European Securities and Markets Authority

The Chair

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John Berrigan
Director General
DG FISMA
European Commission
Rue de la Loi/Wetstraat 200
1049 Brussels Belgium

Ref: Response regarding the current level of margins and of excessive volatility in energy derivatives markets

Dear Mr Berrigan, *dear Sean,*

I am writing to you in response to your letter dated 13 September 2022, calling on ESMA to conduct assessments related to recent developments in the energy derivative markets. We welcome the opportunity to provide further input on this topic.

At ESMA, together with the NCAs, we have been following the developments in energy markets very closely. We have kept in close touch with you at the Commission and reported to the Council committees regarding the developments on several occasions over the past months.

On a general note, in light of recent discussions and measures currently being considered (including those referred to specifically in your aforementioned letter), we would like to stress that the financial market developments appear to us to have been driven largely by the geo-political situation and the associated spot market movements. With this in mind, it will be important to carefully assess any potential policy measures so as to avoid transferring risk from the energy sector into the financial sector. Indeed, significant parts of the currently applicable regulatory framework were put in place in response to the lessons learnt from the Global Financial Crisis and resulted in increased financial stability, and in turn benefited the wider economy in the EU. Furthermore, we would like to underline that while some proposals might help certain market participants in the current emergency situation, the Commission will need to take a holistic perspective on their expected effectiveness as well as potential risks and costs.

Before going into the specific proposals, I would like to emphasise that ESMA and NCAs have been focusing and strengthening their respective market monitoring and surveillance activities on the energy derivatives markets. We will continue to cooperate closely to counter possible threats to market integrity and ensure that any potential signal of market manipulation is followed up and investigated.

Please find below our high-level assessment in the areas you outlined in your request, as well as a number of further suggestions that you may want to consider in your ongoing work on energy derivative markets in the coming weeks and months. We are grateful for the close cooperation with NCAs as well as the staff of the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB) as our assessment has also benefitted from their input, in line with your request.

Circuit breakers

Open and well-functioning commodity derivatives markets play an essential role for price discovery. Due to the recent period of extreme stress, we nevertheless believe that measures to contain excessive volatility could be helpful in improving the overall functioning of these markets. The MiFID II framework already foresees a set of volatility mechanisms (notably trading halts and price collars). However, in the extreme circumstances that commodity derivatives markets (and energy markets in particular) have experienced over the past months, the number of times that trading halts have been triggered on the relevant EU trading venues seems to be very low.

It would, therefore, appear useful to consider implementing, on a temporary basis and for energy derivative markets only, a new type of trading halt mechanism. In ESMA’s view, if adopted, the parameters for such a mechanism should be set at EU level and apply to all venues offering trading in energy derivatives (potentially calibrated depending on the circumstances of specific derivative contracts). We would envisage these mechanisms to trigger halts for a limited period of time only and in exceptional circumstances, for instance, in case of extreme volatility spikes that may lead to disorderly trading conditions. In our view such a measure, by allowing pauses in trading, would support a more orderly price discovery process as it is intended to provide more time to market participants to process the flow of information during extreme market stress scenarios. At the same time ESMA would like to emphasise that it is important to calibrate this measure in a way that ensures price discovery can still take place in order not to negatively affect the ability of all market participants to effectively manage their risks.

It would in our view need to be implemented as part of emergency measures tackling the current energy crisis. ESMA would then stand ready to conduct further work to calibrate this measure, in particular in light of the specificities and liquidity profiles of different types of energy markets.

In parallel, ESMA has already started to review the existing rules and envisages further clarifications and amendments to the existing framework as appropriate, notably through ESMA Guidelines and other ESMA Level 3 measures. To this end, ESMA is considering whether (i) to further clarify certain existing concepts (e.g. static circuit breakers), (ii) to reduce, in justified cases, the level of discretion left to trading venues regarding which mechanisms to have in place, aligning them for trading identical instruments where appropriate, and (iii) to complement the regime with new obligations to enhance transparency (e.g. requiring trading venues to describe publicly the functioning of the circuit breakers deployed on their platforms).

