United States House of Representatives
Committee on Agriculture
"Rising Risks: Managing Volatility in Global Commodity Derivatives Markets."

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Chairman Thompson, Ranking Member Scott, and Members of the Committee, thank you for the opportunity to testify.

I am the head of the clearing businesses for Goldman Sachs and the co-head of its Global Futures business. I am testifying as Chair of the Futures Industry Association (FIA), the leading global trade organization for the futures, options and centrally cleared derivatives markets.

During periods of economic stress and increased market volatility, futures markets take on additional importance because they serve as a critical risk management tool for agricultural and energy end users. Through the market volatility related to the pandemic in March 2020, and the Russian invasion of Ukraine in 2022, futures markets continued to function amid tremendous stress in the financial system.

However, these experiences have also driven the industry to consider what can be done to put cleared derivatives markets, and the end users that rely on them, on even stronger footing through future cycles of volatility.

Today, I'll start by explaining the role of clearing members[1] in helping end users manage risk and supporting market resilience. Then I'll highlight issues that warrant additional attention from policymakers. And lastly, I'll talk about diversity and inclusion in the futures industry, an issue that is personally important to me.

The Role of Clearing Members

Through connectivity to exchanges and clearinghouses around the world, clearing members provide customers, including agricultural and energy end users, with access to global markets to manage the risks of their operations. For example, many FIA members participate in clearinghouses across dozens of jurisdictions to ensure their clients have the ability to transact in any region in which they do business.

Clearing members are intermediaries, which means we stand between an end user and the clearinghouse, and we act as the first and the last line of defense in fostering stability in cleared derivatives markets.

We act as a first line of defense by underwriting the risk of a client's portfolio before it ever reaches the clearinghouse and monitoring that risk on an ongoing basis. This includes determining the appropriateness and suitability of leveraged products, monitoring clients for money laundering and other risks to market integrity, collecting and safeguarding customer margin and guaranteeing the performance of clients to the clearinghouse.

[1] For this testimony, the use of "clearing members" is intended to include futures commission merchants (FCMs).

Perhaps less known is that clearing members contribute substantially all the financial resources that backstop the clearinghouse in the event of a major market disruption or default by a market participant. Looking at just the ten clearinghouses regulated by the CFTC, clearing members contribute $47.6[2] billion in default funds.

Clearing members also hold a significant amount of regulatory capital, which serves as an additional layer of protection to the system that helps ensure clearing members themselves can withstand a severe market disruption. The total amount of capital held by the clearing members regulated by the CFTC was $175 billion as of December last year.[3]

Together, these financial resources reduce the risk that a major market event or default creates wider market contagion.

The importance of robust exchange risk controls

Volatility control mechanisms including exchange risk controls provide important protections against extreme price volatility that can disrupt markets and create systemic risk. A recent example of this: over the course of three days in March last year, the price of nickel increased by over 270% on the London Metals Exchange (LME). As a result of the volatility and market disruption, LME took the extraordinary step of halting trading for five days but also cancelled potentially billions of dollars of trade notional that had taken place during the twelve hours prior to the halt.

It's important to note that CFTC regulated exchanges have a long history of supporting robust volatility control mechanisms, especially in the agricultural markets. This brings confidence to our markets and supports the needs of commodity end users. FIA is working in partnership with exchanges to develop global best practices for exchange risk controls.

Clearinghouse Resilience

The volume of transactions flowing through clearinghouses around the world has increased significantly in the last decade, in large part due to post-financial crisis clearing mandates. While this has had a positive and risk reducing effect for derivatives markets, it has also increased the systemic importance of clearinghouses.

Around the world, regulators continue to make progress in enhancing the regulatory standards applicable to clearinghouses, and there are international standards in place to foster consistency among jurisdictions. But recent market events underscore that more can be done to strengthen the resilience of clearinghouses, and by extension, cleared derivatives markets.

