Specialist Commodity Derivatives Firms: A Case for Differentiated Regulation

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In parallel with the development of the EU’s Markets in Financial Instruments Directive (MiFID), the European Federation of Energy Traders (EFET), the Futures and Options Association (FOA) and the International Swaps and Derivatives Association (ISDA) have been putting forward extensive arguments as to why specialist commodity dealers and commodity markets were entitled to differentiated regulatory treatment. To that end, the associations commissioned two independent reports, one from KPMG and one from Ernst & Young, both of which underpinned the case for regulatory differentiation.

The argument was predicated on the basis that such commodity houses were engaged in commercial rather than investment business, did not deal directly with retail investors and did not take deposits, ie. they posed less risk to the financial system than, say, major global financial institutions.

The European Commission, acknowledging that there was a case for review, agreed to exempt such dealers from MiFID on a temporary basis and issued a Call for Evidence on whether or not differentiated regulation for specialist commodity dealers was justified. In their combined response, the Committee of European Securities Regulators (CESR) and the Committee of European Banking Supervisors (CEBS) concluded that:

“Specialist commodity derivative firms generally do not pose the same level of systemic risk as banks and ISD investment firms and therefore might not warrant the same degree of prudential regulation. The full application of CRD on specialist commodity derivative firms would likely impose a regulatory burden that is misaligned with their potential systemic impact. However, as described in the Market Failure Analysis, negative externalities can still be present and may justify the imposition of prudential requirements that the current regulatory framework does not require.”

CEBS, in its own response, concluded that “in the commodities case studies examined in this report, systemic concerns were limited and contained”.

Shortly after these conclusions were reached, the European Commission found itself dealing with the consequences of a global liquidity crisis of almost unprecedented proportions. As a result, the exemptions for specialist commodity dealers were extended to December 2014, the review was put on the back-burner and the Commission switched its resources to the vital objective of addressing the causes of the crisis, strengthening existing regulatory structures, plugging identified “black holes” in the regulatory perimeter and establishing a more robustly-capitalised financial system.

It is both inevitable and understandable that, in the aftermath of such a severe economic and financial crisis, the regulatory priority is to deliver a much safer and sounder financial services sector. This will, however, have consequences for market liquidity, innovation, diversity, growth and trading and risk management costs. Since the other top priority is to expedite economic and commercial repair, it is critical that the regulatory authorities get the balance between safety and growth right. As Lord Turner, Chairman of the UK FSA put it, “How much we shift the trade-off deserves careful thought” largely because, as it was put in the de Larosière Group Report, over-regulation “slow down financial innovation and therefore undermines economic growth in the wider economy”.

One of the inevitable reactions in the aftermath of any crisis is the propensity to establish new structures and pass yet more rules. Fortunately, the overall focus (to date) has been on making the existing structures work together more efficiently and developing better rules (and better supervision and better enforcement of rules). As Commissioner McCreevy, the European Commissioner for Internal Market and Services, in his address to the European Economic and Monetary Affairs Committee in Strasbourg on 3 February said “Everybody agrees on the need for reform, but the question is not whether we need more regulation, but what kind of regulation. We should regulate thoughtfully and carefully rather than rushing lemming-like to adopt substandard texts.” In this context, it is worth remembering that the crisis had its source in one of the most highly regulated and enforcement-led jurisdictions in the world, namely, the US and, notwithstanding the existence of legions of regulatory authorities, armies of supervisors and tens of thousands of rules (not to mention a plethora of inter-regulatory memorandum of understanding and cooperative arrangements) the crisis spread rapidly and almost unhindered across the world.

Another inevitable by-product of post-crisis repair is a loss of balance and proportionality. In this context, while it is true that many of the reports on the causes and consequences of the crisis have recognised the importance of proportionality and that the focus of repair must be on systemically important institutions, the depth of real commitment to these scattered references is difficult to gauge and, in some cases, distinctly questionable.

