



## CMCE response to the ESMA and the EBA call for advice on the investment firms prudential framework

30 August 2024

### Opening remarks

CMCE welcomes the opportunity to provide feedback on the discussion paper by ESMA and the EBA on the investment firms prudential framework.

CMCE recognises the importance of a balanced regulatory framework that ensures market stability without imposing undue burdens on market participants.

CMCE believes and strongly advocates that the current treatment of commodities firms is appropriate and sufficient to mitigate the risks posed by the sector. Introducing additional prudential requirements for commodity firms already subject to the commodity and emissions allowance dealer regime under the IFR/IFD and extending prudential regulation to firms that are not authorised investment firms is not necessary, appropriate or proportionate. The IFR/IFD regime was put in place to capture non-Credit Institutions which still posed a risk to Clients or Markets through their investment activities such as, for example, underwriting activities or activities which are not in support of commercial commodities activities. Non-investment firms active in the Commodities markets are active in the Financial Markets to support their physical commodities activities and therefore have a completely different risk profile and pose a greatly reduced risk to financial markets than Investment Firms, a fact which is recognised by the exemptions applied under MiFID II.

Additionally, the existing regulatory framework already provides substantial safeguards which have worked well during times of market stress, and further regulation(s) could harm market liquidity, increase volatility, and impede firms' ability to hedge and invest, with potential adverse consequences for EU energy security and increased costs to EU-based end users across all commercial sectors and consumers of products and services across those sectors, including (but not limited to) retail energy consumers. This comes at a time where non-Financial Commodities Firms are under heavy political and regulatory pressure to commit extensive capital in support of the EU's Energy Transition and Sustainability aspirations. Any new measures should be carefully considered to avoid unintended and widespread adverse consequences.

While we do not agree that there is any need for prudential requirements for firms in commodity markets, as elaborated in our answer below, any change in the treatment of these firms must be justified by clear evidence of systemic risk or significant market failures that such requirements would mitigate, which does not appear to be borne out by analysis done to date. Recent analysis of instances of commodity market volatility during COVID-19 and the energy crisis has concluded that overall markets functioned well during these periods of extreme stress.

In addition, given the diversity of firms operating in these markets, from large utilities to smaller commercial entities, a one-size-fits-all approach may not be appropriate and any regime must consider the specific risk profiles and business models of different types of firms.

***Q32: Should there be the need to introduce prudential requirements for firms active in commodity markets and that are not currently subject to prudential requirements? How could the existing framework for investment firms be adapted for those cases? If a different prudential framework needs to be developed, what are the main elements that should be considered?***

CMCE answer

The introduction of prudential requirements for firms active in commodity markets that are not currently subject to such requirements is not necessary, appropriate or proportionate and would almost certainly have adverse effects on commodities markets in Europe, as well as the broader European economy. The immediate risks of imposing additional prudential regulation on commodity firms include:

- Reduced liquidity due to increased costs.
- Increased volatility, impacting the real economy.
- Less hedging by commodity firms, leading to greater price risk and potentially increased credit exposure for the financial sector (through increased credit risk for lenders).

Prudential requirements for commodity firms have been discussed multiple times over the years. For example, the Committee of European Securities Regulators (“CESR”) and the Committee of European Banking Supervisors (“CEBS”) in their technical advice issued in 2008 ([CESR/08/752](#)), noted: “CESR/CEBS believe that application of the CRD requirements (including the large exposures regime) to specialist commodity derivatives firms would be disproportionate and would lead to regulatory failure” [p.3 and para. 107 p. 32].

Additionally, in the same technical advice the CESR and the CEBS stated that “regulation brings net economic benefits only where it addresses potential market failures” (para. 75) and that “extending CRD may not take fully into account the particularities of specialist commodity derivatives firms”, including the fact that “systemic risks arising from specialist commodity derivatives firms appear to be lower than those stemming from credit institutions and ISD investment firms and therefore do not warrant the same degree of prudential regulation” (para. 81). In para. 235, they note “that the activities of specialist commodity derivatives firms do not generate significant systemic concerns.”