In addition, over the last twenty years, the number of clearing firms in the US futures industry has decreased significantly. Using data from the CFTC, we estimate that the total number of clearing firms

[2] The clearinghouses included are: CME, Eurex, Ice Clear Credit, Ice Clear Europe, Ice Clear US, LCH LTD, LCH SA, MGEX Clearing, Nodal Clearing, OCC. Clearinghouse financial data is sourced from the Q3 public quantitative disclosures, published at year end. These calculations do not include the default insurance policy taken out by ICE as an additional layer of defense, to complement its "Skin-in-the-Game."
[3] Source: The CFTC's Financial Information for FCMs report for December 2022. Total capital is the aggregate amount of "adjusted net capital" reported by the 63 FCMs registered with the CFTC as of that date.

that clear futures for their customers has decreased by half, while the amount of customer margin held by these clearing firms has increased by almost six times, from $60 billion in March of 2002 to $347 billion this past December.

Clearing members, end users and investors have to rely on the strength of a clearinghouse's risk management, particularly as many products by regulation require clearing. A core feature of a clearinghouse is its ability to spread losses incurred from a default across non-defaulting clearing members, known as "loss mutualization." This makes it essential that the risk management standards and regulatory frameworks governing a clearinghouse are sufficiently robust to safeguard their role as a critical market infrastructure, including membership criteria, the risk profile of new products it clears and, as I'll discuss more later, margin practices. FIA supports greater strengthening and standardization of these requirements globally.

Transparency and Adequacy of Margin

Margin is the first layer of resources available to a clearinghouse if a participant defaults, and it is foundational to the risk management of the clearinghouse. In recent periods of volatility, such as the onset of the pandemic or the Russian invasion of Ukraine, we saw significant margin increases across futures contracts globally.

In October 2020, FIA released a white paper[4] that examined the increase in margin requirements at derivatives clearinghouses during the first quarter of 2020 due to increased market volatility related to the pandemic. Although the clearing system performed well, the increase in margin requirements created a large and sudden demand for liquid assets that added stress in markets.

To highlight key findings:

- Initial margin requirements for certain benchmark contracts in the US, Europe and Japan jumped by more than 100% between the beginning and the end of the first quarter of 2020 with most of the increase happening during the month of March
- Initial margin held by the ten major derivatives clearinghouses in those jurisdictions rose from $563.6 billion at the end of 2019 to $833.9 billion at the end of the first quarter of 2020, an increase of $270.3 billion or 48%

More recently, we experienced a very sharp increase in margin requirements in the European power and gas and oil markets in 2022 after the Russian invasion of Ukraine. Several large European energy companies that use these markets to hedge their risks faced extremely large margin calls, and in some cases they had to turn to their governments for financial support.[5] This experience demonstrated how margin calls can drive up demand for high quality liquid assets and intensify market turmoil. While margin requirements for listed futures contracts certainly should increase during volatile periods and decrease when markets are under normalized conditions, the magnitude of the increases that we saw in the European power and gas markets were a sign that margin levels had fallen too low.

[4] https://www.fia.org/sites/default/files/2020-10/FIA_WP_Procyclicality_CCP%20Margin%20Requirements_1.pdf

[5] For examples, see: https://www.bankofengland.co.uk/markets/energy-markets-financing-scheme#:~:text=The%20joint%20Bank%20of%20England,closed%20with%20no%20guarantees%20issued); https://www.bmwk.de/Redaktion/EN/Pressemitteilungen/2022/06/20220617-new-hedging-instrument-margining-launched-by-the-german-federal-government-to-protect-companies-affected-by-war.html; https://www.ft.com/content/4ea1dab0-d1a8-4324-97e2-22caed5ed55c

There are a few ways in which this can be addressed. First, improving the transparency of clearinghouse margin models, as well as the opportunity for market participants to provide input to the clearinghouse, will help clearing members and end users be better prepared for periods of volatility. The Commodity Futures Trading Commission (CFTC) issued a proposal last year to enhance clearinghouse governance that was the outcome of market participants and clearinghouses working together towards a solution through its Market Risk Advisory Committee[6] (MRAC).

