The potential impact of extending the capital requirements regime to commodity firms

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The purpose of this paper is to address concerns of commodity firms with regard to the expiration of the exemptions for 'commodity dealers' in the Capital Requirements Regulation (CRR)[1]. In our view, an extension of three years to the two key exemptions contained within Articles 493 and 498 of CRR, which expire at the end of 2017, is essential. Such an extension would allow sufficient time for the European Commission to consider thoroughly the nature and risk profile of commodity firms in the context of the ongoing review of the capital requirements regime. The extension is also needed because the commodities markets may be significantly altered as a result of simultaneous and interrelated regulatory developments, e.g. the implementing measures of the recast Markets in Financial Instruments Directive II (MiFID II)[2]. The application of an unaltered CRR from the end of 2017 to commodity firms has the potential to cause significant damage to the EU commodity markets.

The Markets in Financial Instruments Directive (MiFID)[3] was introduced to increase competition and consumer protection in investment services. MiFID II, which replaces MiFID, furthers these original objectives. In addition, it looks to expand the scope of entities subject to financial oversight and could potentially capture a large number of commodity firms with the knock on effect of bringing them within the scope of the Capital Requirements Directive (CRD IV)[4] and the CRR (jointly referred to in this paper as "the capital requirements regime").

MiFID II may expand the definition of financial instruments to capture activity that previously was considered physical trading and thus out of scope of MiFID, which will mean entities that conduct this activity will be within the scope of financial regulation, many for the first time. Whilst essential elements of the implementing acts of MiFID II remain to be agreed, there is uncertainty about the impact on the commodities sectors (i.e. whether a company will have to apply for a MiFID II license ("authorisation")). Consequently, it is impossible to determine which contracts and companies will be subject to MIFID II and the related capital requirements regime. A more accurate and detailed assessment may only be feasible once MiFID II starts applying from 3 January 2017.

[1] Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms
[2] Directive 2014/65/EU on markets in financial instruments (recast)
[3] Directive 2004/39/EC on markets in financial instruments
[4] Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

The licensing regimes operated by the national competent authorities (NCAs) for regulated firms will present a significant challenge for commodity firms given the short timeframe for obtaining authorisation. This process can take between 6-12 months. The further need to introduce systems and processes to comply with the capital requirements regime within a similar period increases the complexity unnecessarily.

Even if an extension of the key exemptions is granted, a number of other significant issues would also need to be addressed. For commodity firms which have not previously been subject to such rules compliance would require considerable IT, operational and human resource changes, as they would become exposed to a multiplicity of new regulatory measures, which could include:

- Own funds requirements;
- Requirements limiting large exposures;
- Risk management requirements (ICAAP, internal models, etc.);
- Liquidity requirements;
- Regulatory reporting requirements; and
- Public disclosure requirements.

An assessment of the current CRD IV/ CRR provisions indicates that these are significant challenges for the commodities sector as commodity firms are often structured with 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. This is the reason why that part of the exemption was introduced for MiFID I and it remains a significant concern.

Furthermore, the aggregate regulatory burden imposed by MiFID II, together with other ongoing regulatory developments need to be assessed prior to implementing an additional capital regime for commodity firms. Commodity markets are already regulated under MiFID, the European Market Infrastructure Regulation (EMIR)[5], the Market Abuse Regulation (MAR) and the Market Abuse Directive (MAD)[6], and for energy commodity firms specifically, the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT)[7]. There are important links and interactions between the capital requirements regime and these other pieces of legislation, and their aggregate impact on commodity firms should be taken into account.

Imposing obligations that are not suitable for commodity firms under the capital requirements regime may be in conflict with the objectives of key policy frameworks such as the Third Energy Package[8] and the investment efforts required to implement the energy transition[9]. One of the principal aims of the Third Energy Package is to foster liquidity and depth of trading in what were, and in many cases remain, relatively illiquid markets. Additional capital requirements on

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[5] Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories

[6] Regulation (EU) No 596/2014 on market abuse and Directive 2014/57/EU on criminal sanctions for market abuse

[7] Regulation (EU) 1227/2011 on wholesale energy market integrity and transparency

[8] European Commission, Third Energy Package legislation, http://ec.europa.eu/energy/en/topics/markets-and-consumers/market-legislation

[9] Energy Union Package "A framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy", p.8: "*The transition towards a more secure and sustainable energy system will require major investments in generation, networks and energy efficiency, estimated at some EUR 200 billion annually in the next decade.*"

commodity firms are likely to lead to the withdrawal of many market participants, further damaging liquidity and market efficiency to the detriment of consumers.

