What have ESMA[1] has missed regarding commodity companies?

di Murad Harasheh*

In light of the course of the proposed European financial reforms, MiFID II package[2] is designed to widen the definition of financial commodity derivatives to include all commodity derivatives traded on trading platforms, regulated market (RM), Multilateral trading Facility (MTF), Organized Trading Facility (OTF), and the economically equivalent Over-The-Counter (OTC) derivatives, with some exception are grated for energy contracts related to electricity and natural gas traded on OTF that *"must be physically settled"*.

Besides enhancing transparency, safety, and investors' protection as broad goals of MiFID II package, controlling risk spill-over is another motive by capturing commodity companies that trade commodity derivatives for purposes other than hedging or regulatory needs. From ESMA's point of view and after the financial turmoil that hit some European countries in 2011, commodity companies' trading exceeding a certain level can be considered speculation and may aggravate a risk spill-over caused by their contribution to systemic risk.

From a theoretical stand point, ESMA's conception can be true insomuch as companies' participation in commodity derivative trading is material and is proven to be made for speculative purposes. However, the lack of empirical testing for this argument and given that the official reports published by ESMA indicate that their share of total trading is about 2%[3], this makes the strategy by ESMA towards commodity companies to be perceived as overreaction. It is also argued by many practitioners and market participant that the costs of the strategy will not be negligible *(many argue of some expected drawback such as, liquidity decline, cost of hedging increase, big data problem and so on …)*.

In this regard, the spill-over by commodity companies *(or at least energy companies)* is limited since energy companies are now vertically un-bundled and their share of total trading in commodity derivatives is limited.

But, in this picture, what the regulator is neglecting?

To answer directly, the regulator is neglecting the other channel through which commodity companies may impact financial markets. To clarify, let's consider the basic balance sheet for an energy company.

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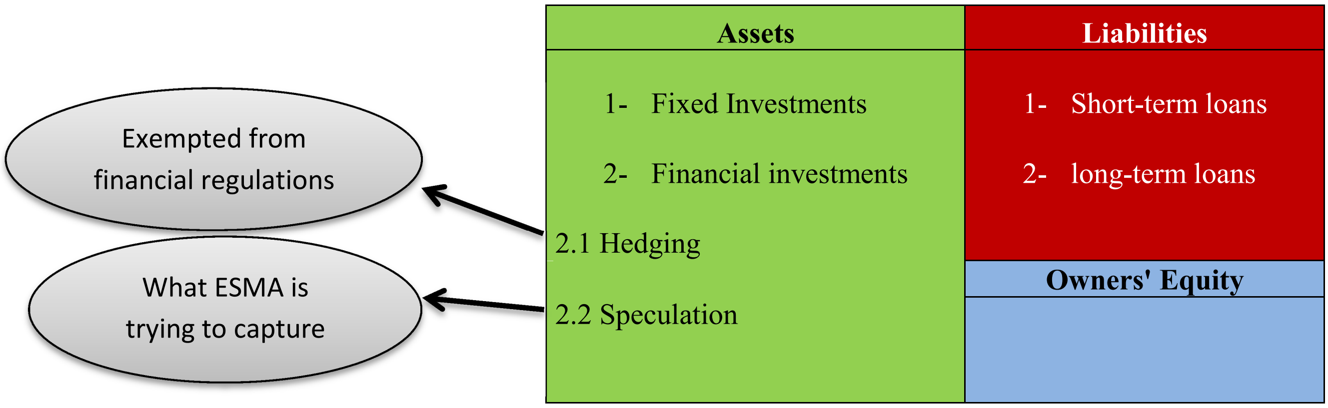
[1] European Securities and Market Authority

[2] Includes MiFID II: Markets in Financial Instruments Directive (2014/65/EU) and EMIR: European Market Infrastructures Regulation (Regulation (EU) 648/2012)

[3] EMIR Preview Report: 13 August 2015 | ESMA/2015/1251



The channel that EMSA is following now passes by the left hand side of the balance sheet; means through the investment side. However, what seems to me is ignored is the liability channel through bank loans; means through the banking system rather than directly through investment markets. In this regard, we focus on the systemic risk of debt side than of the investment side.

Now, let's highlight some differences between the left and the right channels of the balance sheet.

1- Investments (hedging or speculation) uses margin requirements as a prerequisite for entering into a financial investment deal; means that to hedge or speculate € 1 million, the trader needs just to invest maximum of 10% of the position value (€100.000) and the counterparty is, in this sense, protected by the cash margin *(position losses can't exceed €100.000)*.
2- Whereas the liability channel is 100% financing; means that the energy company borrows € 1 million and must repay the total amount plus some interest return, and the counterparty is in this case 100% exposed to the default risk of the borrower. Even though the lending bank securitizes the loan portfolio, this does not eliminate the risk, it is just transferring of the risk from the banking system to the financial market *(bond market)*.

In this sense, I can argue that in all cases the right hand channel seems to be stronger in systemic risk share. And the above scheme is supported by the shocking data released by big American and European banks revealing the huge size of loans granted to energy companies and many of these are facing the risk of default after the oil and natural gas price drops. To give a glimpse on this, reports reveal that $123 billion[4] is the US banks' loan portfolio to energy sector, EU banks are also engaged in such huge amounts that exceed $100 billion[5] and in both areas significant portions of these loans are unfunded which makes the default risk to rise to alerting levels. In the same vein, European banks facing exposure in excess of $100 billion to energy sector loans may need to sell assets to protect against future losses. As a consequence, European banks are under pressure because they have to continually raise capital ratios in order to offset troubled loans.

[4] http://www.bloomberg.com/
[5] http://www.wsj.com/ and http://www.cnbc.com/

To conclude, the financial regulator have been devoting resources including time and money to control the investment channel while did not give any attention to the debt channel in inducing a crisis. I think the balance sheet of the energy sector are going unbalanced and the regulator needs to intervene with the appropriate action before the deformed expected outcome becomes true.