



because it has the potential to threaten what has hitherto been a secure flow of oil to consumers, by failing to allow the market to represent fundamentals through a freely determined open market price.

In practice what does this mean? Well, unsurprisingly the Americans seem to be getting it right on benchmarks, partly because they made their mistakes earlier in Dodd–Frank, and the CFTC have been trying to rectify some of these mistakes. The CFTC has also seen the unintended consequences on liquidity in financial markets, especially for US Treasuries, of restrictive legislation. The European Commission, as always, seems intent on making its own mistakes regardless of the impact on European citizens. It is noticeable that it is the elected European representatives, rather than doctrinaire officials, who are more concerned with the impact of bad regulation on people’s living standards. Much will now depend on whether the Europeans and the US authorities can create a workable third-country regime. If they don’t, it is likely to be European

companies and consumers that will suffer.

Record of industry success in maintaining supply

Keep in mind that there has been no market-induced breakdown in the supply of oil to the consumer in recent history, even during times of intense price volatility. This is a tribute to the industry, which has supplied oil to the consumer when production, transportation, and consumption have all been threatened by wars, political unrest, and misplaced policy. The industry has gained little public recognition for this. Ironically the biggest threat to the cost-efficient supply of oil to the European consumer now comes from a developing regulatory regime that was supposed to provide the consumer with protection.

It is feared that European regulation, however well-intentioned, is having and will continue to have consequences which are opposite to those envisioned by the policy makers. Liquidity will be reduced; transparency will decline;

volatility will increase; standardization of contracts will cease; physical commerce will remain off electronic platforms; and inherent risk will be injected into the market rather than removed.

Probable consequences of regulation

Oil will still flow from producer to consumer, but the direct costs of regulation and the consequential costs of carrying the new and implied risks will be borne by the consumer. Hopefully, for the consumer, the fall in the price of oil will to some extent offset these additional costs of regulation.

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‘WHEN POLICY MAKERS INTERVENE IN THE WORKINGS OF A FREE MARKET, THE EFFECT IS INVERSELY PROPORTIONAL TO THE INTENT.’
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The basic rule of much regulation continues to true, especially when applied to global trade: when policy makers intervene in the workings of a free market, the effect is inversely proportional to the intent.



OTC derivatives market regulation and commodity derivatives

Orçun Kaya

In the wake of the financial turmoil, over-the-counter (OTC) derivatives have become the focus of attention. Indeed, the market size is gargantuan with a notional volume of USD 630 trillion, and it dwarfs the exchange-traded derivatives that have a notional volume of only USD 65 trillion. To date, a significant part of OTC derivatives trades has been handled by a small number of dealers that are the main counterparties of practically all other market participants. In the eyes of regulators and policy makers, the OTC derivatives’

market size, interconnectedness, limited transparency regarding the counterparty exposures, and market participants’ insufficient risk management practices have intensified the impact of the financial crisis and thus are potential sources of heightened volatility and systemic risks. Against this background, the G20 leaders agreed at their Pittsburgh meeting in 2009 to undertake reforms, intending to increase transparency and reduce counterparty risk in the OTC derivatives markets.

Early commitment, lengthy implementation

The main pillars of the derivatives market reforms are that:

- 1 all derivatives trades should be reported to trade repositories,
- 2 standardized OTC derivatives should be centrally cleared and traded on organized venues, and
- 3 non-cleared derivatives should be subject to higher margining requirements.

The Dodd–Frank Act in the USA, the European Market Infrastructure

Regulation (EMIR), and the Markets in Financial Instruments Directive (MiFID) in Europe are the main bodies of legislation for OTC derivatives reporting, central clearing, and exchange-trading rules. The initial implementation deadline was set by the G20 for the end of 2012; however, it was not met by any of the jurisdictions. Almost three years after the targeted deadline, rule making and implementation of those rules have been finalized only in the USA, and this only recently. Meanwhile, cross-border rules and margin requirements for non-cleared derivatives are expected to be finalized by the end of 2015. Europe lags even further behind, and reporting requirements did not start before 2014. The clearing obligation is expected to take effect in 2016. Equivalence determinations have been progressing slowly also in Europe. Since the lion's share of derivatives trades takes place either in the USA or in Europe, other jurisdictions are waiting for the USA and the EU to clarify their regulations and cross-border agreements. For this reason, rule making has just begun in several jurisdictions and progress varies across regions.

Global implementation of these new rules is already far behind the planned timetable. The uncertainty regarding the schedule is of concern for market players and may lead to regulatory arbitrage. An even more important point for market participants is the mutual recognition of central clearing rules, especially between the USA and the EU. Little progress has been achieved on this front so far. This may result in double application of clearing and margining requirements, thereby causing prohibitively high derivatives trading costs.

