ESRB response to ESMA's Final Report on Emergency measures on collateral requirements, including draft RTS amending Commission Delegated Regulation (RTS) 153/2013

The recent political and market developments have led to significant increases in prices and volatility on commodity markets – with electricity and natural gas derivatives markets particularly affected[1] – which have caused CCPs to substantially raise margins to cover the related exposures. These higher margins have strained the liquidity of non-financial counterparties (NFCs), which typically have fewer and less-liquid assets to meet margin requirements, forcing some of them to either reduce their positions or leave them underhedged and exposed to further price fluctuations.

Following a request from the European Commission for ESMA to consider (temporarily) broadening the list of eligible collateral to alleviate some of the burden faced by NFCs and as a follow-up of ESMA's first response[2], ESMA is proposing amendments to the Regulatory Technical Standards (RTS) specifying provisions for eligible collateral.

The ESRB needs to be consulted on changes to the RTS on eligible collateral.[3].On 7 October, it received a request from ESMA to provide comments on the proposed amendments to the RTS by 12 October. The ESRB appreciates that, given the urgent need to find a solution for the liquidity pressure some market participants are experiencing, a fast-track approval process is warranted. However, in view of the need to consult the General Board in this context, the ESRB will only be able to provide feedback on this issue by noon on Friday, 14 October.

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[1] Different energy products have different prices, but collateral is posted at the portfolio level. This means that we cannot distinguish between collateral posted for natural-gas exposures and collateral posted for other type of products.

[2] **ESMA Response regarding the current level of margins and of excessive volatility in energy derivatives markets.**

[3] EMIR mandates ESMA – after consulting the EBA, the ESRB and the ESCB – to specify, via regulatory technical standards, "(a) the type of collateral that could be considered highly liquid, such as cash, gold, government and high-quality corporate bonds and covered bonds; (b) the haircuts…; and (c) the conditions under which commercial bank guarantees may be accepted as collateral…". The regulatory technical standards are contained in Commission Delegated Regulation (EU) No 153/2013.

Proposed amendments

Amending the RTS to extend the list of eligible collateral

ESMA proposes to extend the list of eligible collateral to uncollateralised bank guarantees for NFCs acting as clearing members and engaging in energy derivative transactions, and to public guarantees for financial and non-financial counterparties.[4] Th e ESRB believes that this extension should be temporary, limited to 12 months. It is noted that the extension of the list of CCP-eligible collateral primarily concerns initial margin, although the ESRB is of the opinion that high levels of variation margin have also contributed to the recent liquidity strains. ESMA is aware that a shorter period of authorisation risks limiting the potential impact of this change. At the same time, ESMA is of the opinion that a longer period would undermine the temporary and extraordinary nature of the change.

Additional Q&A on the eligibility of bonds and commercial papers

ESMA also puts forward an additional Q&A that clarifies the eligibility of bonds and commercial papers as collateral accepted by EU CCPs under Article 46 of EMIR and under which conditions these instruments would be acceptable. Regarding the Commission’s request to consider a potential expansion of the list of eligible collateral for the specific cases of bonds and commercial papers, ESMA concluded that the RTS need no amendments. Instead, but proposed to provide Q&A to clarify the application and implementation of Article 46 of EMIR as further specified in the RTS for such instruments. ESMA is updating its Q&A under EMIR in parallel to that effect.

ESRB analysis

Introduction

The EMIR data show that, in 2022, the biggest margin calls faced by EU NFCs acting as both clearing members and clients have related to their exposures to energy and commodity derivatives (Chart 1, panel a). The initial margin posted by EU NFCs peaked around the end of August 2022, exceeding the March 2022 level by around €10 billion. In particular, the volatility in energy futures has heavily impacted the portfolios of utilities and energy companies, which have paid the bulk of the total initial margin posted by EU NFCs for commodity and energy derivative exposures (Chart 1, panel b).