Furthermore, we have significant concerns around the impact of introducing a prudential regime for commodities firms that are not currently subject to such requirements, particularly due to its potential impact on the competitiveness of the EU. We also have serious concerns about the suitability of the IFR/IFD regime for addressing risks in commodities firms. We would also urge legislators to consider the impact of the existing regulatory framework that commodity market participants are already subject to. Each of these areas are addressed in further detail below.

### **Reduced liquidity due to increased costs and an increase in volatility**

Maintaining liquidity is crucial for the commodity derivatives markets. Reduced liquidity can lead to increased volatility and less certainty in hedging, increasing the industry's exposure to price fluctuation risks. Any threat to liquidity, such as imposing additional prudential regulations on commodities firms that are not currently subject to such requirements, should be approached with extreme caution and should be justified by clear evidence of systemic risk or significant market failures that such requirements would mitigate, which does not appear to be borne out by analysis done to date.

Commodity trading firms are typically involved in physical activities, such as the processing, storage, and movement of various goods and the management of supply chains, which require different risk management strategies compared to financial firms that are not part of a group with physical operations. These firms already have robust risk management practices in place, tailored to the specific risks of commodity markets, including price volatility, supply chain disruptions, and geopolitical factors. 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.

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. Reduced liquidity would rather be the result of a lack of supply, and thus be from outside of the scope of financial regulation.

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

- 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.
- They 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.
- Commodity firms themselves have access to stable and diversified financing often through a large number of credit institutions and through access to the capital markets (e.g. Trafigura [launched](#) a syndicated loan in March 2015 with 51 credit institutions).

In the [September 2022 response](#) to the European Commission on margins and excessive volatility in energy derivatives markets, the EBA did not conclude that it would be beneficial to extend existing liquidity requirements to commodity firms.

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.

[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 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, 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. The imposition of additional prudential requirements on commodities firms could have conversely exacerbated the demand for liquidity caused by spikes in margin calls during this time and would not have averted the causes of such commodity market volatility.

It is difficult to see what issue could have been solved, or systemic risk mitigated, by applying financial markets prudential requirements, such as liquidity requirements or concentration risk thresholds, to commodity firms. It is more likely that applying such measures would have exacerbated 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. Low market liquidity leads to higher volatility by making price movements more sensitive to further shocks. This higher volatility will have an impact on the real economy through volatility in commodity prices.

### **Impact on hedging**

Imposing prudential regulation on commodity firms that are not currently subject to such requirements would also impair their ability to hedge by adding costs and restrictions (as well as by reducing liquidity in the hedging markets).

Prudential requirements, whether capital or liquidity-based, would limit a firm's capacity to use its liquid assets (which equates to cash for many commodity firms) to meet margin requirements. This would almost certainly lead to increased pressure and reliance upon margin transformation services and liquidity provisioning from the banking sector, driving up hedging costs. This would be counterproductive, especially during market stress, and may lead to some firms taking on more price fluctuation risk.

The core activities of most commodity firms or groups involve the supply, refining, transport, processing and in some cases, storage of energy, agricultural commodities, or metals, and the management of production facilities. It is important to consider that physical assets (such as oil fields, refineries, 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.

Commodity markets have performed well under stress – as the FSB has concluded. Introducing more barriers to hedging through increased costs and complexity would destabilise the vital mechanisms, such as hedging, that commodity firms use to support these markets.

European commodity firms need to use their funds to invest in the means of ensuring the supply of their underlying commodities to Europe, in cost efficient ways. Increasing the costs of hedging, risks (a) inflationary consequences (through increases in commodity prices for consumers), and (b) reduction of firms' ability to use their own funds to invest in production assets and, in particular, the energy transition. If firms have to borrow from financial markets to plug this gap, the new measure would not have reduced the financial system's credit exposure to commodity industry firms.

