

Statement of
Craig S. Donohue
Chief Executive Officer of CME Group Inc.
Before the
United States Senate
Subcommittee on Securities, Investment and Insurance
Of The
Committee on Banking, Housing and Urban Affairs
July 9, 2008

I am Craig Donohue, CEO of CME Group Inc. (“CME Group” or “CME”). Thank you Chairman Reed and Ranking Member Allard for inviting us to testify at this hearing on “Reducing Risks and Improving Oversight in the OTC Credit Derivatives Market” and giving us the opportunity to discuss approaches to reducing systemic risks in these critical markets.

As you are well aware, trading in credit derivatives – primarily credit default swaps (“CDSs”) – has grown exponentially in a very short period of time. At the end of 2007, notional exposures in CDS trades exceeded \$60 trillion. These products have become critical to the financial markets as a means of benchmarking the cost of raising funds in the capital markets, and as mechanisms to allocate credit risks and hedge corporate debt portfolios. However, the development of systems to manage this enormous market has not kept pace with the rapid growth in trading and the sophistication of market participants and their trading strategies. Market information is opaque and uncertain. The confirmation system suffers from enormous backlogs, in which trades may remain unconfirmed for weeks. Risk management systems are fragmented and produce frequent disputes and inconsistencies in mark-to-market and collateralization practices.

If a major dealer were to default, it would inject enormous instability into the credit markets and in turn the markets for other products, potentially triggering a cascading series of failures across the global financial markets. As you know, the Federal Reserve Bank of New York and other interested parties are actively seeking solutions to these risks. While some progress is being made, much more work remains. We appreciate the invitation to testify before the Subcommittee today because we believe that the

transparent price discovery and multilateral trading and clearing mechanisms of regulated exchanges such as CME Group are the best available tools for monitoring and managing risks on a current basis, reducing systemic risk across the financial system, and enhancing certainty and fairness in credit markets.

As I will discuss, such an integrated multilateral trading and clearing model will offer the best route to improved risk management and enhanced efficiency for all participants in the credit derivatives market and also for the underlying companies on which credit derivatives are based. At the same time, it will offer regulators the immediate information and transparency they need to prevent fraud, manipulation and market abuse. In both cases, we believe this model will greatly reduce significant information asymmetries in the credit markets and protect the broader financial markets against systemic risk.

Background

Credit derivatives became increasingly important beginning in the mid 1990s. The market expanded tremendously during the past five years, as market participants including investment banks, commercial banks, hedge funds, insurance companies, asset managers and others increasingly sought to insure against unwanted credit risks in their fixed income portfolios. Credit derivatives give asset managers a means of offsetting credit risks associated with individual corporate debt issues or overall corporate debt portfolios of their institutional clients, which may include foundations, endowments and pension funds. Others use credit derivatives to take positions in corporate bonds or the corporate debt market as a whole. Credit specialists seek to profit from the volatility in credit spreads that emerges during periods of economic uncertainty. Credit derivatives have become the core benchmark products used by corporate borrowers and market participants to measure the cost of raising funds in the capital markets.

Major investment and commercial banks serve as dealers or market makers in the credit derivatives market. These dealer banks also maintain sizeable credit derivatives positions in order to manage risks in their own loan and corporate bond portfolios. The proprietary trading desks of these dealer banks contribute a substantial part of the daily trading volume in the credit derivatives markets.

To be clear, credit derivatives have not themselves created instability or excess risk. The market has grown precisely because credit derivatives

are an extremely useful innovation that permits dispersion and realignment of certain risks. However, the credit derivatives market, the policies, practices and regulations that apply to them, and the necessary infrastructure and systems capabilities that impact them, have not kept pace with the rapid growth in trading and open positions.

Current Trading Practices

CDSs are executed bilaterally between two counterparties, a protection buyer and a protection seller. Indicative quotes are most often disseminated by email directly from brokers, but CDS market transactions are largely voice-based. Unlike the corporate bond market, there are no price reporting requirements for CDS trades. Standardization is limited except in the index products. While these bilateral trading methods allow counterparties to address specific risks, this model also makes the products more difficult to price, difficult to mark to market, and difficult to manage over the life of the trade. Most importantly, bilateral trading of customized products in an opaque market precludes the netting of positions that occurs on organized exchanges with a central counterparty clearing model. Customization of credit derivatives contributed to the enormous size of outstanding exposures, because a credit derivative purchaser or seller cannot unwind a position except with its original counterparty. Consequently, in order to receive the most competitive price, participants in this market often manage and adjust their positions through the creation of new offsetting positions with different counterparties. While index transactions have now become relatively standardized, many single-name credit default swaps remain customized, preventing timely and efficient trade confirmation, which hinders effective risk management and increases overall risk.

