traditional suppliers, food processors and farmers with fewer means to invest in improving quality, innovation and sustainability in their businesses (Vander Stichele, 2009).

Another profit-making strategy increasingly adopted by companies in the agri-food sector is 'tax planning'. This is a euphemism for legally acceptable ways of evading corporate tax (through tax havens, transfer pricing, etc.). This means that corporations are not paying their fair share of taxes, and that governments are not receiving funds that could be used to invest in public support for sustainable farming.

Although not all agricultural businesses and worldwide conglomerates are listed on the stock market, the dynamics of competition and the focus on short-term financial profits by listed companies have an effect on non-listed companies' strategies and operations. For instance, non-listed companies' financial flexibility and large financial reserves from profits allows them to acquire other businesses – often their direct competitors – in the food supply chain.

2. Shaping the structure of the food supply chain

Another element of financialisation is the way in which the financial sector is influencing the structure of the food supply chain through its financial products, services, strategies and players. Two examples are banks' lending practices and the increasing involvement of funds in land acquisition.

2.1. Banks' lending practices

An obvious area in which the financial sector directly affects farmers is lending. Banks are reluctant to give loans to small farmers, whom they consider risky and non-profitable. When banks do provide loans, the conditions attached sometimes require farmers to invest in larger-scale farming in order to improve their profitability. In some egregious cases, banks have offered loans that include an interest rate swap without the farmer knowing about it. These cases came to light in the Netherlands when the swap resulted in significant losses for the farmers while the banks made a profit (Follow the Money, 2014). The debt burden of farmers has an enormous impact on their operations, their income and their rights, as debt repayment is legally enforceable and is given the highest priority. The string of suicides by debt-ridden Indian farmers who were given loans by reckless banks are one example of just how bad things can get.

The many farmers who do not receive sufficient financing from the financial sector must resort to alternative forms of financing, most of which are under unfavourable terms. Farmers can turn to agribusinesses for financial and hedging services, to contract farming, to long-term contracts with buyers and supermarkets or to the derivatives markets (see below) in order to hedge against the risk of price changes. In none of these options do farmers have a strong bargaining position vis-a-vis the counterparty, making it difficult for them to protect their own interests. In addition, most of these alternative forms of financing have the effect of obscuring pricing as well as the division of income along the food supply chain (Vander Stichele, 2006). This further weakens (small) farmers' bargaining power.

Banks' lending practices also have a considerable impact on the rest of the food supply chain. A large-scale business is a rated by banks to be less risky than small or medium-sized enterprises, which means that a food processing conglomerate is more likely to receive a bank loan than a small innovative company, and a supermarket is more likely to receive a bank loan than the neighbourhood grocery store. Note that when a (structured) loan goes sour, the bank takes over the agro-food business or the commodities which were the collateral.

The financial sector also provides large-scale agribusinesses and food retailers with merger and acquisition (M&A) services, which includes advising, structuring and financing the transaction. Even though most research has proven that the success rate of business mergers and acquisitions is low (on average not more than 50%), banks have a vested interested in promoting M&As because the fees and bonuses for M&A services are substantial.

2.2. The dynamics of investment funds: Land ownership

Rising food prices and the prospect of food scarcity have made land an interesting investment for financial players. The value of agricultural land is expected to rise, more farm land becomes available from retiring farmers, and food production is expected to be profitable, especially when large-scale, intensive farming methods are used and the food is exported. Since banks do not always provide loans for buying up land, other financial players have stepped in to take new profit making opportunities (see also Visser, 2014). Specialized investment funds have created new instruments to finance the acquisition of land all over the world, promising high returns and attracting investors who finance the land acquisition and operation. Their focus on profits and their expectations of high returns are a driving force behind the large-scale acquisition of land. In case of illegal acquisitions, land grabbing as it is called, existing land or customary rights as well as other human rights are often disregarded. Grain (2012) lists the type of financial entities engaged in land grabs:

- Investment management companies targeting institutional investors such as universities or pension funds (up to 1.2 bn $ spent for land);
- Investment funds and holdings created specifically to purchase farm land and to turn it into profitable businesses;
- Hedge funds, including some hedge funds that are owned by agribusiness companies (e.g. BlackRiver by Cargill), mostly aimed at institutional investors;
- Private equity funds and venture capital funds;
- Mutual funds offered by banks and investment management companies ;
- Insurance companies that manage their own assets;
- Investment companies owned by wealthy families;
- Exchange-traded funds (ETFs) whose shares can be bought by individuals on the stock exchange;
- Sovereign wealth funds;
- Individual investors.

