CMCE response to the European Commission's targeted consultation assessing the adequacy of macroprudential policies for non-bank financial intermediation (NBFI)

November 2024

Opening remarks

The Commodity Markets Council Europe (CMCE) welcomes the opportunity to provide feedback to the European Commission on the consultation paper regarding non-banking financial intermediation (NBFI), with a particular focus on commodity market firms. This response builds upon CMCE's previous submissions, including our response to the joint discussion paper issued by ESMA and the EBA on the IFR/IFD prudential framework for investment firms.

CMCE is a cross-commodities industry association focused on market regulation. The CMCE represents the interests of commodity market participants, including commodity trading firms, brokers, and exchanges, and as such our response to this consultation focussed only on the questions directly relevant to commodities markets.

CMCE recognises the importance of ensuring a balanced regulatory framework that promotes market stability while avoiding unnecessary burdens on market participants. We firmly believe that the current regulatory treatment of commodity firms is appropriate and sufficient to mitigate any risks posed by this sector.

The existing regulatory framework already provides substantial safeguards, which have demonstrated their efficacy, even during periods of market stress such as the COVID-19 pandemic and the recent energy crisis. Any additional regulatory burden could adversely affect market liquidity, increase volatility, and restrict firms' ability to hedge and invest, likely undermining the EU's energy security and increasing costs for EU-based end users, including consumers of critical goods and services such as energy, metals and agricultural commodities. This is especially concerning at a time when non-financial commodity firms are being called upon to invest significantly in support of the EU's Energy Transition and Sustainability objectives.

The CMCE strongly advocates that any changes to the prudential treatment of commodity firms must be backed by clear evidence of systemic risk or market failures—evidence that has not been demonstrated in the analyses conducted to date – with a proper analysis of how such requirements would address rather than exacerbate such risks. Recent evaluations of commodity market volatility during the COVID-19 pandemic and the 2022 energy crisis have shown that markets continued to function effectively, even under extreme conditions.

Further, it is essential to recognise the diversity of firms operating in the commodity markets, from large utilities to smaller commercial entities. Most of these firms are not authorised as investment firms and benefit from the ancillary activities exemption under MiFID II, which is a proportionate approach, given the unique nature and scale of activity of commodities firms. A one-size-fits-all approach to regulation would be inappropriate, and any regulatory regime for this sector must consider the specific risk profiles and business models of different types of firms. Regulation which does not apply proportionally risks impacting some market participants unduly and disincentivising their participation in European commodity derivatives markets. Any resulting reduction in liquidity in commodity derivatives markets is likely to have a material adverse impact on the sector and the real economy which it serves.

It must also be noted that many utilities and commercial/industrial companies need to access the commodity derivatives markets in order to hedge and optimise their physical assets. The ability to do so efficiently is critical to their ability to obtain financing for - and make investments in - new assets (particularly with regard to investment in the energy transition). Unduly burdensome regulation would have a dampening effect on the development of new assets for the purpose of energy transition.

Finally, increasing the cost of accessing the hedging markets would – necessarily – disincentive some from participating in those markets, so that they would operate wholly or partly unhedged. That would increase the credit risk they present to their financiers, thereby *increasing* the risk they present to the financial system. Increasing the regulatory burden for such participants, therefore, risks having counterproductive effects.

Question 39: How would you assess the level of preparedness of commodity derivatives market participants in terms of meeting short-term liquidity needs or requests for collateral to meet margins? Please rank from 1 to 5 (lowest to highest) the level of preparedness for the following participants by sector: insurance companies, UCITS funds, AIFs, commercial undertakings, investment firms, pension funds.

CMCE answer

We believe that commodity derivative market participants as commercial undertakings are well prepared to meet short term liquidity needs or requests for collateral to meet margining requirements.

In its 2023 report examining the financial stability aspects of commodities markets, the FSB concluded that markets were resilient through the shocks to the market during the COVID-19 event and shocks seen in February/March 2022 in response to Russia's invasion of Ukraine. The report concludes that despite price volatility and the subsequent increase in margin calls and demand for liquidity, the commodities ecosystem was able to absorb the shocks, markets continued to function and there was little impact on the rest of the financial system. While such geopolitical events can result in market volatility for energy derivatives and did result in increased margin calls, our members consider that, overall, commodities derivatives markets and market participants have demonstrated resilience to such events and the financial system was not affected.