Margins and collateral

Our assessment shows that increased margin requirements and the difficulties faced by certain non-financial clearing members to secure sufficient liquidity to meet these have pushed them, at least in some markets, to reduce hedging activities, and consequently expose them to further risks. Furthermore, while we have not observed a strong trend for a move to over-the-counter (OTC) markets on a consolidated EU level, we have, however, noted a shift to OTC in the Nordic markets.

At the same time, we would like to underline that the proper calculation, the quality of margin and its timely collection are fundamental aspects of the resilience of CCPs and financial stability more broadly. To avoid an undesired shifting of risks to the CCP, the rest of its membership and the financial system more generally, any proposed change to these requirements would need to be carefully considered, strictly limited in time, and subject to rigorous conditions.

EMIR requires that a CCP only accepts highly liquid collateral with minimal credit and market risks to cover its exposures to its clearing members. This is to avoid that the value of the margin declines or that the ability to rapidly liquidate margin collateral is impaired, exposing the CCP and its members to risks. In applying the relevant EMIR requirements, CCPs have to decide what exact type of collateral they accept, and which concentration limits and haircuts are adequate based on the specificities of their markets and own risk management. Finally, EMIR allows bank guarantees to be eligible as collateral under certain conditions for non-financial clearing members (NFCs) only (this differentiated treatment is not permitted for financial instruments).

With respect to the specific asset classes as raised in your letter, our views are as follows:

<u>EU Bonds</u>: EU bonds qualify as transferable securities with a requirement on a CCP to demonstrate to its NCAs that it can manage the related credit, market, currency risk and, therefore, that these should be eligible as part of the CCP's collateral requirement. Hence, we do not consider it necessary to adopt any amendments to the RTS in this regard but could issue a statement or Q&A clarifying that EU bonds are already acceptable as collateral.

<u>Emission allowances</u>: We would not consider it opportune to modify the RTS to enable emission allowances to be accepted as general collateral for reasons linked to the specific features of this instrument (e.g., high volatility, limited legal protections). However, it should be noted that they can already be used by CCPs which clear this type of derivatives and have the adequate knowledge and capacity to manage the related risks.

<u>Commercial paper</u>: We do not consider that the collateral requirements should be specifically amended for commercial paper, whereas if they meet these criteria, they could already be

eligible under the existing RTS requirements. Similarly, ESMA could issue a clarifying statement or Q&A in this regard.

<u>Commercial bank guarantees backed by public entities</u>: ESMA could also consider providing further clarity in the RTS regarding the eligibility of bank guarantees which are issued or backed by qualifying public entities (other than central banks), given the low credit risk of such publicly backed bank guarantees.

<u>Uncollateralized commercial bank guarantees</u>: We have concerns about the impact that extending eligible collateral to cover these instruments may potentially have on financial stability given the heightened risks and the significant uncertainties linked to their use. Consequently, we believe that an amendment to the existing requirements framing the use of commercial bank guarantees should only be considered if subject to strict conditions, applied cumulatively and in a consistent manner:

1. **Condition 1** – Such measures should be limited in time to a strictly defined period, corresponding e.g., to the winter period where heightened volatility and stress on energy markets are expected to continue. It should be clearly communicated that these measures would be temporary and limited to non-financial clearing members.
2. **Condition 2** – As the provision of credit to NFCs is typically concentrated in a few commercial banks, such provision should be subject to concentration limits by the CCP to help diversify risks of the issuer defaulting or being downgraded and ensure that it can be promptly liquidated without significant market risk affecting its value.
3. **Condition 3** – Similarly, CCPs should set limits for these uncollateralised bank guarantees to only represent a small share of the total amount of the initial margin requirement of the non-financial clearing member in view of the intrinsic risk profile.
4. ESMA believes that prudential requirements should continue to underpin any such exposures and limit banks' concentration risk, which would then ave impact on the practical use of such type of collateral.

