AT A GLANCE
Requested by the ITRE Committee
Study in Focus

Check out the original full study by scanning this QR code

The role of financial operators in the ETS market and the incidence of their activities in determining the allowances' price

The original full study[1] investigates the role of financial actors, such as banks and investors, in the EU Emissions Trading System (EU ETS) and their role in impacting price dynamics and volatility. It concludes that activities on the market should be further monitored, and data availability and quality should be improved. While further regulation of market participants may become necessary in the future, it is, at this stage, more important to focus on improving the Market Stability Reserve.

Background

The EU Emissions Trading System is a cornerstone of EU climate policy. It has been in operation since 2005 and covers about 40% of total EU greenhouse gas (GHG) emissions. In the EU ETS, prices for EU Allowances (EUAs) have been fairly low for the majority of its operation, but started to pick up after 2018, when the EU agreed on reforms for the EU ETS in its fourth trading period including strengthening its stability mechanism - the Market Stability Reserve (MSR). EUA prices continued to rise in 2021 when the EU signed its 2050 climate neutrality goal into law and set out to reflect this goal in the architecture of the EU ETS. Following Russia's invasion of Ukraine, the market for EUAs – as other commodity markets – has been in some turmoil with relatively large price jumps and high volatility.

These price movements and the fact that additional financial actors became active on the market for EUAs during the past years, have prompted concerns over the influence of financial actors on EUA prices amongst some lawmakers. Of particular concern are so-called "buy-and-hold" strategies where allowances or derivates are bought and held for a long period of time. This can potentially "squeeze" or "corner" the market.

The aim of this study was to provide an overview of the available knowledge on the role of financials on the market of EUAs and their impact on the allowance price. To achieve this aim, a literature review was complemented by a quantitative analysis of EUA prices, market data, and expert interviews.

Key findings

While new financial actors have entered the market for EUAs, their impact on the price to date is likely limited. Furthermore, this report confirms that the volumes of EUAs held for long-term investment stayed small and that no definite trend can be observed. In this context, it is important to note that rising EUA prices are not an indicator of potentially detrimental actions of financial actors in and of themselves. Rather, these detrimental actions are characterised by price movements that are out of touch with market fundamentals or by excessive price volatility.

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
Authors: Johanna CLUDIUS, Hannah GALSTER, Sean HEALY, Viktoria NOKA and Long LAM
PE 740.053 – December 2022

One recommendation stemming from both the reviewed literature and the quantitative analysis in this report is to improve **data availability and data quality**. Policymakers should also consider setting up an **independent market authority**. Amongst others, this could enable harmonisation of data to detect early signs of market manipulation. This authority could also be responsible for making relevant information about the market available to all stakeholders.

Excluding financial actors from the market for EUAs altogether is generally seen as a step that would entail more risks than benefits at this stage, threatening market liquidity and price formation. The direct **regulation of financials**, e.g. via position limits, should be considered if there is a risk that the market is squeezed due to buy-and-hold strategies. As the line between speculative and risk-reducing activities can be considered blurry, when designing position limits, a political decision must be made on what constitutes "excess" speculation.

Benefits and risks of the involvement of financials in the EU ETS

Benefits of market participation	Associated risks
Provide liquidity to the market Act as counterparties for trading of compliance entities (i.e., take short positions) Facilitate market entry for smaller compliance entities (i.e., trade on their behalf) Perform carry trades (buy physical EUAs, sell EUA futures)	Rely on short-term speculation for profits: This can influence cross-market price volatility Make long-term investments (buy-and-hold strategy): This reduces the number of allowances on the market and can cause price drops if investors liquidise their positions after some time

Source: Authors' own elaboration.

Concerns about **market stability** should first and foremost be addressed via the ETS architecture and not via financial market regulation. The **MSR** is seen by many market actors as an important safeguard against an excessive allowance surplus and therefore an important stability mechanism. Rising interest rates and uncertainty on the market make potential buyers more cautious and the build-up of a surplus of allowances more likely. It is therefore vital that the MSR is strengthened. One way to do this is to introduce **dynamically declining thresholds** as proposed by the European Parliament. The introduction of a price corridor would be the most direct and effective measure for controlling the EUA price path – and would prompt many speculators to leave the market as there would be little uncertainty left to speculate on. However, designing a price corridor entails the risk of setting it too high or – more likely – too low, thereby impeding the achievement of climate goals.

Since it is likely that the EU will introduce a second trading system covering the buildings and transport sector ("ETS-2"), the allowance market in the EU is likely to grow significantly in the near future. It is therefore important not only for the EU ETS but also for the planned ETS-2 to achieve a sustainable level of market stability and reliability without cutting off beneficial roles that are being played in the market, also by financial actors.

[1] Cludius, J., Galster, H., Healy, S., Noka, V., Lam, L., 2022, *The role of financial operators in the ETS market and the incidence of their activities in determining the allowances' price*, Publication for the committee on Industry, Research and Energy (ITRE), Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg. Available at: www.directhyperlink.com.

IP/A/ITRE/2022-11; Manuscript completed: November 2022; Date of publication: December 2022
Administrators responsible: Kristi POLLUVEER, Matteo CIUCCI; Editorial assistant: Irene VERNACOTOLA
Contact: Poldep-Economy-Science@ep.europa.eu
This document is available on the internet at: www.europarl.europa.eu/supporting-analyses

Print ISBN 978-92-848-0013-1 | doi: 10.2861/056224 | QA-03-22-231-EN-C
PDF ISBN 978-92-848-0012-4 | doi: 10.2861/19327 | QA-03-22-231-EN-N