Second, implementing margin floors that are designed to ensure baseline levels remain appropriately calibrated and more stable through time will help to dampen extreme swings in margin.

In our October 2020 white paper, FIA identified several additional recommendations for regulators to improve the transparency and adequacy of clearinghouse margin models to drive this outcome in the future. Additionally, in February 2021, the MRAC approved several consensus recommendations[7] for the CFTC to consider related to clearinghouse margin methodologies. Recommendations include:

- Clearinghouse margin methodologies should be sufficiently transparent to market participants so they can understand how models react to certain market conditions for liquidity planning and risk management purposes
- The CFTC should enhance its flexible approach to supervising how CCPs manage procyclical margin requirements that prioritizes the desired outcome of reducing procyclicality, not the specific means of reducing it

Third, the role of incentives in driving prudent margin practices by clearinghouses has been an important topic for the industry and regulators for many years.[8] This is because nearly all of the capital that would be used to manage a default comes from the clearing members[9] and not the clearinghouses. In other jurisdictions, regulators are in the process of developing new policy[10] to require clearinghouses to put more of their own capital at risk[11] to better align their incentives for strong risk management practices, including strong margin models.

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[6] https://www.cftc.gov/media/6201/MRAC_CCPRGS_RCCOG022321/download

[7] https://www.cftc.gov/media/5706/MRAC_CRGSubcommittee-DiscussionPaperOnBestPracticesinCCPMarginMethodologies022321/download

[8] https://www.bis.org/publ/work866.pdf

[9] While the rate of contributions varies among CFTC-regulated clearinghouses, on average, clearinghouses contribute less than 5% of their own capital to their default funds. The clearinghouses included in this analysis are: CME, Eurex, Ice Clear Credit, Ice Clear Europe, Ice Clear US, LCH LTD, LCH SA, MGEX Clearing, Nodal Clearing, OCC. Clearinghouse financial data is sourced from the Q3 public quantitative disclosures, published at year end. These calculations do not include the default insurance policy taken out by ICE as an additional layer of defense, to complement its "Skin-in-the-Game."

[10] https://www.risk.net/regulation/7955130/boe-official-signals-tough-stance-on-ccp-skin-in-the-game

[11] Last year, European authorities took steps to require European CCPs to hold an additional amount of pre-funded dedicated own resources and noted "This additional layer of capital, or "second skin-in-the game", exposes the CCP's capital before relying on further contributions from clearing members and is meant as an incentive for proper risk management." https://www.esma.europa.eu/sites/default/files/library/esma91-372-1706_fr_rts_ssitg_art_915.pdf

Bank Capital

Capital levels for banks have significantly increased since the financial crisis due to the adoption of Dodd-Frank, Basel III and other reforms. These reforms have made the banking system more resilient to volatility and extreme shocks.

The US banking agencies are in the process of developing a proposal to revise the capital regime for banks that has the potential to further increase the cost of capital.

It will be important that the forthcoming proposal be calibrated correctly so that it does not increase the cost for banks to provide commodity derivatives to end users to meet their hedging needs.

Diversity & Inclusion

As the first female Chair of the Board in FIA's sixty-eight-year history, I can attest that we are making progress in enhancing diversity in our industry. There are many signs that the face of our industry is changing. We don't have to look any further than the CFTC and the historic confirmation of four female Commissioners last year. I do think there's a lot more we need to do, and I have some practical ideas drawn from my own career that I would be very happy to discuss further with any Members or staff on the Committee.

Conclusion

FIA greatly appreciates the Committee's interest in these topics that affect global derivatives markets and the end-users who rely on derivatives products to hedge their risks.

It is an honor to be with you today and to work with this Committee as you consider these important issues.