

SPEECHES & TESTIMONY

Opening Statement of Commissioner Brian Quintenz before the CFTC Market Risk Advisory Committee

June 12, 2019

Thank you Commissioner Behnam for convening today's meeting of the Market Risk Advisory Committee (MRAC). Today's meeting has a robust agenda, including exploring climate-related financial market risks and discussing the implementation of EMIR 2.2. I would like to thank all the presenters and Committee members for their participation and engagement.

I am glad that the attention this meeting has generated, especially among those in the media who normally do not cover our agency, can help remind everyone of the valuable economic purpose derivatives markets serve – to allow commercial businesses to hedge and transfer risk to those most willing to bear it and capable of managing it – as opposed to a one-sided opportunity for entities to “place risky bets.

Robust Derivatives Markets Support Risk Management and Innovation

This past fall, the U.S. Environmental Protection Agency (EPA) released its latest Greenhouse Gas Reporting Program data which found that reported U.S. greenhouse gas emissions declined 2.6 percent in 2017 and have fallen 12 percent since 2011.^[1] In 2017, greenhouse gas emissions were 13 percent below 2005 levels – the biggest reduction compared to 2005 among all the G-20 countries.^[2] A significant part of this decline in emissions has come from an unlikely source: shale oil. Let me explain.

The energy revolution in the United States over the last 10 years has resulted in an 80% increase in oil production. Along with that increased oil production, however, has come a 50% increase in natural gas production. That huge new supply of natural gas has led to a 50% increase in electricity production from natural gas which, in turn, has led to a 2.36 billion metric ton reduction in carbon emissions.^[3]

None of that progress – the benefits to national security secured from energy independence or the climate benefit from carbon emissions reductions – would have been possible without the explorers, innovators, and entrepreneurs behind the shale oil revolution, which, in turn, and in my opinion, would not have been possible without having the world's deepest and most liquid energy derivatives and hedging markets.

In 2010, when the shale boom was just beginning, commodity price risk management in the futures markets enabled entrepreneurs to secure financing from banks, deploy capital effectively, and minimize cash flow fluctuations attributable to commodity price swings. The ability to largely insulate their firms from volatile price movements in the oil and natural gas markets enabled these entrepreneurs to access credit and continue to innovate and expand, resulting in the shale oil revolution.

There is an important lesson to be gleaned here: the vibrancy and liquidity of the American futures and swaps markets have already played an important part in the reduction of carbon emissions related to electricity generation by serving as effective hedging venues that supported private sector ingenuity, discovery, and production of cleaner energy resources.

Unfortunately, the status of those markets, particularly related to energy derivatives, is under significant threat.

Most recently, I have noted my concerns that the Prudential Regulators' proposal to implement the standardized approach for counterparty credit risk (SA-CCR) methodology for purposes of calculating risk-weighted assets under the agencies' capital rule could have a profoundly negative impact on the derivatives markets and energy end-users specifically.[4]

In 2014, the Basel Committee published its formula for SA-CCR calculations, without any supporting data or analysis, that penalized derivatives contracts with exaggerated risk weightings, particularly with respect to cleared futures and swaps. The Prudential Regulators' Proposal goes even further by cherry-picking the Basel Committee's highest "supervisory factor" from the various commodity asset classes and applying it to every energy-related derivative –including exchange-traded, margined, and cleared WTI and natural gas futures, as well as energy swaps. The result is an enormously punitive treatment of oil and gas derivatives transactions on bank balance sheets that, according to some commenters, would increase a bank's exposure calculations under SA-CCR with an end-user counterparty by up to 460%. [5]

Increased exposure calculations will result in higher capital charges to the bank, which, in turn, will either be passed on to the end-user in the form of higher transaction pricing or will simply cause the bank to withdraw from the market. As I have stated previously, I believe the Proposal should revisit the supervisory factors for all types of commodities to ensure they are appropriately calibrated to the actual risks of the underlying commodity and the maturity of the derivatives contract. Failure to do so may do irreparable damage to the energy markets, inhibiting or preventing altogether the next revolution in energy production.

Enhanced Renewable Identification Number (RIN) Reporting

In addition to the derivatives markets, transparent cash commodity markets also play a role in energy policy. For example, the EPA currently implements the Renewable Fuel Standard (RFS) program, which requires that a certain volume of renewable fuel replace or reduce the quantity of petroleum-based transportation fuel used each year. When a batch of biofuel is made or imported, it is assigned a Renewable Identification Number or RIN. One way to demonstrate compliance with the RFS is to purchase standalone RINs from the open market. Because the RIN market was primarily created to demonstrate compliance with the RFS, there have been concerns that it may not be as transparent or competitive as other commodity markets. For example, in 2017, the CFTC assisted the EPA in analyzing 2016 RIN pricing data. One finding of that analysis is that while some terms of a reported RIN transaction between two parties must be identical, a number of fields – including the price – are not required to match.

