Commodity Markets Council - Europe

Hume Brophy
41 Rue de la Science
1040 Brussels
Belgium

Secretariat
Tel: +32 (0)2 234 6860
Fax: +32 (0)2 649 2593
Eml: cmce@humebrophy.com
Wb: www.commoditymkts.org

3 October 2022

John Berrigan, Director General;

DG FISMA
European Commission
Rue de la Loi/Wetstraat 200
1049 Brussels Belgium

Re: ESMA Response regarding current level of margins and of excessive volatility in energy derivatives markets

Dear Mr Berrigan,

We at the Commodity Markets Council Europe (CMCE) read with interest the proposals outlined in ESMA's letter responding to the European Commission's request to conduct an assessment of the question of circuit breakers on the energy markets and possible measures regarding margins and collateral requirements. The CMCE is an industry association comprised of agriculture, energy, metals and other commodity market participants, price reporting agencies and commodity exchanges. We thought it might be useful to provide some insight to this debate based on the experience of our members.

The CMCE agrees strongly with ESMA's view that recent market developments have been driven by the geo-political situation and not by regulatory or market failure. In addition, in recent months we have also seen further supply stress due to droughts and heat waves in Europe. We also agree with ESMA that the current regulatory framework has resulted in increased financial stability and any potential policy measures must be carefully assessed with a holistic perspective based on their expected effectiveness as well as potential risks and costs.

It is, therefore, vital that any measures taken to address the current energy crisis and its knock-on effects focus on providing solutions to specific problems and that these measures will, in a timely manner, directly alleviate issues faced by the market, and, by extension, end consumers. Furthermore, there have been a number of adjustments made to the regulatory framework relatively recently, following due consultation process, and it is not at all clear that there are deficiencies in the effectiveness of these measures.

Further adjustments to the regulatory framework, if poorly targeted, would likely add costs and uncertainty to the market. They also risk distracting attention, vital resources and the focus of debate away from other recommendations which could have a more immediate and constructive impact on the ability of markets to deal with the effects of extreme volatility, driven by a supply situation that is evolving on a daily basis. Further adjustments that are not capable of being very quickly put into effect, would likely fail to address the immediate concerns around energy markets, which are likely to worsen over the fast-approaching Winter period. Such measures could also work against the objectives of policymakers as new regulations which raise costs for market participants are likely to lead to increased costs for end consumers, adding to existing inflationary pressures on European economies.

Circuit breakers

The CMCE believes that circuit breakers can be an effective tool for exchanges to limit short-term volatility. However, we have reservations regarding the efficacy of implementing a new type of trading halt mechanism through regulatory action. Regulatory action is likely to take time to develop, agree and implement and will not address the pressures driving energy markets. As stated above, we believe the current energy crisis is driven by shocks to supply versus demand.

ESMA acknowledges that circuit breakers were foreseen under the MIFID II framework, but appears to have concerns that there have been relatively few trading halts triggered (although we do not see any evidence supporting such concerns). However, it is important to also acknowledge that markets remained open for users to continue to hedge and modify their risk positions in response to changing market conditions.

It would be more effective for ESMA and NCAs to work with trading venues to understand the approaches currently taken and share best practices on how better to use existing measures (as opposed to trying to introduce additional legislation in this area). This is likely to deliver a more effective approach in a timely manner that still respects the particular circumstances and risk management requirements of each venue and clearing house. We believe that adding more regulatory measures to the use of circuit breakers would not achieve the objective of supporting a more orderly price discovery process and would take significant time to implement. They may also obstruct CCP processes, including marking positions to market and - most importantly - default management.

Margins and Collateral

In principle, we welcome more flexibility and clarity around collateral that can be accepted by CCPs. Such action could help mitigate some of the stresses on market participants and help them meet margin requirements for their hedging activity on cleared EU energy exchange markets. We support the use as eligible collateral of bank guarantees subject to appropriate safeguards and, in particular, emission allowances as eligible collateral on a wider basis than ESMA appears to be contemplating.

It should also be noted that the list of eligible collateral is defined by a regulatory technical standard (RTS) and any changes would take time to implement. So, although broadening the list of eligible collateral could help market participants, it is unlikely to provide relief in the short term.

Commodity clearing thresholds

The CMCE welcomed the ESMA's submission of a draft RTS to the European Commission increasing the commodity clearing threshold by EUR 1bn, bringing it to EUR 4bn. This is clearly a step in the right direction and we would agree with ESMA that an RTS increasing the threshold should be adopted by the Commission as soon as possible. However, we would also highlight that an increase of EUR1bn does not well reflect commodity price increases since the EMIR clearing thresholds were originally set in 2012. Since this time, the UK has also left the EU and commodity derivatives contracts traded on UK regulated markets are now classified as OTC derivatives, which has the effect of substantially increasing some firms clearing threshold calculations. Furthermore, ESMA's proposal, and the underpinning analysis and consultations it was based on, were conducted during very different market conditions. Commodity prices have risen substantially over this year and this has been exacerbated recently by the strengthening US dollar.

Therefore, we believe that, given the scale of commodity price rises, there is a very strong case to consider a higher commodity clearing threshold than the EUR 4bn which was proposed in June 2022. We would also note that the EU's approach to the clearing threshold under EMIR is stricter than other jurisdictions and this, in turn, increases the costs of hedging commercial risk in the EU.

The scale of commodity price increases coupled with a low commodity clearing threshold could force some market participants to reduce or even stop trading activities rather than risk breaching this threshold. This is because of the collateralisation requirements that NFC+ status are imposed across all derivative asset classes, even where market participants only use certain classes of derivatives (such as interest rates and foreign exchange swaps) for hedging or treasury financing purposes. This could have the effect of reducing liquidity from the market and driving hedging costs up.

Improving regulatory reporting on commodity derivatives trading

ESMA raises concerns about the visibility NCAs have regarding OTC transactions and wholesale energy products. ESMA, therefore, suggests changes to the scope of EMIR reporting. However, it is unclear how this would address, in immediate terms, the current issues facing the market. As well as the time it would take to adjust the scope of EMIR reporting requirements, there would be questions about the extraterritoriality of such measures and the relevant product scope, how this might affect EU markets and the costs of further changes to the regulation for all market participants (who would need, for example, to update reporting systems in order to comply with any amendments). We would encourage further analysis of what data NCAs need and whether these could be obtained through greater cooperation with other regulators, particularly ACER which already receives transaction reports on wholesale energy product activity under REMIT (we understand ACER is sharing with other authorities on an ad hoc basis).

Regulating and supervising commodity traders acting like investment firms

ESMA states that it would be useful to revise or replace the current test for the ancillary activity exemption under MIFID II to increase the number of non-financial entities licensed as investment firms. We believe that such an approach would be, at best, an unhelpful distraction at this time when it is vital to focus on measures which will address the immediate effects of the geo-political crisis. Furthermore, there have been a number of discussions about the ancillary exemption during the various iterations of MIFID II (most recently for the Quick Fix) and this is a subject that has been very well debated and agreed recently by policymakers. Changes now are likely to take time, increase uncertainty, raise costs of hedging risk and reduce liquidity on EU markets.

We would be very pleased to further discuss the issue and to provide any clarifications you may need.

Yours sincerely,

CMCE Executive Committee

per pro David Cook, Hume Brophy

Cc Verena Ross – Chair ESMA
Edita Hrdá – Czech Permanent Representative to the EU