

WRITTEN TESTIMONY OF SCOTT HILL,
CHIEF FINANCIAL OFFICER,
ON BEHALF OF INTERCONTINENTAL EXCHANGE, INC.
BEFORE THE HOUSE COMMITTEE ON AGRICULTURE

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Introduction

Chairman Conaway, Ranking Member Peterson, I am Scott Hill, Chief Financial Officer for Intercontinental Exchange, or ICE. I appreciate the opportunity to appear before you today to discuss the role of clearing.

Background

Since launching an electronic over-the-counter (OTC) energy marketplace in 2000 in Atlanta, Georgia, ICE has expanded both in the U.S. and internationally. Over the past seventeen years, we have acquired or founded derivatives exchanges and clearing houses in the U.S., Europe, Singapore and Canada. In 2013, ICE acquired the New York Stock Exchange, which added equity and equity options exchanges to our business. Through our global operations, ICE's exchanges and clearing houses are directly regulated by the U.S. Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Bank of England, the U.K. Financial Conduct Authority (FCA), the European Securities and Markets Authority (ESMA) and the Monetary Authority of Singapore, among others.

ICE has a successful and innovative history clearing exchange traded and over-the-counter (OTC) derivatives across a spectrum of asset classes including many energy, agriculture and financial products. ICE acquired its first clearing house, ICE Clear U.S. (ICUS), as a part of the 2007 purchase of the New York Board of Trade. ICUS clears a variety of agricultural and financial derivatives. In 2008, ICE launched ICE Clear Europe (ICEU), the first new clearing house in the UK in over a century. ICEU clears derivatives in several asset classes including energy, interest rates and equity derivatives. ICE Clear Credit (ICC) was established as a trust company in 2009 under the supervision of the Federal Reserve Board and the New York State Banking Department and converted to a derivatives clearing organization (DCO) following implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). Today, ICE owns and operates six clearing houses that serve global markets across North America, Europe and Asia.

CCPs Facilitate Market Participation by Mitigating Default Risk

The risk reducing benefits of central clearing have long been recognized by users of exchange-traded derivatives (futures) and the efficacy of the clearing model throughout even the most challenging financial situations made it the natural foundation of the financial reforms put forward over the past decade for OTC derivatives around the world. Clearing has consistently proven to be a fundamentally safe and sound process for managing systemic risk

INTERCONTINENTAL EXCHANGE

5660 New Northside Drive NW
3rd Floor
Atlanta, GA 30328

Tel: 770.857.4700
Fax: 770.937.0020
theice.com

throughout history. Observers frequently point to non-cleared derivative contracts as a significant factor in the broad reach and complexity of the 2008 financial crisis while noting the relative stability of cleared markets.

The disciplined and transparent risk management practices (including: initial and ongoing counterparty credit monitoring; uniform, risk-based, collateral requirements; and, the daily marking-to-market of losses) associated with regulated cleared contracts serves to reduce systemic risk. A clearing house, by acting as a central counterparty (or CCP), to transactions, minimizes bilateral risk by compressing derivative exposures. For example, since 2009, ICE Clear Credit and ICE Clear Europe have cleared more than \$89.5 trillion in CDS notional, but, in part, through compression (also known as multilateral netting) the amount of bilateral credit exposure among market participants has been significantly reduced. ICE Clear Credit and ICE Clear Europe currently maintain a combined open interest of \$1.6 trillion.

Over the past 100 years, clearing house risk management practices have been repeatedly tested and proven in resolving clearing member defaults including large bankruptcy proceedings such as Lehman Brothers and MF Global. The recent introduction of mandated clearing obligations for certain swaps has prudently extended the significant benefits of clearing to a broader array of vitally important capital markets.

Over the past decade, ICE has invested heavily in our clearing house technology and risk management practices. ICE has kept pace with and often preceded regulatory reforms, new global rules, and international standards¹ that have been established with respect to risk controls, levels of protection and proper functioning of clearing houses. We have worked closely with regulators, clearing members and end users to implement clearing models that meet or exceed modern regulatory reforms and international standards. The result is an even more robust clearing model that includes many ICE-led initiatives, such as the introduction of “skin-in-the-game,” or the contribution by the clearing houses of a designated, fully funded amount of its own capital to the default waterfall.

