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U.S. Commodity Futures Trading Commission

Market Risk Advisory Committee

Provided by:

Delta Strategy Group

OVERVIEW

For questions on the note below, please contact Kevin Batteh or Daniel Austin at 202-547-3035.

Today, the U.S. Commodity Futures Trading Commission (CFTC or Commission) held a meeting of its Market Risk Advisory Committee (MRAC or Committee).

Key Takeaways

- On behalf of the FIA Principal Traders Group, DRW's Graham Harper said that market-wide data would likely illustrate that principal trading firms (PTFs) continued to actively participate in the markets throughout the pandemic. He explained that this level of activity further dispels the narrative that PTFs as a group tend to back away from providing liquidity during times of high volatility. He said FIA PTG would welcome any such analysis done by the Commission on this topic.
- Citadel's Stephen Berger, Co-Chairman of the MRAC Market Structure Subcommittee, said the Subcommittee has pivoted its focus on the swap dealer (SD) landscape and the made available to trade (MAT) process. He explained that there have not been any new MAT filings since 2013, and at the same time, there have been several proposals issued regarding how the MAT process could be revised. He said the MAT process needs to change so that it can evolve with liquidity, new contracts and products, and more.
- Chris Barnes, Clarus Financial Technology, discussed how transparency, brought about by reporting data to swap data repositories (SDRs), was a benefit to market participants. He said other jurisdictions severely lacked timely, accessible post-trade transparency data. U.S. swap market data reporting transparency proved that markets were not "seizing up," removed rumors from the market, and price and helped to remove information asymmetry.
- Chairman Heath Tarbert said the Commission has completed a detailed study on the negative prices in the WTI contract, and it will be released to the public later this fall.

SUMMARY

Opening Statements

Commissioner Rostin Behnam (MRAC Sponsor)

Since we last met in December 2019, the pandemic has profoundly altered our country and the world, and nearly all of our daily experiences have been impacted. The last few months have led to broad fiscal and monetary stimulus to mitigate the pandemic's effects.

With technology, we can mostly continue running on schedule, and MRAC's Subcommittees have continued to meet. This morning, we will receive updates from the four Subcommittees on a variety of timely issues related to the derivatives markets, including interest rate benchmark reform, climate-related market risk, market structure, and market function during the pandemic.

I am confident the Commission will continue to assist in the transition away from LIBOR, and I encourage all market participants to focus their energies on this important effort.

Chairman Heath Tarbert

We witnessed significant volatility in the early months of the pandemic. There were unique macroeconomic factors at play, particularly in the oil markets, but the possibility of negative prices was not a surprise for the Commission.

To help markets to prepare, we issued a staff advisory on preparing for the possibility of negative pricing, low liquidity, and more. We have completed a detailed study on the negative WTI contract, and we plan to make that report public this fall.

I am looking forward to the report from the Interest Rate Benchmark Reform Subcommittee. This Subcommittee's work has and will continue to assist in a smooth transition away from LIBOR.

Commissioner Brian Quintenz

Thank you to Commissioner Behnam for convening today's meeting and to the Subcommittees for continuing their work during these unprecedented times. I look forward to today's reports.

Commissioner Dawn Stump

As the Commission has managed the circumstances of the past several months, the CFTC's advisory committees have been incredibly beneficial. I look forward to today's presentations and discussion.

Commissioner Dan Berkovitz

I am looking forward to today's meeting, and I appreciate the significant amount of work done by Commission staff and the Subcommittees to prepare for today's meeting.

Report from the Interest Rate Benchmark Reform Subcommittee

Thomas Wipf, Subcommittee Chairman, Vice Chairman, Institutional Securities, Morgan Stanley

Since December, there have been several developments related to the LIBOR transition. Various regulators published reports, statements, and recommendations on the transition and the associated risks.

