

Testimony of
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Before the
U.S. House of Representatives
Committee on Agriculture

The Role of Credit Derivatives in the U.S. Economy

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Introduction

Good Afternoon Chairman Peterson, Ranking Member Goodlatte and members of the Committee. My name is John O'Neill and I am the Manager of CDS at Liffe, NYSE Euronext. I have headed up our initiative on credit default swap clearing since the beginning of this year. I thank you and the Committee for the opportunity to testify today.

The evolution of NYSE Euronext as a global company, as well as the similar evolution of several other exchanges internationally, reflects the global nature of financial and commodity markets. As the latest financial crisis has shown, our markets and economies are more connected than ever. NYSE Euronext's geographic and product diversity has helped to inform our efforts in the area of credit derivatives, as we work to bring transparency to, and mitigate the risks associated with, products like credit default swaps.

I. Our CDS clearing solution

a. The CDS market

Credit default swaps are vitally important tools to facilitate the management of risk. They allow the owners of bonds or loans to protect themselves when they fear that borrowers will not honor their promises. They also allow corporations to protect themselves against the risk that partners or suppliers may go into bankruptcy. In difficult economic times, this diversification of risk, if used properly, will continue to add value to the marketplace.

During the past decade, the market for credit default swaps has grown exponentially -- from a relatively small derivative product to a global industry of approximately \$57 trillion in notional value at the end of June 2008.¹ At this time, the CDS market

¹ The Bank for International Settlements estimated that the notional amount of outstanding CDSs in 1998 was approximately \$108 billion. By 2007, that number had grown to approximately \$58 trillion. Bank for International Settlements, Press Release, The Global Derivatives Market at End-

represented as much as 8% of the total over-the-counter derivatives market of \$684 trillion.² The size of the CDS market may well diminish somewhat by the end of 2008, as activity has slowed and the industry has implemented programs to reduce the amount of contracts outstanding. However, credit default swaps will continue to be one of the most active global derivative products.

This rapid growth in CDS transactions initially led to serious processing inefficiencies. Most trades were confirmed manually, and large backlogs developed. Although regulatory pressure from global authorities has improved this situation significantly, inefficiencies remain. The market needs to continue to strive for same day confirmation (so called “T+0”) to be the standard for virtually all trades.

The clearing solution that we will launch in two weeks will provide exactly that.

We strongly agree with by policy leaders in the U.S. and abroad that it is essential that these instruments be cleared through central counterparties.

b. Bclear: NYSE Euronext’s CDS Clearing Solution

Since 2005, NYSE Euronext (through its subsidiary LIFFE Administration and Management (“LIFFE A&M”)) has developed and currently makes available to its members an OTC derivatives processing service, called “Bclear.”

Bclear is a simple, efficient and low cost way to register, process and clear OTC derivative trades. It brings the flexibility of over-the-counter trading to a centrally cleared exchange environment. Bclear has processed OTC transactions with a notional value of over \$8 trillion since launch, and has been widely adopted by dealers, brokers and buy-side firms. Previously, Bclear’s products have been limited to equity derivatives, but this will shortly be extended to other asset classes.

Importantly, on December 22, NYSE Euronext plans to add credit default swaps to Bclear’s portfolio of cleared OTC derivatives. This will provide a mechanism for the processing and centralized clearing of CDSs based on credit default swap indices. This is a longstanding project developed in cooperation with the current market. This is an extremely viable solution for several reasons:

- (1) Bclear is part of a global solution.** Clearing solutions for credit default swaps must address the global market. In that regard, Bclear’s partnership with our

June 2001, December 20, 2001, and Bank for International Settlements Monetary and Economic Department, *OTC Derivatives Market Activity in the Second Half of 2007*, May 2008

² Bank for International Settlements semi-annual OTC derivatives statistics as of June 2008.

clearing firm, LCH.Clearnet Ltd. (“LCH.Clearnet”) is recognized as global in nature. Today, U.S. dealers are among the largest users of LCH.Clearnet, for both their U.S.-based and global operations.

