

Testimony
of
Terrence A. Duffy
Executive Chairman
CME Group Inc.
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House Committee on Agriculture

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I am Terrence A. Duffy, executive chairman of CME Group Inc. Thank you Chairman Peterson and Ranking Member Goodlatte for inviting us to testify today. You asked us to discuss the role of credit default swaps and the regulatory framework that governs. You also asked for our suggestions for modifications of the current regulatory framework to facilitate efficient clearing of credit default swaps. At the outset, I would like to applaud the efforts of New York Fed President Timothy Geithner, SEC Chairman Chris Cox and CFTC Chairman Walt Lukken in working with market participants to reduce gross open CDS exposures by more than 25% from \$67 trillion to \$44 trillion and in working together to facilitate regulatory review and approval of industry efforts, including CME Group's efforts, to enhance the CDS market through central counterparty clearing services.

INTRODUCTION

Credit default swaps serve an important economic purpose in an unfortunately imperfect manner. At the ideal level, credit default swaps permit investors to hedge specific risk that a particular enterprise will fail or that the rate of failure of a defined group of firms will exceed expectations. However, because credit default swaps are not insurance, investors who are not subject to any specific risk can assume default risk to enhance yield or buy protection against a default to speculate on the fate of a company or the economy generally. Credit default swaps are also an excellent device to short corporate bonds, which otherwise could not be shorted.

In an uncontrolled environment, credit default swaps can pose serious problems to the efficient functioning of our capital markets. As has been well documented, the incentives to sell credit default swaps have led to unfortunate outcomes. Firms have sold credit default swaps that bear risks akin to hurricane insurance, but no regulator required that the firm maintained sufficient capital to fund the disaster that was being covered. Volatile pricing of credit default swaps has had direct and severe adverse impacts on companies whose credit ratings, loan covenants and stock prices were impaired by reported changes in their credit spreads. We understand that some pricing conduct is under investigation, but it is too late for the companies that were most impacted. Regulators have been unable to judge the market impact of allowing a firm to fail because the consequences of the failure with respect to their obligations to others and the credit default swaps that would mature have not been immediately discernable. This is the short list of common problems.

While some have characterized credit default swaps as gambling devices or instruments of mass destruction, we do not take that view. If such swaps are marked-to-market to independently and objectively determined prices, if the regulators responsible for controlling systemic risk can easily keep track of the obligations of the banks, brokers and other participants in the market and if a well-capitalized and regulated clearing house acts as the central counterparty for such swaps, we believe that they can serve an important role in our economy without imposing undue systemic risks.

The current regulatory regime does not make it easy to achieve these aims. If credit default swaps are traded between sophisticated parties and the transaction is subject to negotiation, the transaction is excluded from regulation by the CFTC by section 2(g) of the Commodity Exchange Act and excluded from regulation by the SEC by section 206A of the Gramm-Leach-Bliley Act. In consequence, efforts to enhance this market with product standardization and central counterparty clearing services have necessitated collaboration among regulators with uncertain statutory authority. Although the CDS market has historically had some notable shortcomings, it is important to also recognize recent market structure enhancements, including significant reductions in the confirmation backlog, the increased rate at which counterparties are pursuing bilateral tear up and compression arrangements, as well as DTCC's efforts to release information on the aggregate gross CDS exposures held in the Trade Information Warehouse. Also, with the leadership of the New York Fed, the industry has been moving toward the adoption of central counterparty clearing facilities. These innovations improve the risk management capabilities of market participants.

We have formed a joint venture with the Citadel Investment Group and have immediate operational capacity to offer a compression facility and clearing house for standardized credit default swaps and to migrate a high percentage of previously traded swaps into a standardized, cleared environment that will provide regulators with the information they need and customers with a lower cost, lower risk and more efficient market. CME Group has the ability to reduce risk now. We have presented our plan to the Federal Reserve, the CFTC and the SEC. We have addressed regulatory uncertainty in this area by urging the SEC to immediately advance the ball by retaining authority to prosecute for insider trading and manipulation that affects securities markets and otherwise exempting the trading and clearing of credit default swaps that are cleared by a CFTC regulated clearing house. We remain hopeful that the SEC will take this step necessary to achieve these important regulatory and systemic risk reduction goals. We are working with, and will continue to work with, the SEC and CFTC to secure a workable set of exemptions that will give this solution a chance to succeed.

