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Systems at Risk | Episode 1
Walt Lukken, President and CEO, Futures Industry Association

Between the FTX Congressional Hearing and FIA's upcoming Commodities Forum, President and CEO of the Futures Industry Association, Walt Lukken, made time to sit down with David Greely to kick off SmarterMarkets' newest series: Systems at Risk.

Walt Lukken (00s):
I do think we're going to see, and it's not just because of the war in Ukraine or the pandemic, but, you know, there's greater pressures and a greater volatility I think we'll see in commodities in the coming decades. So even though the latest, you know, headline may be the LME nickel crisis, in some ways we need to pull back the lens a bit broader that we're going to see I think more of these types of events where there's some extreme price dislocations that happen in our markets, and I think that is a great role for FIA to play.

Announcer (34s):
Welcome to Smarter Markets, a weekly podcast featuring the icons and entrepreneurs of technology, commodities and finance ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together we examine the questions are we facing a crisis of information or a crisis of trust and will building smarter markets be the antidote?

David Greely (59s):
Welcome to Systems at Risk on SmarterMarkets. I'm Dave Greely, Chief Economist at Abaxx Technologies. We begin our series on risk management in today's markets with Walt Lukken, President and CEO of FIA. The FIA is the leading global trade organization for the futures options and centrally clear derivatives markets whose membership includes clearing firms, exchanges, clearing houses, trading firms, and commodities specialists. FIA's member firms play a critical role in the reduction of systemic risk in global financial markets. Hello, Walt, welcome to Smarter Markets.

Walt Lukken (01m 36s):
Thanks David. Glad to be here.

David Greely (01m 38s):
I'm really glad to have you here today because you know, most of us don't pay much attention to the trading and clearing infrastructure that supports all of our market activity until there's a problem, but that's not true of you and FIA and your membership who work to keep markets functioning smoothly, even through periods of enormous stress like we've been experiencing recently. So I really am happy to have you here today to share your insights into some of those longstanding issues that we need to address, to reduce systemic risk in our markets. I'd like to start by talking about an issue that FIA has been very focused on, which is modernizing the exchange traded derivatives workflow. This is an issue which came to the forefront during the COVID shutdowns of March 2020, when they created record trading activity and extreme price volatility. For our listeners can you describe what is meant by workflow and why is it so vital to markets functioning well?

Walt Lukken (02m 35s):
Well, it's a great question. David may I want to start a bit by talking about FIA in general. I mean, we are trade association. So our members include global exchanges that trade enlisted derivatives, you know, the intermediaries that are helping to provide access to those global exchanges and then the customers themselves but those are all different entities that may have different ideas about, you know, know technology and, and workflow, as you mentioned. So workflow is really trying to get at once a trade happens, how do we make sure that the money and the positions are moved appropriately and safely and accounted for in our markets in order to make sure that those positions are put on correctly. So as you, as you mentioned, we went through a period in March of 2020, when the global economy shut down, there was so much volatility and volume at that time, as people were trying to manage the risk of that economic slowdown, that it caused some, some backlogs in our systems and clearing was not occurring in a timely way as it normally does.

Walt Lukken (03m 42s):
That doesn't mean that the system didn't work. It actually worked perfectly fine, but there created, like I said, some, some backlogs and some potential problems down the road that we needed to address. In one of FIA's clear missions is to try to raise the best practices and standards of our industry. So we stepped into a role of trying to coordinate from all those participants, the exchanges, the intermediaries, the customers to try to say, look, what were the issues, why did we have issues, how can we fix those issues. Are there ways to bring important standards to this, this process and make sure that the trades are getting into the right account on the right day for the right people who traded those, those positions. So since then we've been working on that effort and we've made significant progress.

David Greely (04m 33s):
And as you said, your membership includes a diverse number of market participants, the exchanges, the clearing houses, the clearing members, the market traders and I imagine it's a pretty massive challenge trying to modernize in integrated ecosystem. That's been evolving in kind of a piecemeal fashion as different participants upgrade their own systems in, in their own ways and with the legacy systems of different technologies installed at different points in time and these all need to work together and they need to work together seamlessly and quickly and efficiently. So as you delved into trying to modernize the workflow, what are some of the biggest challenges that you see your members facing and what are some of the things that FIA found that it could do to help them meet the challenge?