Large exchange-trading volume for commodity derivatives

OTC derivatives markets are particularly relevant for the commodity derivatives

segment due to the tailored structure of these contracts. In a nutshell, end-users of commodity derivatives aim to hedge their exposures to price changes of the underlying raw materials such as crude oil, natural gas, precious metals as well as agricultural commodities and livestock. As derivatives market regulation has been tightened up in recent years, commodity derivatives have experienced severe regulatory treatment too. Both Dodd–Frank and EMIR requirements such as central clearing, mandatory reporting, and higher capital charges for non-cleared derivatives apply to commodity derivatives. That said, in both jurisdictions there are exemptions for certain products, such as physically settled commodity swaps or forwards, and counterparties. There is broad usage of commodity derivatives and trading takes place on both organized exchanges and on OTC markets. Before the crisis, OTC commodity derivatives transactions expanded exponentially and outstanding notional amounts jumped from USD 598 billion in 2000 to USD 13,299 billion in 2008.

‘AMONG THE OTC DERIVATIVES TRADED, THE COMMODITY DERIVATIVES MARKET SHARE IS ALMOST NEGLIGIBLE ...’

With the outbreak of the crisis, this trend reversed and outstanding amounts dropped steadily to USD 1,868 billion in 2014. Among the OTC derivatives traded, the commodity derivatives market share is almost negligible and stands at around 0.3 per cent of the outstanding notional amounts. That said, notional amounts are largely inflated, so this means they could be somewhat misleading indicators of economic relevancy. Put differently, counterparties are seldom required to pay out the full value of some derivatives in the OTC landscape; for example, interest rate swaps have huge face values but they are hardly

ever actually exchanged between contracting parties. The exchange-traded commodity derivatives in this vein present an integral picture for the use of commodity derivatives in financial markets. Up from 1.2 billion in 2012 and 3.1 billion in 2013, almost 3.6 billion commodity contracts were traded on exchanges in 2014. This corresponds to around 17 per cent of the total exchange-traded derivatives, which is certainly a significant share.

Exchange trading of commodity derivatives has become widespread in recent years and a divergence between OTC versus exchange-trading volumes is evident. Regulatory pressure to encourage trading on exchange platforms seems to have created some impetus for greater use of these platforms. The high degree of exchange trading of commodity derivatives may also point to an increasing role of institutional investors in this market segment. A large degree of standardization and financialization of commodity derivatives, in particular, would make reporting requirements to trade repositories easier for these products.

Standardization alone is not enough for clearing eligibility

Among the agreed reforms, the mandatory central clearing of OTC derivatives by central clearing counterparties (CCPs) is a drastic change that forces market participants to revise their existing risk management and collateralization practices. To achieve more transparent, efficient, and robust derivatives trading, CCPs interpose themselves between the trading counterparties and become a buyer to every seller and a seller to every buyer in a derivatives trade. Meanwhile, to maintain their soundness, CCPs have stricter collateralization standards than bilateral trades, such as higher initial margin



requirements and more frequent variation calls, as well as contributions to CCPs' default funds (waterfall of resources).

In recent years there has been a significant move from bilateral non-cleared trades to CCPs for certain asset classes. In 2015, for example, around 48 per cent of interest rate swaps have been centrally cleared by the CCPs, up from 34 per cent in 2011. Similarly, a remarkable 21 per cent of credit default swaps have been centrally cleared, up from 11 per cent in 2011. However, central clearing of commodity derivatives has been very limited to date. This is probably due to bespoke features of commodity derivatives and their liquidity characteristics. Expressed differently, the recent uptick in exchange trading may point to the adaption of some commodity derivatives to the standard definitions and confirmation agreements. Standardization of the derivatives contracts is a prerequisite for central clearing eligibility, yet it is certainly not the only criterion. For central clearing eligibility, liquidity and associated efficient pricing are a *sine qua non* that needs detailed elaboration.

Liquidity creates a bottleneck for central clearing

One of the key determinants of a CCP clearing decision is the degree of liquidity. Indeed, in case of a counterparty default, liquidity characteristics of derivatives are crucial for CCPs to manage the portfolio of the defaulting clearing member in a timely and efficient manner. As a result, CCPs primarily accept liquid derivatives that are less volatile and have relatively robust reference entity characteristics for central clearing. The number of trades in commodity derivatives sub-segments sheds some light on the liquidity characteristics of these assets. In 2014, almost one-third

of the commodity derivatives traded on exchanges were agriculture derivatives. Energy and non-precious metals derivatives constitute 28 per cent and 21 per cent of the trades, respectively. Other sub-segments of commodity derivatives, such as precious metals and other materials, have relatively few transactions. These are usually tailored products that are designed to meet the specific needs of counterparties and as a result are traded much less. Due to their lack of liquidity, CCPs will be less likely to offer clearing services for these products. This implies that a large proportion of the bespoke commodity derivatives will remain non-cleared as there will be no clearing house ready and willing to clear them.

