Capital Markets Union at a critical juncture

FIA recommendations with a focus on cleared derivatives markets

September 2024

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INTRODUCTION

FIA welcomes the opportunity to contribute to the Capital Markets Union (CMU) debate at the start of the 2024-2029 institutional cycle of the European Commission and the European Parliament.

As the leading global trade organisation for the futures, options and centrally cleared derivatives markets, FIA advocates for open, transparent and competitive markets, protecting and enhancing the integrity of the financial system, and promoting high standards of regulation and professional conduct.

FIA's membership includes clearing firms, exchanges, clearinghouses, trading companies and commodities specialists from more than 48 countries, as well as technology vendors, law firms and other professionals serving the industry.

Together, as an industry, we support fit-for-purpose regulation, open and resilient markets, fair competition and opportunities for innovation.

At every step, we focus on clients, your ultimate constituents, the end-users. This includes manufacturers, farmers, producers of natural resources, banks of all sizes, pension funds and asset managers. Our markets allow them to hedge price volatility across a wide range of currency, commodity and financial markets, helping to lower costs for consumers and free up capital for economic growth while allowing for investment to address such critical issues as sustainability.

FIA and its members strongly support developing more choices for capital formation and investment wherever clients need funding for growth. The need to conceive capital markets as a living ecosystem populated by a plurality of operators must be recognised and makes a compelling case for evidence-based regulation.

Understanding the role derivatives play in capital markets

Capital markets work more efficiently when tied to derivatives markets. One complements the other.

Exchange traded derivatives (ETDs), derivatives traded on an exchange, introduce liquidity to the markets. With increased liquidity comes a more efficient price discovery process, less friction and lower costs for trading activity. This, in turn, attracts more money to the markets.

Initially developed to create efficient agricultural and other commodities markets, the success of futures and options in that arena led to new market uses. Today, agricultural commodities represent 5% of the industry, with interest rates and equity products leading the pack and metals, currency exchange rates, energy and cryptocurrency comprising the remainder.

Just as the types of futures contracts have diversified, so too has the utility of them. Originally relied upon for risk management, today's futures markets also bring price discovery and liquidity.

That liquidity attracts clients, which brings money to markets. For example, large pools of managed money (pension funds, etc.) tend to use derivatives markets actively. It provides an efficient way to manage allocations across markets with a long-term view. Deep and liquid capital markets are essential to ensure long-term economic growth and unleash the growth potential of European economies.

> In 2023, 89 futures exchanges facilitated 137 billion futures and options contracts. Exchanges across the EU handled approximately 3.5% of that activity.

ETD markets operate based on industry-respected standards. All trading in futures occurs through standardised contracts at regulated exchanges that have clear rules detailing the operations and procedures. This transparency helps reduce risk by mitigating opportunity for fraud.

ETDs are also cleared through central counterparties (CCPs), which serve to decrease counterparty credit risk by managing and mutualising that risk through their clearing members. Centrally cleared derivatives markets are a key ingredient to building a strong CMU in the European Union (EU).

A study by the Milken Institute[1] demonstrates how the use of centrally cleared derivatives markets by banks and non-financial firms positively impacts economic growth through various channels. The use of derivatives allows for a larger volume of commercial and industrial loans, which in turn increases business investment. Additionally, investors assign higher valuations to non-financial firms that use derivatives products, thus are more likely to invest in those firms. Finally, using derivatives helps firms manage risk, enabling more loans and investment in capital.

Understanding the role of derivatives in commodity markets

Commodity derivatives markets play a critical role in managing the impact of market swings and acting as shock absorbers for producers, manufacturers and consumers alike.

The dramatic increase in prices and volatility, which started with the COVID-19 pandemic and continued with the Russian invasion of Ukraine, shone a spotlight on commodities markets and led to questions about their oversight.

However, as recent reports from the Agency for the Cooperation of Energy Regulators (ACER) and European Securities and Markets Authority (ESMA) in October 2023, February 2023 and January 2024 confirm, markets remained resilient despite extremely high prices and volatility.[2] Commodities markets did not experience any major disruptions, margin calls were met, and the derivatives markets appropriately acted as a shock absorber to the observed price swings. The price swings did not represent a failure of the market.

Derivatives markets do not drive the price. Instead, they reflect the price.[3]

The response to the high energy prices triggered by the Russian invasion of Ukraine illustrated the need for a better understanding of the price discovery process in commodities markets. FIA has consistently recommended against the use of controls to cap prices. In a letter to ESMA and the European Commission in November 2022, FIA wrote it was "generally supportive of exchange circuit breakers when used in the context of managing disorderly markets", but warned "they should not be used as tools to control or cap prices and, if improperly implemented and calibrated, these tools can be damaging to the market and the wider financial system".