The Subcommittee's CCP discounting transition tabletop exercise used scenario analysis to identity areas that could strengthen the current discounting transition proposals. The exercise addressed seven different scenarios. The Subcommittee wanted the tabletop to be educational, explore how market participants could react to problems, and more.

There are some gaps in understanding among market participants about precise timing of the discounting transition, as well as the dynamic of the CME and LCH auction processes. In order to mitigate these and other issues, the Subcommittee determined that: (1) enhanced education is needed for all parties involved; (2) risk mitigation strategies should be considered ahead of the discounting transition; and (3) internal preparation is absolutely critical to produce a positive outcome for the market.

The Subcommittee also issued additional recommendations for CCPs, FCMs, buy-side participants, and regulators related to the transition.

Q & A

Nadia Zakir, PIMCO, (MRAC Chair): Has the pandemic impacted transition efforts? *Wipf:* We have been able to navigate these challenges, even in a work-from-home environment. Because we were meeting virtually, the Alternative Reference Rates Committee (ARRC) doubled its number of meetings. We have not seen resources shifted away from transition efforts. We have turned an important corner, and we are using our momentum to ensure a seamless transition.

Stephen Berger, Citadel: Post-trade transparency should be increased with respect to the upcoming auctions. The transition to SOFR is predicated on more transparency, and the transition steps should be transparent as well.

Sujatha Srinivasan, Goldman Sachs: Provide an update on the ISDA protocol. *Wipf:* The ARRC appreciates the CFTC's work on the ISDA protocol and fallback language as we work towards a smooth transition. The dialogue with the Commission has been great, and we look forward to continuing these discussions. Signing up to the ISDA protocol will be important to mitigate legacy risk in the markets.

Report from the Climate-Related Market Risk Subcommittee

Bob Litterman, Subcommittee Chairman, Founding Partner and Risk Committee Chairman, Kepos Capital

The pandemic has slowed down the Subcommittee's work, so we have not yet finalized our report; however, we anticipate it will be complete in August or early September. Although the report is incomplete, it will provide some recommendations to the CFTC and other U.S. financial regulators on how to address and mitigate climate change impacts on economic activity and financial markets.

The report should help inform ongoing and future policy debates, particularly because climate change will continue to be a matter of legislative interest. We began our work with two in-person Subcommittee meetings, and we quickly agreed on the report's outline and found members that would lead the various working groups. As we moved forward, all Subcommittee members contributed to the discussion and writing process.

Q & A

Zakir: Share your thoughts on the pandemic's impact vis-à-vis climate-related risk. *Litterman:* Although there has been a decline in emissions during the pandemic, this decline is very minor in the grand scheme of things.

Report from the Market Structure Subcommittee

Lisa Shemie, Subcommittee Co-Chairman, Associate General Counsel, Chief Legal Officer – Cboe FX Markets and Cboe SEF, Cboe Global Markets and **Stephen Berger, Subcommittee Co-Chairman, Managing Director and Global Head of Government & Regulatory Policy, Citadel**

The Subcommittee initially identified three broad categories for consideration: (1) trading; (2) clearing; and (3) reporting. Following our December meeting, we formed working groups to discuss these issues in greater detail. Beginning in January, we worked hard on trying to focus on topics related to these three broader categories.

Earlier this year, the Subcommittee, with the Commission's blessing, decided to redirect our near-term efforts to investigate how markets performed and functioned during the pandemic. We hope to inform the Commission and MRAC how the markets performed during these volatile times.

Q & A

Zakir: Can you provide more information on why the Subcommittee decided to focus on the SD landscape and the MAT process ? *Shemie:* After several calls, we began to coalesce around these topics. The SD landscape has several issues that impact the Subcommittee membership, e.g., SD concentration, the floor trader exemption, etc.; *Berger:* There have not been any new MAT filings since 2013, which begs the question of why this has not occurred. At the same time, there have been several proposals issued regarding how the MAT process could be revised. There have been a lot of recommendations, but no consensus on the best path forward. I anticipate the Subcommittee will explore the MAT criteria, who can submit a MAT filing, and the process to receive public feedback on MAT filings. We need a MAT process that evolves with liquidity, new contracts and products, and more.

