Commodity Markets Council - Europe

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To:
Mr John Berrigan, Deputy Director-General, DG FISMA, European Commission
Mr Christopher Jones, Deputy Director-General, DG Energy, European Commission

With a copy to:
Mr Martin Merlin, Director of Regulation and Prudential Supervision of Financial Institutions, DG FISMA
Mr Klaus-Dieter Borchardt, Director of Internal Energy Market, DG Energy
Mr Didier Millerot, Head of Unit D2, DG FISMA
Mr Florian Ermacora, Head of Unit B2, DG Energy

Transmitted via electronic mail

Re: Expected Commission proposal on a Prudential Regime for Investment Firms

Dear Messrs Berrigan and Jones,

I am writing to you on behalf of the Commodity Markets Council – Europe (CMC Europe) regarding the proposal that the European Commission is currently preparing on a Prudential regime for investment firms.

CMC Europe is an industry association comprised of energy, agriculture, metals and other commodity market participants, price reporting agencies and trading venues. The majority of CMC Europe members are commodity dealers who specialise in sourcing and moving energy, agriculture and other commodities from areas of surplus to where they are most in demand. CMC Europe members are established and/or operating in the EU, the European Economic Area, Switzerland and neighbouring countries.

CMC Europe appreciates the ongoing work of the European Commission and the European Banking Authority (EBA) in seeking to design a Prudential regime for investment firms, including commodity dealer investment firms, that is distinct from that applied to banks (under the Capital Requirements Directive ('CRD IV') and Regulation ('CRR')[1]. Under the current regime, commodity dealers are exempt from the large exposures and own funds requirements under Article 493 and 498 of CRR until 31 December 2020, in recognition of the distinct nature of their activities which involve trading commodity derivatives for commercial purposes and as a complementary activity to their core physical business.

[1] Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR) and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

It is of utmost importance for the proper functioning of the commodity markets that the new Prudential regime treat commodity dealer investment firms in a manner proportionate with the very limited risk that they pose to the financial system. It was with the objective of designing an appropriate regime that the Commission tasked the EBA with considering whether the new regime should apply to commodity dealer investment firms. The Commission in particular sought advice regarding the suitability of the proposed prudential regime for specialised commodity derivatives firms, and in case this was not possible, on an alternative new regime for these firms[2].

We regret to note that in the advice the EBA submitted to the Commission on 29 September[3] it failed to give due consideration to the specificities of commodity dealer investment firms and recommended that the new regime apply to commodity dealers in the same way as it would apply to purely financial firms, such as asset managers or principal traders.

CMC Europe Members are concerned that if implemented without changes, the EBA proposals will result in additional capital requirements being imposed on energy firms and other commodity market participants that are disproportionate to the risk profile of these firms. Imposing such requirements on energy firms will also have a negative impact on the ability of these firms to invest in helping Europe meet its energy needs and face the challenges of the clean energy transition.

In this context, we would like to note that CMC Europe Members have found it difficult to engage with the EBA on the basis of its data-focused approach. The commodity dealer community is not able to provide the data requested by the EBA because the firms in question have availed of the exemption in place under the CRD IV/ CRR framework and are not regulated entities, which means that they (unlike other types of firms involved in the consultation process) do not have the complex and costly systems required to make the assessments requested.

In the medium term commodity dealer firms are also not able to conclude reliably that they would not be subject to the regulatory capital regime in the future. Those who may currently be exempt from the Markets in Financial Instruments Directive 2014/65/EU (MiFID II), and therefore from the new regulatory capital requirements, rely on the "ancillary activity exemption" under article 2.1(j) of MiFID II[4], whose application will in practice vary from year to year, as it is dependent on thresholds calculated against rolling market size data which is updated annually.

There are material differences in the business models and the risks that commodity dealers pose compared to financial firms and these should be adequately reflected in the new prudential regime.

Significantly, commodity dealer investment firms have access to financial support from the parent Group they belong to and therefore the wider financial resources of the Group should be considered as mitigating the risk of these entities becoming insolvent. Due consideration should be given to the fact that physical assets (oil fields, refineries, ships, real estate) are an essential part of the core business of commodity dealer investment firms and mitigate the risks of their derivative transactions.

The last decade has also shown that even during the financial crisis, there have been no incidents warranting the application of the capital requirements regime to commodity dealers. There have been

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[2] European Commission Call for Advice to the EBA for the purposes of the report on the prudential requirements applicable to investment firms, 13 June 2016.

[3] Opinion of the European Banking Authority in response to the European Commission's Call for Advice on Investment Firms, 29 September 2017.

[4] Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

several instances in which commodity dealer firms have suffered large losses or have failed, but this has not had a systemic impact or caused problems in the broader financial system.[5]

In preparing its legislative proposal, we therefore ask that the European Commission give due consideration to the distinct nature of the activities and the negligible risk of insolvency posed by this small number of investment firms, by either:

i. Mitigating the impact of the Prudential requirements regime on commodity dealer investment firms by placing commodity dealers in Category 3 of the recommended regime for small and non-interconnected investment firms, to which a simple regime will be applied; or
ii. Extending the exemption for commodity dealer investment firms under Article 493 and 498 of CRR (or via an equivalent mechanism under the new legislative proposal) for an indeterminate duration or until the impact of the new Prudential regime on the commodities sector is reviewed in a meaningful way.

We remain at your disposal to answer any questions you may have and would be pleased to have the opportunity to further discuss with you and/or your services.

Yours Sincerely,

Jonathan Hill
Chairman
CMCE Executive Committee

[5] Further explanation of why commodity dealers pose very limited risks to the financial system has been put forward in a White Paper on *The Economics of Commodity Trading Firms* (March 2014) by Professor Craig Pirrong, available [here].