CMCE response to the ESMA discussion paper (EMIR clearing thresholds review) – focus on international aspect
18 January 2022

- The ESMA discussion paper on Review of the clearing thresholds under EMIR can be found here

Section 5: The impact of Brexit and the international perspective on the EMIR clearing regime

Question 6: Please describe your views on how the EMIR framework works (also compared to other regimes) for the purpose of the clearing thresholds and the requirements triggered by those? Please provide examples and supporting data.

CMCE answer

The perspective of the CMCE members is international as commodity firms are globally active companies with the responsibility to manage risk throughout the whole commodity supply chain. Therefore, we appreciate that ESMA is interested in the views on how the European Union framework can work with the rulebooks in other jurisdictions around the world.

Brexit and equivalence

Brexit has and will impact commodities trading in Europe. There is a need to (i) ensure further post Brexit development and tailoring of the applicable UK regulatory framework and (ii) find an appropriate way of cooperation between the EU and the UK. Concerning the impact of post Brexit inclusion of ETDs traded on UK regulated markets, the best way to address it in the short term would be for the EU to make an equivalence decision for the purposes of article 2a of EMIR with respect to the key UK regulated markets. If no such equivalence decision is made, this would artificially place many non-financial counterparties in the EU within the clearing and margin regime under EMIR. This is because many NFC- groups would be at risk of becoming NFC+ groups under EU EMIR, even though they would remain NFC- under UK EMIR.

This could have a major and detrimental impact on risk management costs for those commodity producers and suppliers, who need to access those UK regulated markets to manage their risk. If, as a result, such firms are disincentivised from hedging their business risks, this could increase the risk of insolvencies and market

failure, leading to a largely suboptimal situation, both from the physical risk and from the retail perspective. The impact on hedging and the retail outcome is analysed further below.

At the same time, policymakers could also usefully consider changes in the EMIR framework to reflect the market developments and the rulebooks in other parts of the world.

Other non-EU jurisdictions

Markets in other jurisdictions, such as China and India, have been developing independently from Europe. Their importance has increased greatly for commodities, so that they are becoming important centres of liquidity for risk management products which commodity market participants need to manage price risk across their global businesses.

This makes it worthwhile reconsidering the policy approach under EMIR to the treatment of ETDs on these markets. If they are not the subject of an equivalence decision, they would raise the same issue as we find currently for ETDs on UK regulated markets.

EMIR approach

Based on the considerations related to the UK and other jurisdictions, the CMCE members would like to raise more general questions. Does the EMIR framework take the right approach to commodities? Is it flexible enough to react to market developments? Or does the current EU approach undermine the competitiveness of the European Union? If it is the latter, the impact could be related to both aspects relevant for commodity stakeholders: financial markets operations (hedging activities) and real economy-related aspects (supply chains functioning, commodity prices). It's important to note that the latter is determinant for the former. As mentioned, it is the commodity firms' first and foremost interest and obligation to manage the risk throughout the supply chain, of which the hedging activity is one part. Therefore, internal decisions made by the commodity firms are determined not just by compliance departments assessing the regulatory framework; they are much more complex.

EMIR goes beyond any other jurisdiction (examples & impact)

The CMCE members think that the EU EMIR approach to the clearing threshold is stricter than that of any other jurisdiction that is relevant for commodity markets.

We want to mention three EMIR features that are particularly pertinent in this regard. First, the fact that under EMIR, the threshold is based on a calculation based on the GNV for trading across the global group; second, the approach to financial counterparties (FCs) and non-financial counterparties (NFCs).

