TESTIMONY OF THE CLEARING CORPORATION

REGARDING

REDUCING THE RISKS AND IMPROVING OVERSIGHT IN THE OTC CREDIT DERIVATIVES MARKET

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

JULY 9, 2008

The Clearing Corporation (TCC) appreciates this opportunity to offer the Committee its views regarding the over-the-counter (OTC) credit derivatives market and to discuss its plans to clear certain OTC credit default swaps (CDS). We commend the Committee for its interest in industry efforts to improve the efficiency of the OTC credit derivatives market and to enhance opportunities for risk reduction. These are issues of significant interest to TCC, its clearing participants and the entire financial community.

TCC (originally known as Board of Trade Clearing Corporation) began providing clearing services for the futures markets more than eighty years ago, in 1925. Over the past 18 months, TCC and its participants have been working together to develop a prudent and robust framework for a CDS clearinghouse. TCC and its participants have worked in close consultation with a number of financial regulators in connection with this initiative.

TCC's proposed CDS clearing initiative will provide a central counterparty that will operate rigorous risk management systems and will be subject to comprehensive federal and state oversight. We believe TCC's proposed clearing service has the potential to provide significant risk reduction and operational efficiencies for the CDS market.

TCC welcomes this opportunity to provide the Committee with an overview of its CDS clearing initiative.

BACKGROUND

As the Committee is aware, although CDS are a relatively recent financial innovation, they have quickly become an extremely important and widely used tool for the mitigation of credit risk.

Very generally, a CDS enables a party (the "protection buyer") that has exposure to the credit risk of a company (the "reference entity"), in exchange for making periodic payments, to obtain protection from a third party (the "protection seller") against the risk that the reference entity will become insolvent and unable to pay its obligations. Under a typical CDS, the protection buyer makes periodic fixed payments to a protection seller. In exchange, the protection seller is obligated to purchase from the protection buyer, at par value, an agreed principal amount (the "notional amount") of specified obligations in the event that the reference entity experiences one or more specified "credit events" (such as a payment default or bankruptcy). The reference entity can be a company, a sovereign nation or any other borrower. The deliverable obligations can consist of a specific obligation of the reference entity, a category of obligation, or all repayment obligations.

Thus, a CDS transaction enables a lender, for example, to purchase protection against a borrower's payment default. At the same time, it enables the protection seller to receive income in exchange for assuming exposure to the borrower's credit. There is no requirement that either party to a CDS hold the debt of the reference entity. CDS transactions thus enable market participants to take “long” or “short” positions on the credit quality of companies without transacting in the debt obligations of those companies.

In addition to CDS written on a single reference entity (so-called “single name” CDS), CDS can be written with respect to groups of reference entities. These “index” CDS allow market participants to more efficiently manage or assume exposure to the creditworthiness of various sectors of the economy. Index CDS now represent the largest segment in the CDS market.

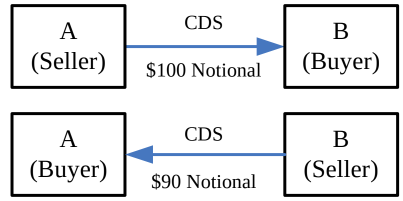
Prior to the advent of CDS, no tradable financial instrument existed that would enable a company exposed to a third party’s default risk to manage that credit risk efficiently and in a liquid market. As a result, CDS have provided enormous benefits both to Wall Street and to Main Street. They enable financial institutions to hedge the credit risks inherent in the corporate financings that are necessary to grow our economy. This enhances the stability of financial institutions and reduces the cost of funds for borrowers. It also frees up additional credit capacity, enabling financial institutions to expand the credit facilities they are able to make available to their corporate clients.

It is therefore not surprising that CDS have seen significant growth in recent years.

The Bank for International Settlements (BIS) has estimated that, as of December 2007, the outstanding notional amount of CDS was just under $58 trillion. We estimate that a majority of the market is comprised of the inter-bank sector, and that the lion’s share of the notional amount within that sector is comprised of index CDS.