Moreover, the EU initiative for Jobs, Growth and Investment of the President of the European Commission Jean-Claude Juncker encourages national governments to boost growth and investment within the framework of the EU Stability and Growth Pact and to "unshackle" firms from "burdensome regulation". The recommendation is to avoid overly-prescriptive regulation that risks stifling innovation and competitiveness for the purposes of generating an extra EUR 300 billion of investments over the next three years. This further supports our request for extending the exemption.

For these reasons, we would recommend:

1. An extension of the two key exemptions for commodity firms (the *own capital* and the *large exposure* exemptions) contained within CRR at least until 2020.
2. An in-depth analysis of the potential impact of extending the current regime to commodity firms, considering carefully the nature and risk profiles of such firms, once the impact of MiFID II on such firms has become clearer.

In the annex to this paper we offer more details on the nature of commodity firms and their risk profile. We also discuss some of the issues experienced by MiFID-licensed commodity firms who are within the scope of CRD IV/ CRR Pillar I on capital requirements.

Annex – Part I

I. The nature of commodity firms

Commodity firms[10] are covering a wide range of commodity classes, which we have broken down below. However, we note that many commodity firms will cover more than one type of commodities.

Commodities undergo a variety of transformations to become consumer goods. These involve spatial transformation (transportation, logistics), temporal transformation (storage) and transformation of form (processing, refining). Constraints in transformation can vary in severity over time. Commodity firms add value by identifying and optimising transformations in commodities that reconcile mismatches between supply and demand. They invest in infrastructure that alleviates physical (e.g. development of distribution infrastructure) or regulatory (e.g. US crude oil, which is subject to export restrictions, may be refined into products which can be sold abroad) constraints.

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, principally, speculate on commodity price risk, but rather seek to profit from differentials in the prices of the untransformed and the transformed commodities. Instead, they engage in physical arbitrage activities, which involve the simultaneous purchase and sale of a commodity in different forms.

A large variety of commodity firms occupy the market – fully-fledged trading firms trading in many or few market segments, to banks with commodity trading operations, to industrial groups with trading and distribution infrastructure. These companies may have upstream and/or downstream operations and may be privately or publicly owned.

Energy firms

Energy firms may take the form of corporations engaged in the development, extraction and production of oil, gas and/or coal, the generation of electricity and the distribution (wholesale or retail) of energy products. Since the 1990s, the generation and supply activities have been liberalised in most European countries, while network activities remain regulated. The liberalisation process brought new risks and required the restructuring of energy companies to deal with those risks:

- Producers are particularly exposed to the price fluctuations of commodities (including CO_2), as well as to prices in wholesale energy markets – they have what can be described as native or natural positions arising from their physical assets.
- Suppliers and retailers also have native positions with a similar exposure to fluctuations in wholesale energy prices and movements in consumer demand.

These natural positions are volatile and companies had to create additional units within their organisations to manage the risks that this volatility brings with it. The role of these risk

[10] See further: Craig Pirrong "Not too big to fail: Systemic risk, regulation and the economics of commodity trading firms", March 2015, http://www.trafigura.com/media/2178/trafigura-pirrong-not-too-big-to-fail-systemic-risk-white-paper.pdf

management units is to optimise the benefits, while minimising risk. When carrying out this activity, they do not analyse each element/risk independently, but as part of a total “portfolio”.

Metals firms

Similarly, metals firms typically engage in the development, extraction and production of various metals (ferrous, non-ferrous, or precious) and the distribution, processing or manufacturing of raw materials, intermediate products and finished goods for a wide range of industrial applications. Whilst the market infrastructure relating to metals is regulated differently – due to fundamental underlying differences in the nature of the commodities – those firms still experience the changing regulatory landscape as noted above.