LCH.Clearnet Group recently signed a non-binding heads of terms regarding a proposed merger with the U.S.-based Depository Trust & Clearing Corporation (DTCC).

From a regulatory perspective, if the U.S. chooses to regulate CDS clearing in a greatly different or more restrictive manner than regulators abroad, a situation may be created that will cause products to move elsewhere. A concerted effort among regulators and market participants is necessary in order to coordinate policies governing the CDS market and strengthen the integrity of that market. While NYSE Euronext is starting in London, we are also working with U.S. regulators to enable us to make this or a similar service available to market participants in the United States.

(2) Bclear is a proven solution. As noted above, since 2005, Bclear has processed OTC equity derivatives transactions with a notional value in excess of \$8 trillion³. All Bclear business is cleared by LCH.Clearnet, a highly experienced clearer of global OTC derivative products, including repos, freight and energy products. LCH.Clearnet is also the world’s only interbank interest rate swaps clearer. LCH.Clearnet is the leading independent central counterparty group (CCP), serving major international exchanges and platforms, as well as a range of OTC markets. LCH.Clearnet a subsidiary of LCH.Clearnet Group Ltd., which is owned 73.3% by users, 10.9% by exchanges and 15.8% by Euroclear (the leading European settlement operator); LCH.Clearnet Ltd has a total of 109 members internationally across all our services. The notional value of interest rate swaps held within LCH.Clearnet stood at \$60 trillion, accounting for approximately 46% of the inter-dealer interest rate swap market as of June 2008, larger even than the total value of the CDS market.

As the counterparty to every clearing member, LCH.Clearnet reduces the scope for counterparty risk between market participants. LCH.Clearnet is legally responsible for the financial performance of the contracts that it has registered and any resulting delivery contracts. All clearing members deposit margin with LCH.Clearnet to cover the risk on their net positions.

LCH.Clearnet has unrivalled experience handling dealer and market participant defaults, including the recent collapse of Lehman Brothers. In this period of extreme financial stress, LCH.Clearnet successfully unwound the Lehman Brothers portfolio of equities, commodities (softs and metals), energy (oil, power and gas), repos and interest rate swaps in five major currencies of \$9 trillion

³ As of December 1, 2008.

notional value. This major unwind was completed well within the margin Lehman Brothers held at LCH.Clearnet, and without any recourse to LCH.Clearnet's default fund or other protections. The total value of margin held by LCH.Clearnet is typically in the vicinity of \$60 billion, and the total size of LCH.Clearnet's Default Fund is approximately \$890 million⁴.

Working closely with its members, LCH.Clearnet has successfully managed not only the Lehman default but also the defaults of:

- Drexel Burnham Lambert Ltd (1990)
- Woodhouse Drake and Carey (1991)
- Baring Brothers & Co. Ltd (1995)
- Griffin Trading Company (1998)

In addition, LCH.Clearnet was heavily involved in managing down of the positions of:

- Yamaichi International (Europe) Ltd (1997)
- Enron Metals Ltd (2001)
- Refco Securities and Overseas Ltd (2005)

The default fund contributions of Members have never been drawn upon in any default managed by LCH.Clearnet.

This is a well capitalized and highly experienced clearinghouse, with unique experience in clearing OTC products. These are exactly the criteria that regulators should consider when assessing the credibility of CDS clearing solutions.

(3) **Bclear is an open solution.** Unlike other proposed solutions, Bclear does not limit the participants who can benefit from its clearing service. It facilitates sell-side, buy-side, and interdealer broker interaction. Significantly, it allows buy-side participants to use an account structure that will isolate their positions from their clearing member. In the Lehman Brothers default, this allowed those customers holding these segregated positions with Lehman to be quickly assured of safety.

(4) **Bclear is a transparent, non-disruptive solution.** Bclear allows the flexible style of negotiation of the OTC market, but with many of the benefits of exchange processing and central counterparty clearing. With Bclear, deals are still pre-negotiated, typically via phone, just as they are in today's OTC market. There is electronic confirmation between the clearing member and LCH.Clearnet, which

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As of December 4, 2008.

stands as the central counterparty to all transactions processed through Bclear.⁵ Mark to market valuations are provided via NYSE Euronext systems on the same day.