It should be noted that the notional amount of outstanding CDS does not represent the actual amount at risk in the CDS market. It is important not to confuse the aggregate notional size of the CDS market (or any other derivatives market) with the probable risk of loss associated with the market, which is very significantly lower. There are several factors relevant to assessing the probable risk of loss within the CDS market, including most significantly the net exposure of the participants, after taking into account offsetting positions;[1] the probability that the underlying reference entities will default; and the probable recovery amounts that the participants will collect upon the occurrence of probable defaults. In the case of protection buyers, probable risk of loss is also affected by the probability of the protection seller's default and the amount of collateral held by the protection buyer to secure the protection seller's obligations.

Aggregate Notional versus Net Exposure



Aggregate Notional: $190

Net Exposure:
A is a net seller of $10 notional
B is a net buyer of $10 notional

The BIS estimated that, as of December 2006, the net credit exposure within the CDS market was just 0.49% of the outstanding notional amount of CDS. This number does not take into account the application of collateral and other risk mitigating factors, but demonstrates the relationship between the aggregate notional amount of the CDS market and the actual amount at risk.

As bilateral transactions, CDS expose each party to the risk of the other party's non-performance.[2] This counterparty risk is a primary concern for CDS market participants.

[1] CDS market participants frequently enter into multiple CDS, both as protection buyers and protection sellers, with respect to the same reference entity or entities. As a result, many of these CDS are economically offsetting, resulting in no or significantly reduced net exposure.

[2] In the case of a protection buyer, this risk only manifests itself as a risk of actual loss in circumstances where both the reference entity experiences a credit event and the protection seller defaults.

Each CDS market participant's ability to honor its CDS obligations directly affects its counterparties' risk calculations. As a result, the credit terms applicable to CDS, governing collateral and related requirements, tend to be extremely important and are frequently subject to significant individual negotiation.

The size and significance of the CDS market has spurred public and private sector interest in the development of market mechanisms to improve efficiencies and mitigate certain of the operational and credit risks associated with CDS. In response to this market interest, TCC and its participants have been actively pursuing the development of a clearinghouse for CDS and plan to integrate these clearinghouse operations with the asset servicing capabilities of The Depository Trust & Clearing Corporation's (DTCC) Deriv/SERV, a service that has proven extremely successful in significantly reducing the post-trade operational backlogs associated with the CDS market.

The primary objectives of this clearing initiative are to reduce the outstanding CDS notional in the market by netting down offsetting transactions to the maximum extent possible and to ensure that the resulting transactions are adequately collateralized in order to minimize the consequences of the failure of any individual participant.

DISCUSSION

The Clearing Corporation's History and Experience

TCC is a Delaware corporation with a proven track record clearing and guaranteeing trades as an independent clearinghouse since 1925. A closely-held corporation, TCC is owned by 11 major financial institutions, three leading OTC derivatives inter-dealer brokers, an international exchange and a leading OTC services provider.[3] Currently, TCC has over 50 participants and provides derivatives clearing services for multiple exchanges and marketplaces, including the Chicago Climate Futures Exchange, the United States Futures Exchange, the Eurex Global Clearing Link, OTC Benchmark Treasury Futures, and the Financial and Energy Exchange (FEX Australia). As a registered derivatives clearing organization, TCC is currently regulated by the Commodity Futures Trading Commission.

The Clearing Corporation Trust Corporation

In an effort to reduce CDS counterparty risk, TCC is in the process of creating the Clearing Corporation Trust Company (<u>CCTC</u>), a wholly-owned, limited purpose New York trust company. TCC is currently working with the New York Banking Department and the Federal Reserve Bank of New York in order to obtain for CCTC a New York State banking charter as a limited purpose trust company and membership in the Federal Reserve System. As a New York State limited purpose trust company and Federal Reserve System member bank, CCTC would be subject to direct supervision and examination by the Federal Reserve Bank of New York as well as by the New York State Banking Department. TCC also anticipates ongoing consultation and cooperation with other interested financial market regulators.