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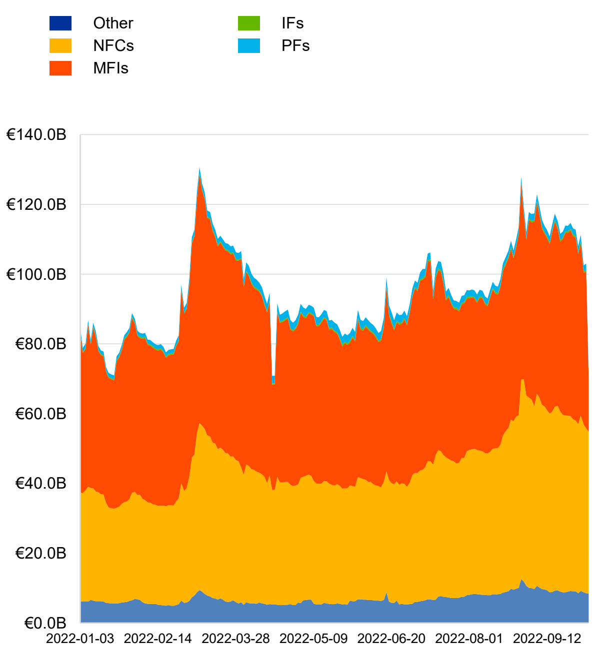
4 More precisely, ESMA proposes that (i) uncollateralised bank guarantees for NFCs will be subject to strict prudential requirements (including concentration limits) and may only be accepted for the clearing of energy derivatives, and (ii) public guarantees be temporarily accepted as collateral in general (for both financial and non-financial counterparties and for all cleared asset classes). It should be noted that the benefits of central clearing depend on the types of market being served and the advantages for financial stability are generally most relevant for markets with financial counterparties.

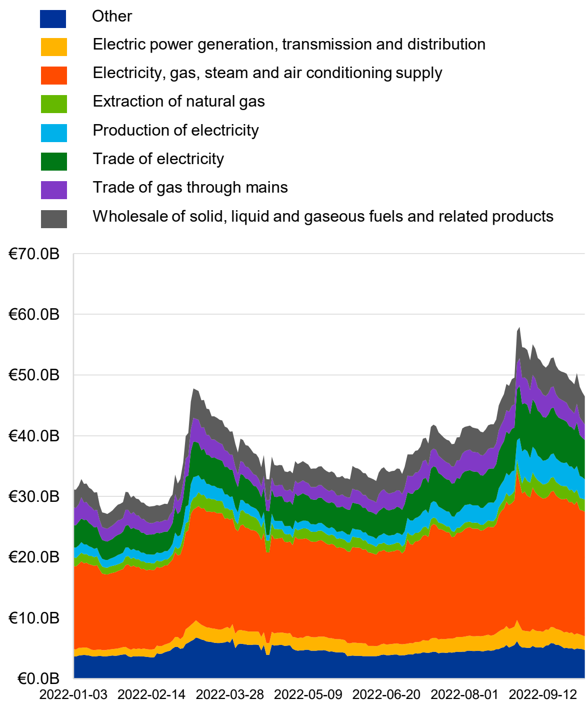
Chart 1

a) Net initial margin paid by EU entities for energy and commodity derivatives, by sector
(EUR billions, 2022)



Source: EMIR database.
Notes: NFCs stands for non-financial corporations; MFIs stands for monetary financial institutions; IFs stands for investment funds; PFs stands for pension funds. The latest observations are for 4 October 2022.

b) Net initial margin paid by EU NFCs for energy and commodity derivatives, by NACE code
(EUR billions, 2022)



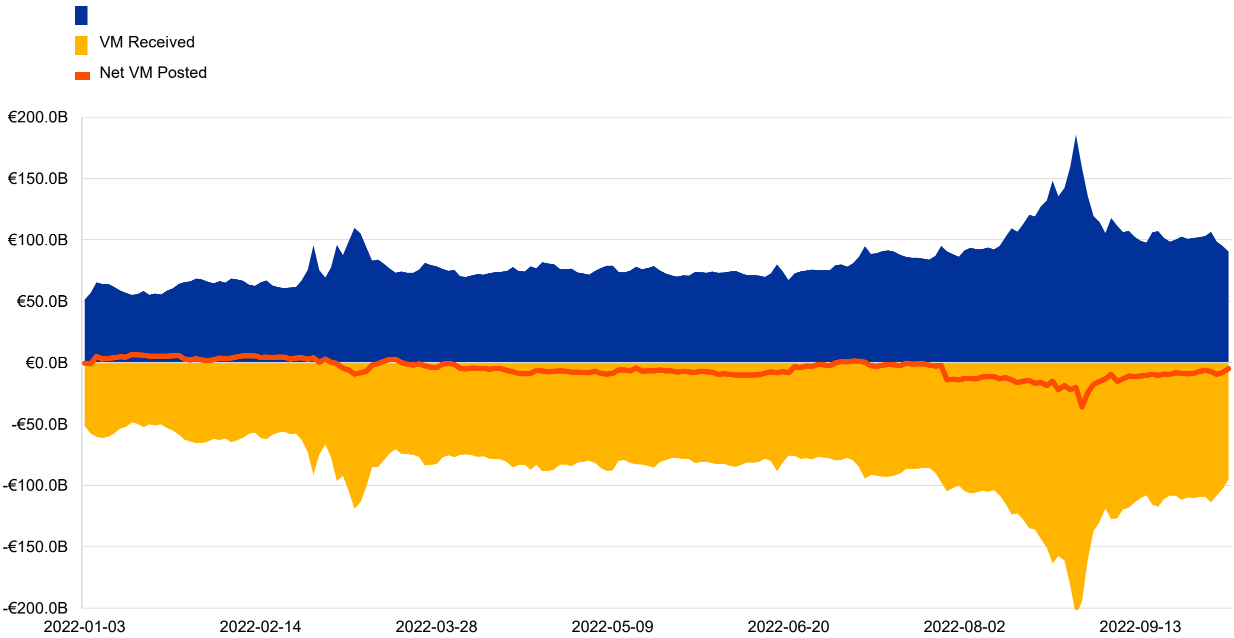
Source: EMIR database.