The vast number of outstanding positions that are maintained on a bilateral basis creates the systemic risk that caused such well-founded alarm earlier this year during the Bear Stearns crisis. As one major participant in the market suffered severe distress, credit spreads for most dealers widened, credit market volatility increased and liquidity declined. Counterparties worried over the status of unconfirmed transactions. Intervention became necessary to ensure that a Bear Stearns collapse did not lead to a cascading series of defaults across the financial markets.

Benefits of an Integrated Trading Platform and CCP Clearing

An integrated exchange and central counterparty (“CCP”) clearing model for the credit derivatives markets would have substantially reduced

such risks. A centralized execution platform would aggregate liquidity and improve efficiency. It would provide the market with much-needed price discovery and transparency, and also audit trail information for use by risk managers and regulators.

Central counterparty clearing that is available to all participants would further improve the model by mutualizing risk across the entire market. Clearing limits systemic risks by protecting all parties against the effects of a default by any one participant. With an independent and neutral guarantor as the counterparty to all, excess exposures are netted, no firm is uniquely exposed to the failure of another, and the market has no cause to speculate as to which firm may be the next domino to fall. Straight-through processing of trade confirmations gives risk managers accurate, real-time views of risk exposures. The clearinghouse employs dynamic risk management, twice daily marks-to-market, settlement variation payments and adjustments to collateral requirements. Because these requirements are established and enforced by a neutral third party, they impose further discipline on participants and give confidence to the market, thereby reducing volatility and enhancing liquidity for all.

By contrast, in the current OTC trading environment, volatility is greater and liquidity can evaporate for those firms that are – or that are perceived to be – in financial distress. The crisis can then feed upon itself, pushing weaker but otherwise stable firms into insolvency. In addition to the ballooning size of outstanding exposures, the credit derivatives markets are subject to many of the other problems and risks inherent in OTC markets:

- First, the markets are opaque: protection buyers cannot readily determine the best prices for the products they seek, as they could on a centralized marketplace. Efficient and accurate mark-to-market practices, which are critical for ongoing risk management and proper accounting, are further hindered by the lack of transparency in the markets. Disagreements over how to value existing positions are common, leading to subjective and inconsistent mark-to-market calculations and potentially incomplete disclosure to investors of unrealized losses on open positions. Additionally, movements in the credit derivatives markets can have a material impact upon other markets, including those that are traded on-exchange.

- Second, the risk assessment information that is available to regulators and even to market participants is inadequate. Precise information on gross and net exposures across the market is not available; instead, each market participant knows its own exposures, which it must assess against its best estimate of the entire market. The protection buyer seeks to hedge its positions by shifting credit risk in the reference entity from itself to the protection seller. In doing so, however, the protection buyer effectively exchanges credit risk in the reference entity for credit risk in the protection seller – without visibility into the range of risks in the seller’s own credit derivatives positions. The true consequences and costs of a default by one or more participants cannot be measured by any of the disparate parties to these bilateral transactions. No independent exchange or regulator is available to evaluate and manage aggregate risks across the whole, or to fairly assess and manage concentration risks within a particular firm’s or customer’s portfolio.
- Third, the OTC market lacks standardized risk management protocols for bilateral CDS transactions. Portfolio valuation used to determine initial and variation margin is derived from proprietary internal systems, leading to disparities in exposure calculations, infrequent portfolio reconciliation and disputes related to margin calls. Dispute resolution is agreed on a bilateral basis and relies on the availability and cooperation of third parties in providing prices, resulting in uncertain and disparate outcomes across a portfolio and the market as a whole. Even the timing of margin delivery differs across the industry. Furthermore, collateralization is often one-sided, in that the dealer banks require collateral from their buy-side CDS counterparties but do not consistently post collateral themselves. While recent proposals for inter-dealer solutions will solidify collateralization among the dealers, this approach fails to protect buy-side participants against default, many of whom have very significant exposures. The asymmetry in collateralization practices exacerbates risk and market uncertainty.
- Fourth, trade processing and confirmation is enormously inefficient compared to what occurs on organized exchanges, particularly with respect to novated transactions. Electronic matching and confirmation solutions currently available for bilateral CDS trades are not yet fully scalable and may be susceptible to failure during periods of market

turmoil. In the current system, novated trades often remain unconfirmed for 30 to 45 days. On several occasions during the past three years, the Federal Reserve Bank of New York has assembled the major CDS market participants to strongly suggest that poor confirmation procedures were an unacceptable roadblock to effective risk management.

