

**MINUTES OF THE EIGHTH MEETING OF
THE U.S. COMMODITY FUTURES TRADING COMMISSION'S
MARKET RISK ADVISORY COMMITTEE
JUNE 20, 2017**

The Market Risk Advisory Committee ("MRAC") convened for a public meeting on Tuesday, June 20, 2017, at 10:00 a.m., at the U.S. Commodity Futures Trading Commission's ("CFTC" or "Commission") Headquarters Conference Center, located at Three Lafayette Centre, 1155 21st St., NW, Washington, DC. The meeting consisted of three panels. Panel 1 included a presentation by the CFTC's Division of Clearing and Risk regarding how the Division conducts risk surveillance of central counterparties ("CCPs"). Panel 2 discussed how to better inform the CCP regulatory framework through academic research and economic analysis. Panel 3 advised the Commission on the potential effects of Brexit on financial markets.

MRAC Members in Attendance

Biswarup Chatterjee, Global Head of Electronic Trading & New Business Development, Credit Markets, Citigroup
Thomas Coyle, Vice President and General Manager, Chicago and Illinois River Marketing, LLC
Andrew Gray, Managing Director, Group Chief Risk Officer, Depository Trust and Clearing Corporation
Sebastian Koeling, Chief Executive Officer, Optiver US
Clifford Lewis, Independent Director, Eurex Clearing
Dennis McLaughlin, Group Chief Risk Officer, LCH.Clearnet
Dale Michaels, Executive Vice President, Financial Risk Management, Options Clearing Corporation
Richard Miller, Consultant, American Council of Life Insurers
Susan O'Flynn, Managing Director and Global Head of CCP Strategy, Governance and Optimization, Morgan Stanley
Edward Pla, Managing Director, Head of Clearing and Execution, UBS Investment Bank
Marnie Rosenberg, Global Head of Clearinghouse Risk & Strategy, JP Morgan
Marcus Stanley, Policy Director, Americans for Financial Reform
Robert Steigerwald, Senior Policy Advisor, Federal Reserve Bank of Chicago
Kim Taylor, President, Global Operations, Technology & Risk, CME Group
Luke Zubrod, Director of Risk and Regulatory Advisory Services, Chatham Financial

Invited Speakers and Panelists in Attendance

Chris Edmonds, Senior Vice President, Financial Markets, Intercontinental Exchange, Inc. ("ICE")
Eileen Kiely, Director, BlackRock
Vikash Rughani, Business Manager, triReduce/triBalance, TriOptima

CFTC Commissioners and CFTC Staff in Attendance

J. Christopher Giancarlo, Acting Chairman, CFTC
Sharon Y. Bowen, CFTC Commissioner and MRAC Sponsor
Petal Walker, Chief Counsel, Office of Commissioner Bowen, Designated Federal Officer

Eileen A. Donovan, Deputy Director, Division of Clearing and Risk
Michael Gill, Chief of Staff, Office of Acting Chairman Giancarlo
Joseph Miller, Assistant Director, Division of Clearing and Risk
Hugh Rooney, Assistant Director, Division of Clearing and Risk
Glenn Schmeltz, Risk Analyst, Division of Clearing and Risk
Sayee Srinivasan, Chief Economist, Office of the Chief Economist
Richard Haynes, Supervisory Research Analyst, Office of the Chief Economist

I. Opening Remarks

Petal Walker called the MRAC meeting to order.

Following welcoming remarks by Commissioner Bowen, Acting Chairman Giancarlo made his opening remarks and noted that the meeting will address many aspects of the increased use of clearing for swaps. He also commented that the Commission is requesting additional resources to strengthen its clearinghouse examinations capability, and that this will enable staff to keep pace with the explosive growth in the number and value of swaps cleared by designated clearing organizations (“DCOs”). He also stated that there has been an enormous increase in the complexity of DCO’s counterparty risk management oversight programs and liquidity risk management procedures and an increase in the complexity of the products themselves. Further, DCOs have developed a large number of individualized margin models and other risk management tools to address these different risks, which in turn generates an increase in the complexity of the agency’s oversight responsibilities.