Since then, the EPA has issued a proposed rule including reforms designed to strengthen the integrity of the RIN market.[6] Among the reforms being considered are requiring public disclosures of RIN holdings over certain limits, prohibiting certain non-obligated parties from purchasing RINs, and requiring both parties in a RIN transaction to enter the same RIN price. A transparent, competitive RIN market free from price manipulation is essential to the success of the RFS program. I look forward to the EPA's consideration of these important reforms and hope that if additional transaction reporting reform, data analysis, or market surveillance expertise is necessary, the CFTC will be able to support the EPA's efforts to the extent possible with our agency's limited resources.

EMIR 2.2

We will also have the privilege and honor today of hearing from Steven Maijoor, Chairman of the European Securities and Markets Authority (ESMA). ESMA recently published several documents for public consultation regarding the implementation of the third-country CCP provisions contained in EMIR 2.2. These are the new provisions governing the licensing of a CCP organized outside of the European Union so that the CCP may clear for EU citizens. EMIR 2.2 establishes a new category of third-country CCPs that are systemically important for the financial stability of the European Union or one or more of its member states (otherwise known as “Tier 2 CCPs”). A Tier 2 CCP will be subject to EMIR unless ESMA grants substituted compliance with the CCP’s local regulatory regime.

ESMA has proposed a set of criteria (14 “indicators,” or factors, and numerous subfactors) that it will use to determine whether a third-country CCP should be classified as Tier 2. Considerations include the nature, size and complexity of the CCP; the effect the CCP’s failure would have on markets; the CCP’s clearing membership structure; and the availability of alternative clearing services. In explaining each of these factors, ESMA lists many qualitative criteria, but not a single quantitative metric to assess whether a CCP is systemically significant. I think this failure to quantify the interconnectedness or importance of a third-country CCP to the European Union will cause significant confusion in the financial markets and will grant practically unlimited discretion with very little public accountability.

Like ESMA, the CFTC is also considering how it will identify a third-country CCP that poses “substantial risk to the U.S. financial system.” Currently, the Commission is considering two objective metrics for evaluating “substantial risk.” First, if the CCP holds 20 percent or more of the required initial margin of U.S. clearing members across all CCPs; second, if 20 percent or more of the initial margin at the CCP is attributable to U.S. clearing members. If both of these two metrics are satisfied, then the Commission would likely view the CCP as posing substantial risk to the U.S. financial system. I hope that through the consultative process, ESMA’s criteria for assessing systemic significance will be amended to depend upon specific quantitative metrics, like those the CFTC is currently considering, that promote transparency, consistency, and fairness in the process for determining whether certain third-country CCPs are Tier 2 CCPs.

Moreover, I would like to emphasize that any regulatory regime that proposes to regulate a third-country CCP should first anchor that oversight in a cooperative and productive relationship with the entity’s domestic regulator. It is my opinion that the CFTC’s future relationship with ESMA and the European Commission will depend on a reasonable, predictable, transparent, and deference-based process under EMIR 2.2.

In closing, I would like to reiterate my thanks to all of today’s panelists and the MRAC membership for their participation, as well as Commissioner Behnam for organizing this meeting.

[1] Greenhouse Gas Reporting Program, EPA, <https://www.epa.gov/ghgreporting/ghgrp-reported-data#emissions-trends>.

[2] Inventory of U.S. Greenhouse Gas Emissions and Sinks, EPA, <https://www.epa.gov/ghgemissions/inventory-us-greenhouse-gas-emissions-and-sinks>.

[3] August 2018 Monthly Energy Review, U.S. Energy Information Administration, <https://www.eia.gov/environment/emissions/carbon/?src=email>.

[4] Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 83 Fed. Reg. 64,660 (proposed Dec. 17, 2018) (hereinafter, the “Proposal”), available at <https://www.federalregister.gov/documents/2018/12/17/2018-24924/standardized-approach-for-calculating-the-exposure-amount-of-derivative-contracts>.

[5] Comment Letter from Coalition for Derivatives End-Users at 5 (March 18, 2019).

[6] Modifications to Fuel Regulations to Provide Flexibility for E15; Modifications to RFS RIN Market Regulations, 84 Fed. Reg. 10584 (March 21, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-03-21/pdf/2019-05030.pdf>.