Therefore, a proportionate regime for commodity markets should be considered and maintained to preserve liquidity and diversity in the marketplace.

Understanding the regulatory environment for derivatives and the importance of cross-border cooperation

A fit-for-purpose regulatory environment benefits both regulated financial institutions and their customers.

For the EU, based on legislation agreed by the co-legislators, ESMA and National Competent Authorities (NCAs) predominantly regulate the derivatives industry. However, derivatives clearing is a global business and many of our members provide services in multiple jurisdictions, which means they must navigate multiple legislative and regulatory regimes.

To avoid conflicting or duplicative requirements, which can complicate the ability of sell-side and buy-side firms to serve their customers and increase the cost of doing business, regulatory cooperation and engagement by global standard setters is of paramount importance, including in the EU. We note the EU already has recognised the risks of diverging transposition of EU directives in Member States' legal regimes and has set out many of the financial services requirements in EU regulations instead.

A recent survey conducted by FIA and Acuiti[4] on the state of the European derivatives markets sets out the most significant obstacles for market participants in the EU. In response, 53% of market participants believe regulatory burdens present the biggest challenge to growing the derivatives business in the EU over the next 5 years. Additionally, 40% of respondents do not believe EU regulations are proportionate to the risks of their activity. The survey also underscores how more respondents look outside the EU, rather than in, for client growth of their business. Sell-side firms, which includes both bank and non-bank brokers, ranked client growth outside Europe as the top opportunity for growth over the next five years. Buy-side firms, comprising hedge funds and asset managers, expressed the same view.

Nevertheless, we believe opportunity exists to continue growing the EU's financial markets and making them even more competitive in a global environment, while striking the appropriate regulatory balance to maintain financial stability.

Cross-border cooperation

Market participants face ever-increasing regulatory burdens across the globe. They look for ways to improve the efficiency of their business functions – including operations, surveillance, reporting and other compliance-related areas.

Several initiatives exist on which jurisdictions can collaborate – particularly on cross-border issues that require a global response, such as climate change, AI and operational resilience.

FIA recommends setting international standards through dialogue among peer regulators and subjecting them to rigorous public comment rather than one jurisdiction making rules in isolation. A more unified, global approach will result in greater efficiency and reduce market fragmentation for the benefit of EU markets and participants.

In addition to strong communication, collaboration and information sharing across borders, FIA recommends defining what is "systemically important" and subsequently creating global standards for those activities and entities. This would result in better coordination on impactful cross-border regulation, ease some challenges firms face in operating in a global environment and support global financial stability.

CMU – KEYS TO A SUCCESSFUL IMPLEMENTATION

The further development of the CMU in the EU requires many ingredients. First, the EU should place a strong emphasis on a more agile regulatory framework with a strengthened focus on proportionality, supported by in-depth cost benefit analysis, predictability and certainty for market participants. Equally important, the EU needs strong incentives for citizens, market participants and institutions to want to invest their savings in European companies and do business in the EU.[5]

The importance of addressing these challenges is echoed by key EU institutions and policymakers. The European Commission President's political guidelines for the next Commission stated a strong emphasis on enhancing the EU's competitiveness. As did Enrico Letta's report on the future of the EU single market, the Eurogroup CMU statement, ESMA's CMU position paper, the ECB statement on advancing the CMU, and the anticipated Draghi report on the future of EU competitiveness.

1. Support clearing and financial stability

CCPs are critical inter-connectors in the financial system, acting as a buyer to every seller and a seller to every buyer. FIA strongly advocates for client access to CCPs as a cornerstone of resilient global derivatives markets. FIA clearing firm members contribute in a meaningful way to financial stability as key facilitators of the transition to central clearing for many derivatives products, a core objective of the G20 response to the 2008 global financial crisis (GFC).

This transition continues as new segments of the market, such as pension funds, fulfil their obligations. Yet, clearing firms face several issues threatening to impact their ability to provide clearing to this growing customer base. Put clearly, the capacity to clear is under pressure.

Several concerns need addressing so clearing firms have adequate capacity to provide robust clearing services in the EU. These concerns include capital constraints, access to CCPs, access to liquid and eligible collateral and margin transparency.