The Acting Chairman next noted that he has advocated relief from the misguided application of the supplementary leverage ratio and is proposing two practical steps to significantly reduce capital costs for clearing members—potentially as high as 70 percent—but would translate into only a small 1 percent capital reduction at the bank holding company level. If these savings are passed on to customers, this would translate into a three-fold increase in trading activity and create a safer financial system. The Acting Chairman then noted that last week, the European Commission (“EC”) proposed an amendment of EMIR to regulate third-party CCPs, including a process to introduce a CCP location policy. The Acting Chairman noted that this is an important development that needs to be handled with “great care.” He also stated that the one-year anniversary of the agreement between the CFTC and the EC regarding CCP equivalence is coming up, and the Commission has demonstrated its unwavering commitment to the agreement. Further, whatever the outcomes of the Brexit negotiations and the EU’s internal discussions about how to supervise CCPs, the Commission does not contemplate any change to the CFTC-EC equivalence agreement.

II. Panel 1: Risk Surveillance Activities of the Commission’s Division of Clearing and Risk

The Division of Clearing and Risk gave a presentation on risk surveillance activities by its Risk Surveillance Branch (“RSB”). Glenn Schmeltz explained that RSB strives to conduct independent assessments of the risks posed by market participants, principally through stress testing. The daily data RSB receives continues to increase and is received from nineteen DCOs across multiple market segments, allowing RSB to see trader positions across clearing members and across DCOs. RSB identifies significant positions, estimates the magnitude of the risks of those positions using stress tests, and compares the potential losses to available assets of the

clearing firm. If this analysis uncovers accounts with the potential for concern, RSB investigates whether other assets are available.

Joseph Miller discussed the RSB's core risk monitoring program, which seeks to identify traders and clearing members in the markets that may require enhanced scrutiny. He described a number of reports that are used to find risk, including the Position Risk Summary Report, futures equivalent delta position reports, reports to identify notable short option positions, and inter and intra commodity spread position reports which are analyzed for correlation breakdowns. He explained that stress testing is one of RSB's most important jobs, and through the use of a combination of proprietary and vendor risk management software systems, RSB is able to highlight the riskiest traders and concentrations of those traders at clearing members. He noted that RSB could take various actions if it becomes concerned about a trader's risk (e.g., contacting the trader, its clearing firm, or the DCO).

Mr. Schmeltz noted that margin adequacy is a crucial component of risk management. He described RSB's margin back-testing program. He also noted that in November, RSB conducted a supervisory stress test of clearing houses ("SSTs"), which confirmed that each DCO had pre-funded resources to cover any two simultaneous clearing member defaults. RSB is transitioning this work into a systemic stress-testing program and is currently focusing on automating it. RSB is also working to incorporate liquidity into an SST so it can assess whether collateral is liquid enough to be available when necessary for variation margin payments. He described RSB's participation in a joint study with fourteen other authorities analyzing central clearing interdependencies. He also stated that RSB staff: (1) was also involved in creating the CPMI- IOSCO framework for supervisory stress testing of CCPs; (2) is beginning work on a couple of fronts to help client porting go smoothly in a default; and (3) has also been working with staff at the Bank of England, BaFin, and Bundesbank as well as CME, Eurex, and LCH on a multi-CCP default exercise.

Hugh J. Rooney gave an overview of Regulation 1.73, the CFTC's regulation for risk management that affects clearing members who are also registered as future commission merchants ("FCMs"). The regulation requires that certain risk management procedures be done within certain timeframes, and the CFTC evaluates their compliance with these requirements. The CFTC has visited every firm subject to the regulation in the past three years. This field work enables the agency to understand the industry and keep up with developments. Richard Miller asked whether the CFTC has information sharing arrangements and protocols with other agencies. Mr. Rooney responded that RSB does not have extensive formalized procedures, but works with other agencies as events take place. Another part of DCR, the Examinations Group, looks directly at clearing organizations and works more closely with other regulators than RSB.

Marcus Stanley asked whether RSB is dependent on clearinghouse internal models for its stress test scenarios. Mr. Schmeltz replied that the RSB Team includes quants and reviews any new margin models as well as any changes to these models. Dale Michaels asked about RSB's expectations with respect to the liquidation exercises that clearing members perform. Mr. Rooney explained that as RSB conducts the rule 1.73 review, it asks clearing members to demonstrate how they comply with the regulation. He further stated that RSB does not have an internal model and accepts what clearing members provide. Additionally, to date, RSB has not found any deficiencies in this area.

