Public hearing on Consultation Paper on the review of commodities business

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Outline

- Background – current and previous Calls for Advice
- Market failure analysis
- Regulatory failure analysis
- Potential shortcomings of MiFID and CRD
- Regulatory options

Background

- **December 2006**: European Commission's Call for Evidence
- **2006/2007**: separate Calls for Advice to
  - CESR:
    - **survey on the transposition of Articles 2(1)(i) and (k) of the *MiFID* and Article 38 of the *MiFID* Implementing Regulation and the practical application of these provisions by European securities regulators.**
  - CEBS:
    - **survey of current prudential supervisory practices for the commodities business and for firms carrying out commodities business, as well as an assessment of the prudential risks arising from *commodity markets* and from the activities of firms carrying out commodities business.**

Background

- **December 2007**: Joint Call for Advice to CESR and CEBS
  - Analysis of market failures arising from the present regulatory and market situation
  - Analysis of regulatory failures arising from differences in the regulatory treatment across categories of firms providing investment services relating to *commodity derivatives*, or across Member States
  - Probability that any such failures would be eliminated as a natural consequence of market evolution in the short to medium term
  - Do *MiFID* and *CAD* treatment of firms providing investment services relating to *commodity derivatives* continue to support the intended aims of market and prudential regulation?
  - Does analysis vary significantly depending on the type of entity providing the investment services or the underlying of the financial instrument?
  - CESR's and CEBS's views on various options and combinations of options relating to the exemptions set out in the *MiFID* and the *CAD*.

Market Failure Analysis - Questions

– Are the aims of market regulation hampered by information asymmetries?

– Are the aims of prudential regulation hampered by negative externalities?

Market Failure Analysis – Information asymmetries

- Market failure through information asymmetries and...
  - Failure to act in the client's best interest
    - Potential for significant market failures is limited
    - But: some market participants may have informational advantages by being active in both the commodity derivatives market and commodity production/supply
  - Market transparency
    - Concerns about information asymmetries result in particular from the significance of OTC commodity derivatives markets which are by nature less transparent than regulated markets
  - Market abuse
    - Information asymmetries can result in abusive market conduct like insider dealing or market manipulation

Market Failure Analysis – Negative externalities

Market failure through negative externalities

- Of regulatory concern if they have the potential to create a systemic risk

Market Failure Analysis – Negative externalities

- Impact on Financial Markets – Transmission channels
  - Directly through credit risk/equity risk exposures
  - Indirectly through impact of price and spread movements on institutions which have invested in commodities markets

Market Failure Analysis – Negative externalities

- Impact on Financial Markets – Types of firms
  - Specialist commodity derivative firm
    - Traditional focus on price optimization
    - Relatively low systemic relevance
  - Banks
    - Central role in economy
    - High potential for cross-market contagion in case of difficulties/failure
  - ISD investment firms
    - Active in many financial markets
    - Growing role in clearance and settlement processes
    - High potential for cross-market contagion in case of difficulties/failure

Market Failure Analysis – Negative externalities

- Impact on Underlying Market
  - – Firm failures can affect price and availability of commodities

- Conclusion
  - – Systemic risk of specialist commodities firms appears to be relatively low compared to banks and ISD investment firms

Market Failure Analysis – Energy firms

- No evidence that risks generated by energy-only investment firms differ materially from those posed by other specialist commodity derivative firms

Regulatory Failure Analysis – Questions

- Potential regulatory failures because of differences in regulatory treatment, in particular
  - significant competitive distortions
  - significant impairment of the free movement of services between Member States
  - regulatory arbitrage?
- Likelihood that such potential failures would be eradicated in the short or medium term as a natural consequence of market evolution, i.e. without regulatory/legislative intervention?

Regulatory Failure Analysis – Conclusions

– Potential regulatory failures are generally due to requirements that were not made with commodity derivatives markets in mind and were not adapted to their specific nature

– Patchwork of regulatory requirements across the EEA
  - Super-equivalence with respect to EU rules
  - Different national implementation of EU rules
  - Different regimes for areas not covered by EU legislation

  ⇨need for convergence

– Ability of market to correct these issues in the short to medium term is unlikely

Potential shortcomings of MiFID and CRD – COM questions

- Does MiFID and CRD treatment of firms providing investment services relating to commodity derivates and exotic derivatives continue to support the intended aims of market and prudential regulation?
- Does the analysis vary significantly depending on the type of entity providing the investment services or the underlying of the financial instrument?
- CESR's/CEBS's view on several [combinations of] options for the regulatory treatment of these firms

Potential shortcomings of MiFID and CRD – MiFID Organisational Requirements and COB

- Organisational requirements and COB rules in MiFID support aims of market regulation in respect of commodity derivatives business
- Expressions of concern about client categorisation rules in call for evidence
- CESR/CEBS looking for evidence on problems posed by client categorisation rules

Potential shortcomings of MiFID and CRD – MiFID definition of commodity derivatives

- The call for evidence suggested limited concerns about the definitions. CESR/CEBS trying to explore whether:
  - there are any serious concerns about the clarity of the definition;
  - the criteria for physically-settled OTC contracts leads to regulatory avoidance

Potential shortcomings of MiFID and CRD – Art. 2(1)(i) and (k) of the MiFID

- Revision of the exemptions is appropriate
  - intended to provide a temporary solution to the lack of a specific capital regime for specialist commodity firms
- Modification rather than abolition

Potential shortcomings of MiFID and CRD – CRD LE and free deliveries regime

- LE regime of the CRD
  - – Full application disproportionate
    - would require significant amounts of capital
    - Activities for specialised commodity derivatives firms do not generate significant systemic concerns

Potential shortcomings of MiFID and CRD – CRD LE and free deliveries regime

- Free deliveries
  - – No need for adjustments of capital requirements
  - – Rather extension of treatment as an exposure to a period that is more in line with market practices where payments are regularly made more than 5 days past due

Potential shortcomings of MiFID and CRD – CRD Maturity ladder approach

- Not suitable for certain commodities as it may over- or underestimate capital requirements
- Possible alternative approaches:
  - Use of current forward price instead of spot price when calculating market risk charges
  - Develop approach not solely depending on current forward prices

Regulatory options – Appropriate prudential regime

- Option 1: No regulatory capital requirements but qualitative risk management
  - No regulatory capital requirements
  - Emphasis on existing risk management practices, i.e. no simple copying of banks' practices
  - Disclosure of risk management practices and risk exposures
  - European passport ✓

Regulatory options – Appropriate prudential regime

- Option 2: Pillar 2 approach
  - Requirement to calculate and hold necessary [economic] capital to cover risks
  - Subject to supervisory scrutiny and, if necessary, intervention

Regulatory options –
Appropriate prudential regime

- Option 3: Recalibrated CRD
  - Reduce Pillar 1 capital charges to reflect the lower systemic risk arising from specialist commodity derivatives firms
  - facilitate model approval
  - Relax model requirements once model is approved

Regulatory options – Appropriate prudential regime

- Option 4: Full application of CRD to relevant specialist commodity derivative firms

Regulatory options – Appropriate prudential regime

- [General] opt-in/opt-out option complementary to options 1 to 3 in order to achieve status as institution according to Art. 3(1)c CAD and the related preferential treatment