This fully cleared approach will reduce the total size of the outstanding market even further, while increasing the confidence that will allow participants to trade. This more efficient use of capital will reduce stress on financial institutions. It will also allow regulators to see clearly the size of outstanding CDS positions, particularly important in situations of extreme stress. U.S. regulators will be able to access this information from the U.K. Financial Services Authority (the “FSA”) under existing Memoranda of Understanding (MOU).

II. Regulation of the CDS market

The importance of international regulatory cooperation is underscored by the regulatory arrangements under which we operate. Bclear is a service operated by LIFFE A&M, which is a Recognized Investment Exchange, regulated by the FSA. As part of the market operated by LIFFE A&M, the Bclear service is subject to FSA oversight.

LCH.Clearnet is also subject to FSA oversight, and is also subject to the regulatory oversight of the U.S. Commodity Futures Trading Commission pursuant to that agency’s recognition of LCH.Clearnet as a Derivatives Clearing Organization.

In addition, we believe that as of today, LCH.Clearnet meets all 15 of the CPSS/IOSCO Recommendations.⁶ The CPSS-IOSCO Recommendations for Securities Settlement Systems and for Central Counterparties establish the types and level of risk mitigation that should be exhibited by safe and efficient infrastructure providers. They provide a benchmark against which to consider the major types of risk that such organizations are likely to face. These recommendations represent an internationally

⁵ On October 31, 2008 LIFFE announced changes to its clearing arrangements which, subject to regulatory approval, will be implemented in the first quarter of 2009. These will involve LIFFE A&M becoming the central counterparty to all transactions entered into on the LIFFE market and all transactions which are accepted by LIFFE A&M through Bclear, including CDS transactions. Under these arrangements, LIFFE A&M will outsource certain functions to LCH.Clearnet, including those concerning the management of clearing member defaults. At this time, we are not seeking exemptive relief for LIFFE A&M to act as the central counterparty to CDS transactions.

⁶ LCH.Clearnet Ltd was assessed in June 2006 by the FSA and Bank of England against the CPSS-IOSCO recommendations for CCPs. The findings of the FSA/BoE review are publicly available; LCH.Clearnet Ltd was deemed to observe fully 14 of the 15 recommendations and to broadly observe the remaining one. Today we believe that LCH.Clearnet fully meets all 15 of the recommendations

developed and agreed minimum standard of good practice that systemically important CCPs should seek to achieve.

The U.K. government has had information-sharing and cooperation arrangements with the U.S. Securities and Exchange Commission and the CFTC in place since 1991. These arrangements were updated most recently in 2006, when the FSA entered into Memoranda of Understanding pursuant to which the FSA and the respective Commission have agreed to cooperate and share information in connection with the oversight of financial services firms⁷. These agreements provide the means by which the relevant Commission may access information regarding Liffe business, including transactions processed by the Bclear service and cleared by LCH.Clearnet, to address any potential issues, such as insider trading, manipulation and similar matters.

We strongly support the policy objectives announced by the President's Working Group on Financial Markets (PWG) on November 14, 2008, particularly the PWG's support for the use of central counterparty arrangements for OTC derivatives including credit default swaps and other OTC derivatives asset classes. We believe this policy can significantly strengthen the OTC derivatives market and reduce systemic risks.

We have been working with U.S. regulators, as well as the FSA, in connection with our efforts to make our CDS clearing solution available to U.S. market participants. The extensive cooperation we have seen among these regulators is essential to developing a strong global structure for the OTC derivatives market, and we stand ready to help regulators and Congress to achieve that goal.

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In 2006, the FSA entered into two *Memoranda of Understanding Concerning Consultation, Cooperation and the Exchange of Information related to Market Oversight and the Supervision of Financial Services Firms*, one with the Securities and Exchange Commission (signed on 14th March 2006) and one with the Commodity Futures Trading Authority (signed on 17th November 2006).