(Break)

III. Panel 2: An Economic Perspective on the Clearing Regulatory Framework

Sayee Srinivasan gave a presentation on research on clearing. He stated that there is not a conceptual framework yet in the research community to systematically study CCP or market structure issues. He also stated that arguments are made that CCPs need skin-in-the-game and more capital is better. And, that the goal is to improve the system's resilience, but there is no consensus on the objective measure of resilience.

Richard Haynes stated that academic literature is often one-sided and examines only part of the issue, without full examination of the tradeoffs. Regulators, policy makers, and market participants must take this into account. He further commented that there are clear benefits of central clearing, but there is also a risk transformation.

Robert Steigerwald stated that credit risk to be managed through clearing and other mechanisms gets transformed into liquidity risk and operational risk. He also noted that the substitution of liquidity exposure for credit risk exposure is sensible, but it changes the system in ways that make it quite unpredictable and more interconnected. He pointed out that there is hidden complexity in clearing arrangements and hidden vulnerability. He described CCPs as "commitment mechanisms" that establish trust and confidence among anonymous participants. Among other comments, he remarked that CCPs are not banks, and there is a fallacy of imposing on CCPs a policy structure that is designed for banks. Further, the rules of the clearinghouse, the default management program, and the default waterfall are intended to create an incentive structure that supports the continuity of open positions at the clearinghouse, but that this is very difficult to accomplish.

Elaine Kiely stated that there is a lack of comprehensive research addressing CCP capital by the regulatory and academic community. She opined that more capital is not necessarily better, and there needs to be an analysis of what the optimal level is that does not introduce moral hazard. She also stated that a critical element in this analysis is that CCPs are for-profit entities that provide a service that clients pay for and that service is credit risk mitigation.

Commissioner Bowen asked whether resolution authority and bankruptcy are effective tools. Mr. Steigerwald stated that intervention by a resolution authority may be helpful where stakeholders in a clearing venture are unable to collaborate in an effective way, but in the absence of public funding for solvency, he is not sure what more a resolution authority can do than the primary stakeholders can. Kim Taylor expressed concern that current proposals may not enforce current loss-sharing models and ensure that CCPs can go through their default procedures, but rather "jump to resolution." Mr. Stanley mentioned last week's Treasury Report and asked about the impact on clearing houses if liquidity planning for bankruptcy or resolution of a major bank is weakened. Mr. Srinivasan said that economists have very little to say about this. Marnie Rosenberg added that variation margins, gains haircutting and initial margin haircutting are not popular tools, noting that there has been a lot of discussion in Europe about explicitly prohibiting the use of haircutting of initial margin. She offered that all initial margin should be bankruptcy remote, and it should not be assumed it will be used to cover remaining losses.

(Break)

IV. Panel 3: Market Input – Brexit’s Effects on Markets

Ms. Kiely presented first for the third panel and stated that, while Brexit appears to be priced into the markets and the potential impacts of the hard Brexit seem to be largely constrained to the UK, numerous event risks still linger in the market and could result in significant market disruption. Other members agreed with that assessment. Mr. Zubrod noted that derivatives are sources of comfort rather than fear, as they are tools to mitigate against the uncertainties of events like Brexit.

MRAC members then addressed planning challenges. Susan O’Flynn gave the sell-side perspective for its UK broker-dealer. She commented that trading access to European clients may no longer be available from both a house execution and client clearing perspective. Additionally, she stated that access to European CCPs may be subject to additional requirements, both from a CCP membership perspective for non-EU institutions (third country institutions), as well as domestic regulation to be a member in those jurisdictions where those CCPs are located. Given these unknowns, she noted that to prepare for a hard Brexit, banks will have to establish a new European entity or relocate certain activity to existing European entities in order to continue to transact with European clients. Further, in order to ensure continuity of activity, this entity may require new exchange and clearing memberships. Among other remarks, she stated that post-Brexit there will be a new paradigm for derivatives trading in Europe and the UK, which will result in increased costs for dealers, both from a margin and SLR capital perspective at the outset. Further, planning will become more complex if equivalence of UK CCPs is not retained or if relocation of euro clearing were to occur.

Ms. Kiely stated that as an end user, Blackrock is looking to its clearing members to determine how they are going to structure and will adapt accordingly. She expects there to be a large re-papering exercise across their funds, but other than that, there is very limited clarity as to what they need to do. Further, they are trying to manage through the uncertainty, and keep their structure “nimble enough” to adapt to requirements as they solidify.