Furthermore, and building on the theme of preparedness, the key driver behind the lack of systemic financial risk in the commodity market is the existence of a physical underlying and the supporting group infrastructure which allows for continuity of the production and sale of that underlying. In a bankruptcy scenario, it is often possible to continue to operate the productive assets of a real asset firm, which may be different for a financial services firm that relies mainly on intangible productive assets closely tied to its intellectual property and the human capital of its workforce. Whether a commodity firm in financial difficulties is part of a larger group with significant physical operations or a simpler specialist trading operation, its bankruptcy will not prevent the ongoing extraction/production of the underlying commodity which will itself retain value. While the financial failure of a market maker in a given commodity would reduce liquidity within that market, the imposition of a capital requirement would not address this risk.

The liquid capital needs in commodities markets and of commodity firms are very specific and differ from the needs of financial institutions as:

- Commodity firms do not normally fund their activities through deposits repayable on demand;
- Commodity firms do not interfere in the interbank markets and have no access to central bank liquidity provision;
- Commodity firms do not provide loans to consumers or take deposits and therefore, are not subject to sudden demand for large cash outflows from such business lines in stressed conditions; and
- Some commodity firms themselves have access to stable and diversified financing often through a number of credit institutions (e.g. committed Revolving Credit Facilities) and through access to the capital markets.

Additionally, some smaller participants in the commodity markets are not asset-owning. These firms play an important role in helping to boost liquidity in the market. Imposing onerous prudential requirements on them would risk a reduction in the liquidity they provide.

Our members also consider that an extension of financial markets liquidity and prudential requirements to commodities market participants would only exacerbate the ability of such firms to address and manage liquidity during such stressed market conditions. It is unclear what issue would be solved or what perceived systemic risk to the financial system would be avoided. Imposing such requirements on commodities market participants would only add to their operational, compliance and cost burdens, noting the diversity in size and nature of these market participants.

A more proportionate and useful measure would be for the Commission to support the work of CCPs on more transparent margin models for initial and variation margin and standardisation of margining practices including the scheduling of margin calls and collateral management, including widening the scope of eligible collateral. This would be more effective in helping commodities market participants manage the effects of and their response to commodity market volatility. We consider work on Increased transparency in CCP margining practices, forming part of the BCBS-CPMI-IOSCO consultation "Transparency and responsiveness of initial margin in centrally cleared markets: review and policy proposals" as crucial to liquidity preparedness and will help commodity market participants better prepare for potential margin calls.

Question 40: In light of the potential risk of contagion from spot markets or off-exchange energy trading to futures markets, do you think that spot market participants should also meet a more comprehensive set of trading rules for market participation and risk management? Please elaborate on your response.

CMCE answer

The introduction of a more comprehensive set of trading rules for spot market participants and off-exchange energy trading is unnecessary, redundant and potentially counterproductive. It is also not clear what such trading rules would entail or how any perceived risk of contagion would be mitigated. We consider this a perceived risk given there was no detrimental impact on futures markets further to the recent COVID-19 pandemic or geopolitical shocks, as noted in the FSB report referred to above. Any perceived risk of contagion from spot markets or off-exchange energy trading to markets in financial instruments is already adequately addressed.

Imposing additional rules would increase the regulatory burden in this already over-complex system of rules and regulations, and would likely have the converse effect to that intended, resulting in adverse effects on market efficiency, liquidity, and the ability of market participants to effectively manage risks. Additional regulatory requirements can also act as a barrier to entry for new market participants which would in turn place limits on opportunities for growth in liquidity and improved price discovery.

Spot market participants, especially in energy and other commodity markets, are already subject to a range of regulatory requirements aimed at ensuring market integrity and transparency, and reducing systemic risks.

The Market Abuse Regulation (MAR) already applies not only to financial instruments, but also to underlying spot commodities and related OTC products. It presents a comprehensive code governing market conduct across those elements of the commodity sector which interact with the commodity derivatives markets including market manipulation and insider dealing offences. Any perceived risk of "contagion" from spot to financial is therefore already addressed by the broad scope of MAR.

