

Testimony of
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On Behalf of CME Group
Before the House Committee on Agriculture
June 27, 2017

Good morning, Chairman Conaway, Ranking Member Peterson and Members of the Committee. I am Jerry Salzman appearing today on behalf of CME Group and its Chairman and Chief Executive Officer Terry Duffy. Thank you for the opportunity to testify today regarding Central Counterparty Recovery and Resolution.

CME Clearing is a central counterparty or "CCP." CCPs are risk neutral organizations. When a contract is submitted for clearing, a CCP becomes the buyer to the seller and the seller to the buyer. This is what CCPs call a matched book. By maintaining a matched book, a CCP does not take on any market risk and remains risk neutral. Furthermore, the substitution of the CCP eliminates the original counterparty risk and permits a party to exit its contract without dealing with the original party to the trade. Clearing members and their customers can trade without regard to the identity or credit of their counterparty and thereby achieve operational and financial efficiency.

Both CCPs and banks can be systemically important to the functioning of financial markets, but it is a mistake to assume that recovery and resolution planning for banks and CCPs should follow the same path. Unlike CCPs, banks have depositors whose assets are employed in the risk-taking activities of banks. Banks engage in lending, investment banking, asset management, and other similar services that pose risks to their depositors and the financial system. Banks engage in and offer bespoke, illiquid derivative and other financial products. CCPs participate in none of these risk-taking activities. As a result of the different services and products offered by banks and the consequence to depositors of bank failure, the regulations governing banks and CCPs—including plans to address impending failure, capital requirements, and liquidity requirements—must be quite different.

While some banks faced considerable challenges during the 2008 financial crisis, CCPs performed well. This strong performance led to the Congressionally-mandated expanded use of central clearing. The expansion of clearing in response to the 2008 financial crisis has increased the number of contracts cleared and, correspondingly, the amount of performance bond¹ collected by CCPs to minimize the risk that a clearing member fails to meet its obligations when due (or defaults) and the risk of contagion resulting from that failure.

While CCPs have become intermediaries for more open positions, this increase in transaction clearing reduces the risk of a systemic failure. The critical point is that clearing lessens systemic risk by (1) netting down positions, (2) interposing a neutral party to set performance bond and pay and collect daily gains and losses, (3) netting pays and collects, (4) providing a properly scaled guaranty fund, and (5) isolating the impact of the failure of a clearing member by acting as the sole counterparty. In formal terms, increased clearing of positions significantly

¹ Performance bond is also called initial margin.

reduces the likelihood that a member default would impact other clearing market participants. Because of the protections that a CCP provides, a CCP interposed between its member firms is far less likely to fail and create system wide losses and systemic risk than a member firm or firms without the benefit of clearing.

As clearing has expanded, so has the focus on the safety and soundness of CCPs. The Congress, US and foreign regulators, clearing members, customers, and banks, which provide services and liquidity facilities, have all been engaged in the efforts to build on the safety and stability demonstrated by CCPs during the 2008 financial crisis.

For example, the Commodity Futures Trading Commission ("CFTC") enhanced its CCP rules, making a strong regime of oversight even stronger. The CFTC also implemented rules requiring CME Clearing to maintain plans to recover should an extreme, but plausible, event occur and to permanently cease, sell, or transfer one or more clearing services should a CCP's recovery plan fail—all without using any taxpayer funds. The CFTC exercises diligent oversight of these plans.

In addition to these recent CFTC regulatory enhancements, the Committee on Payments and Market Infrastructures ("CPMI") and the International Organization of Securities Commissions ("IOSCO") published international guidance known as the Principles for Market Infrastructures or the "PFMIs" that calls for CCPs like CME Clearing to prepare and maintain a recovery plan.² The PFMIs provides that the CCP recovery tools that impact clearing members and their customers should be transparent to help clearing members and their customers measure, manage, and control their potential losses and liquidity shortfalls when electing to clear with the CCP. CPMI and IOSCO also published recovery guidance providing that CCP recovery tools should create appropriate incentives for participants of the CCP to "(i) control the amount of risk that they bring to or incur in the system, (ii) monitor the [CCP's] risk-taking and risk management activities, and (iii) assist in the [CCP's] default management process."³