Note: The latest observations are for 4 October 2022.

Although the measures proposed by ESMA would alleviate the collateral concerns primarily for initial margins – as variation margin is still mainly met in cash – the ESRB feels that an analysis of the developments in variation margin also illustrates the liquidity strains that NFCs are experiencing. Unsurprisingly, EU NFCs registered the highest value of gross variation margin exchanged (for energy and commodity derivative portfolios) as well at the end of August. The variation margin (VM) posted significantly tapered down in September, driven mainly by a reduction in the price of electricity and natural gas futures (Chart 2). The net VM posted by EU NFCs is negative in aggregate, meaning that in-the-money positions exceed out-of-the-money positions. Nevertheless, companies that have used short positions on natural gas and/or electricity are facing significant negative VMs on their portfolios and substantial liquidity needs. Short positions are commonly used by utilities and energy companies to hedge their commercial activities with a view to protecting themselves from falling prices for products for future delivery.

Chart 2
Variation margin posted and received by EU NFCs for energy and commodity derivatives

(EUR billions, 2022)



Source: EMIR data

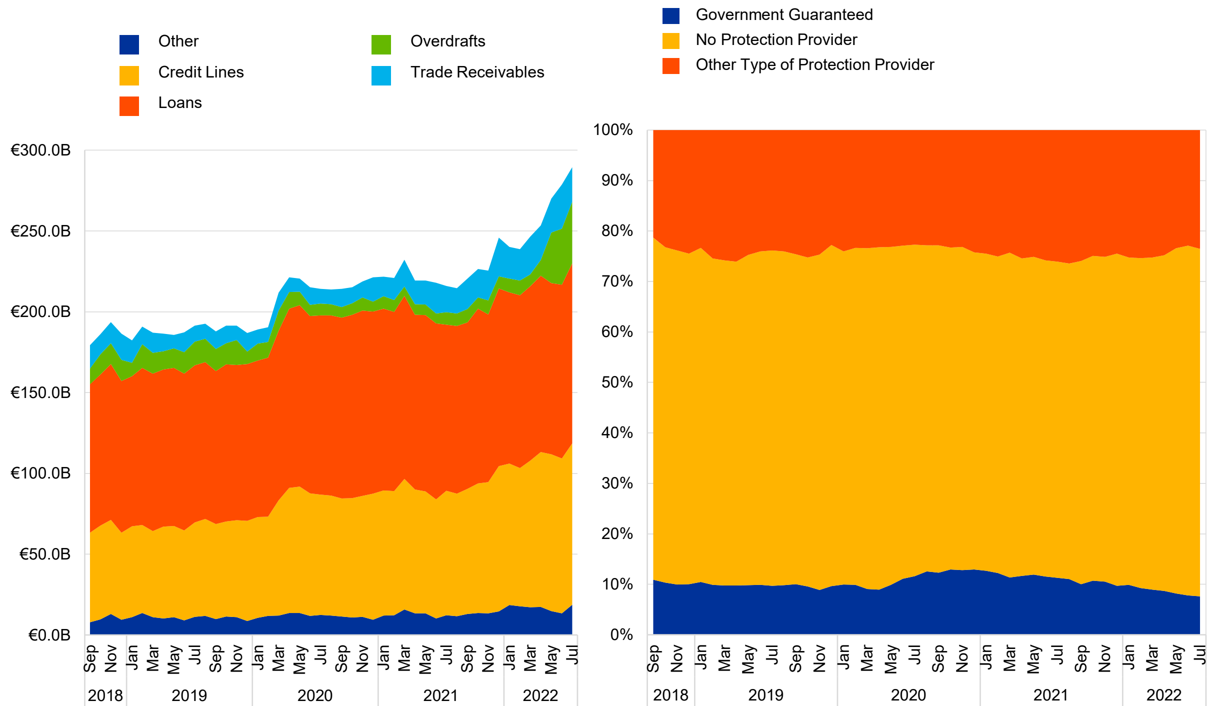
Note: The latest observations are for 4 October 2022.