Market Function and Performance During the Early Months of COVID-19

Presenters

Chris Barnes, Clarus Financial Technology

March 2020 marked a new all-time record for cleared volumes at CCPs across all rate OTC derivatives. The clearing infrastructure was able to scale up in major currencies, and market participants continued to choose trading through CCPs: 96 percent of fixed-float swaps were cleared in March 2020.

Swap data repository (SDR) data provided the opportunity to translate notional amounts into risk amounts. The volumes in March 2020 were not solely a result of a lot of short-dated, large notional trades. The amount of risk passing through the market was a new record.

Transparency, particularly in the U.S. markets, was a benefit to market participants. Other jurisdictions severely lacked timely, accessible post-trade transparency data. U.S. swap market transparency proved that markets were not "seizing up," removed rumors from the market, and price and volume information were a key to removing information asymmetry.

In uncleared markets, transparency is limited. We were unable to conclude whether markets went dark or failed to scale in the same manner as cleared markets. We also could not determine if market participants avoided taking on more bilateral counterparty credit risk, nor could we conclude whether the uncleared margin rules limited trading.

Adam Peralta, Head of Rates Electronic Trading, Bloomberg LP

In March 2020, the market experienced unexpected volatility due to the pandemic resulting in an overall increase in trading volumes. As market volatility increases, market participants naturally question their ability to access liquidity and their ability to transfer risk at any given point during a trading day.

Interest rate volatility peaked during the week of March 9-13. As a result, Bloomberg SEF (BSEF) experienced peak trading volumes when compared to March 2019. The platform performed well for large size trades, and rejected trades were minimal across all buckets. BSEF observed a slight increase in "passed" trades, which is expected during uncertain market conditions.

Elisabeth Kirby, Head of Rates Product and Strategy, Tradeweb

March 2020 proved to be our busiest month ever. Increased volatility leading into the pandemic led to record volumes across multiple asset classes. Interest rate swap trade counts and volumes increased sharply; however, non-competitive block trades saw a disproportionate increase. The overall number of trades on Tradeweb SEF increased 77 percent in March, and the number of non-competitive blocks increased 285 percent relative to the prior month.

Hit rates and quote rates decreased in March but rebounded near pre-crisis levels in April. This is a strong indication of the health of the SEF marketplace. Bid/offer spreads widened out, particularly for less liquid instruments but returned to platform averages.

We observed market indicators of constrained liquidity but not market interruption. SEFs were flexible enough to absorb modified client behavior, and clients remained able to transfer risk.

Comments and Q & A

Graham Harper, DRW, on behalf of FIA Principal Traders Group: From the perspective of FIA PTG, overall there is general agreement the markets functioned well through a period of significant volatility and high volumes. As a group, we were committed to remaining active in the market to ensure participants had access to the liquidity they needed. For DRW, specifically, our data demonstrates that across asset classes our market share increased meaningfully. I think market-wide data would illustrate that PTFs continued to actively participate in the market and further dispel the narrative that PTFs as a group tend to back away from providing liquidity during times of high volatility, and we would welcome any such analysis done by the Commission.

B. Salman Banaei, IHS Markit: As a trade processor, the ability to transact was available, and the market infrastructure performed well. There has been a stabilization across the derivatives markets since the heightened volatility from earlier this year, but we anticipate a return of increased volatility over the next couple of months.

Lee Betsill, CME Group: When volatility was at its most extreme, the ability to manage exposures and conduct transactions was always available on our platforms. We experienced significant growth in daily volumes, proving that the ability to trade was available. Our interest rate complex had an all-time record during Q1, and other asset classes also saw record volumes.