The approach to facilitate and incentivise clearing should centre on establishing appropriate capital requirements and reducing other restrictive measures to alleviate clearing capacity for intermediaries. This will ensure a successful clearing obligation mandate transition, as well as provide a 'clearing home' for those who need it in times of market stress, in particular in the event of a clearing member default (also known as porting).

The need to preserve the competitiveness of all EU market participants is of paramount importance when further developing the CMU. Policies such as the active account requirements under European Market Infrastructure Regulation (EMIR) 3.0 could, if not properly calibrated, adversely impact the competitiveness of EU firms and the efficiency of the clearing ecosystem, ultimately impacting EU investors. Many other supply-side elements of EMIR 3.0 will improve the competitiveness and attractiveness of EU markets.[6]

Capital

The provision of derivatives clearing services is a low risk but relatively capital-intensive activity. Prudential regulators and policymakers must consider the specific features of central clearing, including the mandated shift to clearing of derivatives, as part of the GFC reform or any new reforms when designing capital and other prudential requirements for financial institutions. Already, the EU plays an important role in the Basel Committee framework where global capital standards are set. We encourage EU policymakers to continue actively participating to help design the global principles on capital for banks and then implement them faithfully via EU Capital Requirements Regulation/Directive (CRR/CRD).

Capital constraints often come to light in a crisis scenario where sufficient clearing capacity available for clearing activity to take place must exist. For example, the 'porting' of positions and assets of a defaulted clearing member's clients to one or more other clearing members must occur. Prudential and market regulators should discuss the impact of any capital change on clearing to ensure that it does not detrimentally impact this important activity, which is a risk mitigant itself as recognised in the response to the GFC.

We also recommend paying special attention to the prudential regime for EU investment firms (IFR/D). Globally, very few jurisdictions have such a regime in place, which raises questions about a level playing field. Accordingly, it is important to ensure the EU IFR regime is proportionate to the risks these firms bring to their counterparties, themselves and the market as a whole. If the EU designs a disproportionate prudential regime, it may remove competitiveness from the equation and firms may reduce their business in the EU, reducing liquidity in these markets. This would be a sub-optimal outcome for the successful creation and completion of the CMU.

Margin transparency

Margin requirements are key to financial stability considerations. And global consistency is essential regarding cleared margin transparency. The availability of consistent and appropriate CCP margin simulation tools and relevant documentation to clearing members and their clients, including non-bank financial intermediaries (NBFIs), will increase transparency and enhance understanding of CCP margin models, their main components and their responsiveness to changing market conditions.[7] EMIR 3.0 has made an important first step towards providing additional margin transparency for clearing firms and their clients. However, we recommend global consistency and appropriate implementation timeframes.

2. Simplify the EU regulatory framework

Financial markets have experienced significant regulatory change in the past two decades. Pausing to allow time to implement the rule framework and allow supervisors sufficient time to fulfil their supervisory goals will help identify areas of excessive red tape and overlapping requirements that may pose barriers to further enhancements of the CMU.

FIA supports fine-tuning - rather than overhauling - existing regulations and offers the following practical/technical recommendations for better rulemaking:

Scope

Establish clear definitions of scope in EU legislation (Level 1), early clarifications on territorial scope and personal scope

- Each piece of EU regulation should make clear what parties are in and out of scope, and whether and to what extent third-country firms are impacted by EU regulation.
- They should clearly define when requirements come into effect, especially where Level 2 work is required, to avoid short-term compliance efforts and investment while the final rules are not yet in place.
- Regulations should clearly set out to enable market participants to determine whether a regulatory requirement applies to over-the-counter (OTC) derivatives and/or to ETDs. For example, EMIR defines 'derivatives' and 'OTC derivatives' but does not include a definition of ETDs, while Markets in Financial Instruments Regulation (MiFIR) does.

Implementation timeframes

Allow sufficient time for implementation of requirements before carrying out regulatory and legislative reviews.

- We recommend amending implementation timeframes and taking a more proportionate approach. The implementation of significant regulatory reform has highlighted the importance of providing the European Supervisory Agencies (ESAs), NCAs and market participants with adequate timelines to deliver change and financial reform. In particular, compliance dates of Level 1 and Level 2 requirements should align, in that Level 1 requirements should not start to apply before applicable Level 2 instruments have come into effect to avoid legal uncertainty (with EMIR 3.0 being the latest example).

Engagement

Conduct public engagement/consultation with industry and independent experts on important Level 3 rules before publishing them.

- Thorough engagement and consultation with industry and independent experts, including end users of derivatives, is a key feature of good policy making. We suggest strengthening this as part of the process of publishing ESAs' Questions and Answers (Level 3).