Walt Lukken (05m 22s):
Well, I think the good news is we have had a tremendous amount of buy in from all three segments of the community. I mentioned, I would also add that the vendor community is very supportive as well. The people who service our industry because they realize if we can't talk the same language, if we don't have standards, very difficult to build solutions, very difficult for markets to talk to each other and so I think we really stepped up to try to say how can we address these things. We over the period of time leading into to last fall, we developed a blueprint of how we can standardize and reform and modernize our markets and that really came up with this idea of, you know, should we form a standards body that could house important standards that was open access to our industry and that we could talk about certain best practice and workflow standards that will help everybody and bring competition to our markets.

Walt Lukken (06m 21s):
And a more standardized way of dealing with some of these post-trade processes. We really identified, you know, a few areas that needed help, you know, give up transactions. Oftentimes somebody executing in our markets wants one broker who executes and another broker that clears the way that they clearing broker and the executing brokers talk to each other is through a give up agreement and we have worked with them on ways to improve and make more efficient that process. We think there's some, some ways to standardize their allocations. So oftentimes large asset management firms are speaking on behalf of their customers and trading on behalf of their customers and can come with, you know, large orders at the end of the day that are allocated to different clients. We want to make sure that there's a process and a standardization around those efforts as well and average pricing is another one. So even though there's a variety of customers that may be allocated trades, you know, we don't want one customer to be disadvantaged over another customer because those trades happen at different times of the day. So exchanges have ways of average pricing those positions so that everybody gets the same fill of those positions. We think there's ways for our industry to help focus on the average pricing as well. So those are sort of the three areas that we're focused on at first, and we hope to make significant progress in the coming months.

David Greely (07m 51s):
That's great and I'm curious, obviously there's a need for, for standards to get everyone on the same page and able to work together effectively and efficiently. But I imagine you also, a lot of people will feel their way as the best way and should be adopted as the standard. So I was just curious, like, how do you find the industry and the membership engaging and, you know, being willing to build a consensus around standards?

Walt Lukken (08m 13s):
Well, I do think we have to separate what our competitive advantages of the industry. We're not trying to, you know, pick winners and losers in the competition game, then there's areas in which it there really is no competitive advantage, you know, language, taxonomy process standards that we think we can really lend some help as an industry. So we are going to allow the vendors and the exchanges to, you know, really the creative minds of those entities really work on the former and we are going try to stay on the latter side of really those really non-competitive standards areas that, you know, really everybody can agree to. So far, we have gotten a lot of good ideas

from our working group, our task force that is helping us to look at this. That's been incredibly helpful. As you mentioned, there may be one entity within that task force that does have the golden source that does have the best practice already in the industry and that's great. We can actually take that and try to mutualize that across the industry with everybody's support and maybe that gets tweaked maybe, but we have, are trying to build a process in which we can take a lot of those good ideas that may already exist and try to socialize them more broadly across the globe.

David Greely (09m 32s):
And as you said, one of the impetus to really focus on this was some of the delays in processing that occurred during March of 2020 and even though markets continued to work well, many market participants, you know, use the futures in derivative markets because they're trying to hedge market price risk and as they're hedging, it, that's creating new forms of risk, whether it's counterparty or credit risk and sometimes I guess the counterparty and credit risk could be exacerbated if trades are taking longer to process and margins being taking longer to be posted and move through accounts. So I was curious, you know, how do you think these workflow challenges increase the potential for other risks that might potentially reduce the market's ability to do what a lot of people come to it for, which is the hedge price risk?

Walt Lukken (10m 20s):
Well, as I mentioned to begin with, you know, the system largely worked, you know, people forget that our industry is working on a T-zero settlement cycle. You know, the securities industry is trying to get from T plus three to T one. I mean, we're already largely settling trades on the day of the trade, but we do have this unique feature of give ups that sometimes causes hiccups, you know, clearing is always happening on trade day, but it may be that, you know, the executing broker wasn't planning to have that position at the end of the day, it was really supposed to be in the count of the clearing broker and if that doesn't happen, that puts additional capital strain or margin strain on the executing broker that wasn't expecting to have it there. So, you know, for us, that is where we're trying to solve is, is to make sure that the expectations of all the parties and get making sure that these positions get into the right account at the end of the day.