As a result, metals producers also have native or natural exposures that are subject to fluctuations in wholesale commodity prices arising from their asset profiles, with suppliers and retailers assuming similar market risk and changes in client demand. In addition, there is a group of specialist commodity firms who provide London Metal Exchange (LME) brokerage services to metal producers, consumers and other counterparties. These firms have been subject to legacy UK FCA capital rules (Chapter 3 of IPRU-INV) which bear many similarities to CRD IV/ CRR Pillar 1.

Agricultural firms

Agricultural markets are characterised by a large and diverse number of players. Those include farmers, cooperatives, collectors, traders and food and feed processors who use derivatives to manage risks for their own physical operations and for their customers. These markets also have a strongly pronounced seasonality element, as usually there is considerable supply of commodities just after the harvest period, but the demand is spread out over time. Storage helps to balance better the supply and the demand.

Agricultural futures and derivatives contracts have been designed to reflect the value of the agricultural commodity and the need of the agricultural players to hedge against price risks and inherent fluctuations. Such contracts have become indispensable to the proper functioning of the business. Using physical forward contracts also secures a stable delivery pattern for refineries and food factories, which need the product to continue to operate physically their plants. They can be used by food producers to “lock” or stabilise production margins, secure stable cash flows and reduce liquidity risks.

II. Risks and hedging strategies of commodity firms

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 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 incidental to the primary business of their parent company, it still forms an integral part of the company’s risk management and hedging strategies.

The main and natural risk for commodity firms is the market risk comprising commodity risk and, to a considerably lesser extent, foreign exchange risk or interest rate risk. Credit/ counterparty risk arises from running the main business and from hedging. However, this credit risk is not highly leveraged – commodity firms typically bear basis risk (the difference between prices and spreads) on commodities. This means that commodity firms tend to be exposed to trading volumes rather than prices.

Furthermore, commodity firms are not very dependent on short-term funding. Consequently, a default of an equivalent average-sized commodity firm would be unlikely to have a disruptive impact on the financial markets. Additionally, 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 concentrated around a limited number or type of commodity derivative contracts. Consequently, many commodity firms aggregate positions and use proxy hedging[11].

The collapse of a commodity firm is unlikely to pose a systemic risk to the overall financial system. 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 debacle 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 bankruptcy (i.e. commodity extraction and its sale). Under the bankruptcy proceedings or administration, it is often possible to continue operating the productive assets of a firm. Regardless whether the commodity firm in question is part of a larger group with significant physical operations or simply a specialised trading operation, the

[11] Commodities markets are not always liquid enough to allow for a perfect hedge of an open physical position. Also, it is often not possible to find a perfect hedge in the OTC market. For this reason, commodity firms need the flexibility of proxy hedging. For example, some power plants use a specific fuel-oil (with 3.5% of sulphur), which is rather difficult to hedge if we look for it in the OTC market. The trading team can cover the risk using fuel-oil 1% NWE or fuel-oil 1% Med, which are listed products by some traders, although they are sometimes not very liquid, or even with Brent, since this is the most liquid product with a high price correlation with fuel-oil.

default of such a firm will not impede substantially the continuing extraction or production of the commodity, which will itself have a significant offsetting value.

We note that under both EMIR and MIFID, intra-group transactions and hedging transactions can be excluded from certain thresholds and calculations (e.g. MIFID II Ancillary test, EMIR bilateral risk mitigation, position limits). A consistent approach should be considered when reviewing whether and how to apply regulatory capital to commodity firms, regardless of whether a commodity firm is required to adopt an 'FC' status as a result of low ancillary exemption thresholds under proposal. In acknowledging that neither hedging or intra-group transactions are an area of concern across other areas of EU regulation, capital requirements should also apply similar principles to ensure any capital held is proportionate and focussed only on activity where there are genuine risks to address.