No-action letters

Enact more meaningful ESA regulatory forbearance powers and a more practical reading of the Meroni doctrine.[8]

ESAs should have more meaningful powers to temporarily suspend the application of specific regulatory requirements in certain circumstances and within a reasonable timeframe. This would provide market participants with much needed legal certainty that no enforcement action will occur during that time.

Cost-benefit analysis

Provide meaningful cost-benefit analysis before proposing new requirements and add a competitiveness test as part of important policy proposals.

- Establish a renewed focus on data-driven and evidence-based policymaking by supporting policy designs and implementation practices with knowledge, information and meaningful cost-benefit analyses.

3. Enable efficient markets

Openness and market-driven solutions are key ingredients when building robust financial markets and deeper liquidity pools. FIA and its members have long advocated that optimally managing financial stability risks begins with regulatory and supervisory cooperation at a global level. This approach ensures authorities have the information they need to protect market participants and benefit the economy.

While seeking to develop and enhance its own capital markets, EU policymakers should continue to allow access to global markets for EU market participants. EU clearing firms need to have access and offer competitive access to their clients' preferred CCP, irrespective of location. At the same time, EU financial markets need to attract international participants.

Any restrictions to access for clearing services across borders would harm the objectives of the CMU. Hindering EU clearing firms from participating in international markets could hamper the development of a competitive EU clearing environment in the future.

FIA recommends facilitating client choice on where to clear and protecting the international competitiveness of EU market participants should guide any measures to increase the attractiveness of EU clearing.

Providing a more attractive and resilient EU clearing landscape supports the EU's strategic autonomy and preserves the region's financial stability. Setting the right regulatory environment for all market participants to thrive is paramount to the growth and success of the EU's capital markets.

In addition, the EU should establish a holistic overview for the treatment of derivatives within its sustainable finance framework. This will allow market participants to hedge risks and continue investing to achieve the EU's sustainable transition goals.

Equivalence reviews and recognition of Third-Country CCPs

Optimise further CCP equivalence reviews and improve transparency.

- Equivalence is a core principle of the regulatory framework overseeing the global nature of derivatives markets. FIA recommends the EU makes best use of CCP equivalence reviews to ascertain where changes could be made and provide greater transparency on outstanding decisions on remaining jurisdictions.
- In cases of equivalence determinations being revoked, or a third country CCP de-recognition by ESMA, market participants should have sufficient transitional timeframes.
- Regulators should also consider equivalence decisions in other areas for the benefit of EU participants.
- The Commission must proceed with equivalence determinations under EMIR Article 25 for key jurisdictions, such as the UK, in a timely fashion and to provide certainty to market participants, preferably on a more consistent basis. The extension for third-country Tier 2 CCPs (TC-Tier 2 CCPs) ensures EU counterparties have access to global liquidity pools without disruption and in times of crisis. It also ensures that EU clearing members can continue offering clearing services on TC-Tier 2 CCPs to their clients competitively for the benefit of EU market participants and the economy.
- While EMIR 3.0 introduces a more proportionate equivalence regime for third-country CCPs, we recommend considering 'de-linking' the EMIR Article 25 equivalence decision process and the QCCP status under EU CRR, specifically in the context of the capital regime that applies to third-country CCPs that have applied for, but not yet received, recognition by ESMA. The current own funds regime for exposures to CCPs relies and depends entirely on EMIR Article 25 equivalence (see EU CRR Article 497 for the temporary QCCP status) even where the risk profile of the third-country CCP remains unchanged. We believe in establishing a better, more proportionate and risk-based assessment to determine the capital treatment that applies to exposures that clearing members have related to third country CCPs not yet recognised or that have lost recognition (for example, because of their jurisdiction being 'blacklisted' for anti-money laundering reasons). We appreciate this would require innovative thinking by ESMA, EBA and other authorities, but we would welcome a new, fit-for-purpose 'test' for a CCP to become a QCCP for capital purposes (as opposed to for market access purposes).

Insolvency framework

Harmonisation of certain aspects of non-bank insolvency laws in the EU.

- Insolvency law varies from jurisdiction to jurisdiction. The EU will struggle to complete its CMU without a degree of harmonisation of national insolvency laws. While we recognise the mammoth task, a convergence of EU insolvency laws would bring benefits for market participants and the EU economy by reducing risks and providing predictability and efficiency of the EU insolvency regime. This could result in greater cross-border activity and investments. We note the European Commission's attempt in 2022 to codify and harmonise certain aspects of non-bank corporate insolvency law in the EU and expect that the new Commission and the co-legislators will return to this topic in the new legislative cycle.
- In the context of derivatives clearing specifically, we believe existing national insolvency law regimes must explicitly protect CCP default management 'tools', such as porting and 'leapfrog payments', in the event of insolvency of a clearing member.