DISCUSSION

Trading of financial futures on regulated futures markets, subject to the oversight of the Commodity Futures Trading Commission, has been a net positive to the economy, has caused no stress to the financial system and has easily endured the collapse of one and near collapse of two firms that were very active in our markets. This is a record of which this Committee, the CFTC and our industry can be justifiably proud.

When Lehman Brothers filed for bankruptcy, no futures customer lost a penny or suffered any interruption to its ability to trade. The massive proprietary positions of Lehman were liquidated or sold, with no loss to the clearing house and no disruption of the market. This tells us that the margining, financial safeguards and customer protection mechanisms of the futures industry work in times of immense stress to the financial system.

Fourteen years ago, on June 14, 1994, we testified before the Subcommittee on Environment, Credit, and Rural Development of the Committee on Agriculture of the House of Representatives on the topic of regulatory issues for OTC derivatives.¹ At that time, OTC swaps were in their infancy - the market had grown from approximately \$2 trillion in 1989 to less than \$8 trillion in 1994. We sounded a number of very clear warnings respecting the steps that would be necessary to assure that this rapidly growing market did not result in systemic problems to our economy.

“There are common themes in the recent stories, beyond the obvious ones of massive financial losses and attempts to shift the blame to others. . . In almost all cases of unexpected losses, properly linked to derivative instruments, three elements are present, to varying degrees: (1) the accuracy of pricing the instruments involved; (2) the assessment of risk before the fact; (3) and the rapidity with which small losses became huge.”

Interestingly, what was true of the nascent OTC interest rate swaps market in 1994 is just as true with the nascent CDS market in 2008. By contrast to the elements that contribute to significant loss events in OTC derivatives markets, centrally cleared derivatives are subject to daily mark to market, risk management and stress testing via the margining process. Both of these critical risk management functions prevent small losses from accumulating unnoticed.

Since at least the early 1990s, CME has had a consistent philosophy respecting the regulation of OTC derivative trading and the superiority of regulated exchanges with central counterparty clearing. We have not sought to ban all OTC trading, we have urged that OTC trading be limited to truly sophisticated investors trading contracts that are too individualized or too thinly traded to be brought onto a trading platform for standardized products. We were right then and we are right now.

On September 26, 2007, I testified before the House Agriculture Subcommittee on General Farm Commodities and Risk Management and discussed our view of the success of the Commodity Futures Modernization Act and the amendments that we believed were necessary to extend the benefits of central counterparty clearing to OTC derivatives.

I do not intend to repeat that testimony, which was detailed and extensive. I will only note that we suggested that Congress look to “first principles,” which means the findings and purposes adopted by Congress to guide the Commission’s exercise of its

¹ Testimony of CME’s then Chairman John F. Sandner

jurisdiction. Section 5(b) of the Commodity Exchange Act charged the Commission with a duty to oversee “a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals” and to “deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices.”

We suggested that there is a growing conflict between these “purposes” and the statutory exemptions for unregulated markets that had been inserted into the CEA by various special interests. It is clear to us that all of the key purposes mandated by Congress in Section 5(b) are jeopardized if trading facilities for contracts in exempt commodities are permitted to coexist with regulated futures exchanges that list those same commodities.

Rather than looking back and trying to assess blame, we want to move forward and explain what CME Group is offering and planning to offer to alleviate the risks to the economy currently represented by the almost \$600 trillion in outstanding notional value of OTC swaps. We are in the process of offering a means to convert a significant proportion of outstanding OTC interest rate swaps into centrally- cleared instruments subject to the high risk management standards and regulatory requirements of the CME Clearing House as a Derivatives Clearing Organization supervised by the CFTC. If customers accept this program, we expect that standardization of these outstanding contracts and submission to our clearing system will permit a multilateral netting process that will reduce the outstanding exposure on the current open exposures submitted to our clearing system by a factor of at least five.

I want to particularly focus on our plans to play a role in the CDS market. CME Group’s goal is to respect the value and importance these markets provide to managing risks in corporate debt portfolios and to work with the dealer community and buy-side participants to facilitate their current hedging, trading, and dealing activities while providing them with netting, risk management and other central counterparty clearing services that reduce their costs and risk and increase investor confidence in these markets. It is also our goal to provide counterparty credit risk intermediation, reduction in gross exposures, and transparency around aggregate open exposures in a manner that reduces the potential need for regulatory intervention in distressed credit situations going forward.