Annex – Part II

Lessons from the experience of MiFID- licensed commodity firms

A limited number of energy commodity firms are already operating under the MiFID regime. Companies licensed prior to 31 December 2006 cannot benefit from the commodity firm exemption from the *large exposure* requirements (Article 493 CRR) and the *own funds* requirements (Article 498 CRR), and they are fully within the scope of the CRD IV/ CRR Pillar I on capital requirements. In addition, the specialist LME brokerage firms have been subject to legacy UK FCA capital rules (Chapter 3 of IPRU-INV) which have many similarities to CRD IV/ CRR Pillar 1. Based on the experience of these firms, the following issues relating to the application of regulatory capital requirements to commodity firms have been identified.

1. Own fund requirements (Part II, Title II of the CRR)

Institutions, as defined under CRR, have to comply with the capital ratios below:

- Common Equity Core Tier 1 (CET 1) / RWA ≥ 4.5%
- Tier 1 (except CET 1) / RWA ≥ 1.5%
- Tier 2 (T 2) / RWA ≥ 2.0%

These requirements will gradually increase from 2016 onwards to include conservative CET 1 and countercyclical buffers (starting in January 2016, increasing in gradual steps up to, or in some circumstances exceeding, 2.5%), set according to the economic context. As a result, the required solvability ratio should be between a minimum of 8% and a maximum of 13% and the own funds requirement for investment firms will amount to not less than 10.5% in 2019.

These thresholds have been calibrated for entities, which employ significant leverage to lend money against which they hold capital. They do not take into account the risk profile of commodity firms, or the particularities of commodity markets in terms of prices volatility and liquidity. Generally, commodity firms employ significantly less leverage than other market participants. Moreover, due to the features of global commodities markets, credit risk is far less significant (where the participant is not in the business of intermediation of credit) than volatility and liquidity of the underlying commodity markets. Whilst other market participants may also hold exposures to high-quality sovereign or multinational counterparties, which attracts low risk-weighting, commodity firms' exposures (largely) to corporates may attract punitively higher risk-weighting.

Commodity firms active in financial markets have other loss-absorbing instruments than the abovementioned capital instruments. Those firms have a sustainable foundation – namely their physical assets, e.g. power plants (or more general upstream assets), commodity assets (stocks in general, e.g. metals, gas or coal in storage, CO_2 certificates, LME warrants). A financial market regulation also applicable to commodity firms should account for these differences and should classify prudentially-valued physical assets as eligible instruments to absorb unexpected losses from engagements in financial markets. Therefore, commodity firms should be allowed to exclude other sustainable capital instruments held by them from the solvability ratio calculation. The own fund capital ratios should also be revised downwards in order to reflect properly commodity firms' risk profile.

Tier 2 (subordinated loans) conditions and, in particular, the requirement for a subordinated loan to have an original maturity of 5 years, are also inappropriate for commodity firms as they are too inflexible. Commodity firms do not require a permanent type of capital.

It is also important that commodity firms are able to include interim profits within their available financial resources as they arise without the requirement for external verification, which is both costly and time consuming, creating an unnecessary delay in being able to make use of these profits. There is no concept of interim losses being externally verified, even though we agree that financial resources must be reduced as soon as the losses arise. For information, the UK FCA allows unverified interim profits to be included within the financial resources calculation for Chapter 3 commodity firms. Furthermore, credit institutions were allowed to use unverified profits under the Basel II Tier 3 capital rules to cover commodity risk, so this concept is not without precedent.

2. Risk capital requirements

CRR offers several methods that an entity could use to measure its risk in order to calculate its capital requirements, namely:

i. The standardised (STD) approach, which is based on external ratings issued by external credit assessment institutions (ECAI); or
ii. The Internal Model (IM) approach, whereby a firm can rely on an internal model, however, subject to the prior validation and approval of such a model by the NCA.

Developing an internal risk model is complex and very time-consuming. Therefore, it is likely that many commodity firms would have to rely on the standardised approach. Moreover, an internal model would also require NCA approval. Depending on the NCA, this may include an observation period of up to three years. To our knowledge, only credit institutions have been able to obtain NCA approval of their IMs so far. Consequently, commodity firms would have to apply the standardised approach, at least until authorisation of the internal model is granted.

As explained in further detail below, the standardised approach may be punitive in relation to the nature of commodity firms' exposures. It remains an open question as to whether this approach could be made to fit the business model and a review of the standard approaches would be needed. Within the current framework, both the risk exposure calculation and the weighting attached to the risks should be revised to take into account the particularities of commodities markets.