Recent Developments

Over the past few years, market forces have responded to regulatory calls relating to the operational and risk management problems inherent in the credit derivatives markets and begun to address these issues. For example:

- CMA, a company recently acquired by CME Group, provides credit market pricing data and intra-day services that increase productivity, efficiency and transparency. CMA focuses upon information services and redistributes pricing data received from buy-side market participants.
- Markit, which is owned by a consortium of sixteen major banks, also offers credit market pricing data and owns the most actively traded credit default swap indexes. Markit and Creditex, an inter-dealer broker recently acquired by IntercontinentalExchange, jointly developed Credit Event Fixings in close cooperation with ISDA, which are designed to ensure a fair, efficient and transparent process for the cash settlement of credit derivative trades following a credit event. Creditex and Markit have jointly acted as administrators of the Credit Event Fixings since their inception in June 2005.
- Additionally, TriOptima, a privately-owned company, offers its triReduce service to the CDS market, which is a means for mass multilateral termination or netting of OTC contracts.

These and other types of services and offerings have allowed for some level of increased efficiency and transparency. However, none of these solutions – individually or collectively – provides for the processing efficiencies and systemic risk mitigation that an exchange model with CCP clearing would provide. An exchange model that integrates a trading platform with CCP clearing would provide much more effective price discovery through transparent means that are accessible to all market participants. It would generate market data and audit trail information that

will greatly enhance risk management systems and regulatory oversight. Confirmation of trades would occur virtually in real time, giving risk managers the timely and accurate position information that they need to assess risks and exposures in their portfolios. Trading of standardized products with central counterparty clearing would greatly reduce gross exposures by permitting market participants to adjust positions much more easily than they can in a bilateral environment.

Exchange Model Solutions

An exchange model, which integrates a transparent and neutral trading platform with CCP clearing, would offer the CDS market scalable solutions to keep pace with the rapid growth of trading and independent and effective risk management practices that would greatly reduce systemic risk.

On the execution side, moving to an exchange model would offer standardization of product and price transparency through a multilateral trading facility. This offers all participants a level playing field, in which the best prices are known and available to all. Externally distributed market information would give a timely and accurate view of developments in the credit markets to all financial markets participants, regulators, the public and the companies on which credit derivatives are ultimately based. Accounting for open positions and public reporting to investors would be improved. The real-time stream of market data would also permit more effective market supervision and regulation.

The costs of trading and post-trade processing are also substantially reduced. Trading can occur through an efficient and low-cost electronic platform. Trading may also continue to occur through existing bilateral means, but trades in the standardized products of the exchange can be submitted to the exchange for novation and clearing. Straight-through processing allows near-instantaneous confirmation of trades, and enhances position management. Disputes about trades occur less frequently and are resolved far more quickly. Risk managers can more clearly and quickly monitor and manage the aggregate risks to which their firm is exposed.

Central counterparty clearing is the critical second half of the integrated exchange model approach. Central counterparty clearing of standardized instruments permits the most complete and effective multilateral netting of exposures. With the cooperation of market participants and the assistance of interested regulators, existing open trades could be substituted into the standardized cleared products. Any such “tear

up” of current exposures, which would best reduce risks associated with existing positions, would be complex to implement. Adopting a CCP clearing model, however, would achieve a more comprehensive reduction of current risks than existing compression services can offer.

A central counterparty can also offer objective daily settlement methodology for mark-to-market purposes, based upon neutral, market-based processes implemented by experienced personnel, rather than the more subjective views of the trade participants themselves. An independent clearinghouse, with a risk-neutral position and no stake in market direction, would be positioned to fairly assess risk and manage collateral requirements fairly on behalf of all market participants.

Finally, a neutral central counterparty would most reliably guarantee performance on behalf of all market participants through a well-capitalized, dynamically-managed guarantee pool. Improved accuracy and transparency of position values, combined with central counterparty clearing, would also materially reduce capital charges for firms that are active participants in these markets. Better transparency around market prices and trading activity would permit risk management practices that are both more prudent and more capital-efficient.

Collectively, these enhancements would lead to a more orderly and more liquid market for credit derivatives. A transparent exchange-traded and cleared credit market would serve the needs of corporate issuers, banks, hedge funds, asset managers and other market participants to benchmark the cost of raising funds and balance and distribute the credit risks in their investment portfolios. It would also present fewer risks to the broader financial markets and the US economy in times of financial stress.

CME Group is actively working to develop solutions that will enhance the evolution of the credit derivatives market. As the leading global derivatives exchange, we have a long history of developing standardized products in cooperation with market participants. We also manage the world’s largest derivatives clearing facility. We are uniquely positioned to bring effective, mutualized risk management practices to these markets.

In 2007, CME Group matched over 316 million transactions on our trading platforms, with a notional value that exceeded one quadrillion dollars. Transactions on CME’s electronic trading platforms are matched and confirmed within milliseconds, and immediately novated by the CME Clearinghouse. In 2007, the clearinghouse cleared more than 2.8 billion

contracts traded on CME and The Chicago Board of Trade, our two fully-regulated futures exchanges, in addition to clearing OTC transactions in foreign exchange and commodities. The Clearinghouse currently holds more than \$60 billion of collateral on deposit and routinely moves more than \$3 billion per day among market participants, with movements of up to \$10 billion on exceptionally volatile days.

