FIA, ISDA AND AFME POSITION ON THE EUROPEAN COMISSION MARKET CORRECTION MECHANISM PROPOSAL

7 DECEMBER 2022

FIA, ISDA and AFME (together "the Associations") welcome and support the European Commission ("Commission") initiatives to address the current energy crisis and consider the broadening of eligible collateral and the increase of the commodity clearing threshold as reasonable first steps to ensure financial stability providing Central Counterparties ("CCPs"), Clearing Members ("CMs") and their clients with appropriate means to manage their liquidity resources.

We share the Commission's concerns of the social and economic effects on consumers and enterprises related to the current high gas prices and support appropriate tools and interventions to cushion such effects. However, the Associations would like to express their deepest concerns regarding the "market correction mechanism" proposal that aims to cap the Dutch TTF front month future contract price as adopted by the Commission on 22 November 2022 including the compromised text extending the scope to other delivery months, reducing the trading price cap and trigger conditions.

This letter reflects the Associations' views regarding the detrimental implications of such measures to financial stability and the functioning of safe, efficient and liquid markets. Furthermore, the proposal could severely impact security of gas supply at a critical moment for citizens and businesses, which is contrary to the EU's intended objective of ensuring sufficient gas supplies at adequate prices. The level of interdependence within the commodity markets is significant between cleared and non-cleared products, exchange traded , OTC derivatives and physical markets to create a balanced financial ecosystem. The proposal will impose a significant structural change in a targeted element of the commodity market and will have detrimental ripple effects causing serious unintended consequences. In addition, such fundamental change requires an extended period of testing and a comprehensive industry wide risk assessment, also including the delivery process, to assess the full impact, risks and possible benefits. Given the short notice implementation during the holiday period, the lack of industry impact assessment, the increased risks to the European gas market liquidity, transparency and integrity and the serious risk management implications, this proposal introduces unacceptable levels of systemic and operational risk for the entire industry threatening financial stability.

The Associations urge policymakers to revisit the proposal and exclude any price cap on the wholesale gas market, and focus instead on securing supply, reducing demand, supporting the liquidity needs of energy firms and accelerating the energy transition. These measures will contribute to achieving the primary policy objective to lower gas and power prices for consumers, whilst the "market correction mechanism" proposal will not contribute to this objective but increase uncertainty and risk in the European gas and power market.

Liquidity implications

A fundamental requirement for exchanges is to provide fair and orderly markets. The proposed "market correction mechanism" is not compatible with this obligation and if implemented, would have profound adverse effect on liquidity[1], leading to increased volatility, significant risk complications and risk the creation of a disorderly market.

Market participants will be forced to trade alternative European gas contracts on venues outside the EU which could become the key price reference for hedging or bilateral deals (OTC) to minimise uncertainty and reduce market risk. This would result in a significant reduction in liquidity on the Dutch TTF market traded on exchange, the most liquid contract to hedge gas prices, impacting EU firms ability to safely and efficiently hedge their risk especially during extreme market volatility.

There are strong indications that the liquidity is also likely to move OTC[2], however, pricing and valuation of OTC derivatives in this market are typically influenced by the exchange traded price of the relevant instrument. If liquidity and volume substantially reduce in those instruments on exchange, this will be detrimental to the pricing in the OTC market. This in turn could potentially affect this particular market, widening the bid-offer spread.

As market participants are able to make use of other instruments or venues to buy and sell gas at uncapped prices, the shift in liquidity means the policy objective to cap the price cannot be achieved.

Risk management implications

The lack of price transparency, reduction in market liquidity and the increased market volatility and uncertainty will significantly impact CCPs and CMs' risk management capabilities on open positions, especially in the event of a default, adding pressure to financial stability.

CCPs use Variation Margin ("VM") to ensure no clearing participant builds up uncollateralised exposures and is based on settlement prices of the exchange or CCP. If this price is capped, VM is also capped and CCPs might end up with under-collateralised clearing participants compared to the real risk. However, it is unclear yet how CCP might derive appropriate prices when the cap mechanism is activated which increases uncertainty. To mitigate for such risk, CCPs will have to increase margin requirements substantially[3] resulting in increased costs and liquidity challenges for market participants and hedging business which will naturally move to other venues or contracts or OTC. To the extent that counterparties moving to hedge their risk bilaterally with OTC counterparties are not required by regulation to meet collateral requirements, this trading activity may not be collateralised to the extent it is in a cleared environment, implying increased counterparty risk. Indeed, there may be lower risk appetite and higher risk limits, which may create challenges for counterparties to hedge risk appropriately.

The proposal would also affect parties' ability to risk-manage deliveries of gas as Futures prices tend to converge to spot prices as futures contracts get closer to expiry. This adds to the complexity and uncertainty for CCPs, CMs and their clients and they will have to thoroughly assess and review the implications, especially if exposures of contractual future delivery are on the Dutch TTF spot market, which is not in scope under the proposal. The resulting price dislocation between the spot market and

[1] For example, sellers would have no incentive to sell at the artificially low capped price when they could wait and sell at a higher price in the spot market.