The proposed regulatory treatment of OTC derivative products, while commendable in many respects, is an example in point. It is true, of course, that the vast majority of the OTC derivatives markets – and is particularly true of commodity markets – had no part to play in causing the crisis and performed well throughout its duration. Nevertheless, it is generally accepted that there is a clear need for more effective regulatory oversight, more comprehensive trade reporting requirements and CCP clearing of standardised OTC derivatives. There is a real risk that this will go too far and the drive to use regulation (particularly in the area of capital) to "encourage" the use of standardised products and reshape the OTC market will (a) reduce the number of individually-tailored risk-management transactions available to end-users; and (b) increase the cost of those that are left to the point where risk management becomes uneconomic. Paradoxically, this means that the regulators themselves could be directly responsible for undermining the key post-crisis regulatory objective of enhancing the risk-management capability of institutions and organisations. As it was put in the FSA’s Discussion Paper “A Regulatory Response to the Global Banking Crisis” (DP09/2), “intervention by regulators explicitly designed to alter market structure needs to be taken with great caution” (para 10.50).

Of course, much will turn upon the definition of what is meant by a “standardised” OTC transaction and whether or not the new requirements covering non CCP cleared OTC transactions will be fair, proportionate and authentically risk-based. Already, there are growing “rumblings” from the corporate, insurance and commodity “buy-side” that the consequences of these changes will be to impair their ability to manage their underlying risks (many of which are not susceptible to being addressed through the use of standardised hedging instruments) and increase hedging costs. Others are concerned over what appears to be a “trade-off” by which the credit risk of an OTC transaction is reduced, at the cost of increasing basis risk and, further, that the consequential mismatch between an underlying risk and the use of a standardised CCP cleared risk management transaction will delay them the use of hedge accounting treatment.

Another possible by-product of regulatory repair is “spill-over” or the adoption of a “one size fits all” approach. For small and medium-sized firms or organisations, such as commodity trade houses, which pose low levels of risk to the financial system, the imposition of high-cost rules designed for systemically important institutions will have severe economic consequences and an adverse impact on their competitiveness. Assurances by the regulatory authorities that any such “spill-over” will be properly risk-based and accompanied by a
full market impact analysis offer some comfort, but, for example, the unregulated commodity affiliates of key banking groups will still come under much closer scrutiny and may even be subjected to “indirect” or “shadow” regulation. While the implications of this are not yet clear, the prospect of differentiated regulatory treatment of commodity affiliates which are part of banking groups and those which are either freestanding or part of non-banking group will have consequences for their competitiveness.

Aside from the threat of over-regulation of the OTC derivatives markets and the risk of a “one-size-fits-all” approach, there is now another threat to commodity market liquidity (both OTC and exchange traded), namely, the drive in the US to curb non-commercial participation in commodity markets through the use of position limits. While government concerns over the social and economic impact of severe increases in the price of consumer-sensitive commodities are understandable, blaming them on the activities of “speculators” is more populist than proven. Denying legitimate trading access to market participants in what are essentially free markets is a very serious step and is only justifiable on a properly evidenced basis. To date, the vast majority of independent reports have attributed energy price volatility to tensions in supply and demand and not to speculative trading activity.

Even more to the point, categorising all non-commercial trading as “ speculative” is both pejorative and incorrect. A high percentage of non-commercial trading activity in commodity markets is undertaken for financial investment, asset diversification or portfolio hedging purposes, reflecting the fact that commodity prices move at different times in the economic cycle to more traditional forms of investment such as equities. Nevertheless, it is clear from the “legislative language” for the proposed Over-The-Counter Derivatives Markets Act of 2009 released by the US Treasury and the related pronouncement by Gary Gensler, Chairman of the CFTC, that strict position limits will be imposed on non-commercial trading activities in commodity markets. While much will depend upon the detail and the related exemptions, reducing the role of financial traders in commodity markets carries the severe risk of (a) reducing liquidity; and (b) impairing the capacity of commodity markets to fulfil their risk management function. Moreover, the US authorities have stated that they will be looking to impose their position limits on an extraterritorial basis to prevent business migration and/or US regulatory avoidance – irrespective of the fact that the majority of non-US authorities have developed their own effective processes and methodologies for addressing unacceptable levels of speculative trading. There is also the risk that the much broader basis of setting position limits in the OTC markets, i.e. on contracts which “perform or affect a significant price discovery function with respect to a US regulated market” may be extended to exchange-traded contracts which currently need only apply US position limits to those contracts which are actually priced or settled off a US-regulated contract.