CME CLEARING INITIATED PROTECTIONS FOR FINANCIAL INTEGRITY

CME preserves the financial integrity of its CCP by mitigating the risk that a clearing member will default and by minimizing the impact of that default on the customers of the defaulting clearing member and other clearing members and their customers. CCPs maintain multiple layers of pre-funded financial resources as protection. In addition to the financial protections discussed below, CME Clearing regularly performs risk management and regulatory surveillance reviews to evaluate the quality of the risk management of its clearing members and to determine that clearing members are in full compliance with CFTC and CME Clearing financial and operational requirements and that customer funds are properly segregated.

The first layer of the pool of pre-funded financial resources is based on our valuation of the portfolio of a firm's open positions. We require deposit of performance bond in an amount that has a high probability of covering the loss caused by a potential default. Performance bonds

² CPMI-IOSCO, TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES § 3.3.8 (Apr. 2012), *available at* <http://www.bis.org/cpmi/publ/d101a.pdf>.

³ CPMI-IOSCO, BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, RECOVERY OF FINANCIAL MARKET INFRASTRUCTURES § 3.3.7 (Oct. 2014) ("CPMI-IOSCO Recovery Guidance"), *available at* <http://www.bis.org/cpmi/publ/d121.pdf>.

are posted in the form of high-quality, liquid assets and are isolated from CME Clearing's assets.

Next, at least once or twice each business day, the portfolio is marked-to-market. If a position has lost value, we require the clearing member to make payments to CME Clearing to settle that loss. If a position has gained value, the clearing member receives a payment from CME Clearing to reflect that gain. This process—which we call settlement—avoids the build-up of exposures.

If a clearing member defaults,⁴ CME Clearing will use as the first resource to cover that loss the defaulted clearing member's posted performance bonds and any other assets of the defaulted clearing member that are available to CME Clearing, including the defaulter's contributions to the guaranty funds (described below). Performance bonds posted by the defaulted clearing member to secure its customers' positions may only be used to cover unpaid losses for customer positions that were cleared through the defaulted clearing member.

In our 100+ year history, CME Clearing has resolved every clearing member default it has experienced by using only the defaulter's performance bonds.

Third, the Chicago Mercantile Exchange, Inc. ("CME Inc.") has committed \$300 million of its own funds to the three separate guaranty funds it maintains for its different asset classes—one to support futures and options on futures (which are called "Base" products), one to support credit default swaps and one to support interest rate swaps. Each of these is called a "CME Contribution." If losses remain after CME Clearing exhausts the performance bonds and other assets of the defaulter that are available to CME Clearing, CME Clearing would use the CME Contribution to the relevant guaranty fund to cover or reduce the remaining losses. The CME Contribution to the guaranty funds for Base products, credit default swaps, and interest rate swaps is \$100 million, \$50 million, and \$150 million, respectively.

Fourth, if losses still remain after the CME Contributions to the relevant guaranty funds are exhausted, CME Clearing would use contributions from CME Clearing's non-defaulting clearing members to the relevant guaranty funds to address the remaining losses. These contributions may only be used for this purpose and are pre-funded by clearing members. The amount of a clearing member's contributions to each guaranty fund is proportionate to the risk of the positions in the relevant asset class that are held by the clearing member for itself and its customers. The proportionality of this requirement is designed to incentivize clearing members to control the risk they bring to the CCP. The requirement to contribute to the relevant guaranty funds also incentivizes clearing members to support strong CCP risk management programs. Clearing members' guaranty fund contributions are held in the form of high-quality, liquid assets and are isolated from CME Clearing's assets.

CME Clearing's pre-funded protections are robust and are based on resources that are substantial. CFTC regulations require CME Clearing to maintain financial resources sufficient to withstand the simultaneous default of its two largest clearing members. Stress tests performed

⁴ References to "default" are not limited to instances of a failure to meet an obligation to CME Clearing. As used herein, "default" includes instances where: "financial or operational condition of a clearing member or one of its affiliates is such that to allow that clearing member to continue its operation would jeopardize the integrity of [CME Inc.], or negatively impacts the financial markets by introducing an unacceptable level of uncertainty, volatility or risk . . ." CME Rule 975.

by the CFTC as recently as November 16, 2016, have confirmed that CME meets this requirement. As of March 31, 2017, CME Clearing's guaranty funds and the CME Contributions exceeded \$8.5 billion.

