TESTIMONY OF

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before the

U.S. Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment

"Reducing Risks and Improving Oversight in the OTC Credit Derivatives Market"

July 9, 2008

Mr. Chairman, distinguished Members of the Committee. Thankyou for the chance to appear.

Credit derivatives are typically just default insurance contracts. Some credit derivatives are customized to the needs of investors looking for specific sorts of diversification or protection.

The financial industry got ahead of itself by allowing extreme growth of its credit derivatives markets before it had safe and effective ways to manage the associated risks. I have been concerned about inadequate methods for the pricing and risk management of the types of credit derivatives that played a role in the recent credit crisis, and also about a lack of robust operational infrastructure. I am going to focus now on operational issues such as trade documentation and clearing, but I am happy to try to answer more general questions.

Credit derivatives are traded almost entirely in the over-the-counter market, where a dealer normally acts as a seller to buyers of default protection, and as a buyer to sellers of default protection. In order to balance their positions, dealers often take positions with other dealers. In addition, hedge funds often expose one dealer to another when they re-assign their positions in an existing contract. As a result, dealers find themselves significantly exposed to the event of default by some other dealers, normally a very remote but potentially dangerous possibility.

Had Bear Stearns collapsed before the 2005 initiative of the Fed lead to reduced documentation backlogs, and had quick action by the Fed and J.P. Morgan not occurred, the unwinding of Bear Stearns' derivatives portfolio could have been extremely dangerous. In the absence of clear and up-to-date records of current derivatives positions, dealers would have been uncertain of their own and other dealers' exposures, and could have responded by a dramatic withdrawal of financing to each other, which could have indeed caused other dealers to fail, with potentially disastrous economic consequences.

In addition to a lack of good records, the market has suffered from an unnecessary buildup of exposure of dealers to each other. For a simple illustrative example, suppose that Goldman Sachs has credit derivatives contracts that expose it to Merrill Lynch through a one-billion-dollar credit derivatives position, while at same time Merrill Lynch has a similar one-billion-dollar exposure to J.P. Morgan, and J.P. Morgan has the same exposure to Goldman. If all three dealers in this circle of exposures were to re-assign their contractual positions to a central clearing counterparty, then each dealer's positions would net to zero. None of them would be exposed, nor would the central clearing counterparty. In practice, however, the growth of the credit derivatives market has been accompanied by an exceptional increase in the exposures of dealers to each other that could have been significantly avoided by central clearing.

Through a new electronic confirmation platform known as DerivServ, I believe that the trade documentation problem has now been largely addressed, although even more progress should be made in that direction. A central clearing counterparty known as TCC is likely to come on line in the credit derivatives market later this year, and will reduce dealers' exposures to each other significantly for standardized credit derivatives, which constitute the bulk of dealer exposures. I have reviewed the architecture of the TCC, and it offers roughly the benefits that are offered through exchange-based clearing.

The market is achieving a more robust infrastructure through these and other procedural improvements, such as new protocols for auction-based cash settlement of contracts at credit events, and for "novation," meaning the assignment of a customer's position to a new dealer. Further improvements in the OTC market architecture are planned.

These infrastructure improvements have come to the over-the-counter derivatives market rather late. Many of their benefits have been available all along with exchange-based trading.

Separate from the issue of operational risks, exchanges and over-the-counter markets offer different merits as venues for finding counterparties and for negotiating prices. Exchanges are more transparent and more easily regulated. They are natural for trading highly standardized contracts. The OTC market suffers from a lack of price transparency. On the other hand, the OTC market is more flexible, and thus better suited to financial innovation and to customization for clients, especially those seeking to transfer large amounts of a specific type of risk.

I would be concerned about the unintended consequences of a regulatory allocation of certain types of financial trading between the OTC and exchange markets. Aside from the chance of getting it wrong or of dampening incentives for future innovation, there is also the question of international competition. The

United States has the world’s premier derivatives exchange, but is competing with the United Kingdom for leadership in the OTC derivatives market.[1] Over several decades, the U.S. over-the-counter derivatives market has nevertheless served as an engine for innovation and economic growth in the financial-services sector in a manner analogous to the role of Silicon Valley in the manufacturing sector.

Thankyou. I would be happy to address questions.

[1] See “Competing for a Share of the Global Derivatives Markets: Trends and Policy Choices for the United States,” by Darrell Duffie and Henry T.C. Hu, Working Paper, June 3, 2008, Graduate School of Business, Stanford University.