FIA response to the EBA-ESMA Discussion Paper on the European Commission Call for Advice on the investment firms prudential framework

London, 23 August 2024

1. Introduction

FIA[1] welcomes the opportunity to respond to the EBA-ESMA Discussion Paper on the European Commission Call for advice on the investment firms prudential framework (Consultation). We have split our response into two main parts. First, we provide some high-level commentary and observations on the current prudential regime for investment firms in the EU in the context of derivatives clearing. Second, we set out our preliminary member views on Question 32 that requests feedback on the potential introduction of prudential requirements for firms active in the commodity markets.

We note that a subset of FIA members, the principal trading firms represented via FIA EPTA, have submitted a separate, comprehensive response to this DP that represents the views of those firms.

2. Prudential regime for EU investment firms – high-level comments

FIA is a strong proponent of open, transparent and competitive markets, with a view to protecting and enhancing the integrity of the financial system and promoting high standards of professional conduct.

Against this background, we note that there is only one other major jurisdiction[2] with a prudential regime for investment firms with similar complexity, impact and compliance burden that the EU prudential regime for investment firms (EU IFR/D) has introduced for EU investment firms (EU IFR firms) when it came into effect in June 2021. It is therefore of the utmost importance for EU policy makers to ensure that EU IFR/D is fit for purpose and that it includes requirements that are proportionate and risk-based, reflective of the type, business activity and size of EU IFR firms, which in most cases, even among themselves, provide different services/activities and have different risk profiles to credit institutions. A key consideration is the calibration of the regime to ensure that EU IFR firms have a level-playing field and are not disadvantaged or less competitive, compared to competitor market participants in other jurisdictions, who are not subject to equivalent prudential requirements. A disproportionate and unduly onerous regime may ultimately lead to certain EU IFR firms relocating to jurisdictions outside of the EU, so as not to bear the burden of compliance with prudential requirements.

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[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets. Further information is available at www.fia.org.

[2] To our knowledge, it is only the UK that has introduced a similar prudential regime for UK investment firms (IFPR).

As it has been reported in the press[3], we are aware of examples where EU principal trading firms (market makers) that provide liquidity to EU equities and exchange-traded derivatives markets have cancelled their MiFID II licences and moved their businesses to other jurisdictions (or relocated their holding companies), citing the disproportionate EU IFR/D regime as the main reason.

The relocation of firms from the EU that have provided liquidity to EU markets risks undermining deep and liquid European financial markets that form the basis of financial stability, especially in times of stress and market volatility. Robust market liquidity is key to enable end-investors to achieve their investment and risk management objectives.

We believe that the EU IFR/D Review that has been initiated by the Consultation should aim to ensure that the regulatory regime that: (i) is proportionate and risk-based, so that it attracts more market participants to provide investment services and activities in the EU and therefore results in more capital and liquidity flowing into the EU; (ii) incentivizes competition that may lead to lower costs for end-investors; (iii) helps create more capacity for growth and innovation in the EU; and (iv) ultimately contributes to the development of an effective and resilient Capital Markets Union.

In terms of proportionality, we note that EU IFR firms should not be disadvantaged by being subject to a prudential regime that is stricter than the one that applies to credit institutions (EU CRR). By way of example, EU IFR firms should be able to apply credit risk mitigation to counterparty credit risk exposures in the same way that credit institutions do under the CRR. This should include allowing both funded and unfunded credit risk mitigation for counterparty credit risk purposes for managing K-TCD and K-CON (i.e., recognition of collateral as exposure-reducing).

We are also strong proponents of a well-calibrated K-CMG factor requirement for mitigating risk to market. We understand that in practice K-CMG is not utilized by many EU IFR firms as the 1.3 multiplier combined with the third highest amount of total margin required on a daily basis over the preceding three months prevent it to be risk sensitive and dynamic enough to be used by EU IFR firms, such as market makers and other firms that trade for their own account. We stand ready to work with the EBA and ESMA to recalibrate and fine-tune the K-CMG methodology to make sure it is more risk-sensitive and does not result in capital inefficiencies for EU IFR firms. This could support their competitiveness internationally and thus support the attractiveness of EU capital markets, without compromising on prudent risk management.

3. **Q32:** ***Should there be the need to introduce prudential requirement 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?***

FIA members believe that the application of prudential rules to commodity firms would be inappropriate, unduly complex, disproportionate (based on a risk-based approach) and would establish a barrier to market entry for many small-size market participants, in addition to increasing the operational costs/ cost of doing business and compliance for existing market participants to the point it is uneconomical/ prohibitive to operate. FIA members also consider that their commodity firms do not pose systemic risk to financial markets.