Despite the robustness of our financial safeguards, some have suggested that a CCP maintain an additional tranche of pre-funded resources or "skin in the game" to cover losses resulting from a clearing member default. If the intent of the proponents of more skin in the game is to substitute the contribution of the CCP for obligations now borne by the clearing firms that are responsible for creating the risk, this adds an element of moral hazard that is inimical to sound risk management practices. Each clearing member should be responsible proportionately for the risk it adds to the clearing process.

We made a business decision to put the CME Contributions ahead of any call on the default fund as a means of assuring our clearing members that we were protecting them and doing an appropriate job of risk management. We sized our first line contribution to meet this purpose. We do not agree that our contribution should be a function of the size of the largest clearing member's obligation to the default fund. That amount is a function of the risk that the clearing member has determined is appropriate to its business and its risk assessment. If the biggest clearing member has a \$1 billion contribution level because of the risk it undertakes, there is no relationship between that amount and the purpose of our being first in line to cover losses. In fact, scaling the CCP's contribution in this manner would effectively reduce the mutualization of risk among clearing members, creating moral hazard.

The reasons to avoid excess skin in the game are apparent. Trapping additional resources of the CCP in a commitment to the guaranty fund is detrimental. Devoting substantial assets to a totally unproductive use impinges on the efficient management of the business and adds to the costs of clearing that must be passed on. Adding costs to clearing could, in effect, exclude smaller clearing members from the markets resulting in concentration of risk in fewer clearing members and will restrict access to the markets for certain classes of smaller customers including farmers and ranchers. Access to clearing and a diversity of clearing members and market participants is critical to the stability of the broader financial markets.

During the three major market crises since 1987, no US CCP has failed. In the few instances where a clearing member was on the verge of failure, CME Clearing took action in advance of failure to close out or transfer positions and protect the defaulting clearing firm's customers. And even when a clearing member has defaulted, there were no losses to non-defaulted clearing members or their customers. At no time in CME Clearing's history have the losses arising from a clearing member failure come close to exceeding the failing firm's performance bonds. As a result, CME Clearing has never even approached utilizing the relevant CME Contributions or non-defaulted clearing members' contributions to the relevant guaranty funds.

Nonetheless, CME Clearing has planned for the possibility that CME Clearing would access and exhaust the CME Clearing contributions and non-defaulted clearing member contributions to the relevant guaranty funds and that losses could remain. Under CME Clearing's rulebook, if losses from multiple clearing member defaults exceed our pre-funded financial resources, CME Clearing would assess additional funds from clearing members to satisfy remaining losses. The rulebook provides for a maximum amount of funds that CME Clearing may collect as assessments from its clearing members that participate in the relevant products. The amount of assessments collected from a particular clearing member is proportionate to the risk of positions held by the clearing member in the relevant asset class. CME Clearing monthly informs each clearing member of the maximum amount they could be assessed under these powers, enabling clearing members to measure, manage, and control their exposure to the CCP. This

requirement is designed to incentivize clearing members to control the risk they bring to the CCP and to participate actively and bid aggressively in CCP default management processes.

CME Clearing believes that these assessments, combined with the guaranty fund and the CME Contribution, would cover at least the simultaneous default of the four largest clearing members (which would equate to the simultaneous default of the four largest global banks).

In addition to the aforementioned financial safeguards, CME Clearing would utilize its default management processes to address a clearing member default. If a clearing member defaults, CME Clearing would step quickly into the positions of the defaulted clearing member to liquidate the clearing member's own positions and/or work to transfer positions to another clearing member that elects to take them.

CME Clearing would attempt to transfer or "port" the defaulted clearing member's customer positions to willing and able non-defaulted clearing members. To date, CME Clearing has always been successful in porting 100% of such positions where a clearing member has failed. Any customer positions that cannot be ported to a non-defaulted clearing member would be liquidated. CME Clearing requires that the required performance bond of each customer of a clearing member be held at CME Clearing—so-called "gross margining." This facilitates our ability to transfer the customer positions held by a defaulted clearing member promptly upon the clearing member's default.