A look at how hedge funds and private equity funds are involved in the acquisition and exploitation of land reveals the pressure to make profits at work here. To finance the operation, the funds tend to rely mostly on debt (with hedge funds using very high leverage ratios) as well as external sources of money that are attracted by the promise of high returns. The investments are moreover for a short period of time compared with the lifetime investments that farmers put into their farms. The hedge funds and private equity funds typically sell the land and financial assets after six to eight years at a high profit, which are needed to repay the loans and the investors who were attracted by the high returns as well as to pay the very high bonuses of the managers of these funds. The emphasis on short-term financial gains results in practices that can easily lead to breaches in the rights of local communities and farmers. It also encourages large-scale extensive farming, with few incentives to invest in long term environmentally sustainable agricultural production.

3. Financial instruments that deepen the financialisation of the food supply chain

A third element of the financialisation of the food supply chain is the wide range of financial services and products provided by the financial sector that cause and support advanced financialisation. This subjects the agri-food sector to financial market strategies that are far removed from the realities of the sector. The agri-food sector itself has become subject to financial speculation.

The initial public offering of shares (IPOs) of agriculture and food-related companies are prepared and underwritten by investment banks, which earn substantial fees from the IPO and later from share trading services. In preparing the prospectus for the share offering, the investment banks pay little attention to non-financial-related issues, such as the right to food, so that shareholders lack such information and neither the company nor the investment bank can be held responsible.

Stock exchanges are themselves listed companies that pursue high volumes of trade and strive to have a large number of companies listed on their exchange. Trade volumes can be increased by allowing high frequency trading carried out by highly computerised and automated traders, from whom stock markets earn extra fees. Speculation in micro-seconds by such high frequency traders can result in share prices and trading that are out of sync with the actual performance of the underlying company.

3.1. How the fund industry uses the agro-food sector

The stock market listing of various agriculture and food-related companies has allowed mutual funds to invest billions of dollars/euros in the shares of the listed companies, attracting investors with expectations of high financial returns. The fund managers are only interested in companies that are likely to generate high financial returns. They are generally not interested in acting as shareholders and have no interest in the companies' performance in social and environmental terms.

Exchange traded funds (ETFs) are shares that individual and institutional investors can buy (or sell) on a (specialized) stock exchange. Because ETFs track a basket of shares, an index or a particular kind of asset, their expense ratios are significantly lower than investment funds in which fund managers actively manage the composition of the fund.

ETFs can invest in shares of agricultural related companies, securitised loans to such companies, or agricultural commodity derivatives. It is not always clear for the shareholders of the fund which assets the fund holds, since the fund managers play up the attractive parts and hide the risks (although there are regulations to prevent such practices). Some financial players even speculate with the shares of ETFs.

Commodity index ETFs offer the return of the price of a commodity derivatives index minus the fees for managing the fund’s assets. The commodity index that such an ETF tracks is created by an investment bank (which earns fees for intellectual property rights) and is composed of a basket of commodity derivatives traded on commodity exchanges (usually a mixture of agricultural and non-agricultural commodities derivatives) where prices are set on a daily basis. These ETFs buy commodity derivatives directly (or indirectly through a total return swap) on the exchanges. The majority of the fund’s assets, however, are not commodity derivatives but other securities. The direct and indirect buying and selling of agricultural commodity derivatives, not always based on events in the agricultural sector, by the funds have an effect on prices on the agricultural commodity exchanges, thereby contributing to speculation and volatility (Vander Stichele, forthcoming 2014).

All these financial instruments make the shares of agricultural and food-related businesses vulnerable to volatility in the financial markets and speculative strategies. As a result, the share performance and the prices of the agricultural derivatives only partially reflect the real performance.

In general, in their pursuit of profits, the financial industry offering the financial services and products based on the agri-food sector relies on high trade volumes, price volatility, many financial players, and speculative strategies even when prices drop. Some investment banks are even active in both the physical and financial commodity markets, which gives them access to sufficient knowledge to make their financial commodity price speculation (via derivatives) very profitable (Omarova, 2013). Once the profitability of agro-food companies' or derivatives declines, the financial players withdraw, which once again affects the commodity derivative prices (see below) and the agro-food sector (Vander Stichele, 2012).

3.2. Agricultural commodity derivatives markets

Where there is price volatility and risk, the financial sector sees opportunity. This was the case with agricultural commodities, which led to the development of agricultural commodity derivatives markets. Although they are meant to be insurance instruments that allow farmers to protect themselves against price volatility, agricultural commodity derivatives are in fact speculative instruments that can also result in losses for farmers if the bets made at the time of the signing of the derivative contract go in the opposite direction. They are a commercialisation and commodification of the risk that farmers are left to confront individually. Because physical agricultural markets and trading are not regulated and price setting is opaque, agricultural commodity exchanges have become important price benchmarks for many agricultural products. For instance, the Chicago Board of Trade (CBOT) has become an important price benchmark for agricultural products and their trading around the world, even though the underlying agricultural products are produced mostly in the US.