Credit demand from NFCs active in the energy market

In the first seven months of 2022, EU NFCs with energy derivative exposures have increased the amount of credit drawn from euro area banks by around 20% (€45 billion, Chart 3, panel a). This credit might have been used to fund hedging transactions or possibly, at least by some entities, to (highly leveraged) speculate on further price fluctuations. The uncertainty around this warrants deeper analysis and the ESRB Secretariat could investigate this issue in more detail in liaison with ACER. Furthermore, this also suggests that targeted temporary measures would need to be calibrated with caution. According to AnaCredit data, the increased credit has been extended mainly via uncollateralised credit lines and overdrafts. In the most recent period,[5] some euro area banks have reported reaching their risk-appetite limit for exposure to EU NFCs active in the derivatives market. The growth of uncollateralised lending to EU NFCs is therefore expected to slow down. On the other hand, governments might increase public guarantees on NFC loans in the near future. This would increase the share of government-guaranteed credit that, as of July 2022, constituted less than 10% of the total (Chart 3, panel b).

Chart 3
a) Credit extended by euro area banks to EU NFCs active in the energy and commodity derivatives markets, by instrument type
(EUR billions)

b) Share of government-guaranteed credit extended to EU NFCs by euro area banks
(percentages)



Source: AnaCredit.
Note: The latest observations are for 31 July 2022.

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Considerations

In general, the ESRB agrees with the cautious approach taken by ESMA and welcomes the temporary, targeted nature of the changes proposed. The ESRB would like to highlight that the current liquidity pressure that some market participants are experiencing is predominantly the result of geopolitical developments and that

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5 See para. 25 of the **EBA response to the European Commission on the current level of margins and of excessive volatility in energy derivatives markets.**

the regulatory framework is not the cause of these problems. ESMA should therefore be very cautious in making changes to regulatory provisions, in particular in order not to unduly transfer risk from the real economy to the financial sector. It should also be considered that the temporary expansion of eligible collateral could possibly raise expectations and trigger pressures from market participants to further water down prudential requirements for CCPs, either by making the proposed measure permanent or by consequently questioning the need to collateralise bank exposures in general. Furthermore, the ESRB notes that since all exposures of banks acting as clearing members towards CCPs must be collateralised, allowing uncollateralised guarantees issued by those same banks as collateral to be posted by NFCs, even if subject to the conditions mentioned by ESMA in the draft EMIR RTS, would make the EMIR risk framework inconsistent.

From a systemic risk perspective, the ESRB supports the temporary expansion of CCP-eligible collateral to include public guarantees issued by EEA public entities or multilateral development banks, as this may increase the ability and willingness of banks to provide liquidity to non-financial counterparties without materially transferring risk from the real economy to banks or CCPs; the ESRB would, however, like to express some reservations with respect to uncollateralised bank guarantees. The ESRB notes the constraints faced by clearing members in light of the CRR and clearing members' internal risk appetite frameworks, and in addition to the potential negative spillover effects for CCPs' risk management (increased wrong-way risk). In this context, the effectiveness of this measure might be limited and hence the acceptance of uncollateralised commercial bank guarantees for NFCs may be reconsidered or should at least be carefully monitored by NCAs as ESMA proposed. The ESRB calls upon ESMA to properly consider the risk implications of expanding eligible collateral to uncollateralised bank guarantees and weigh them against the actual effectiveness of this measure, given the fact that these emergency measures, albeit targeted and strictly temporary, are watering down prudential requirements for CCPs.

In addition to this, the ESRB would like to highlight that current liquidity strains might also be caused by the add-ons that clients, such as NFCs participating indirectly in CCPs, need to pay to their clearing members. The ESRB appreciates that banks may want to overcollateralise and that this may be justified under their own assessment of a client's risk profile or their own ability to fund margin calls on behalf of the client. Taking this into account, but at the same time looking at the macro considerations in this context, a set of different measures could be considered to alleviate the situation for affected market participants. In this vein, broadening the collateral base that CCPs accept from non-financial clearing members might not be the most appropriate response.