2.1. STD approach for determining risk weight (Part III, Title II, Chapter 2, Section 2 of CRR)

The STD approach for determining risk weight (RW) is designed to take into account exposures to a diverse range of counterparties of varying credit quality: from highly creditworthy-rated sovereigns to unrated corporates. It does not take into account the specific features of commodities markets and fails to reflect the real risks arising from commodity activities.

The approach is based on external ratings issued by ECAIs. The RW ranges from 0% to 150%, where 0% is applied to "AAA" – "AA-" sovereigns and 150% to defaulted exposure. When there is no available ECAI, credit exposure is weighed to be 100%, which means that ECAI is currently the only way to estimate the credit quality of counterparty under the STD approach.

This approach is punitive for commodity firms. Firstly, most consumers of commodities tend to be corporates of varying quality, many of which are unrated. Thus, they would attract a 100% risk weighting, which will expose commodity firms to unduly high composite risk weighting of their customer base. Secondly, many commodity firms are themselves unrated and hence, 100% risk-weighted, regardless whether their parent company is rated. As gaining a rating is a cumbersome and costly process, it is unlikely that commodity firms will become rated in the future. As a result, two unrated corporate counterparties will both attract a 100% RW, irrespective of their different revenues and leverage profiles. Equally, asset-backed commodity firms are penalised in this approach, as tangible assets (e.g. generation, storage, and transportation facilities) are 100% risk-weighted (Article 134 CRR).

Credit Risk Mitigation

CRR allows for credit risk mitigation through collateralisation of exposures. However, there is limited scope for commodity firms to recognise tradable commodity assets (for example, LME warrants) to reduce counterparty exposures under the STD approach (Article 199(6)), whilst physical assets may be recognised under the Internal Rating Based (IRB) approach. In addition, parent company guarantees, which are frequently used by commodity groups as intra-group credit support, will only be recognised under the STD approach if they have a credit rating (Article 201(g)(i)). This is problematic as the trading arms of many companies are not externally rated.

Exposures to Central Counterparties (CCPs)

CCPs are an integral part of the market infrastructure, particularly for the clearing of derivatives (financial or commodity). For example, LME brokerage firms are clearing members of the LME. Exposures to CCPs largely depend on the classification of the CCP as a Qualifying CCP (EU/EEA CCP authorised under EMIR, or third-country CCP, the jurisdiction of establishment of which has been deemed equivalent by the European Commission) – trade exposures against which attract a 2% risk-weighting, or non-Qualifying CCPs – trade exposures against which are treated as regular corporate exposures under the STD approach (minimum 20%).

Default fund contributions to CCPs also attract exposures treatment, which can be prohibitive. For commodity firms access to exchanges and CCPs to hedge their natural exposures is a fundamental part of their respective commercial strategies. Exposures values, particularly collateral posted in the form of cash or financial instruments are meaningless when the commodity firm is short with respect to the derivative. This is because the entity already has a natural exposure to the underlying, yet these exposures can attract risk-weighting which may render hedging uneconomical. This, in turn, may have knock-on effects on the large exposures regime, particularly for commodity firms with large exposures to CCPs. There is surely a case to be made that exposures to CCPs should receive a zero risk weighting now that EMIR is under review.

2.2. Counterparty risk requirement (Part III, Title II, Chapter 6, Section 2 of CRR)

CRR requires institutions to take into account “Exposure at Default” (EAD) (which itself takes into account complex calculations of leverage ratio, exposures to central counterparties, CVA capital charge and large exposure monitoring) when calculating counterparty credit risk. The current regulatory framework provides two non-internal model approaches, i.e. (i) the

Standardised Method (SM) and (ii) the Current Exposure Method (CEM). The latter is the one most commonly used by credit institutions, because SM is considered too conservative. It is likely that commodities firms would also opt for CEM.

a) CEM
CEM for OTC derivatives implies a replacement cost (mark-to-market) of the transaction plus a supervisory add-on factor deemed to reflect the potential future exposure (PFE). The current CEM formula is not appropriate for commodity firms, as it is not risk sensitive and it oversimplifies the net-to-gross ratio. It has at least the following limitations:
- Within a netting agreement, off-setting of positions is limited to 60% when calculating PFE;
- Long and short positions cannot be offset; and
- The add-on factors:
    - Are unable to reflect the different correlations and volatilities over the different commodity sub- asset classes (oil, gas, power, metal, agricultural); and
    - Have not been revised since the 1990s and as such, do not consider recent stress periods.