CONCLUSION

As the EU works to enhance the CMU, derivatives will play an important role.

Derivatives introduce liquidity to the markets. With increased liquidity comes a more efficient price discovery process, less friction and lower costs for trading activity. This, in turn, enables end users to better manage their business activity risk, and it attracts more money to the markets.

And derivatives markets are global. FIA members contribute to the resilience of the financial system in Europe and globally and help ensure system readiness in times of stress.

FIA and its members also advocate for a fit-for-purpose regulatory environment. Well-designed regulation provides protection for the end user, transparency for market participants and protection for all involved, including governments, during times of stress.

More transparency, public stakeholder engagement and certainty would ease the often complex and lengthy legislative process in the EU, as would finding consensus with international peer regulators on systemically important issues.

As the EU advances on the CMU, it should work toward and promote an open, competitive, pragmatic, predictable, safe, well-regulated/supervised and fair marketplace for domestic and international financial institutions alike.

Any measure by the EU that falls significantly out of step with other major relevant non-EU markets will risk causing a fragmentation of liquidity, which hampers the ability of end users to manage the risks associated with their exposures as part of their legitimate hedging strategies.

Well-designed (cross-border) regulation will contribute to the success of the CMU, as will the participation of international institutions. FIA remains ready and eager to participate in the dialogue with industry to support the implementation of a successful Capital Markets Union.

ENDNOTES

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[2] The August 2022 surge in the price of natural gas futures, European Securities and Markets Authority, October 2023
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[3] Don't blame increases in commodity prices on derivatives markets: IDX panellists, Market Voice, June 2024
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[4] FIA and Acuiti release report on challenges and opportunities for the European listed derivatives markets, FIA, June 2024
https://www.fia.org/fia/articles/fia-and-acuiti-release-report-challenges-and-opportunities-european-listed-derivatives

[5] It is worth highlighting the success experienced by Nordic markets, particularly Sweden. It has functioning and deeply liquid capital markets considering the size of its economy. The Nordic investment culture and openness of the markets has played a key role, as discussed during FIA's 2024 Stockholm Forum.

[6] FIA response to EMIR 3.0 proposal and prudential requirements amendments, FIA, February 2023
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ABOUT FIA

Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of the financial system and promote high standards of professional conduct.

Derivatives markets play a critical role for the world economy by discovering prices and allowing businesses to manage risk across the global economy. FIA is the leading global trade organisation for futures, options and centrally cleared derivatives markets.

FIA represents a wide array of market participants from around the world that depend on these markets. Our members include client clearing firms, exchanges and clearinghouses, executing brokers, software vendors, legal firms, consultants and proprietary trading firms. Our membership is corporate, and our work supports the cleared derivatives industry as a whole.

Our purpose is to provide a voice for each of our member firms. We do this by:

- **Partnering with global regulators:** While regulatory structures are fragmented, modern cleared derivatives markets know no boundary. FIA works closely to bring together market participants and policymakers to ensure transparency, competition and open access.
- **Promoting industry-led best practices:** Our members represent both the buy-side and the sell-side, front-office and back-office. FIA brings together this diverse group of market participants to promote efficiency, competition and integrity across every step of the trading lifecycle.
- **Supporting efficiency and innovation:** FIA offers a host of forums to promote thriving cleared derivatives markets by addressing inefficiencies and supporting plans for growth and innovation. These include dozens of internal working groups dedicated to specific industry or regulatory issues, as well as broader coalitions and industry-wide events to discuss the foundational concerns for our markets.
- **Protecting the integrity of derivatives markets:** Global cleared derivatives markets offer vital risk-management tools, and both the public and private sector depend on these markets for protection. FIA works both with our members and with the global regulatory community to ensure the safety and soundness of global cleared derivatives markets now and into the future.

BRUSSELS
Office 502
Square de Meeûs 37
1000 Brussels, Belgium
+32 2.791.7571

LONDON
Level 28, One Canada Square
Canary Wharf
London E14 5AB
Tel +44 (0)20.7929.0081

SINGAPORE
One Raffles Quay North Tower
Level 49
Singapore 048583
Tel +65 6622.5781

WASHINGTON
2001 K Street NW
Suite 725, North Tower
Washington, DC 20006
Tel +1 202.466.5460

FIA.org