#### **Impact on European competitiveness**

We also believe that additional prudential regulation will disproportionately harm European commodity firms. By imposing increased costs and operational burdens, these firms will face a significant competitive disadvantage against global counterparts operating in less restrictive jurisdictions. This could lead to capital flight, reduced hedging, and higher commodity prices for European consumers. Moreover, diverting essential capital away from investments in supply chain infrastructure and the energy transition threatens Europe's energy security and climate goals. Paradoxically, such regulations may even increase financial system risk by forcing firms to rely more heavily on external financing, margin transformation, and liquidity provisioning.

#### **Impact of existing regulation**

It is worth noting that all commodity firms, including those which are not authorised as investment firms, are already highly regulated by financial regulators. For example, the transaction reporting regime applicable under EMIR imposes reporting requirements in respect of all derivative financial instruments, to which regulators have access. It also imposes various risk mitigation requirements, including mandatory initial and variation margining requirements for many participants' activities in uncleared derivatives. Beyond the transaction reporting and risk mitigation requirements under EMIR, commodities firms are also subject to various rules designed to preserve market integrity and stability. For instance, position limits and position management regimes under MiFID II and other regulations such as the MAR and REMIT were implemented to ensure that commodity markets operate fairly and transparently.

Furthermore, the Frontier Economics Report "Principles of Energy Market Regulation – Securing Efficient & Resilient Energy Trading" ([the "Frontier Report"](#)) notes that such regulations collectively aim to mitigate risks and maintain orderly markets, underscoring the extensive regulatory oversight already in place for commodity firms. Many of these regimes, including EMIR 3.0 and REMIT 2.0, have been recently reviewed,

and their impacts on sensitive commodity markets have not yet been fully observed. More time is needed to assess these impacts before imposing new measures.

We would also strongly urge regulators to consider how they may more effectively use the significant amount of data to which they already have access under various existing reporting regimes before assessing whether additional measures are necessary.

### **Limitations of the IFD/IFR regime for commodities firms**

We believe that imposing prudential regulation on commodity firms not currently subject to such rules is unnecessary and inappropriate. The IFD/IFR regime is designed to address risks posed by Investment Firms providing Investment Service and Activities to clients or financial markets. The IFR/IFD regime does not adequately address the unique challenges faced by commodity and emissions allowance dealer investment firms within industrial (non-financial) groups. Many of these firms primarily exist to aggregate and manage group commodity price risk arising from industrial activities, akin to how treasury divisions manage group financial risk. These firms do not pose a systemic risk to the financial system. Counterparty credit risk from their trading operations would only arise if the activity were substantial enough to potentially trigger the default of a commodity firm, which could then cause financial institution counterparties to default. As iterated above, it is important to note that these risks are already addressed by existing regulations such as EMIR, which themselves have only just been reviewed and updated.

Large industrial firms, such as utilities, mining companies, and food producers, heavily rely on commodity derivatives markets. Unlike credit institutions or authorised investment firms that are not within industrial (non-financial) groups, these asset-owning businesses primarily operate in the real economy and need financial markets to hedge. Prudential regimes are appropriate for credit institutions and financial authorised investment firms because they limit exposure levels, which is appropriate for firms not managing industrial business assets. Large commodity industrial firms, on the other hand, should be incentivised to use financial markets to hedge price fluctuation risks (or, at the very least, not be penalised for such economically prudent activity) and are already subject to substantial limitations as aforementioned. Imposing further limitations through prudential requirements would be a risky move. Rather, greater transparency around margin requirements from financial firms (including CCPs and clearing members) and availability of margin modelling tools would be enormously beneficial.

It has been recognised that prudential regimes designed for financial firms are inappropriate for commodity firms due to differences in operations and risk profiles. Exemptions under CRR have been extended continually, acknowledging the need for a tailored approach. Developing suitable prudential rules for commodity firms would require a long-term, in-depth study involving relevant sectoral DGs to consider impacts on supply security and consumer costs.