CCTC's business will be limited initially to the provision of clearing services for the CDS market. It will act as a central counterparty to its participants, guaranteeing all CDS transactions accepted for clearing and collecting margin and other credit support from its participants to collateralize their clearing obligations. We anticipate that CCTC will initially

[3] TCC's shareholders include: Bank of America, Citigroup, Credit Suisse, Creditex Group, Deutsche Bank, Eurex, GFI Group, Goldman Sachs, ICAP, JP Morgan, Lehman Brothers, the Markit Group, Merrill Lynch, MF Global, Morgan Stanley and UBS.

accept for clearance only specified index CDS transactions and will ultimately expand its operations to accept other indices, index tranches, and single-name CDS transactions.

CCTC Participants

Participation in CCTC will be open to all qualified applicants. In order to qualify as a participant of CCTC, an applicant will be required to satisfy CCTC's participant criteria. These are currently expected to include the following requirements:

- minimum net capital of $5 billion;
- minimum long-term debt rating of "A" from Standard & Poor's (or its equivalent from other nationally recognized rating agencies);
- demonstrated operational competence in CDS, including positions having a minimum outstanding notional contract value of $500 billion;
- demonstrated risk management capabilities; and
- participation in CDS industry organizations (such as the International Swaps and Derivatives Association and DTCC's Deriv/SERV).

These requirements are consistent with international standards for central counterparties as articulated by the Bank for International Settlements in its 2004 report "Recommendations for Central Counterparties", which requires "participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation" in a clearing organization.[4]

TCC expects that all of TCC's owner banks and dealers (each of whom currently meets these requirements) will participate as clearing participants of CCTC. As noted above, we believe the inter-dealer market represents the most significant portion of the outstanding notional

[4] Recommendations for Central Counterparties, Bank for International Settlements, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (IOSCO), November 2004.

amount of the CDS market and that TCC's shareholder banks and dealers account for the majority of this volume. Accordingly, CCTC should be in a position from its inception to clear a significant portion of the CDS market and to reduce significantly the associated counterparty risk.

As participation in CCTC will be open to all qualified applicants, TCC anticipates that its participant base will quickly expand beyond TCC's shareholders to other qualified market participants, further reducing counterparty risk in the CDS market.

Clearing CDS Transactions

<u>Post Trade Acceptance of Matched Transactions</u>

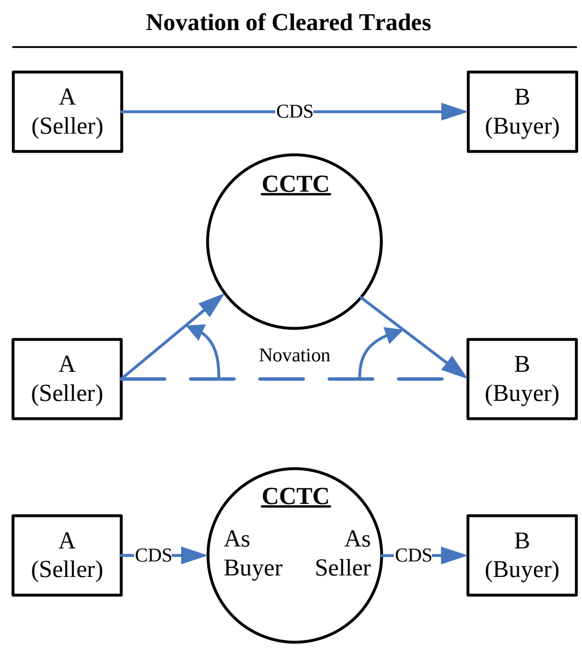
In order to clear transactions, CCTC must first receive accurate and reliable information regarding the transactions that are submitted for clearing. Additionally, as a clearinghouse, CCTC's primary role will be to reduce the credit risk associated with cleared CDS transactions. Accordingly, CCTC's trade submission process is designed to ensure that it maintains a matched book of offsetting CDS contracts, a prerequisite for any central counterparty.