Once all positions of the defaulted clearing member and its customers are (i) transferred by CME Clearing from the defaulted clearing member (for whom CME Clearing has stepped in) to solvent clearing members and/or (ii) liquidated, CME Clearing will have restored a matched book.

CME Clearing maintains credit facilities with third parties to further its ability to meet the potential liquidity issues that could result from a clearing member default. In a default situation, CME Clearing's liquidity resources would allow it to meet the settlement obligations of the defaulted clearing member in all relevant currencies while CME Clearing works to transfer and/or liquidate the positions.

REGULATORY ENHANCEMENTS: RECOVERY, WIND-DOWN, AND RESOLUTION

In 2013, the CFTC adopted regulations designed to further strengthen CCPs' risk management practices. These regulations require us to develop and maintain two types of plans in case we experience an extreme, but plausible, stress event that could threaten our viability—a recovery plan that sets forth how CME Clearing intends to recover and a wind-down plan that sets forth how CME Clearing would permanently cease, sell, or transfer one or more of its clearing services if its recovery plan fails. CME Clearing has developed these plans in consultation with the CFTC. Neither plan relies on taxpayer funds.

Our recovery plan divides the extreme stress events that could threaten CME Clearing's viability into two categories—one for clearing member defaults and a second for any other extreme stress event that could threaten our viability (which we call "non-default loss"). Recovery tools that could impact clearing members and their customers are set forth in the CME Clearing Rulebook, which is publicly available.

The extreme stress event most likely to trigger CME Clearing's recovery plan would be the simultaneous failure of four or more global, systemically important banks that are clearing members of CME Clearing as well as the failure of the bank resolution regime. In our recovery

plan, we identify assessments as our first recovery tool to solve for losses arising from clearing member defaults that exceed CME Clearing's robust, pre-funded financial safeguards.

Domestic and international regulators believe that they can ease the process of recovering from clearing member defaults by requiring CCPs to have tools in place to allocate fully all losses that arise from clearing member defaults and to restore a matched book after a clearing member default.

Under current law, before adding new recovery tools to the CME Clearing Rulebook to address these regulatory requirements, CME Clearing published its proposed rules and submitted them for review by the CFTC who consults with the Board of Governors of the Federal Reserve System, along with analysis regarding the potential impact of the proposed tools on CME Clearing's clearing members and their customers.

To satisfy the regulatory requirement to fully allocate losses, CME Clearing adopted rules providing for net portfolio gains haircuts ("haircuts", which are also known as "Variation Margin Gains Haircuts" or "VMGH") for Base products should losses remain after CME Clearing exhausts its assessments. VMGH is designed to extinguish or "haircut" a portion of amounts due to clearing members and their customers with a net portfolio gain for a settlement cycle while collecting the full amount from clearing members and their customers with a net portfolio loss for the settlement cycle. CME Clearing determines the amount of the haircut based on the amount received from clearing members and their customers with net portfolio losses applied on a pro rata basis across the clearing members and their customers with net portfolio gains for the relevant account class for the settlement cycle. CME Clearing's rules provide for up to five days of haircuts for Base products and require that the legitimate interests of clearing members and customers of clearing members be considered before CME Clearing may change the duration of haircuts.

Also to satisfy the regulatory requirement to fully allocate losses, CME Clearing added rules providing for voluntary contributions in Base products. If losses from a clearing member default remain after CME Clearing has exhausted the financial safeguards package for Base, CME Clearing may offer clearing members and their customers an opportunity to make voluntary contributions to assist in curing remaining losses. Clearing members and their customers may elect to make voluntary contributions in order to avoid haircuts. It is expected that voluntary contributions would only occur if the amount of contributions received are in the aggregate sufficient to fully mitigate all losses and thus avoid haircuts.