ICE clearing houses are subject to extensive regulatory oversight and strong corporate governance requirements, exercised largely through customer-constituted risk and advisory committees and independent boards of directors.² Risk committees include representatives from our clearing member firms and, in some cases, end clients. ICE clearing houses regularly conduct margin back-testing, default fund stress testing, and liquidity stress testing - the results of which are publicly available and reviewed by clearing members and regulators. In addition, the clearing houses' margin, guaranty fund and liquidity methodologies are independently validated on a routine basis and are subject to the review and approval of the relevant risk committee, board and prudential regulator(s).

The rules, practices and procedures of ICE's clearing houses are fully transparent and are publicly disclosed in a consistent manner, as set out within the CPMI-IOSCO Principles for

¹ Committee on Payment and Settlement Systems, International Organization of Securities Commissioners (CPSS-IOSCO), *Principles of Financial Market Infrastructures* (April 2012). <http://www.bis.org/publ/cpss101a.pdf>

² An overview of the risk governance at ICE clearing houses can be found online: ICE Clear Europe - www.theice.com/clear-europe/risk-management; ICE Clear US - www.theice.com/clear-us/regulation; ICE Clear Credit - www.theice.com/clear-credit/regulation

Financial Market Infrastructures (PFMIs)³ and various regulatory requirements. Any material changes to ICE's clearing processes are subject to rigorous internal governance review as well as applicable regulatory review and approval.⁴

CCPs Facilitate Market Participation by Managing Liquidity Risk

ICE's clearing houses collect a significant amount of collateral largely in the conservative form of cash and U.S. government securities. The management of these large collateral balances and the need to facilitate daily variation margining requires the mitigation of custodial/depository risk and collateral liquidity risk.⁵ While CCPs have successfully managed these risks in the past through commercial arrangements, such arrangements are frequently with institutions that are also clearing members. Central banks, including the Federal Reserve, can (1) eliminate custodial/depository risk by allowing CCPs to deposit cash collateral in a Federal Reserve System account and (2) eliminate any liquidity risk by granting CCPs access to the discount window for the limited purpose of transforming U.S. treasuries into cash. Fed account access benefits the market, reduces depository and investment risk and has proven to be a useful tool, allowing designated CCPs to more safely and soundly manage collateral, including client funds.

Fed account access provides the maximum level of protection for customer collateral, a central goal of regulators and policymakers, and such access should be made available to all CCPs. By providing selective access to designated clearing houses, the current policy unintentionally drains more liquid assets from non-designated CCPs, exacerbating their liquidity challenges. In addition, customers of designated CCPs are provided enhanced protections from commercial and depository risk while customers of non-designated CCPs are not. Why should a wheat farmer enjoy a greater level of protection than a cotton farmer? The government should promote a policy that expands and equalizes access to Fed accounts to level the playing field for all market participants. It is important to note that such access creates exactly zero additional risk to the taxpayer.

In addition, as noted above, CCPs should have access to the discount window for the limited purpose of transforming U.S. treasuries into cash. Such access simply provides a facility to turn U.S. government securities, at a hair-cut appropriate to the market environment at the time of access, into U.S. dollars to facilitate the vital variation margin process during a time of unprecedented stress. Again, such access in no way creates any additional risk to taxpayers.

Basel Impact on Clearing

Despite the growth in the volume of cleared contracts, the number of futures commission merchants ("FCM") available to provide clearing services for end-users has dropped considerably in recent years. There were around 190 firms providing clearing services in 2004

³ *Supra, nt. 1.*

⁴ For an overview of ICE central clearing operation and governance see:

<https://www.theice.com/publicdocs/CentralClearingReducingSystemicRisk.pdf>

⁵ The liquidity of U.S. government securities is a topic of industry debate. ICE believes that U.S. government securities are one of the more liquid forms of collateral and that historically, during times of stress, there has been a flight to the quality of U.S. government securities.

but only approximately 56 today, according to the Futures Industry Association. Exacerbating the decline, the majority of these FCMs focus only on futures execution services with only a subset providing both futures and over-the-counter swaps post trade clearing services. Consequently, the bulk of derivatives clearing is now concentrated amongst a few bank owned global FCMs and some customers find themselves excluded from markets because they cannot access clearing services. The term “off-boarding” of clients has become more prevalent in the industry than on-boarding.