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[3] https://thefullfx.com/regulation-pushing-prop-trading-firms-out-of-europe-survey/
and https://www.risk.net/regulation/7959064/eu-watchdogs-to-launch-prop-trader-capital-review-in-april

Therefore, it is unclear what the imposition of prudential requirements would achieve other than burdensome, disproportionate regulation that could lead to commodity firms potentially exiting the market with a detrimental impact on EU commodity market liquidity and energy end consumers. Imposing increased costs and operational burdens on EU commodity firms would also be likely to cause commodity markets to function less effectively and would disadvantage those firms compared to commodity firms in other jurisdictions where they would not be subject to prudential requirements, making the EU a less competitive jurisdiction for these firms to operate in.
EU commodity firms have an important role to play in providing financing, hedging and risk management for the commodity markets which ultimately leads to EU end consumers benefitting from better prices. The imposition of onerous prudential requirements could lead to increased migration outside the EU, resulting in reduced hedging activity across the market, increased volatility and poorer liquidity and therefore higher prices for EU end consumers. Ultimately, this could have the counterproductive effect of increasing reliance on the banking sector to provide more external financing, margin transformation services and liquidity provision, which they may not be willing to provide thus creating a gap and even if they were willing to provide such services, concentrating such risk in the financial sector. Unlike their involvement in other markets, the appetite of banks and other financial institutions to be involved in commodity markets varies greatly from time to time – any regulations that are imposed on the commodity markets should be designed in a way that does not unduly discourage smaller, more specialised entities that trade in and provide financing and risk management solutions, given the fact they add to the stability of the market over time. In addition, diverting much-needed funds away from investments in clean energy and physical supply chain infrastructure has the potential to undermine the EU's green energy and security of supply goals.

Commodity markets are very different from financial and capital markets; with unique characteristics given they are linked to physical underlying products which are subject to a different regulatory regime. The entities trading on commodity markets are far more varied and range from producers or utilities (who need to trade to hedge their price and market risk) to trading firms who provide risk management and hedging services to commodity market participants.

Commodity market participants are already subject to regulation specifically tailored to them and the characteristics of such markets, e.g. under MiFID II, EMIR, MAR and REMIT. These regulations require participants to comply with requirements which include transaction reporting, data reporting and in the case of firms that are subject to MiFID II, regulatory capital and investor protection requirements as well as market abuse rules under REMIT and MAR. Commodity firms also must comply with clearing and exchange requirements to trade and are subject to counterparty requirements under trading agreements e.g. to meet creditworthiness criteria and to provide collateral. Therefore, there is already a risk that the current suite of regulations and the costs associated with them and trading activity are imposing a heavy operational and cost burden on existing commodity firms, which can act as a barrier to entry for smaller firms in these markets. There are important links and interactions between the capital requirements regime and these other pieces of legislation. Their cumulative impact on commodity firms of existing requirements and potential prudential requirements should be taken into account on a risk-based proportionate basis when assessing the need for potential prudential obligations in respect of this sector. The current network of regulations recognises the need for proportionate, risk-based regulation and provides exemptions based on the nature and scale of firms' activities (e.g. the ancillary activity exemption to MiFID II) for firms whose derivative activity is mainly designed to reduce their risk and where it is only a minor element of their overall activity.

Prudential requirements for commodity firms have been discussed multiple times over the years, with the same outcome each time – in that they have not been imposed because they are disproportionate. For example, CESR/CEBS in their technical advice issued in 2008 (CESR/08/752), on page 3 and para. 107 p. 32

note: "*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*".

CESR/CEBS state further in the same document 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*."

FIA members do not believe that the situation is any different now. The introduction of prudential requirements including regulatory capital requirements, liquidity requirements, monitoring and financial reporting requirements would be truly disproportionate given commodity firms do not pose systemic financial risk in the way that financial institutions do. It is difficult to see how such prudential requirements would enhance the solvency or financial resilience of such firms and FIA members consider that commodity firms would be better served by measures which improved CCP margin transparency, for example.

Commodity trading is fundamentally underpinned for asset owners or operators (e.g. of power /gas plants or infrastructure) by the existence of a physical underlying and the supporting group infrastructure which allows for continuity of the production and sale of that underlying physical product (for example, power or gas) and which is vital for security of energy supply and is also subject to energy regulation. In an insolvency scenario, firms would still want to operate the producing assets of the firm that owns the asset (for example, a gas or power producing plant), 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 insolvency will not prevent the ongoing extraction/production of the underlying commodity which will itself retain value. This contrasts with a failure of a bank or financial institution. While the financial failure of a market maker in a given commodity would reduce liquidity within that market, it is difficult to see what the imposition of a capital requirement would achieve – it certainly would not lead to an increase in such lost liquidity. Reduced liquidity would rather be the result of a lack of supply, and thus be outside of the scope of financial regulation.