[2] Financial stability risks from energy derivatives markets (europa.eu), Chart A.4

[3] ICE noted $33 billion of additional margin will immediately be requested from energy firms and other market participants should a price cap mechanism be adopted. This would equate to an 80% increase in margin requirements.

the futures market, might leave firms with liquidity mismatches, a risk that adds to the current liquidity pressure.

One of the key risk pillars of CCPs and CMs is to manage a default event. The proposal introduces uncertainty about price formation and price risk, and therefore liquidating or auctioning portfolios containing positions under the scope of the proposal is at risk. Participants will be unlikely to take on such portfolios due to legal and also practical risk considerations on the back of liquidity reduction and sub-optimal hedging alternatives.

Furthermore, the commodities market functions via highly integrated technology and operations infrastructure where exchanges, CCPs, CMs and their clients are interconnected. Fundamental change due to the proposal would require an extended period of review and testing from an operational perspective to prevent substantial risks to operational resilience. Additionally, European Gas and Power markets are extremely integrated as gas is used to generate electricity and these markets display high correlation. The proposal could exacerbate contagion of gas market stress conditions to the power market which could be detrimental to financial stability and could directly impact consumers.

Given the serious adverse effects, this proposal will likely lead to overall reduction in clearing capacity and an increased concentration of energy clearing intermediaries, caused by the increased cost, complexity and risk management implications, posing additional substantial threat to financial stability.

Impact on OTC Derivatives

The OTC derivatives market is likely to be significantly adversely impacted by the market correction mechanism. It is common for participants in the OTC derivatives markets to hedge their OTC exposures using futures traded on an exchange. These hedges will likely become dislocated in the event that the cap becomes effective, either because uncapped payment obligations under the OTC contracts are no longer fully covered by corresponding receipts under futures contracts or because the operation of the cap is deemed to be a 'market disruption event' under the terms of the OTC contracts which could ultimately lead to their early termination.

Although industry's standard documentation ,such as that published by ISDA, contains robust contractual provisions against these kinds of events, both historic and recent experience (such as when LME suspended Nickel trading in March 2022) shows that market participants still suffer significant legal uncertainty as they attempt to identify impacted contracts and their terms and work out on a trade-by-trade basis what the outcome will be. Having conducted this analysis, it is common for the parties to seek to renegotiate their terms in order to secure better outcomes. Replicated across a large number of trades and a large number of counterparties, this represents a very significant logistical challenge. Achieving all of the above by 1 Jan 2023 introduces very considerable operational risks.

Long-term consequences

The last decade has been focused on building a robust European financial ecosystem where markets are transparent and liquid, allowing a broad range of market participants to take part and improve financial stability and in turn, provide a solid platform for the real economy to thrive. For years, European and national legislators, regulators, supervisors as well as trading venues, CCPs and market participants have made tremendous efforts to improve regulation, legislation, and supervision to achieve these goals. The proposal threatens this framework by potentially setting an artificial price that will impair risk management and market integrity, further reduce liquidity in a trusted source of pricing and benchmark, further increase volatility, fragment the European gas market, create additional operational risk and increase uncertainty.

The price cap measures also have the potential to undermine trust in the European gas market, discouraging participants to trade on exchange and rather move to OTC, which is in stark contrast to the decade long work to encourage and develop safe, efficient, transparent, resilient, regulated and supervised financial markets in the EU. We note that some other markets have implemented different controls, such as limiting maximum daily price moves and/or circuit breakers, to mitigate some of the challenges presented by extreme volatility. We would encourage policymakers to continue working with exchanges on such types of controls as these tools would be better suited to current circumstances recommended by FIA in the letter to the Commission and ESMA on the 2 November[4].

Conclusion

The proposal is likely to have detrimental implications on the reputation and the liquidity of the Dutch TTF market and the wider European gas market, and the way these contracts are risk managed adding a level of uncertainty in a critical and sensitive market. This will add significant risk that could, in combination with other factors as detailed in this letter, threaten financial stability and can have long lasting consequences to the European gas market and financial ecosystem whilst not necessarily contributing to the policy objective to lower gas and power prices for consumers.

Furthermore, the implications on security of gas supply for EU households and businesses should not be underestimated. The uncertainty, instability and risks that the proposed “market correction mechanism” could cause in the gas markets, can have severe implications on the ability of the EU to secure sufficient volumes of natural gas needed immediately for the coming winter heating season, but also looking ahead, for the 2023 gas storage filling season.

Therefore, we urge policymakers to consider other alternatives than a price cap mechanism such as continuing its effort with exchanges to implement or improve existing tools and controls such as price limits or circuit-breakers, but most importantly focus on key policy priorities to ensure securing supply, reducing demand, supporting the liquidity needs of energy firms and accelerating the energy transition.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of

[4] https://www.fia.org/resources/fia-makes-recommendations-circuit-breakers

the financial system, and promote high standards of professional conduct. Information about FIA and its activities is available on the Association's website: www.fia.org.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: www.afme.eu.