In the energy sector, there is also additional sectoral regulation covering both spot gas and power products and gas and power derivatives under the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT), which has been recently expanded in scope under REMIT II, including market manipulation and insider trading offences as well as disclosure and reporting obligations. As a result, in the energy sector, both spot and financial products are regulated with respect to market conduct under a financial sector regime and an energy sector regime. Adding more regulation to this complex network of overlapping regulation would be otiose.

In addition to these regimes, commodity derivatives market participants are already subject to systemic risk management and transparency obligations under the European Market Infrastructure Regulation (EMIR) as well as obligations to limit, manage and report large positions in commodity derivatives under the Markets in Financial Instruments Directive (MiFID II). Both these regulations have been recently amended and the cumulative impact of these recent changes in these regulatory frameworks on commodities market participants remains to be seen.

These regimes provide a comprehensive regime for the regulation of participation in commodity derivatives markets by physical commodity market participants, ensuring transparency, market integrity, and risk management.

For these reasons, we see no benefit in creating any new regime to address the risk of contagion to financial markets from spot commodity markets. That risk has been analysed and adequately addressed through multiple layers of existing regulation.

For the reasons already cited in the introduction, we do however see a risk of additional regulation having material adverse effects, both for those markets themselves (in terms of liquidity reduction, especially) and for the financial system in general (by increasing the credit risk which financiers take when lending to commodity firms which are less able to hedge or optimise their assets).

Further, we note that the risk profile of spot markets differs significantly from that of futures markets, particularly in terms of liquidity and leverage. Spot market participants are typically dealing in the physical supply of commodities, where the underlying asset and its management form a substantial part of their risk profile. These participants are primarily managing operational risks—such as logistics, supply chain disruptions, and short-term supply/demand variables—which are tied directly to the real economy. The factors which influence these risks differ from commodity to commodity, presenting a material challenge for any proposal to implement a single regime for all spot commodity markets.

We, therefore, do not believe that imposing additional trading rules on spot market participants is necessary or proportionate. The existing regulatory frameworks have proven effective in managing risk and maintaining market integrity and stability. Introducing further rules could have unintended consequences, such as reducing liquidity, and increasing volatility (as well as increasing the risk of insolvency among commodity firms, by disincentivising hedging), without addressing any clear systemic risk or market failure.

The downside risks of introducing new regulatory burdens into this sector are significant and we do not think would address any of the issues experienced due to commodity market volatility. Accordingly, any proposed regulatory changes should be justified by (a) clear evidence of systemic risk or market failure, and (b) a proper analysis of how the proposed new regulations would address rather than exacerbate systemic risks. We note that recent analyses of market performance during times of stress (such as the FSB report), do not present evidence of systemic risk or market failure during the energy crisis, concluding that the market emerged largely unscathed from a period of stress. We also note that regulators have access to significant amounts of data from commodities market participants through regulatory reporting regimes under REMIT II, EMIR and MiFID II. We strongly urge regulators to consider how they may more effectively use and analyse the significant amount of data to which they already have access to before considering other measures.

Question 41: How can it be ensured that the functioning of underlying spot energy markets and off-exchange energy trading activity does not lead to the transmission of risks to financial markets?

CMCE answer

As noted in detail in the response to question 40, we note that physical spot markets are in essence fundamentally different to financial markets and there is a tangible impact on them from energy asset availability, demand and supply of physical commodities and geopolitical events. Therefore, the focus of any regulatory consultations or interventions should be to support commodity market participants active in spot markets to use financial markets for risk management, hedging and investment and financing for the energy transition rather than addressing any perceived potential transmission of risks from physical spot markets to financial markets. As noted above, the interaction between spot and financial markets, from which any such contagion might arise, is already subject to detailed, complex, burdensome and robust regulation under a series of overlapping regimes, some of which have been recently reformed, including MAR, REMIT, EMIR and MiFID. These frameworks ensure market integrity by preventing market abuse, promoting transparency, limiting/managing large positions on exchange, imposing transaction reporting obligations and subjecting commodity derivatives market participants to substantial risk management obligations.

As we explain above, the physical nature of commodities markets and the nature and diversity of scale in business models operated by commodities market participants means that imposing liquidity or capital requirements designed for financial institutions would not be a risk-based, proportionate or even appropriate measure to address the core risks of the commodity sector. Instead, they would limit participants' ability to hedge or invest in essential infrastructure.