Studies conducted following increased volatility in commodity prices during Covid or the energy crisis came to the conclusion that markets worked well and we do not see how this would be improved by the imposition of prudential requirements. For example, FSB in their 2023 report on the Financial Stability Aspects of Commodities Markets state on page 1 that "*the commodities ecosystem as a whole was largely able to absorb the shock. There were no major disruptions to market functioning – with the exception of the LME nickel market – and there was a limited impact on the rest of the financial system*". FSB also recognise on the same page that it was "*the Covid-19 event, subsequent supply chain bottlenecks, and the Russian invasion of Ukraine in February 2022 [which] led to a surge in the price of key commodities and extreme volatility in some commodities and related derivatives markets*". It was this volatility that led to a spike in margin calls and increased demand for liquidity. FSB on page 4 recognises that "*commodity prices tend to be particularly sensitive to geopolitical events in the countries where they are sourced or grown*". The application of additional prudential requirements would not have been able to prevent such volatility caused by external events, in fact, they could have exacerbated the crisis by trapping liquidity needed for margin payments. Therefore, we question which problem would be solved by applying prudential requirements aimed at financial markets, such as liquidity requirements or concentration risk thresholds, to commodity firms.

Any proposal to introduce prudential requirements for firms in commodity markets, in our view, would have to be justified by clear evidence of the specific systemic risk or significant market failures that such requirements would aim to solve or mitigate, the rationale for which does not appear to be supported by analysis done or events that have occurred to date.

Nature of commodity firms and risk management

Commodity firms specialise in producing and analysing information that identifies optimal transformations, responding to price signals and investing in physical and human capital to perform these transformations. They do not, in the main, speculate on commodity price risk, but generally engage in physical arbitrage activities, which involve the simultaneous purchase and sale of a commodity in different forms (e.g. the untransformed and the transformed form of the commodities) and times. They generally aim to reduce various of the risks associated with their physical activities through hedging. Those hedges, and whatever speculative activity is carried out, bring price discovery and liquidity to the markets.

The risk profile, risk management and hedging strategies of commodity firms reflect the specific features of commodities markets. Commodity firms' risk arises from the natural exposure of those firms to physical assets and economic and logistic variables, such as demand forecasting and physical capacity.

Commodity firms also encompass clearing and execution brokers dealing in commodities and commodity derivatives and firms dealing in commodities on own account. Many commodity firms form part of larger groups involved in the production and delivery of commodities (largely energy products, metals and "softs"). For these firms whilst trading is frequently incidental to the primary business of their group, it still forms an integral part of the company's (and its group's) risk management and hedging strategies.

Furthermore, the concentration of risk in the asset structure of commodity firms in relation to specific global commodity markets tends to be minimal.

Many commodity firms contribute significantly to liquidity in global commodities markets (including, for instance, end users involved in energy production and manufacturing) and ensure continuity and availability of counterparties and prices. The dynamic nature of commodities markets requires that positions and their associated risks be constantly managed and optimised. The use of derivatives, in particular, helps to manage the temporal exposure of commodity firms to the underlying commodity, with the consequence that large volumes of commodity derivatives trading is carried out for hedging purposes, rather than speculation.

Whilst commodity firms can manage risk, they can never eliminate it entirely. In this regard, it is important to consider proxy hedging and position aggregation to understand the differences between financial derivatives and commodity derivatives. Contrary to the former, liquidity in commodity derivatives is typically concentrated around a limited number or type of commodity derivative contracts. Consequently, many commodity firms aggregate positions and use proxy or portfolio hedging to reduce risks.

The collapse of a specialised commodity firm is less likely to pose a systemic risk to the overall financial system than of a financial institution. Let us take Enron as an example. Enron was a major commodity player in Europe before its demise. The firm controlled about one fifth of the European electricity trading market, including 40% of the German market. Yet, the collapse of Enron did not trigger the failure of a credit institution, or another major commodity firm. In a statement from 20 December 2001, Standard & Poor's noted that direct financial loss at major European utilities following the Enron collapse appeared to be "limited as most counterparties

maintained adequate credit management procedures". A similar conclusion was reached by the Congressional Research Service in a report published in January 2003 entitled "The ENRON collapse: an overview of financial issues".