As a result, the common CEM formula is not adequate for commodity firms to estimate the credit risk exposure to counterparties as it will often lead to an overestimation of the risk which, considering the nature of commodity markets, may disadvantage commodity firms. Therefore, a more risk-sensitive approach should be adopted. The Basel Committee on Banking Supervision (BCBS) recognised in its Guidelines from March 2014 the limitations of the current CEM, whilst acknowledging the benefit of margining, the legal compensation within netting set and the off-set of long and short positions.

b) SM
Like CEM, the SM has been criticised for failing to differentiate between margined and non-margined transactions, for the operational complexity of its definition of a "hedging set", and generally for not allowing for a true representation of current exposure and potential future exposure.

The necessary revision of the current standardised approaches, both the CEM and the SM, will have broad implications. Indeed, EAD also enters into the calculations of leverage ratio, exposures to central counterparties, CVA capital charge and large exposure monitoring.

2.3. Settlement risk (Part III, Title IV of CRR I)

CRR requires institutions to hold capital against exposures to price differences arising from financial and physical transactions, which are settled 5 or more days after the due settlement date, ranging from 8% for 5-15 days to 100% for 46 days or more, until the financial settlement of the trade. Institutions dealing in dematerialised securities enjoy settlement through the provision of book-entry systems, for which settlement can (and is often required to) take place within a few working days. Naturally, a delay in payment where settlement is, in practical terms, immediate, could indicate that the counterparty may be unable to meet its obligations. However, it should be noted that settlement of transactions in physical commodity markets is fundamentally different to the delivery of dematerialised securities. Payment terms under invoices or transaction structures may not necessarily be aligned with delivery and off-take. In addition, delivery and settlement are subject to actual delivery risk, which could be affected by factors, such as, logistical issues, weather, and political turmoil.

Settlement terms vary widely across commodities and mostly exceed 5 working days, as demonstrated in the below table:

Market	Typical terms
Oil	Bill of Lading + 30 calendar days
	Barges + 5 days
Gas	20th of month or 10 days after invoice
	LNG 7 business days after invoice
Power	UK 10th banking day of following month or 5 days after invoice
	European 14th days of following month
	Physical T+51
Coal	T+90
Base Metals	Delivery date + 30 calendar days

Table 3: Typical settlement terms per markets

Owing to the inbuilt delay in settlement terms inherent in commodity markets, commodity firms would be unduly penalised by the current capital requirements. The CRR capital requirements are designed to take into account late payment based on a counterparty's inability to meet a payment, rather than on the bespoke payment arrangements in commodity transactions.

Moreover, MiFID II may bring into scope physically-settled forwards, that were previously not considered to be financial instruments and which now may have to be considered in the calculation of the settlement risk. If the current rules are applied unaltered, commodity firms will be obliged to set additional capital against settlement risk. Commodity firms typically have a large percentage of physical forward trades in their portfolio and consequently, the impact of this regulation on commodity firms will be great and may include commodity firms that are trading only physical commodities.

2.4. Market Risk

The standardised methods (both the simplified approach and the maturity ladder approach) are not appropriate for commodity firms who have very large positions in commodities. In addition, a typical producing commodity firm has primarily same-way positions, e.g. long positions from its future commodity production. This means that the ability to net their positions is not very helpful for such firms, and it would require producing commodity firms to assess larger capital requirements than necessary. If commodity firms are able to apply internal models, they would have to apply value-at-risk (VaR) models and other stress models. However, as set out above, the majority of commodity firms currently have not implemented internal models, which comply with quantitative and qualitative standard under the capital requirement regime. Therefore, we call for a review of the internal model approach.