Also, as ESMA rightly states, under the amended RTS, CCPs would need to update their risk management framework to accept the newly admitted types of collateral, upon decision of their board and after consulting their risk committee and involving the relevant authorities. These processes, especially the latter, might take a considerable amount of time unless an "emergency" procedure is followed, delaying the effectiveness of these temporary measures.[6] It would be preferable, and consistent with the urgency of this emergency measure, to implement these changes as soon as possible, without curtailing the robustness of the supervisory process foreseen under EMIR, however. Such a robust supervisory process is crucial to ensure a prudent, harmonised outcome, in particular in view of the new type of collateral showing specific risk characteristics.

In addition to this, CCPs would not be obliged to make these changes, so the success of these measures depends to a large extent on the cooperation of CCPs and their NCAs. Should CCPs decide to introduce changes to their risk management frameworks, it is important that (i) such changes include proper concentration limits to help mitigate the risk of a default or downgrade of the guarantee issuer, and (ii) for uncollateralised bank guarantees, appropriate caps are set limiting the share of this type of collateral in the total amount of the initial margin required from the non-financial clearing member and in line with the CCPs' risk profiles.

To avoid CCPs becoming excessively exposed to critical NFC members or guarantors, some adjustments should be made in order to address the systemic risk concerns that could arise from the degree of flexibility with regard to the CCPs' collateral policies and more particularly the uncollateralised bank guarantees. Regarding uncollateralised bank guarantees, among other things ESMA could consider (i) a quantitative limit by member, and (ii) a quantitative limit on total collateral accepted by the CCP in the relevant business line. For public guarantees, it might be advisable to restrict the scope to energy markets, as there is no strong reason to provide such support for other cleared markets at this stage and being too proactive in this regard could raise moral hazard issues from implicit public support.

Finally, the ESRB is of the opinion that it might be more appropriate and timely to use special intervention measures such as targeted state support to individual troubled entities (provided that the analysis of their business model justifies such support), given the nature of the problems, and in particular the fact that most losses for EU NFCs' derivative portfolios come from the short electricity derivatives positions which are extremely concentrated (with the top three entities making up approximately 45% of the aggregate short positions in EU NFC electricity futures as of October 2022), rather than broadening the collateral base of CCPs to respond to this crisis. This would also be more efficient than having public guarantees for commercial bank credit lines, which might be challenging from a legal point of view and potentially not feasible within an acceptable time frame in times of liquidity stress. Such tools may be more effective in alleviating exceptional liquidity stresses of energy companies than allowing uncollateralised bank guarantees as CCP-eligible collateral with considerable risk implications. Of course, any provision concerning the extension of state aid within the single market should be observed, to avoid distortions in competition.

The ESRB has no comments on the Q&A on the eligibility of bonds and commercial paper and welcomes the clarification the new Q&A provides.

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[6] ESMA could evaluate if a Q/A would be useful to clarify this point.

Conclusion

The ESRB is of the opinion that the proposed amendments to the RTS, in particular with respect to public guarantees, could alleviate the liquidity stress of targeted NFCs in these extreme circumstances and hence yield some financial stability benefits. It would like to reiterate, however, that such changes could lead to a situation where risks in the real economy are unduly and to an inappropriate extent transferred to the financial sector. To address this, government guarantees on banks' NFC loans can be used as a mean to sustain credit supply to NFCs' derivative exposures in a situation of higher margin calls, while at the same time limiting the transfer of risk to the financial sector. The acceptance of uncollateralised bank guarantees should not be a first choice and, if allowed, should only be acceptable under a very limited scope and time frame. The ESRB would also like to emphasize that the current market developments and volatility, and the ensuing liquidity pressure, are largely the result of exogenous factors such as geopolitical tensions and adverse climate developments.

In this light, the ESRB would like to stress that any amendments to the RTS must be strictly of a temporary and targeted nature, and that any changes to CCPs' risk management frameworks should be accompanied by relevant safeguards.

From a broader, medium-term perspective, the ESRB concurs with ESMA's statement in its letter to the EU Commission, in that beyond these temporary and "emergency" measures, it is worth assessing the broader implications of the recent market developments in commodity and energy markets for CCPs' risk management and whether there is room for structural improvement of the current requirements, to better adapt them to the specificities of these markets (e.g. antiprocyclicality measures, increasing transparency and predictability of margin requirements from clearing members to clients, etc.). The ESRB stands ready to cooperate on such analyses and provide a macroprudential perspective.