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In order to promote central clearing and to ensure that sufficient collateral is collected, policy makers imposed substantially higher margin requirements and additional capital charges for non-centrally cleared derivatives trades. To define the cornerstones of the additional measures, the BCBS-IOSCO (Basel Committee on Banking Supervision and the International Organization of Securities Commissions) has released a framework and set the initial margin requirements for non-centrally cleared commodity derivatives to 15 per cent of the notional exposure. After the full implementation of the reforms it is likely that the trading of particular commodity derivatives will be prohibitively expensive and they might be unattractive at the free-market price. In this respect, market participants using these instruments for hedging purposes may need to revise their practices and business models.

Cost of central clearing will probably be passed on to end-users

Before the crisis, longstanding trading relationships of counterparties with high creditworthiness allowed flexibility for bilateral derivatives trades. By contrast, CCPs have strict rules on initial and variation margin requirements and offer much less flexibility to negotiate. As a result, the cost of derivatives trading will significantly increase for the centrally cleared products. In the eyes of some observers, the additional costs will eventually be passed on to the end-users (buy-side clients) of derivatives contracts. In short, there are three different types of transactions in derivatives markets. The first type of transaction takes place between two dealers that trade for market making and liquidity. These types of trades are probably the least of concern for regulators. The second type of transaction occurs between a dealer and a financial end-user such as a pension fund, insurance corporation, or asset manager that is trying to hedge for risk in their portfolios. The third type of trade takes place between a dealer and a non-financial end-user that aims to reduce balance-sheet volatility, eliminate uncertainty in their cash flows, and mitigate risk for their future investment plans. The last two types that try to hedge their business risks are of particular concern for the policy makers.

Figures from ISDA (the International Swaps and Derivatives Association) may help to delve deeper into the composition of traders in the OTC landscape. In 2013, around 16 per cent of the derivatives trades took place between two dealers, down from 28 per cent in 2012. A striking 80 per cent of the transactions meanwhile are between a dealer and a financial institution, and around 3 per cent are between a dealer and a non-financial end-user. If the cost of central clearing is passed on to financial and non-

financial end-users via higher spreads etc., this could have implications for the real economy. Expressed differently, the heightened hedging costs of financial and non-financial firms may lead to unhedged positions and thereby more volatile balance sheets and subdued investment levels.

Uncertainty regarding the hedging criteria in Europe

Taking into account the potential side effects of the new regulatory reforms on the real economy, regulators on both sides of the Atlantic have introduced central clearing exemptions for non-financial counterparties (NFCs) that engage in derivatives transactions to hedge or mitigate commercial risk. For example, NFCs are not subject to the mandatory central clearing requirement under EMIR on the

condition that notional amounts of their derivatives trades are below certain thresholds. Notwithstanding, the European Securities and Markets Authority (ESMA) has recently released a report recommending the removal of the hedging criteria for NFCs. The background reason is to simplify NFC definition along with the fact that hedging may not be the most relevant criterion in determining the systemic relevance of NFCs. However, the exemptions for NFCs that hedge a commercial risk are particularly important for the commodity derivatives segment, considering that NFCs are vital and important market participants. More specifically, another report from ESMA shows that among different OTC derivatives the share of the NFCs is the largest in commodity derivatives: they account for one-fifth of the gross notional amounts traded. Of these,

80 per cent are below the threshold defined by EMIR. In this light, changes in the hedging criteria as recently recommended may have negative consequences for NFCs that trade commodity derivatives.

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'... THE NEW RULES AND REGULATIONS WILL FUNDAMENTALLY CHANGE THE DERIVATIVES MARKETS ...'

All in all, the new rules and regulations will fundamentally change the derivatives markets after their full implementation. It remains to be seen to what extent they will affect the pricing, liquidity, and trading of commodity derivatives.

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MiFID II: the impact on commodity markets from a venue perspective

Ben Pott and Graham Francis

Commodity derivative markets have been a cornerstone of modern financial services since the Big Bang in 1986. The ability of end-users to hedge their commodity exposures and anticipate price movements has ultimately had a stabilizing effect on end-user prices and, together with deepening liquidity in these markets, has led to tighter bid-offer spreads, again leading to reduced costs for the end-users. This link between end-users and financial trading is perhaps unique in financial markets. It means that changes to the trading landscape can have direct consequences on the price at the pump, or on the household energy bill at the end of the month.

However, commodity markets – like any other financial market – have not been

immune to the effects of the 2008 crisis. Over-extension and a speculative bubble have led to market participants' failure, with knock-on consequences for investors. Whereas other markets have experienced a withdrawal of liquidity as banks had to rein in their trading books, the commodity sector has seen a more dramatic change in participation – away from the traditional broker dealer banks towards trading houses, often based outside of the European Union perimeter.

However, commodity markets today are still experiencing the turmoil of the post-

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crisis regulatory reform programme. Whereas bank reform has changed the face of participation, it is market-specific reform – Market in Financial Instruments Directive (MiFID) II – which will have a more profound impact on the intermediated commodity markets. This paper sets out not just the future challenges faced by participants but also focuses specifically on the reorganization and reshaping that is required by these intermediaries – today's brokers and trading venues.

Background

MiFID II will be a key milestone in commodities trading markets. The requirements to trade on venues (trading obligation), together with the organizational requirements on