

WRITTEN TESTIMONY OF CHRIS EDMONDS
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ON BEHALF OF INTERCONTINENTAL EXCHANGE, INC.
BEFORE THE HOUSE AGRICULTURAL COMMITTEE, SUBCOMMITTEE
ON EXCHANGES, ENERGY AND CREDIT

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Introduction

Chairman Scott, Ranking Member Scott, I am Chris Edmonds, Senior Vice President, Financial Markets for Intercontinental Exchange, or ICE. I appreciate the opportunity to appear before you today to discuss the role of clearing and trade execution.

Background

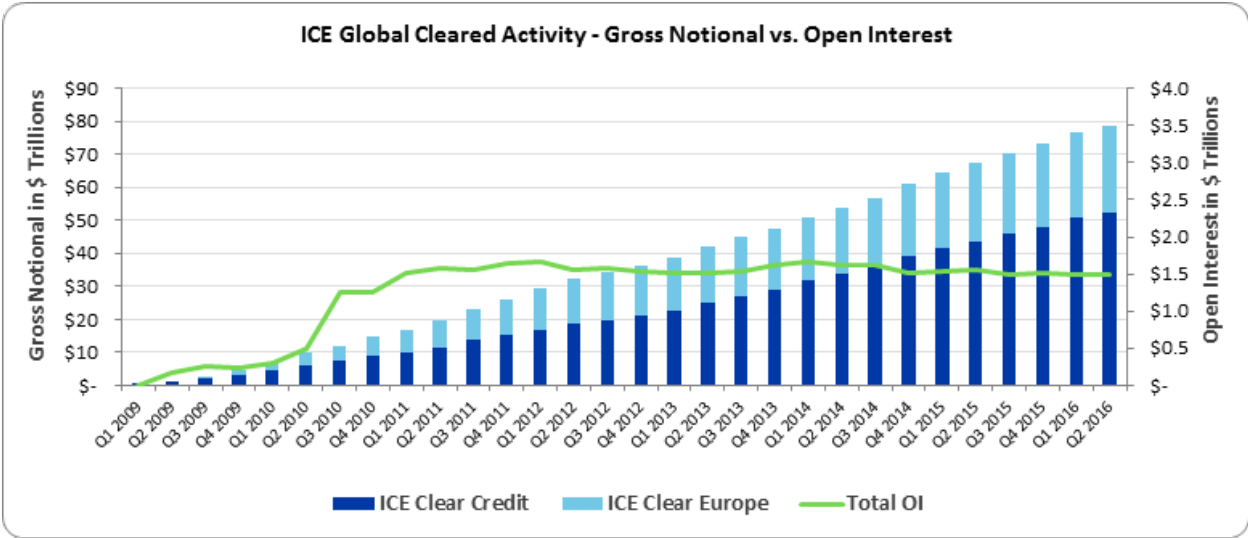
Since launching an electronic over-the-counter (OTC) energy marketplace in 2000 in Atlanta, Georgia, ICE has expanded both in the U.S. and internationally. Over the past sixteen years, we have acquired or founded derivatives exchanges and clearing houses in the U.S., Europe, Singapore and Canada. In 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 and the Monetary Authority of Singapore, among others.

ICE has a successful and innovative history clearing exchange traded derivatives and OTC derivatives such as energy and credit default swaps (CDS). ICE Clear Credit (ICC) began operating 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). 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, agriculture, interest rates and credit. In total, ICE owns and operates six clearing houses in North America, Europe and Asia.

Current Clearing Environment

Observers frequently point to a lack of cleared derivative contracts as a significant factor in the broad reach and complexity of the 2008 financial crisis. The disciplined and transparent risk management practices (including uniform collateral requirements and the daily marking-to-market of losses) associated with regulated cleared contracts serves to reduce systemic risk. Whereas, opaque bilateral OTC derivative transactions result in counterparty exposures that can become hard to unwind when the market experiences a period of widespread stress. A clearing house, by acting as a central counterparty (CCP) to transactions, minimizes bilateral risk by compressing derivative exposures. For example, since 2009, ICC and ICEU have cleared more than \$78 trillion in CDS notional, but through compression currently maintain a combined open interest of \$1.5 trillion, significantly reducing bi-lateral credit exposure among market participants and reducing systemic risk.