Walt Lukken (11m 18s):
And these unexpected, you know, hiccups that we have, you know, try to minimize those, you know, we, we have already seen just one anecdote, you know, since 2020, we had the recent Russian invasion of Ukraine. We saw actually higher volatility, higher volumes than even March of 2020 and there were less backlogs in this go around than there was two years ago, for some of the reasons that I've explained that we have actually made improvements in the, in the two year period of time, by raising attention to the issue by you know, a lot of our members have put resources towards this issue to try to prevent this from happening again. So I think there's a lot of wood for us to chop here and, you know, improvements to be made, but we've already made some good progress in the two years since we've raised attention to the topic.

David Greely (12m 10s):
Yeah. This environment certainly does test progress and you've made it. I wanted to come back to a point you raised of, you know, how you've already moved to, you know, basically T plus zero settlement for the most part and there's been a lot of conversation recently with the development of decentralized finance and distributed ledger technology that there have been proposals to move to real time clearing to mitigate some of these risks most notably by FTX and I was curious, how do you think about the potential benefits and risks created by real time clearing and more broadly how do you think about the role of these new technologies in modernizing the derivatives ecosystem and workflow?

Walt Lukken (12m 50s):
Well, I think it's incredibly exciting. I think real time risk management is a trend that we need to be supportive of, but there's always tradeoffs with these things and I think, you know, we want to make sure that in collecting these margins quicker, that there's enough financial resources to, to cover a default. The last thing you want to do is to have the margining system, which is supposed to be taking risk off the table, actually adding some element of strain you know, if we're having to collect margins and it's causing more defaults we want to make sure that that is being appropriately accounted for elsewhere in the default waterfall of the clearing house. So, like I said, I think in general, it's a very productive conversation for us to be having trend wise you're seeing the securities market try to quicken the cycle. We're trying to quicken the cycle.

Walt Lukken (13 m 44s):
FTX is trying to quicken the cycle with a very innovative idea, but there's always tradeoffs that you have to balance in doing so and they're important tradeoffs that have to be factored into this to, to make sure that, you know, it's not additive risk to the system. So those are the things I think we're trying to weigh, you know, one reasons and I'll give a plug for the intermediary community you know, they have very sophisticated systems that help if clients are being asked to margin real time, 24/7, it's oftentimes difficult for a pension fund or a commercial hedger to keep a hedge and not, you know, be in default 24/7 you know, what banks do very well is they're able to manage that dislocation of a client with the clearinghouse need to make sure they have proper margin all the time.

Walt Lukken (14m 38s):
So I do think there is gonna continue to be a need for some intermediation in that cycle, even as things move forward because there is ultimately just gonna be commercial entities that don't want to have to margin this 24/7 or have their hedge blown out at two in the morning unexpectedly, you know, they're there to manage risk and to keep that hedge in place, whereas intermediaries can make sure that the financing and the margins and everything else are being met in more real time. So I think there, it's an incredibly exciting period of time for us and there's a lot of good ideas like FTX is going forward, but they have to be thought through very carefully.

David Greely (15m 17s):
Right because they want to introduce more risks and it is fascinating to think of the role that the intermediaries continue to play because of their ability to extend credit and manage a lot of the flows of margin in the system. Just wanted to ask when you follow up on looking at the modernization of the, the workflow itself, are the standards entertaining ideas of how to use some of this Defy technology and distributed ledger technology to accelerate workflow or make it more reliable, or is that, you know, a level down from where the standards are, are, are working?

Walt Lukken (15m 52s):
No, I do think we are open to all sort of technology ideas. There's some interesting technology vendors in our space that are bringing Blockchain and Defy and other ways of, of thinking about how to quicken that cycle, make it more secure, making sure that the accountability and the ownership chain is, you know, Blockchain is a great mechanism for making sure that the ownership change of assets is very accountable and transparent. So we're certainly welcome to all those, those new technologies. Again, there are tradeoffs to some of those things, you know, there are current technologies and databases cloud technology included that are competing in that space that can do a lot of the real time risk management that even the Blockchains and the Defys are claiming to do. So I think for us, it's all comers are welcome. You know, I just think for us, we're going to be weighing those based on our needs, but some of those things are very exciting.