ESMA stands ready to work with the Commission, and where appropriate with the EBA and prudential regulators, to specify further this particular measure. ESMA will also work with the CCPs and respective NCAs, through the relevant EMIR procedures and convergence tools, to ensure consistent application as well as put in place appropriate monitoring on the provision of such uncollateralized bank guarantees.

Beyond these temporary alleviations, ESMA is also assessing the broader implications of the recent market developments in commodity and energy markets for CCP risk management and whether the current requirements are adapted to the specificities of these markets, including anti-procyclicality measures, access by NFCs to CCPs, margin requirements from clearing members to clients, concentration risks and lack of transparency on client positions and access to daily supervisory data on CCPs, clearing members and, where possible, clients.

Commodity clearing thresholds

In June 2022, ESMA submitted an RTS to the Commission where it was proposed to increase the commodity clearing threshold by EUR 1bn, bringing it to EUR 4bn. ESMA has reviewed its analysis based on a more recent set of data and confirms the appropriateness of this proposed increase. Against this background, we would invite the Commission to now adopt this measure as soon as possible.

Improving regulatory reporting on commodity derivatives trading

Recent developments have highlighted the need for enhanced market supervision and proper risk assessment of market participants' positions. We consider it crucial to put NCAs into a position to have increased visibility regarding OTC transactions for contracts with the same underlying as those traded on EU trading venues. This should apply independently of the country of establishment of those entities. In this way, NCAs would be able to assess their exposures and the risks these entities might face in the event of extreme market circumstances. Furthermore, we consider that the current exemption to the reporting in EMIR of transactions concluded between two subsidiaries of the same non-financial group, where at least one of the entities is non-financial, should be removed.

In addition, we would like to point out that under MiFID II, wholesale energy products (gas and electricity) that must be physically settled and traded on an Organised Trading Facility do not qualify as financial instruments. As such, they are not covered by transparency and reporting requirements, neither under MiFID II nor EMIR. No information is available to NCAs or ESMA on the amount of trading taking place and on positions held in those derivative products, nor on the firms trading those instruments. Instead, the REMIT framework applies. To provide financial regulators with better visibility on these products, we consider that further consideration should be given to submitting them to minimum reporting requirements to NCAs and ESMA, including transaction reporting and daily position reporting.

Regulating and supervising commodity traders acting like investment firms

Non-financial entities can trade and provide investment services in commodity derivatives without being authorised as investment firms. This is possibly due to the so-called "ancillary activity exemption" set out in MiFID II and based on the principle that as far as the trading activity of a non-financial entity remains ancillary to the main commercial business of the entity, the entity should not be subject to the same requirements as an investment firm. To the best of our knowledge, all European commodity firms have been able to benefit from this exemption. Considering the size and nature of the business of some of these entities, it would be useful to revise or replace the current test to ensure that the biggest entities are duly licenced and supervised as investment firms for their trading and investment service provision activities. This would ensure that such significant entities active in commodity derivatives markets conducting essentially the same business as investment firms would be subject to the stringent requirements established in financial regulation, noting however that some specific requirements, e.g., around retail investor protection may not be warranted for commodity firms.

We hope that our initial assessment will prove to be helpful, and we stand ready to provide further technical input to help addressing the current situation. In this regard, subject to political decisions on emergency measures to be taken by the EU Institutions, ESMA stands always ready to put forward concrete proposals to implement individual measures, taking due account of the urgency of the current situation.

In addition, ESMA would be keen to contribute to a more holistic review of the functioning of the commodity derivatives markets and possibilities for enhanced supervision going forward. In the meantime, and being conscious of the particularly difficult situation at the current period, we will continue to monitor developments in the energy markets very actively and closely, together with NCAs.

Yours sincerely, *Yours*

Verena Ross