The majority of traders in derivatives on the agricultural commodity exchanges have traditionally been agricultural producers, traders, processors and end-users who want to hedge against the uncertainty of the price at the time of harvest. Since the deregulation of the commodity derivatives markets in the US in 2000, however, the majority of traders have become financial players with little interest in investing in the agricultural sector but keen to see higher prices of the derivatives contracts themselves to resell them with a profit, without having the agricultural products delivered. Agricultural derivatives can also be traded off-exchange (OTC), which makes their trade opaque. The financial players can be hedge funds, institutional investors, investment banks and fund/ETF managers, swap dealers or even high frequency traders. They pursue high profits with little to no knowledge of agricultural markets or agricultural production and consumption. They have contributed to higher price volatility and higher interconnectedness with the financial markets, so undermining the integrity of the pricing and hedging functions of the agricultural commodity exchanges even though the financial industry argues the contrary and academic studies are not conclusive (given the lack of information).

An example of how agricultural commodity markets are being run with little regard for farmers' interests is the way in which the financial sector was able to influence the regulation of the agricultural commodity derivatives markets in the EU (Vander Stichele, forthcoming 2014). The EU commodity derivatives markets regulation (MiFID II and MiFIR, 2014) thus prioritised the interests of the financial sector over the need for farmers to hedge and for derivatives markets to perform the function of price discovery. First, farmers and agricultural policymakers had little to no input on the new EU laws regulating commodity derivatives, which moreover were not specific for food commodities but covered all commodities. EU lawmakers also neglected to regulate how farmers' hedging needs are to be served. For instance, they failed to link the derivatives markets with the required infrastructure for warehousing the underlying physical agricultural products (delivery points). Second, the financial sector lobby had a huge influence on the decision-making of the EU law. Consequently, the 'position limits' to be imposed on financial players and speculative positions in the commodity derivatives markets are weak and include many loopholes. Their effectiveness at reducing the amount of speculative derivatives trading has yet to be proven.

4. Agribusinesses expanding into finance

Another level of financialisation of the agri-food sector is the fact that some agribusiness conglomerates, (agricultural) commodity houses and global food retailers have themselves become financial actors. These businesses earn profits by engaging in financial commodity derivatives speculation as well as hedging for their suppliers (farmers), by providing loans and payment and other financial services, by owning hedge funds that for instance buy up land or speculate through commodity derivatives (Vander Stichele, 2012), or by running commodity funds.
Given the large scale of the conglomerates, often combining agricultural and non-agricultural commodities, more research needs to be done about their impact on the financial markets as well as the agro-food markets, especially what would happen if their financial services and speculative activities fail.

5. Next steps

The financialisation of the agri-food sector described above is key in understanding the dynamics in the sector in ways that are not always beneficial for small-scale producers, small-scale food processing and retailers, for consumers and for the environment. And yet the financial players driving this financialisation are not being held accountable for their role in distorting the basic function of the food supply chain nor for their disregard of the need for environmental sustainability in food production. The growing influence of the financial sector has resulted in what Jennifer Clapp calls ‘distancing’ (Clapp, 2013) since the driving forces are not always knowledgeable or interested in the food production and the impact they have on the agro-food sector.

So far, the focus of financial regulators and supervisors has been almost exclusively on financial stability. No financial reform or regulation has held the financial sector responsible for the impact of its financial activities on the economy, the society and the environment. There are ways of making the financial sector and (individual) investors more aware of their impact and more accountable for their actions. It will take a long time for politicians to muster the will and for the right regulation with the right instruments to be implemented to prevent the financial sector and financial players from financing harmful activities, but some initiatives are already being developed.

In the meantime, alternatives are also being developed. For instance, funds are being initiated by committed individual investors in order to buy up farms from retiring farmers. These funds offer no promise of high returns and no easy withdrawal from the fund, but instead focus on the careful selection of farms and the surrounding land (with involvement of the investors if possible to create a direct link). They make farms available to (young or poorer) farmers for rent, supporting them in making their farming profitable but with sustainable agricultural methods.

All movements in the direction of long-term solutions will have to start with greater awareness and clear analyses of the impact of financialisation. Only then can initiatives be developed to break the detrimental interlinkages between the financial sector and the food supply chain and to find alternatives based on the basic functions and sustainable requirements of the agri-food sector.

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