David Greely (16m 52s):
And we, we started off today talking about the strains that those initial COVID shutdowns put on the market infrastructure, even though it continued to operate well. And as you mentioned now, we've had the additional pressures caused by the war in Ukraine and the sanctions on Russia and very high in volatile commodity prices and I wanted to get your thoughts on, you know, some of the, some of the results of those pressures we've seen in commodity markets recently. One of those was notably the problems in the LME nickel market, which, you know, decided to handle it in part by canceling trades and I was curious how your members are, are thinking and dealing with this new risk around finality of settlement?

Walt Lukken (17m 32s):
It's a great question. I do think we're going to see, and it's not just because of the war in Ukraine or the pandemic, but, you know, there's greater pressures and greater volatility. I think we'll see in commodities, in the, you know, coming decades, you know, primarily due to this shift from a petroleum based society to one of a green energy society, you know, we have been very reliant on certain economies that are less stable than some of other economies around the globe and so we are trying to think through how do we become energy independent, or at least less reliant on some of those less stable parts of the world. So I think we're gonna see more volatility as a result of that and much more pressures on risk management in the coming years ahead. So even though the latest, you know, headline may be the LME nickel crisis, in some ways we need to pull back the lens a bit broader that we're gonna see, I think more of these types of events where there's some extreme price dislocations that happen in our markets.

Walt Lukken (18m 39s):
And I think that is a great role for FIA to play and we get back to our standards conversation. How do we make sure that the risk management markets are at their highest standards globally to make sure we can sustain those types of moves that we can, you know,

make sure that there's the property margining systems in place, the principles around law, you mentioned finality of settlement. You know, this is a concept that we feel is very important that once a trade happens, that that trade is final and this is an important part of the rule of law of making sure that people have confidence in making markets and coming to the marketplace to price discover, you know, we saw it not only in London, some concerns around that at the LME, but in Texas, you know, with the energy crisis there a couple years ago where prices skyrocketed because of a freeze and super storm there.

Walt Lukken (19m 37s):
So finally of selling is important concept that we have promoted to make sure that markets function efficiently and people have confidence in it and will continue to support that principle going around the globe. I would note that even China has put it in its new law that was recently passed, that there is some confident in the marketplace that once a trade happens, that it is final and the prices are final. So we've had some success around the globe and will continue to preach that preach that principle to others as, as it comes up around the globe.

David Greely (20m 09s):
That's great and as you mentioned will likely be in this high volatile commodity price environment for some time, you know, even beyond what's happened with Ukraine and Russia and one other form of risk that's being created by this is this enormous liquidity pressure on commodity trading firms with billion dollar margin calls becoming almost routine and a number of trading firms asking for, but notably not receiving liquidity support from the European Central Bank. I was curious what does FIA and its members think can be done about the potential systemic risks posed by high volatile and in many cases pro-cyclical margins on hedges?

Walt Lukken (20m 50s):
Well, we want to make sure that, you know, margin is meant to anticipate volatility before it happens and you know a lot of these models are risk based. They look back over a period of time, you know, 10 years is often looked back, but all trying to capture large volatility moves in order to calculate what the forward looking margin should be. And again, margin is meant to capture the volatility of one day's price movement. So what we have seen in the past, and we've done a lot of work in this area is that oftentimes as, you know, markets become less volatile, a lot of those extreme movements fall off the look back period, and the margin becomes, you know, too low, not really reflective of the likelihood of a volatile event in the future. And so, you know, many exchanges have pro-cyclicality or air type pro-cyclical provisions in there that sort of indicate that, hey, margins shouldn't fall so low, we're gonna have a bit of a floor or some ways to prevent, you know, an artificial too low margin for some of these products.