Biswarup Chatterjee, Citigroup: We experienced some trouble with trades that were just below the block size, as well as with trades that were longer in duration. There was a big interlinkage between the various markets because of the lack of liquidity in the Treasury markets. We saw fewer market participants actively trading.

Robert Mangrelli, Chatham Financial: Some experiences I had during my March trading activity were dealers not responding to RFQs, widening of spreads, decreased liquidity, and instances of increased latency of response.

Craig Messinger, Virtu Financial: The differences in the application of margin, when there is not a backstop provided by the Federal Reserve (Fed), has strained some markets. There is not a lot of predictability in regard to market structure or market participant activity in the equity markets. I think programs in the future that the Fed and regulatory bodies consider should help smooth out equity markets and their corresponding derivatives.

Sam Priyadarshi, Vanguard: During mid-March, many of the fixed-income markets had become dysfunctional until the Fed intervened to provide liquidity. This disruption was driven and exacerbated by bank balance sheet allocation and the market's reliance on high-frequency and automated market making.

Marcus Stanley, Americans for Financial Reform: Did the Fed's intervention play a role in propping up the derivatives markets? *Barnes:* We expected a link between cross-currency swaps and central bank FX facilities. When these facilities opened, we anticipated that banks would take advantage of them and subsequently resume more normal trading activities.

Report from the CCP Risk and Governance Subcommittee

Alicia Crighton, Subcommittee Co-Chairman, Global Co-Head of Futures and Head of OTC and Prime Clearing Businesses, Goldman Sachs, representing the Futures Industry Association (FIA)

We have structured the Subcommittee into a series of work streams to produce recommendations and best practices to the Committee. In mid-May, we began meeting on a weekly basis to discuss each of the work streams. It is possible our recommendations may not be agreed upon, but our discussions on these topics will be presented to the MRAC.

Lee Betsill, Subcommittee Co-Chairman, Managing Director and Chief Risk Officer, CME Group

The Subcommittee has five separate work streams – margin, default management practices, governance and transparency, stress testing and liquidity frameworks, and CCP capital/skin in the game – and each stream is considering various topics.

COVID-19's Impact on Margin, Processing, and Operational Health in Cleared Derivatives

Presenters

Richard Haynes, Supervisory Risk Analyst, Division of Clearing & Risk, CFTC

Derivative markets responded quickly to the events in March, with initial margin (IM) and variation margin (VM) calls increasing as volatility increased. Although IM calls increased in March, these demands remained isolated to just a few days. VM was generally correlated with volatility measures.

Alicia Crighton, Global Co-Head of Futures and Head of OTC and Prime Clearing Businesses, Goldman Sachs, representing FIA

The number of futures and options traded on U.S. exchanges reached 1.43 billion contracts in March, the highest volume on record. FIA is looking at how CCPs manage their end-of-day cutoff times during days of high volume, and FCMs would benefit from how to request clearing window extensions.

U.S. FCMs collected an additional $136 billion in customer funds in March, representing a record-setting increase. Customer segregated funds continue to remain high today. IM requirements for many widely-used futures contracts rose dramatically in Q1 2020. The number of margin breaches more than doubled between Q4 2019 and Q1 2020.

Lee Betsill, Managing Director and Chief Risk Officer, CME Group

The pandemic had an incredible impact on market volatility. WTI saw its two largest price and percentage moves ever and went negative for the first time. U.S. Treasury yields saw their largest daily percentage shifts and lowest levels ever, with the entire yield curve dropping below one percent for the first time.

Most CCPs implemented business continuity plans in response to the pandemic, enabling full or partial remote working and/or remote sites. CCPs restricted travel, further leveraged technology tools, and required quarantine, where necessary. Despite these measures and the increase in trading volumes, core systems at CCPs remained resilient.

The size of overall IM increases relative to volatility, including as demonstrated by the VM flows, were relatively muted. The anti-procyclical characteristics of CCP margin models worked, while maintaining appropriate coverage.