CRR also prescribes the use of mark-to-market valuation based on spot market valuations. This, however, may be inappropriate for commodity firms trading in derivatives. They may see a significant divergence in exposure between the spot price and the price of the derivative, particularly when the market is in contango or backwardation.

3. Liquidity minimum requirements (Part IV of CRR)

The CRR liquidity requirements include:

a) A short-term ratio, the liquidity coverage ratio (LCR), which promotes the short-term resilience of credit institutions to liquidity risks by ensuring that they have sufficient high-quality liquid assets (HQLA) to survive a significant stress scenario lasting for one month. The LCR will be progressively implemented from 2015 onwards, starting at 60% and reaching 100% in 2018.

b) A medium-term ratio, the net stable funding ratio (NSFR) defined as "available stable funding/required stable funding", that should ensure that institutions have an acceptable amount of stable funding to support their assets and activities over a one-year period. This ratio might be implemented gradually from 2018 onwards, subject to the capital requirements regime review.

Whereas the NSFR seeks to ensure that institutions match their asset and liability profiles and hold enough liquid assets to be able to meet their committed financial obligations, the purpose of LCR is to ensure that institutions are able to meet their funding requirements in the face of short-term market-wide or firm-specific liquidity shocks. Indeed, during the financial crisis it became clear that many financial market participants were overly-dependent of short-term financing and central bank liquidity provision. As a result, they did not hold sufficient liquid assets to meet the demand of consumers, investors and/or depositors to withdraw large funds in stressed market conditions.

These metrics are not appropriate for commodity firms as such 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.

We are concerned about the potential application of the LCR obligation to commodity firms (both under the current regime and under a future prudential regime if deemed appropriate). For a number of reasons, the liquidity requirements and needs in commodities markets and of commodity firms are very specific:

- Commodity firms do not participate in the interbank markets and have no access to central bank liquidity provision;
- They 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 launched a syndicated loan in March 2015 with 51 credit institutions and the Noble Group in May 2013 with 71 different credit institutions).

Overall, academic studies[12] and regulatory bodies[13] have previously considered commodity firms to have a low to zero systemic risk profile. It should also be noted that the current definition and

[12] See further: Craig Pirrong "Not too big to fail: Systemic risk, regulation and the economics of commodity trading firms", March 2015, http://www.trafigura.com/media/2178/trafigura-pirrong-not-too-big-to-fail-systemic-risk-white-paper.pdf

[13] CESR/CEBS technical advice to the EC on the review of commodity business, 15 October 2008 (CESR/08-752):

categorisation of HQLAs for the LCR calculation is too restrictive, inappropriate and even punitive for commodity firms.

The recognised categories of HQLAs, such as sovereign bonds, cash and exposures to the ECB are assets that are not held by, nor available to commodity firms. In order for commodity firms to comply with a future LCR by acquiring HQLAs, a material cash injection may be needed, resulting in a significantly increased cost of capital due to the required capital increase. The cost for commodity firms to comply with the LCR would be substantial and will impact materially commodity firms' current business model and potentially put at risk the business continuity of some of them.

In case commodity firms are not exempted from the LCR, a thorough impact assessment would need to be carried out. Modifications to the current regime would be required to mitigate the impact of those new requirements on commodity firms' business model and on the real economy. Those shall include the addition of further assets to the current categories of HQLAs.

Whereas the conclusions of the impact assessment recently published by the European Banking Authority (EBA) (15 January 2015)[14] demonstrate that the liquidity coverage requirements have only a limited impact on the business models of large credit institutions and that the implementation of the LCR is not likely to have a negative impact on the stability of financial markets and of the supply of bank lending, the same would not be true if the LCR needs to be implemented by commodity firms. Therefore, any decision of the European Commission should be preceded by a comprehensive impact assessment.