The group then discussed the recent ESMA proposal to deny third-party country recognition to CCPs of “substantial systemic importance” unless they relocate to the EU-27. Clifford Lewis commented that systemically important clearinghouses will need to assess the costs versus benefits of any changes. Additionally, there could be considerable operational and legal costs. He further noted that if there is an ability to cross-margin on a portfolio basis, then incremental initial margin would not necessarily be material. And, there may also be a benefit to risk managers if the proposed move would remove any questions as to the ability of a systemically important clearinghouse to access central bank liquidity in extreme circumstances.

Dennis McLaughlin stated that the potential to fragment liquidity is not good from a systemic risk point of view because if you artificially fragment a smaller number of members into a smaller CCP away from a larger global liquidity pool, there are fewer members to absorb defaults, bid on a portfolio, and to which you could port a portfolio. He also stated that assessments on surviving members in that smaller CCP would be orders of magnitude times what is in the global CCP. Additionally, CCPs may have portfolio margining between many currencies, and if you break out one currency, the costs can be substantial as you lose the portfolio margin benefits between that currency and the others.

Mr. Michaels expressed fear of unintended consequences, and warned that as portfolios are split up, diversification is impaired, margin increases, and the clearing fund increases dramatically.

Ms. Rosenberg expressed concern that denying third country recognition to CCPs judged to be of substantial systemic significance would effectively force them to relocate, which could cause market disruption, liquidity fragmentation, and loss of netting efficiencies. She noted that fragmentation through splitting of portfolios could lead to additional margin requirements, and that loss of netting and trade compression could lead to larger aggregate exposures to CCPs and less efficient risk management. Additionally, any denial of third country recognition forcing CCP relocation could lead to significant challenges in default management during a crisis.

Ms. Kiely explained that although she did not expect fragmentation to impact the willingness and ability to trade, it could impact pricing and client returns. Biswarup Chatterjee expressed concern that the need for collateral will go up, and noted that uncertainty creates questions around the legal framework for collateral. Mr. Lewis expressed concern about the limited capacity of end users to deal with so many regulatory changes given that the EC is contemplating other hugely expensive and time-consuming market structure changes. Ms. Taylor said she hopes that global policy makers understand that disrupting market access, and uncertainty about outcomes, is not good for market stability. She was encouraged by Acting Chairman Giancarlo's statement that the EU's proposal will not disrupt the U.S.-EC equivalence agreement.

The group then discussed whether businesses are anticipating moving and the challenges that they are facing. Mr. Chatterjee stated that moving either physical infrastructure or people would take several months or years of planning and execution. Ms. O'Flynn agreed that it is a very large task and believed that most banks and broker-dealers are close to executing a strategy given the timeframe. Chris Edmonds added that, from a clearinghouse perspective, he believes that most of the challenges are member-related. Ms. O'Flynn stated that it is incumbent on market participants to look at the costs, including the impact on supplemental leverage ratio capital. She believed that loss of compression is a bigger-ticket item than margin.

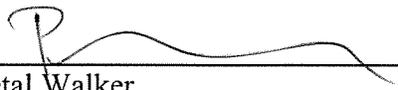
The group then discussed how the derivatives markets will look post-Brexit. Mr. Lewis noted that the Chairman is making progress on the bank capital rules and other major policy items, which he suspects are at least as important as the issues being discussed today. Additionally, there is a potential serious divergence in the fundamental approach towards regulation in the U.S. versus the EC, and the consequences could be very serious and far more important than Brexit. Ms. Kiely added that any forced relocation of market activity will negatively impact market liquidity, as capital requirements at dealers will rise materially. Additionally, the splitting up of books across clearing members is expected to affect their ability to take and unwind trades.

V. Closing Remarks

In closing, Commissioner Bowen announced her intention to leave the Commission in the next few months or perhaps sooner if another nominee is confirmed. She explained that having only two Commissioners has made routine business difficult and important policy decisions almost impossible. She also expressed her appreciation of the agency and its dedicated staff. Speaking on behalf of the Acting Chairman, Michael Gill expressed his appreciation for Commissioner Bowen's leadership and for the important work of the Committee.

Ms. Walker adjourned the meeting at 12:55 p.m.

I hereby certify that the foregoing minutes are accurate.



Petal Walker
Acting Chair, Market Risk Advisory Committee

10/3/17

Date