By utilising the strengths of the existing framework, the European Commission can continue to safeguard financial markets while supporting the critical role that commodity markets play in the European economy and the transition to sustainable energy, as noted in the recently published Draghi report.

Question 51: What role do concentrated intraday positions have in triggering high volatility and heightening risks of liquidity dry-ups? Please justify your response and suggest how the regulatory framework and the functioning of these markets could be further improved?

CMCE answer

Low liquidity is a significant issue faced by short term physical commodity markets.

Where liquidity reduces, markets become more volatile and less efficient. Each commodity market addresses this issue in its own way – some short term markets are operated as auctions, and others operate on a continuous order book model, but with price assessment periods during which market liquidity is usually concentrated. Higher intraday activity in such periods is essential to the smooth functioning of the market. It is therefore vital that markets enable not only producers/end-users of commodities to participate in these markets, but also liquidity providers, particularly in times of market stress. Introducing prudential requirements or new regulatory burdens for commodity firms, including those who provide liquidity by trading for speculative purposes, would threaten liquidity and risk exacerbating volatility risks in both short term and longer dated markets.

The existing regulatory framework already contains a number of mechanisms which address volatility issues in the derivatives markets; position limits and position management rules under MiFID II help curb the ability of any single participant or group of participants to accumulate overly concentrated positions within a short period; circuit breakers and volatility controls are already in place in many financial markets to halt trading if prices move beyond predetermined thresholds within a short time frame.

Imposing prudential requirements could reduce market liquidity by increasing the cost of capital for these firms, potentially leading to reduced market participation and efficiency. Consequently, this would result in a reduced availability of free capital for these firms to adapt and invest in pivotal EU initiatives, such as the EU Energy Transition, trade flows, and sustainability.

It is difficult to see what issue could have been solved, or systemic risk mitigated, by applying prudential requirements, such as liquidity requirements or concentration risk thresholds, to commodity firms. It is more likely that applying such measures would exacerbate the problems facing the market, by reducing liquidity and increasing volatility as a result, and would - by reducing the effectiveness of the hedging markets as a risk management tool for the industry – potentially have weakened the sector's resilience at a crucial juncture.

Anything that restricts commodity firms' ability to manage their risk, such as additional prudential requirements, will hamper their ability to protect themselves against shocks in the future.

While CCPs will need to make intraday margin calls to manage volatility, these can impact liquidity planning and collateral management for commodities market participants who are direct clearing members or clients of clearing members. This is the case given the short deadlines that can be applied to transfer margin

As stated above, we consider that a more appropriate and proportionate measure would be the Commission to support the work of CCPs on more transparent margin models for initial and variation margin and standardisation of margining practices including the scheduling of margin calls and collateral management, including widening the scope of eligible collateral. We consider work on Increased transparency in CCP margining practices, forming part of the BCBS-CPMI-IOSCO consultation "Transparency and responsiveness of initial margin in centrally cleared markets: review and policy proposals" as crucial to liquidity preparedness and will help commodity market participants better prepare for potential margin calls. Increased transparency would help alleviate the pressure of unscheduled intraday margin calls with limited time to make transfers (during periods of volatility) on market participants and therefore, transparency and guidelines would be a more effective measure to manage liquidity and concentrated intraday positions.

Question 66: What are the benefits and costs of gradually giving ESAs greater intervention powers to be triggered by systemic events, such as the possibility to introduce EU-wide trade halts or direct power to collect data from regulated entities? Please justify your answer and provide examples of powers that could be given to the ESAs during a systemic crisis.

CMCE answer

Granting ESAs greater intervention powers—such as the authority to impose EU-wide trade halts or collect real-time data from regulated entities—risks regulatory overreach. Commodity markets are dynamic, and intervention measures, if applied too broadly or prematurely, can distort natural market functioning. Trade halts, for example, can disrupt price discovery and create pent-up market pressure, leading to greater volatility when trading resumes. Frequent or ill-timed interventions could reduce market participants' trust in the self-correcting mechanisms of the market.

When market participants fear sudden regulatory intervention, such as trade suspensions, they may hesitate to participate in the market, leading to a reduction in liquidity. Lower liquidity, in turn, can exacerbate market volatility and lead to higher transaction costs for businesses and investors.