The risk management practices that an experienced clearinghouse would bring to this market are critical. The CME Clearinghouse performs continuous real-time monitoring of market positions and aggregate risk exposures, together with twice-daily financial settlement cycles, to remove financial risk from the markets we clear. The clearinghouse conducts advanced portfolio-based risk calculations to ensure that posted collateral will cover potential losses. We monitor individual large account positions and perform daily stress testing to identify potential risk exposures. Finally, our clearinghouse has a proven ability to scale operations to meet the demands of new markets and unexpected volatility.

CME Group is actively exploring solutions to reduce the risks and inefficiencies of the current credit derivatives markets. We believe that the best solution must be one that involves all market participants and addresses their different interests, goals and objectives in the credit derivatives markets in an open and equal access environment. We believe that an exchange model does so. In an exchange model, dealers will serve crucial roles as market makers for listed credit products, and as intermediaries that may execute trades and clear on behalf of their prime brokerage clients. The needs of protection buyers will also be met: successful on-exchange products would concentrate liquidity and offer the buy side the best available prices for the contracts they seek. Active buy-side trading firms would also be able to make markets in listed products, furthering the price improvement process.

The needs of regulatory agencies and the public would also be met. Clearing of credit derivatives products would substantially reduce the systemic risks of unknown size in the current OTC credit markets. The dynamic risk management and mutualization of risk that occurs with clearing would go further to prevent a “domino effect” of cascading defaults than can the compression services offered in the OTC market. Transparent pricing, active market surveillance and appropriate reporting requirements will improve accounting and corporate disclosures concerning credit derivatives and reduce the risks of manipulation and other market-distorting

practices. Successful exchange-traded products would also provide investors and policy-makers a reliable stream of credit derivatives market data.

Unresolved Issues

We have met with the CFTC and the Federal Reserve and will meet with the SEC this week to promote the integrated exchange and CCP clearing model that I have proposed. We believe that there is a path that will permit futures exchanges to trade and clear this product subject to the CFTC's jurisdiction and to allow securities and options exchanges to trade and clear the product subject to the SEC's jurisdiction. The recent MOU between the CFTC and the SEC demonstrates a new era of cooperation in bringing novel products to market and allowing competition between regulated futures and securities markets. We hope to make progress with all of the concerned agencies and avoid any delays in bringing solutions to market that might, in the past, have been hindered by jurisdictional disputes. We are strong proponents of regulatory accommodation that promotes competition. In the case of CDSs, there is a risk that regulatory uncertainty, or a forced regulatory outcome, may not adequately address the particular needs of this market; anything that hinders prompt implementation of an effective solution extends the systemic risks in the current market.

We recommend that financial market regulators be encouraged to foster an open environment in which various solutions can compete to meet the needs of market participants and to satisfy important public policy goals. Our goal is to advance these markets beyond their current opaque, inefficient and risky practices. This requires product structures that conform to existing practices, and rules and regulatory oversight that are suited to those products and the manner in which they are traded. That may not occur if exchange-traded credit products must be fitted within regulatory frameworks that were developed for entirely different markets.

The firms that are the primary dealers in the credit derivatives markets must accept changes that will make these markets more transparent and efficient, and more actively managed from a risk standpoint. I do not mean to suggest that the dealers in these markets do not see the risks or are not prepared to make changes. These firms are themselves subject to the risks of these markets. Their back offices are frustrated by the slow confirmations and frequent problems in documentation. Their risk managers

worry about the size of exposures and the possibility of cascading defaults. Their CFOs and accountants seek accurate mark-to-market information and a sensible approach to reporting. The dealers also have been working to develop solutions. It is important, however, that these solutions be genuinely progressive and not merely stopgap measures or means of forestalling changes that will bring greater transparency and oversight to the credit derivatives markets.

CME Group is actively working to develop solutions that will enhance transparency and opportunities for participation, greatly improve efficiency, and reduce the threat of systemic failures in the credit derivatives markets. We are prepared to work with the Federal Reserve, the Treasury Department, the Commodity Futures Trading Commission and the Securities and Exchange Commission to resolve regulatory uncertainty and establish effective regulatory approaches for these markets. The credit derivatives markets have become a critical means of dispersing and allocating credit risks. Without them, our capital markets would be less efficient and effective. Credit derivatives are not a problem that needs to be fixed. But the credit derivatives market is a market that needs to adopt trading and confirmation practices and a risk management structure that is appropriate for a market of such size and importance to the global economy.

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