One of the biggest constraints on clearing service providers is the proposed Basel Committee on Banking Supervision’s leverage ratio framework (“Basel III”). Basel III requires a bank to hold regulatory capital against clearing customer margin on its balance sheet notwithstanding the fact that the customer margin is posted to a clearing house and held at the clearing house on a segregated basis. Said differently, risk *reducing* margins collected from customers and segregated on a bank’s balance sheet are considered risk *enhancing* for capital requirement purposes. For example, Basel III treats the capital requirements for a client cleared transaction with initial margin (“IM”) the same as a formerly bi-lateral trade without any IM posted. Without allowing IM Offsets, the clearing member is penalized for having a position that is actually more collateralized which makes the provision of clearing services far less attractive. As a direct result, and as reflected in the aforementioned statistics, the unintended consequence is that many FCMs are shrinking or ceasing their clearing services business at exactly the same time regulations are encouraging the increased use of clearing.

In addition, these increased capital costs may also impede customer porting from a failing clearing firm to a healthy clearing firm in a time of stress. Under current rules, FCMs accepting new customer positions from a defaulted FCM must immediately be willing and able to sustain large capital charges to absorb the new positions. While the global CCPs and their members successfully managed through the large bankruptcy proceedings involving Lehman Brothers and MF Global, Basel III capital rules did not apply and mandatory client clearing rules for OTC swaps had not gone into effect. In the current construct, FCMs are likely to be far more reluctant to accept ported positions which will exacerbate the instability in markets already present in a default situation.

CCP Recovery and Resolution

To accommodate extreme and unlikely circumstances that result in losses in excess of a defaulting clearing members’ margin and guaranty fund resources, ICE clearing houses have established robust recovery plans that are clear and transparent and provide sufficient detail for members and regulators to anticipate the likely actions and tools that may be used during a default. ICE has been working with regulators and clearing members to implement changes to its recovery rules to further enhance the recovery process and incentivize clearing members, CCPs and market participants to work together during a crisis situation to maintain the viability of the market by returning to a matched book. The recovery rule amendments have been approved by regulators and clearing members for certain ICE clearing houses and we are actively working to harmonize changes across all ICE clearing houses.

Further, ICE believes that, to the fullest extent possible, resolution authorities should not interfere with a CCP’s implementation of its existing recovery process. If it does become necessary for a resolution authority to intervene before a CCP has exhausted its available

tools, the resolution authority should continue to act consistently with the CCP's existing rules and arrangements. ICE additionally believes that resolution should be invoked only in a situation where all efforts at recovery have been unsuccessful (whether taken by CCP itself, the resolution authority, or a combination of the two).

Finally, an appropriate resolution authority should possess a deep understanding of the markets and role of CCPs. The Commodities and Futures Trading Commission ("CFTC") possesses this requisite knowledge and experience given its direct regulatory oversight over CCPs and is well positioned to be the resolution authority for the CCPs it oversees.

Conclusion

ICE has always been, and remains, a strong proponent of open and competitive markets with appropriate regulatory oversight. As an operator of global futures and derivatives markets, ICE understands the importance of ensuring the utmost confidence in its markets and we take seriously our obligations to mitigate systemic risk. To that end, we have worked closely with regulatory authorities in the U.S. and abroad in order to ensure they have access to all relevant information available to ICE regarding trade execution and clearing activity on our markets. ICE looks forward to continuing to work closely with governments and regulators at home and abroad to address the evolving regulatory challenges presented by derivatives markets and to expand the use of demonstrably beneficial clearing services that underpin the best and safest marketplaces possible.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you and members of the subcommittee may have.