In response to the financial crisis, the G20 finance ministers decided that, to the extent possible, the OTC derivative market should be cleared. Congress followed suit with the DFA, which created a clearing requirement for liquid standardized derivatives. Today, certain U.S. and European CDS indices and certain interest rate swaps are mandated for clearing by the CFTC. The European Market Infrastructure Regulation (EMIR) created a similar clearing mandate for Europe. As a result of increased clearing, market participants are realizing that moving uncleared positions into clearing results in risk, operational and capital efficiencies.

Basel-Fueled Headwinds

Ironically, despite mandate-driven and natural 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. What had been an industry of 190 firms in 2004 was reduced to 76 firms by 2014, according to the Futures Industry Association. The bulk of derivatives clearing is now concentrated in a few bank owned global FCMs. These firms are constrained by 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 that the customer margin is posted to a clearing house and held at the clearing house on a segregated basis. This Basel III capital requirement makes it more expensive for banks to offer clearing services, at the very time clearing capacity is shrinking and customer demand is increasing. Further, Basel III makes the transfer (or porting) of client positions much more difficult as banks must perform an assessment of their capital costs before accepting a client position transfer. This will complicate default resolution as banks will be less likely to accept client positions from a defaulting clearing member.

ICE has joined a group of concerned FCMs, end users and other clearing house operators to encourage the Basel Committee to reconsider and refine aspects of the rule which is set to become final at the start of 2017. CFTC regulations already prohibit banks from using customer margin funds in any way other than to mitigate the risk reflected in customer positions. The Basel committee recently indicated it may rethink this position and has requested further comment on the proposal. ICE and the broader derivatives industry are hopeful the Basel Committee will recognize the segregated and risk reducing nature of customer funds that are restricted on bank balance sheets.

Regulatory Coordination

Earlier this year, European and U.S. regulators reached an important milestone on margin equivalence standards for CCPs in their respective jurisdictions. This determination encourages continued cross-border activity and will help prevent a fragmentation of liquidity for related contracts. Further coordination between the regulators is still required to ensure the standards do not create opportunities for regulatory arbitrage or balkanize global markets, but this first step brings important regulatory certainty to clearing customers. We are also hopeful that global regulators will reach agreement on equivalence between trade execution platforms within a reasonable timeframe.

Since the enactment of the DFA, ICE has also worked with the CFTC and the SEC to provide CDS market participants the benefits of capital efficiency that can come with the portfolio margining of risk off-setting positions.¹ The SEC developed a portfolio margining regime that requires each clearing member to create its own set of portfolio margining standards. Under these rules, there has been some progress in single name clearing but uncertainty remains.

¹ CDS Index instruments are subject to CFTC regulation, while CDS single name instruments are subject to SEC regulation, therefore a coordinated effort was required to provide for portfolio margining for CDS.

We look forward to working with the SEC to resolve the questions still limiting market participants' ability to use these critical risk management tools.

CCP Operation and Role in the Financial System

The central counterparty clearing model is effective and has been relied upon in futures markets for more than 100 years. The recent introduction of mandatory clearing obligations for certain swaps has increased awareness around clearing and the significant benefits it brings to the capital markets. Over the past 100 years, clearing house risk management practices have been repeatedly tested and have performed as designed in resolving clearing member defaults.

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 standards² 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,” the clearing house’s contribution of a designated 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 risk and advisory committees and independent boards of directors.³ Risk committees include representatives from clearing member firms and, in some cases, end clients. ICE clearing houses regularly conduct margin

² 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>

³ For an overview of the risk governance at ICE clearing houses see

: 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

back-testing, default fund stress testing, and liquidity stress testing, the results of which are reviewed by clearing members and regulators. In addition, the clearing houses' margin, guaranty fund and liquidity methodologies are independently validated on a routine basis.

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 Financial Market Infrastructures (PFMIs)⁴ and various regulatory requirements. Any material changes to ICE's clearing processes are subject to rigorous internal governance as well as applicable regulatory review and approval.⁵

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and derivatives markets, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with regulatory bodies in the U.S. and abroad to ensure they have access to all relevant information available to ICE regarding trade execution and clearing activity on our markets. ICE continues to work closely with governments and regulators at home and abroad to address the evolving regulatory challenges presented by derivatives markets and will continue to work cooperatively for solutions that promote the best and safest marketplaces.

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.

⁴ *Supra*, nt. 2.

⁵ For an overview of ICE central clearing operations and governance see: https://www.theice.com/publicdocs/Central_Clearing_Reducing_Systemic_Risk.pdf