Currently, CDS are bilaterally negotiated and executed. Major market participants frequently use DTCC's Deriv/SERV matching and confirmation service when documenting their CDS transactions. This service creates accurate, electronic records of transaction terms and counterparties. As part of this service, market participants separately submit the terms of an executed CDS transaction to the service in electronic form. Paired submissions are compared to verify that their terms match in all required respects. If a match is confirmed, the parties receive an electronic confirmation of the submitted transaction. Confirmed transactions are forwarded to the Deriv/SERV Transaction Information Warehouse, which serves as the primary registry for confirmed transactions and has recently begun to manage payment flows, settlements, and adjustments to contract terms through the life of the transaction.[5] This provides additional operational efficiencies to market participants who use the service.

CCTC will leverage the Deriv/SERV infrastructure to operate its CDS clearing service. Deriv/SERV's matching service will forward to CCTC qualifying matched transactions under which both parties have elected clearing.

5 Use of the DTCC Deriv/SERV confirmation matching facility by major CDS market participants has contributed significantly to the substantial decrease in post trade unprocessed CDS confirmations at major firms.

Novation



In order to achieve the benefits of multilateral netting, CCTC will act as the central counterparty to all submitted transactions.

Under CCTC's clearing rules, each bilateral CDS contract between two clearing participants that is submitted for clearing will be "novated". As part of this process, the submitted contract is replaced by two superseding CDS contracts, one between CCTC and each of the parties to the submitted transaction. Under these new contracts, CCTC will act as "protection buyer" to the original "protection seller" and as "protection seller" to the original "protection buyer".

In order to further mitigate risk to CCTC and its clearing participants, all cleared CDS transactions will be governed by a uniform credit support framework and related clearing rules.

Reducing Counterparty Credit Risk

Because CCTC will be a counterparty to each of its participants, CCTC is exposed to the risk of its participants' default. To address this risk, CCTC will both require its participants to provide credit support for their obligations under cleared CDS transactions and establish rules that "mutualize" (as described below) the risk of a participant's default across all CCTC participants. CCTC's risk management infrastructure will be structured specifically for the CDS market. The credit support collected by CCTC to secure its CDS participants' obligations will not be subject to the claims of futures market participants transacting in other futures and derivatives contracts cleared by TCC.

Credit Support Requirements

CCTC will maintain strict margin collateral requirements subject to regulation and oversight by the Federal Reserve System Board of Governors and the New York State Banking Department. These collateral requirements will also be consistent with industry practice and international standards established for central counterparties.[6] The amount of collateral required of each clearing participant will be continuously adjusted to reflect the size of, and risk associated with, the participant's cleared transactions. Margin will consist of two components: initial margin based upon a risk-based calculation of potential loss in the event of a significant adverse market movement; and variation or replacement margin, based upon an end-of-day mark-to-market of outstanding positions. Acceptable collateral will initially include only cash and G7 government debt. Participants will be required to cover any end-of-day margin deficit by the following morning and CCTC will have the discretion to require and collect additional margin as it deems necessary.

CCTC will also maintain a guaranty fund to cover losses arising from a participant's default on cleared CDS transactions that exceed the amount of margin collateral held by CCTC. Each clearing participant will be required to contribute to the guaranty fund, based on anticipated CDS position exposures, when it becomes a participant. The adequacy of the guaranty fund will be monitored daily and additional contributions will be determined on at least a quarterly basis, based on the size of participant exposures within the clearinghouse. As a

[6] See note 5 above.

result, the guaranty fund will grow in proportion to the risk associated with the aggregate volume of CDS transactions cleared by CCTC over time.

Mutualization

Mutualization is designed to protect CCTC from losses arising from a participant's default by making other participants' contributions to the guarantee fund available to cover the defaulting participant's losses.

In the event of a clearing participant's default, CCTC will first look to the margin collateral posted by the clearing participant. If the margin is insufficient to cover the defaulting participant's obligations to CCTC, CCTC will then look to the defaulting participant's contribution to the guaranty fund. Ultimately, if the defaulting participant's margin collateral and guaranty fund contribution are insufficient to cover its obligations, the risk of a clearing participant's default will be mutualized, as CCTC will be authorized to use, to the extent needed, other clearing participants' guaranty fund contributions to satisfy any remaining obligations of the defaulting clearing participant.

