Information on commodity futures

This fact sheet contains information on commodity futures traded through Danske Bank.

What is a commodity future contract?
A commodity future contract is a binding agreement between two parties to buy or sell a commodity at a fixed price at a specified future date (expiry).

Commodity futures may be traded as OTC transactions with Danske Bank as the counterparty. The transactions are based on standardised contracts admitted to trading on a regulated market ("reference contracts").

The contract size, settlement date, specification of commodity quality and type of settlement of a reference contract are defined by the individual regulated market.
For commodity futures with physical delivery of the commodity, you must close the transaction not later than three business days before the commodity future expires. If you do not, Danske Bank will be entitled to close the transaction on your behalf. A transaction is closed by way of an off-setting transaction on the basis of prevailing market prices with a term corresponding to the term to maturity of the original future contract. All other terms should be identical to the original terms.

Using commodity futures
Commodity futures can be used by manufacturers and consumers to hedge a price risk on a commodity.

They may also be used as investment instruments for the purpose of generating a profit on expected price developments.

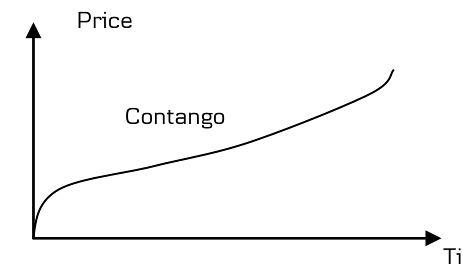
Term
The term of a commodity future may vary from a single day to several years depending on the terms and conditions of the underlying future contracts. The contracts will typically be settled on a specific day of the month.

Pricing
As for many other assets, the market price of commodities is determined by supply and demand.

Under normal circumstances, the price of a commodity future is determined as the sum of the market price (spot price) and the cost of carry.

Cost of carry reflects the costs associated with storing and insuring the commodity and also include opportunity cost as represented by the loss of interest income from investing the funds in a non-interest bearing asset.

With an upward sloping forward curve, a market is said to be in contango. This means that the futures price of the commodity will be higher than the prevailing market price.



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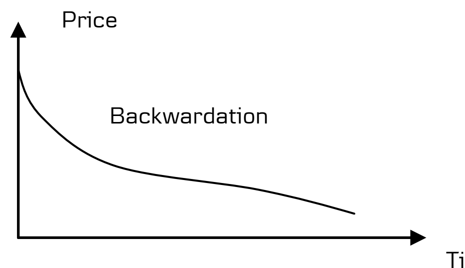
With an inverted forward curve a market is said to be in backwardation. This means that the futures price of the commodity will be lower than the prevailing market price. Backwardation occurs in markets with strong demand for the commodity in question, such as energy during the winter months.



The difference between the spot price and the futures price is called the basis.

A rising spot price relative to the futures price strengthens the basis. In this case, the basis becomes more positive or less negative.

Conversely, a falling spot price relative to the futures price weakens the basis. In this case, the basis becomes more negative or less positive.

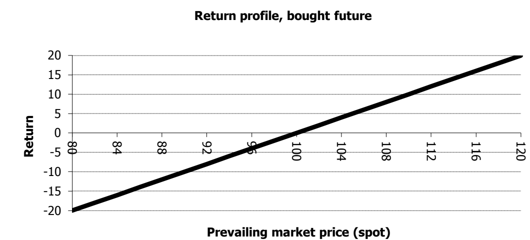
Basis risk can be eliminated by holding a future contract until expiry. As the future contract approaches the last trading day, the contract and the spot price will converge.

If a future contract is not held until expiry, the total risk will consist of a spot and a basis risk. If the spot price falls and basis is weakened, the buyer of the future contract will incur a loss both from spot price developments and the weakened basis.

Using commodity futures

Buying a commodity future

A buyer of a commodity future gets a right and an obligation to buy the underlying asset at an agreed price at a specified future date.
Any increase in the prevailing market price will increase the value of the acquired commodity future. Any fall in the prevailing market price will lead to a fall in the market value of the acquired commodity future.



Selling a commodity future

A seller of a commodity future gets a right and an obligation to sell the underlying asset at an agreed price at a specified future date.
Any fall in the prevailing market price will increase the market value of the sold commodity future. Any increase in the prevailing market price will lead to a fall in the market value of the sold commodity future.

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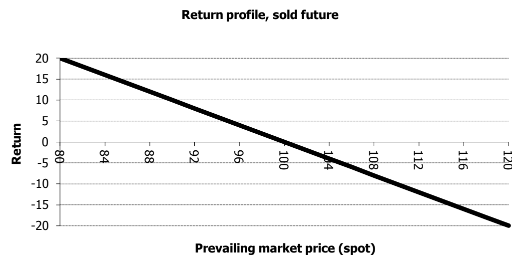

Risk factors

You should be aware that this type of transaction involves substantial risk.

Under the executive order on risk-labelling of investment products, this product type is in the "RED" category.
The "Red" category consists of: "Investment products involving a risk of losing more than the amount invested, or product types which are difficult to understand".

The risk-labelling categories defined by the Danish Financial Supervisory Authority ("DFSA") can be found at www.danskebank.dk/risikomaerkning [(in Danish only)].
The risk-labelling system should not form the exclusive decision-making basis of an investment. It is only intended as a supplement to the information you should obtain before making an investment or to the advice you receive from the bank after defining your investment profile.

A commodity future entails a risk that the transaction must be settled at an unfavourable price compared with the market price at the settlement date.

If you have bought a commodity future for settlement at a price that is higher than the market price of the commodity at the settlement date, you will incur a loss from the transaction. The loss will equal the difference between the price of the commodity future and the market price. Similarly, the transaction will yield a gain if the agreed price is lower than the market price at the settlement date.

Conversely, if you have sold a commodity future, the loss may in principle be unlimited because the market price of the future could theoretically rise infinitely.

Collateral

When you enter into transactions with Danske Bank as the counterparty, we may require that you provide collateral.

Special market conditions

Under special market conditions, it may be difficult or impossible to close a position; for example if, during periods of frequent price fluctuations, prices rise or fall to such an extent that we are unable to fix a price or the stock exchange suspends or restricts trading in contracts.

Tax

The tax treatment of gains or losses on commodity futures depends on whether you are trading as a private individual or on behalf of a company.

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Due to the complex nature of this area, we recommend that you consult an accountant or other professional adviser to clarify the tax and accounting consequences to you of engaging in such trading.

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