One of the key causes of the crisis was the fundamental mismatch between national regulation and global markets. In essence, the national regulatory authorities may have been geared up to deliver on their largely domestic public policy objectives, but were less able to address the impact on the financial system of globally-traded markets and products. The consequential crisis has demonstrated all too vividly the need, as it was put by the European Commission and the US SEC in their Joint Statement on Mutual Recognition in Securities Markets, signed by the EU Commission and the US SEC to “intensify work on a possible framework for EU-US mutual recognition for securities in 2008”. Resumption of the transatlantic open-market dialogue would be also wholly consistent with the consensus reached by the international standard-setting bodies and many of the national regulatory authorities that the crisis must not result in closed markets or protectionist regulation. Indeed, the post-crisis drive to establish common regulatory standards, enhance cross-border regulatory cooperation and develop improved structures for macro-prudential oversight provide a sound regulatory basis for not only progressing that dialogue, but extending it to include other jurisdictions.

Unfortunately and despite all these assumptions, the regulatory programme for repair is being based increasingly on protectionism, national solutions – exemplified by the US approach to position limits and the imposition of “do as we do” conditions to any form of recognition. In the EU, current examples include the Directive on Alternative Investment Fund Managers, the call for domestic clearing of Euro-denominated CDSs and the proposed regulatory structure for credit-rating agencies. In the US, this is matched by the intended extraterritorial application of US rules (with the approach to position limits being an example in point) and the assertion in the US Treasury White Paper that the US “leadership position in the international community” should be used to promote “initiatives compatible with the domestic regulatory reforms described in this report” and that “higher regulatory standards here in the US mean that we must ask the world to do the same”. In other words, the basis for regulatory recognition is moving away from the test of regulatory adequacy/commonality in standards and outcomes to regulatory sameness/equivalence. This is a regressive step which will not only entrench regulatory nationalism, but will make regulatory recognition that much more difficult to achieve.

CESR’s recently-issued Call for Evidence on Mutual Recognition demonstrates that there is at least one regulatory group – soon to become a new European Supervisory Authority – which is looking to progress the transatlantic dialogue (and extend it to other jurisdictions). Even so, the international standard-setting bodies, which have so decréd protectionist regulation, must take a much more proactive stance to ensure that it does not happen. The fact is that the bottom line to post-crisis repair is as much about accelerating economic business repair as it is about delivering on the agenda for regulatory repair – and what better time to develop commonly-accepted standards and regulatory outputs than when all the major regulatory authorities have recognised the need for regulatory change?

Reverting to the pre-crisis conclusions of CESB/CESR and the need for proportionate and authentically risk-based treatment of specialist commodity dealers, the inevitable question is will that consensus survive the reshaping of the OTC markets, the current protectionist mood, the drive to deliver tougher regulation and the risks of regulatory “spill-over” or the adoption of a “one-size-fits-all” approach (not to mention the Commission’s review of its market abuse regime, part of which is looking at how it applies to the commodity sector)?

In its recent Communication, “Ensuring Efficient, Safe and Sound Derivatives Markets: the future policy actions”, the European Commission recognises that derivatives play “a useful role in the economy” and, in their previous paper, recognised that, while the risks posed by the use of derivatives must be adequately covered by any new framework of more intensive regulation, this should not involve undermining their economic performance. The UK FSA in its Discussion Paper “A Regulatory Response to the Global Banking Crisis” has emphasised that the emergence of a sounder and more sustainable international banking system should be one “that engenders competition and will be capable of delivering the essential intermediation services that economies and consumers need”. The need to strike a sensible balance between, on the one hand, establishing a safer financial system and, on the other hand, sustaining market diversity and commercial competitiveness is clearly recognised – and that means adopting a proportionate, risk-based and differentiated regulatory treatment of organisations such as commodity trade houses, which do not pose high levels of systemic risk. But will these assurances be delivered “on the ground” or are they just “words on a page”? Markets are different for good business reasons and, even though regulatory differentiation adds unwanted complexity to the role of the regulatory authorities, the market reality is that “one size” most definitely does not fit all.