1) Under EU EMIR, the clearing threshold calculation includes activity in entities across the global group. In large commodity groups, this can include entities which trade in products and regions which do not touch or involve the EU at all, even where those entities are held directly by the ultimate parents of the

group and which, therefore, have no impact on the financial strength of its EU sub-group. For example, if a US group holds its European and Asian trading entities in different sub-groups, they may do so to help manage and segregate the risks accruing in those businesses separately. Under EU EMIR, however, where a non-EU trading subsidiary in that group trades on a non-EU futures exchange, its trading would have to be included in the clearing threshold calculation for trading entities in the EU sub-group. This is an issue particularly for groups with a non-EU ultimate parent, though it also a concern for EU groups, with non-EU sub-groups which are separately risk managed. In terms of non-EU jurisdictions, this is relevant for instance for several of the APEC countries and also for Argentina, Brazil, Dubai, South Africa, Turkey or Ukraine. There is no clear policy justification for requiring the threshold calculation to be made across the global group. This approach also creates more complexity and increases cost for market participants when gathering data
It is clear that the impact of this cannot reliably be alleviated through the equivalence mechanism. The most appropriate solution would therefore be to exclude from the calculation GNV for entities which are not part of the relevant EU sub-group in which the relevant trading entities are located.

2) The approach of the non-EU jurisdictions also differs when it comes to the consideration of FCs and NFCs. For instance, in the US, under the Dodd-Frank Act regime the corresponding calculations for NFCs only include genuine OTC contracts with some link to the US (either US entity, counterparty or US guarantee involved). By contrast under EU EMIR, NFCs are required to include all OTC derivatives in the calculation, regardless of whether they have any connection to the EU. According to the knowledge of the CMCE members, other jurisdictions than the EU and the US mostly apply mandatory clearing/margin to FCs.

3) Another point is that the EU threshold of EUR 3 billion in GNV for OTC commodity derivative contracts is low. In the US, the Major Swap Participant threshold, when reached, triggers the obligation for the entity to be registered and subject to margining and other regulatory requirements. The calculations of the threshold for non-financial entities that maintain a substantial position in swaps for any of the major swap categories, excluding both positions held for hedging or mitigating commercial risk, are relatively complex. The calculations factor in open exposure and notional amounts. There are thresholds for the different product categories based on the combination of open exposure and potential future exposure (which is based on the notional, type and residual maturity of the transactions). For commodity swaps with less than one year residual maturity, this is essentially equivalent to a notional threshold of up to $20 billion – substantially more for FX/interest rates. There is a component to the overall assessment which has a calculation including hedging transactions but the thresholds applied for this calculation are very much higher.

The CMCE members consider that the EU EMIR clearing threshold calculation approach is currently incapable of addressing the increasing swift evolution of markets in the global commodities sector. We also consider that it currently presents a risk to the globally important energy transition process and impedes the proper relationship between financial firms and their customers for hedging services.

1) Energy transition.

   Lower threshold of EUR 3 billion in GNV for OTC commodity derivative contracts, combined with the wider scope on the EU side, compared to the US, the EU regulatory regime captures many more entities. In the case of the energy transition, this could be highly disruptive for the commodity markets operators.

Price risk management for key commodities is critical for the energy transition (including hydrogen and battery metals, for instance). Asset light approach might be highly relevant for the energy transition in the EU. In that case, firms would only take a hedge for the asset and not for the infrastructure supporting the supply chain, including storage, ports, plants etc. Nevertheless, these firms would still want and need to offset the respective risk. If EU EMIR continues to impose unduly harsh hedging costs on EU firms, who need to source and risk manage battery metals and hydrogen (often by trading in non-EU markets), this will disadvantage such firms against their non-EU competitors and impede their progress in contributing towards climate change and environmental objectives.

2) Customer flow in the EU

Stricter thresholds certainly disincentivise the commodity traders from using their EU entities for trading, but it will also disincentivise non-EU firms from trading with EU financial services firms when they need to hedge. If EU EMIR approach remains stricter than that in other jurisdictions, this will lead to a situation where non-EU firms are required to clear/margin trades with EU financial services firms but would not have to do so when trading with non-EU financial services firms.

The CMCE notes that as a result, the current EU approach to the clearing obligation thresholds and scope concerning the commodities trading might undermine the transition to a sustainable economy and limit the business growth.