In response to the regulatory requirement to restore a matched book, CME Clearing adopted rules to govern the use of voluntary or mandatory tear-ups for Base products. After identifying clearing members and customers whose positions are on the opposite side of defaulter positions that remain open, CME Clearing would provide those clearing members and customers an opportunity to agree voluntarily to have their positions extinguished to restore CME Clearing's matched book. It is expected that voluntary partial tear-ups would only occur if the universe of positions marked for voluntary partial tear-up are in the aggregate sufficient to fully mitigate all losses and would restore a fully matched book. If needed, CME Clearing would turn to mandatory tear-ups. CME Clearing designed the mandatory tear-up process to reestablish a matched book in a manner that, to the extent possible, localizes the impact of a failure to the markets in which defaulters' positions have not been fully transferred or liquidated and avoids impacting other markets. CME Clearing's rules for Base products explicitly require that the legitimate interests of clearing members and customers of clearing members be considered when determining the appropriate scope of tear-ups.

By fully allocating losses and restoring a matched book after clearing member defaults, CME Clearing could continue to offer clearing services and promote the stability of the broader financial markets.

By design, a CCP's recovery tools incentivize clearing members to participate in managing the default of fellow clearing members, without impact to taxpayers. This participation is critical in order for the CCP to recover. Any ability or expectation that the government could intervene to resolve the CCP before these tools are exhausted would undermine these incentives, weaken the CCP's ability to recover, and subsidize clearing member risk taking.

CME Clearing's recovery plan addresses separately the extreme and remote scenarios that could threaten CME Clearing's viability as a going concern other than clearing member defaults as "non-default loss". These events include a disorderly failure by a settlement bank while it is holding money for CME Clearing; the failure of a custodian bank that is holding assets for CME Clearing at the same time as a clearing member defaults; a fraud or crime event; and a cyberattack.

CME Clearing believes that any non-default losses that could be allocated to clearing members and/or market participants should be set forth clearly in a CCP's rulebook. Under CME Clearing's rulebook, none of the pre-funded financial safeguards (neither performance bonds nor CME Contributions or clearing member contributions to the guaranty funds) or assessment powers could be used to solve for a non-default loss. CME Clearing maintains insurance coverage to address non-default losses arising from a number of insurable risks, including employee fraud, a crime event, and cyber risks.

CME Clearing maintains credit facilities with third parties to address liquidity issues resulting from temporary disruptions of the settlement and payment system upon which clearing relies.

Our wind-down plan would be activated only if recovery fails. Pursuant to CFTC regulations, CME Clearing's wind-down plan contains actions CME Clearing could take to permanently cease, sell, or transfer one or more of its clearing services. No taxpayer funds would be involved.

CME Clearing maintains financial resources to effect an orderly wind-down of its clearing house as required by CFTC Regulations.

If Title II of Dodd–Frank applies to derivatives clearing organizations like CME Clearing, a government-ordered resolution of our clearing house would only be permitted after the failure of multiple layers of protection—namely, the failure of: (1) banking regulations designed to prevent the collapse of the largest global banks; (2) the bank resolution regime which is designed to ensure a failed bank can continue to meet its systemic obligations; (3) our prefunded financial resources; (4) our recovery plan; and (5) our wind-down plan. Thus, government-ordered resolution would and should remain an extremely remote possibility. If this sequence prescribed by Title II of Dodd–Frank is followed, market participants will be responsible for their actions and both the financial markets and US taxpayers will be better protected against future financial stress.

We are concerned by a trend we have observed of some market participants and groups of regulators across the globe looking to bank resolution structures and processes as precedent when considering how CCPs should be resolved if the need arises. Regulations or standards

that treat CCPs like banks would weaken—rather than strengthen—CCPs and would be a mistake. To the extent that CME Clearing could be expected to comply with international standards in order to maintain international business, it is important that the international standards not require actions that would weaken CCPs.

The objective of CCP recovery is to promote the continuity of critical clearing operations and services and the stability of the broader financial markets. In order for recovery to achieve this objective, it is essential that resolution frameworks and strategies not undermine recovery or promote resolution over recovery. Government should not require CCPs to change their operations in order to become successful failures; instead, government should promote successful CCP recovery.

Thank you for your consideration of CME Group's views on these significant issues.