The CDS market has grown because credit derivatives permit dispersion and realignment of credit risks. These instruments are a tremendously valuable financial tool in the right hands and used properly. However, the individual and systemic risks created by the exponential growth of such contracts has not been properly managed - in some cases it appears not to have been well understood. The lack of transparent mark-to-market, standardized contract terms, multilateral netting and all of the other advantages that flow from a comprehensive and open central counterparty clearing system have compounded risk and uncertainty in this market. The gross notional exposure in that market is about \$44 trillion. It is estimated that portfolio compression by netting could reduce that exposure by a factor of 5 to 10.

There is a solution. The compression facility and multilateral clearing mechanisms that have been proposed by CME and Citadel Investment Group offer a systematic method to monitor and collateralize risk on a current basis reducing systemic risk and enhancing certainty and fairness for all participants. Our solution offers regulators the information and transparency they need to assess risks and prevent market abuse. Our systematic multilateral netting and well-conceived collateralization standards will eliminate the risk of a death spiral when a jump to default of a major reference entity might otherwise create a cascade of failures and defaults.

Let me provide a few examples of the problems, and the solutions that our proposal offers:

- First, best price information in CDS markets is not always readily available. Disagreements are common, leading to subjective and inconsistent marks and potentially incomplete disclosure to investors of unrealized losses on open positions. For example, earlier this year, Toronto Dominion Bank announced a \$94 million loss related to credit derivatives that had been incorrectly priced by a senior trader. In a centrally cleared model, with independently determined, broadly disseminated mark to market prices such errors are much less likely to occur.
- Second, risk assessment information is inadequate, and risk management procedures are inconsistent across the market. Precise information on gross and net exposures is not available. The true consequences of a default by one or more participants cannot be measured – exactly the sort of systemic risk brought to light by the Bear Stearns and AIG crises, which caused major disruptions in the market. As Bear Stearns and AIG faltered, credit spreads for most dealers widened, volatility increased and liquidity declined. Intervention became necessary.

Transparent mark to market price information combined with risk management protocols enforced by a neutral clearing house could have mitigated this outcome. Risk managers would have had accurate and timely information on their firms' positions, exposures and collateral requirements. Collateral to cover future risks would have been in place or positions would have been reduced. The clearing house and regulators would have seen and been able to manage concentration risks within a particular portfolio, and stress-test the consequences of a major default.

Our long experience is a tremendous asset in efforts to reduce systemic risk in the CDS market. The CME Clearing House currently holds more than \$100 billion of collateral on deposit and routinely moves more than \$3 billion per day among market participants. We conduct real-time monitoring of market positions and aggregate risk exposures, twice-daily financial settlement cycles, advanced portfolio-based risk calculations, monitor large account positions and perform daily stress testing. Our clearing house has a proven ability to scale operations to meet the demands of new markets and unexpected volatility.

CME Clearing also brings significant scale with risk management expertise and default protections. You may have seen press questioning our decision to include CDS clearing in a consolidated guaranty fund with our existing futures and energy and commodity OTC business. To clarify the record, we want to say the following.

A CCP guaranty fund is similar to a mutualized insurance or loss sharing vehicle. As such, the risk profile to the pool is reduced whenever the risks covered by the pool are diversified. We have seen very real evidence of this diversification benefit whenever we have added large pools of business to our guaranty fund – whether the products are correlated or uncorrelated to the existing product set. The London Clearing House has also successfully pursued a consolidated guaranty fund approach across its futures and OTC business since the mid-1990s.

In evaluating this approach, we took great care to ensure that the risk profile faced by non-CDS participants who contribute to the guaranty fund – traditional futures participants – is not adversely affected. We effectively risk manage the CDS products – via participation restrictions, margining techniques and risk monitoring practices – such that the risk profile to the guaranty fund posed by a CDS product is comparable to that posed by a traditional futures product. The CDS market requires product structures, rules and regulatory oversight that are suited to the needs of all participants. That may not occur if centrally traded and cleared credit products must be fitted within regulatory frameworks that were developed for different markets or to meet different policy goals. We are working with the New York Fed, the CFTC and the SEC to find a way quickly to bring our solution to market.

We are in ongoing negotiations with the SEC and do not believe that it is appropriate to comment publicly on the pending proposals and our mutual efforts to reach a satisfactory accommodation that will permit our venture to provide a valuable service to the industry, the economy and the regulators.

I thank the Committee for the opportunity to share CME Group's views, and I look forward to your questions.