Two key elements accounting for the lack of systemic importance to the financial system and the resilience to systemic risk of commodities markets are the nature of the settlement (i.e. the physical delivery of the underlying) and the group infrastructure, which enable the operations of the main business to continue in the case of insolvency (i.e. commodity extraction and its sale). Under insolvency proceedings or administration, it is often possible to continue operating the productive assets of a firm. Regardless of whether the commodity firm in question is part of a larger group with significant physical operations or simply a specialised trading operation, the default of such a firm is unlikely to impede substantially the continuing extraction or production of the commodity, which will itself have a significant offsetting value.

Liquidity Risk

Capital requirements regulations were born out of the fractional reserve banking system and were put in place to ensure that banks retain appropriate levels of 'skin in the game' by way of capital to protect consumers and the larger financial systems against overleveraging and adverse liquidity events.

Liquidity 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 short-term deposit-like instruments. In addition, as with most non-financial entities, liquid capital is usually kept to a minimum, so as to generate a meaningful return for shareholders. Thus, commodity firms are unlikely to have large unfunded exposures which may not be met due to short-term liquidity crunches.
- 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 and depositors and therefore, are not subject to sudden demand for large cash outflows in stressed conditions;
- Commodity firms themselves have access to stable and diversified financing often through a large number of credit institutions (e.g. Trafigura Closes USD2.7 Billion-equivalent Syndicated Revolving Credit Facility and Term Loan Facilities | Secured Finance Network (sfnet.com)).

In the September 2022 response to the European Commission on margins and excessive volatility in energy derivatives markets, the EBA concluded that it would not be beneficial to extend existing liquidity requirements to commodity firms. Instead, in Chapter 3, they explored a number of other ways to reduce liquidity challenges, such as increased transparency of margin calls or government guarantees.

Indeed, extending liquidity requirements to commodities firms could have exacerbated the demand for liquidity caused by spikes in margin calls (e.g. from CCPs and clearing members) during this time and would not have averted the geopolitical causes of such energy derivatives market volatility. It is difficult to see what issue could have been solved, or systemic risk mitigated, by applying financial markets liquidity requirements to commodity firms.

Concentration Risk

Prudential requirements created for financial markets and based on concentration risk can be problematic for commodity firms, as they are often structured with only one market-facing entity trading on behalf of the group. That entity then enters into internal back-to-back trades with relevant group entities that own the

underlying exposure to be hedged. The trading entity could end up being subject to additional capital requirements due to exposure in excess of 25% to its parent company and other counterparties within the same group, which would not be a true indication of the risk and would make the firm uneconomic to operate. This is the reason why that part of the exemption was introduced for MiFID I and subsequently the exemption for commodity and emission allowance dealers in article 42 of the IFR, which needs to be maintained for commodity and emissions allowance dealers that are already investment firms.

If large exposure requirements were implemented, commodity firms that are not already subject to prudential requirements might encounter problems in finding banks willing to offer bank guarantees, as the latter's business with a group is also subject to the 25% limit. It should be recognised that a corporate group with its fully consolidated group entities represent one single credit unit and, therefore, single group entities cannot impose any additional systemic credit risk to the financial market. This is particularly true if the group parent company provides guarantees for the group entities, as is often the case with commodity companies. Thus, the large exposure regime is not sustainable for commodity firms, a conclusion that has for example been recognised by CESR/CEBS in their technical advice issued in 2008 (CESR/08/752), in paragraph 84 CESR/CEBS say they *"believe that due to the prevalence of group structures in which the authorised entity acts as an intermediary between the group to which it belongs and the market, the application of a large exposures regime to entities acting as intermediaries for their group is likely to impose significant costs with respect to the exposures to the group to which the authorised entity belongs."*

More recently, rather than supporting the extension of regulations regarding concentration risk requirements, which were designed for the financial markets, to commodity markets, FSB in its 2023 report on financial stability aspects of commodity markets suggested "*monitor[ing] developments in commodity markets and the preparedness of commodities firms, working with CCPs and clearing members – to manage sudden increases in margin on derivatives position*". This issue would be resolved by the proposed CCP margin transparency measures.

Conclusion to Q32 response

FIA Members do not believe that prudential requirements designed for financial markets should be extended to commodity firms. Any proposal to introduce prudential requirements for firms in commodity markets should be based on clear evidence of the specific systemic risk or significant market failures that such requirements would aim to solve or mitigate, the rationale for which does not appear to be supported by analysis done and events that have occurred to date. EU commodity firms have unique characteristics given they are tied to physical markets and are already subject to a substantial suite of regulation. As stated above, it is unclear what imposition of prudential requirements would achieve and there is a real risk the additional costs and operational burdens could lead to commodity firms potentially exiting the market with a detrimental impact on EU commodity market liquidity and energy end consumers.