Whilst the CRR states that a single set of regulations for all market participants is needed to establish a level playing field between institutions active in the same markets and for avoiding regulatory arbitrage, it should be recognised that the LCR has been based on recommendations of the Basel Committee. Those were designed for the weak position of some financial market participants during the financial crisis due to lack of short-term liquidity. Such standards cannot be applied *mutadis mutandis* to commodity firms. Already in 2008, the CESR/CEBS recognised that "(…)*, regulatory failure could also arise if regulation is not appropriately tailored to the specific characteristics of commodity derivative markets."*[15]

4. <u>Large exposure limits (Part IV, CRR I)</u>

CRR requires institutions to monitor and control their exposures where the value of these is equal to or exceeds 10% of their eligible capital. Institutions shall not incur exposures (after taking into account effect of credit risk mitigation) the value of which exceeds the lower of 25% of eligible capital or €150 million. Exposures above 10% of an institutions' eligible capital are

- p. 22, § 56 "*although connections do exist between specialist commodity derivatives firms and broader financial markets, systemic risks generated by these firms appear in the opinion of the CESR/CEBS in general to be relatively low compared to the systemic risk generated by credit institutions …*"
- p.28, §81: "*In conclusion, CESR/CEBS are of the opinion that specialist commodity derivatives firms generally do not pose the same level of systemic risk as credit institutions and ISD investment firms and therefore do not warrant the same degree of prudential regulation. The full application of CRD to specialist commodity derivatives firms is in their opinion therefore likely to impose a regulatory burden that is disproportionate to their potential systemic impact.*"

[14] EBA Second report in impact assessment for liquidity measures under article 509(1) of the CRR, http://www.eba.europa.eu/documents/10180/950548/2014+LCR+IA+report.pdf

[15] The CESR/CEBS technical advice to the EC on the review of commodity business, 15 October 2008 (CESR/08-752), p.24, §62.

subject to reporting and risk mitigation requirements. Breaches of the 25% of eligible capital limit are accepted for trading positions, but must remain as exceptions and incur additional capital requirements.

If a commodity firm is part of a non-financial group, intra-group exposure is currently considered as an external risk and it is subject to the 25% concentration limit. This does not make sense as such transactions are the main reason for the existence of the business unit and in reality intra-group risks are very limited.

Consequently, commodity firms will struggle to meet the 25% requirement. Despite the implementation of several mitigation techniques like netting and margining, it is very likely that exposure to their respective parent and affiliated group companies will exceed 25% of their own funds. In order to remain below the 25% limit, commodity firms will have a disproportionate need to recourse to bank guarantees at an additional very high cost.

As a result of the same large exposure limitations, commodity firms might encounter problems in finding banks willing to offer bank guarantees, as the latter's business with a group is also limited 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 fully guarantees the group entities through appropriate contractual relationships. Thus, the large exposure regime is hardly sustainable for commodity firms, a conclusion that has already been recognised by CESR/CEBS in their technical advice issued in 2008, §107 p. 32: "*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*".

5. Capital buffers

We question the benefit of capital buffers in the context of commodity firms. Capital buffers are considered as macro-prudential instruments and are defined as "softer" requirements over and above the minimum capital requirements. They were implemented as one of the responses to the financial crisis in order to boost the minimum capital requirement, reduce systemic risk and mitigate economic cyclicality. However, as previously noted, the collapse of a commodity firm does not present a systemic risk to the overall financial system. It would not seem appropriate or consistent, therefore, for the current capital obligations to be placed upon commodity firms.

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EFET promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We improve the conditions for energy trading by:

- Finding solutions for market design and advocating suitable policies and regulatory measures;
- Providing standard solutions to the repetitive aspects of wholesale energy transactions;
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FIA Europe, formerly the Futures and Options Association (FOA), represents some 175 firms involved in the exchange-traded and centrally-cleared derivatives markets – including banks, brokers, commodity firms, exchanges, CCPS, vendors, law firms and consultants. FIA Europe works with its members to maintain constructive dialogue with government and regulatory authorities and deliver high standards of industry practice. In 2013, FIA Europe formed an affiliation with FIA under a new structure – FIA Global. Under this arrangement, FIA, FIA Europe and FIA Asia have strengthened their influence on cross-border issues, substantially increasing the coordination and information flow between regions and providing a powerful global voice to express the views of their members. The organisations preserve their ability to deal with legislative, regulatory and market issues in their respective time-zones and continue to operate with their own leadership and staff, separate boards of directors and distinct memberships. For more information, visit our website at https://europe.fia.org/.

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