Furthermore, in markets like commodities, where financial elements can affect the physical markets, sudden interventions in financial markets could have ripple effects on the physical side, disrupting supply chains and operational activities. For instance, halting futures trading may prevent commodity producers from hedging their positions, which could destabilise their physical operations.

Instead of granting the ESAs sweeping new powers, it may be more effective to focus on refining and improving the existing regulatory frameworks, ensuring that the tools already available—such as position limits, transparency requirements, and existing crisis management procedures—are used efficiently and appropriately. Any additional powers should be considered carefully, with clear safeguards to prevent overreach and protect market stability.

Question 67: What are the benefits and costs of a more integrated system of supervision for commodities markets where the financial markets supervisor bears responsibility for both the financial and physical infrastructure of the commodity futures exchange, including the system of rules and contractual terms of the exchange that regulate both futures and (cash/physical) forward contracts?

CMCE answer

A more integrated system of supervision for commodities markets, where the financial markets supervisor oversees both the financial and physical infrastructure of the commodity futures exchange, presents significant concerns. Commodity markets operate fundamentally differently and serve a different purpose to financial markets, as explained above. The profile of market participants is different and diverse: commodities markets have unique characteristics relating to the physical energy production, generation and supply assets they relate to. Consequently, we consider, consolidating supervision of physical and financial commodities markets could impair rather than improve market functioning. As noted in our previous response, certain aspects of the financial regulatory/ supervisory regime under MiFID II, EMIR and MAR already subject commodity market participants to elements of financial markets regulation including with respect to transaction reporting and market conduct rules. Indeed, commodities market participants who trade on exchange are also already subject to exchange rules.

Commodity firms are typically involved in physical activities, such as the production, refining, processing, storage, and movement of various goods and the management of supply chains, which require different risk management strategies compared to financial firms. The risk management considerations of these firms differ from those typically found in the financial sector. The existence of a separate sector-specific regime for physical energy markets (under REMIT II which relates to gas and electricity) is testament to the fact that not only are such considerations different from those in the financial sector, but they also differ from commodity to commodity.

It is important to consider that physical assets (such as oil fields, plantations, mines, refineries, generation assets, storage facilities, ships, and real estate) are essential parts of the core business of commodity firms (some of which are commodity and emissions allowance dealer investment firms) and the majority of their derivative transactions help mitigate their risks by hedging their current or anticipated risks arising in connection with their, or their group's, physical activities and assets, which is completely different to derivative activity in purely financial markets. Maintaining stability in supply chains to enable commodity firms to effectively service markets and consumers is critical.

The key driver behind the lack of systemic financial risk in the commodity market is the existence of a physical underlying and the supporting group infrastructure which allows for continuity of the production and sale of that underlying. In a bankruptcy scenario, it is often possible to continue to operate the productive assets of a real asset firm, which may be different for a financial services firm that relies mainly on intangible productive assets closely tied to its intellectual property and the human capital of its workforce. Whether a commodity firm in financial difficulties is part of a larger group with significant physical operations or a simpler specialist trading operation, its bankruptcy will not prevent the ongoing extraction/production of the underlying commodity which will itself retain value.

Moreover, commodity markets have evolved distinct regulatory frameworks tailored to the unique characteristics of physical and forward contracts, which differ substantially from the financial futures markets Attempting to integrate these frameworks into a single supervisory structure could disrupt the established market mechanisms that currently work well for the industry.

Bringing these frameworks together under the umbrella of one supervisor could weaken the effectiveness of these regulations by applying one-size-fits-all solutions that do not account for the nuances of different physical markets. It is not apparent what risk would be mitigated or addressed by having a common supervisor. Indeed, we note that pan European Agency For Energy Regulators and ESMA cooperate with respect to the regulation of wholesale energy markets in the EU and have a memorandum of understanding to this effect https://www.esma.europa.eu/press-news/esma-news/esma-and-acer-update-memorandum-understanding-strengthen-cooperation. Both agencies announced this strengthening of their cooperation during the energy crisis of 2022.

We consider a more effective approach would be for these agencies to strengthen their cooperation and use and review the large amounts of transaction data already reported under EMIR, MiFID II and REMIT with respect to the regulation of energy markets. We note in this regard the LNG reporting requirements introduced in response to the energy crisis and also the additional powers afforded to ACER under REMIT II.