Walt Lukken (21m 58s):
So have been advocates of making sure that those are to the highest standards that exchanges have some sort of meaningful floors so that we don't get this artificially low margin level. We've also asked that exchanges be a bit more transparent on how they calculate margin. You know, again, a lot of the intermediaries and one of their roles is making sure that they can, if they need to add concentration risk to certain clients or add more margin, if they feel like the exchange is not collecting enough for a certain counterparty. So the more transparency we can have into those margin models, the better we can help manage the risk of the client and prevent these types of big margin calls that may cause, you know, systemic risk in the system. So to me you know, I think we are working with global exchanges to see where we can make improvements in that area, but as I mentioned, you know, these a hundred year floods seem to be happening every 10 years now and so is there a way that we can better anticipate some of these events in the risk systems and make sure that we're ready for them when they happen versus causing one of these systemic events in a big margin call?

David Greely (23m 12s):
I wanted to ask you that point, you raised about having more transparency. So one can see concentration in positions because often the, the positions are on multiple exchanges or on an exchange and through OTC counterparties, what do you see as some of the potential steps that could be taken to address concentration risk through opening up some transparency for positions across OTC in exchange?

Walt Lukken (23m 38s):
Well, I think I personally say I support, you know, exchanges and risk managers, FCMS having all access to clients' positions, even over the counter. You know, this was when I was acting chairman of the CFTC. We saw this with the Amreth situation where the transparency on exchange was there, but off exchange it, it wasn't there and people couldn't see what the potential positions of some of these traders might be collectively both off exchange and on exchange. So since that time, I mean, regulators, both, you know, in the US and

internationally have given authorities to either the government entities to be able to look through and see those positions or the exchanges themselves. So to me, that's an important aspect. You have to understand the totality of the position in order to risk manager. So I think if there are gaps in that law, those can be addressed.

Walt Lukken (24m 29s):
I don't think anybody would question the ability for regulators to, to see that information in order to make sure that they understand where the concentration of risk may be. You know, once you have that information and the transparency, then you can start to work to manage that risk. You can put on concentration risk charges, you can do certain things you can even, you know, at extreme situations, ask, ask them to liquidate some of those positions if their positions could cause, you know, some type of manipulative situation in the marketplace. So, you know, once we have the transparency, then I think we have the tools that can deal with that concentration problem and there are, like I said, I think that this is not, shouldn't be a difficult thing to, to solve for, but something we'll have to sort out in the coming months.

David Greely (25m 16s):
And in addition to that, you know, before we wrap up, I was curious, you know, I know you've spent a lot of time thinking about workflow, but could you share with us what you may also see as some of the next big risk management challenges that we need to address to make sure these markets keep working well?

Walt Lukken (25m 31s):
Well, there's a variety of things. I mean, just at a very high level, we do work and we with closely with central counterparties to make sure that there are standards there and I've already mentioned the anti-pro cyclicality provisions, but there's been a lot of good productive work with the global CCP community to work towards good global standards for risk management and so that's certainly an area of focus for us. I would say the other one is really about access to markets. You know, one of our jobs is to make sure that customers have the ability to access markets for risk management, no matter where markets may be located and no matter where clients may be located. So the last thing we would need is for us to build silos around borders of nations that artificially keep people, you know, limit their access to, to markets, to manage risk.

Walt Lukken (26m 27s):
So a lot of, of the products that we trade are global benchmarks. You know, whether it's the Brent crude oil contract or the WTI contract, or, you know, global grain, you know, interest rates, whatever they might be. We want people to have access to those risk management and so we work at a regulatory level to make sure that regulators, you know, abide by this equivalence decision, you know, or equivalence process in which somebody who is regulating a market overseas might be recognized from a third party country to make sure that the protections are in place, but people don't have to regulate, become a global regulator in order to gain access to those markets. So we do a lot of work in that area to make sure that our members have access to markets globally and then lastly, you mentioned on the ops front, there's a lot of important work to be done there as you we've already discussed. We hope to be even more prominently out there on the operations. We are trying to form a, a standards body, our derivatives markets, industry standards, or demist what we call it, entity that will he help house these things going forward. And we think that can be very beneficial to the industry as we help to improve and modernize the workflow of, of, of our markets.

David Greely (27m 51s):
Thanks again to Walt Lukken, President and CEO of FIA. We hope you enjoyed the episode. Join us next week when our guests will be Bob Anderson, the Executive Director of the Committee of Chief Risk Officers. The CCRO provides an independent forum for members of the energy industry to work together, to develop best practices for all issues related to risk management.

Announcer (28m 15s):
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