Transaction Administration

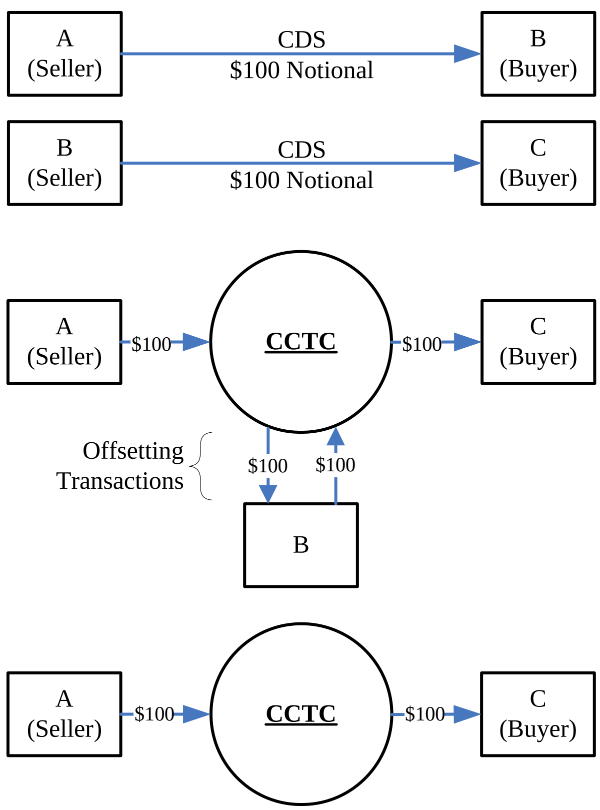
Once transactions submitted for clearing are novated, the resulting positions will be communicated to Deriv/SERV's CDS warehouse, which will maintain a duplicate registry of all open CDS positions that have been accepted for clearance by CCTC. CCTC will use Deriv/SERV's Coupon Payment Facility to administer the calculation and transfer of periodic payments owed by protection buyers to protection sellers under outstanding CCTC-cleared CDS contracts.

Credit Risk and Operational Benefits Arising from CCTC's Proposed Operations

By requiring the collateralization of outstanding transactions and mutualizing the risk of loss, CCTC will simultaneously reduce the risk of inter-dealer counterparty credit losses and reduce the risk that a major participant's default in the CDS market will lead to other participants' defaults. TCC and its shareholders believe that these mechanisms will reinforce other private and public sector initiatives to promote financial stability.

Operational Benefits

Effect of Multilateral Netting



In addition to credit risk mitigation, CCTC's clearing service will also offer its participants significant operational efficiencies. One direct result of transaction novation to a central counterparty is the facilitation of multilateral netting. Because CCTC is a central counterparty to all cleared CDS transactions, offsetting transactions entered into by a single clearing participant will be netted down to a single exposure, even where offsetting transactions are initially executed with different clearing participants. Multilateral netting will significantly reduce the outstanding notional amount of each participant's CDS transactions as well as the number of transactions it must administer and manage.

Additionally, because CCTC is the central counterparty to each participant, each clearing participant will only face a single counterparty on its cleared CDS transactions; CCTC. This will greatly simplify clearing participants' cashflow management since payments due on different CDS contracts can be netted to a single daily payment obligation or entitlement. With fewer transactions and counterparties to manage, clearing participants will be better able to track and manage their positions and to further reduce any residual operational backlogs.

CCTC anticipates that these operational and credit risk reduction benefits will provide a strong incentive for its participants to confirm their CDS transactions using the Deriv/SERV service so as to ensure their eligibility for clearing.[7]

A Phased Approach

When CCTC's CDS clearing service launches, it will first address the reduction of existing open index CDS transactions. This is expected to significantly reduce the outstanding notional amount of inter-bank index CDS transactions, possibly by as much as an order of magnitude or more. On a regular basis, CCTC will process and clear outstanding inventories of qualifying CDS transactions. Once existing CDS inventories have been addressed, CCTC will begin its "live" clearing service and clearing participants will be able to indicate at execution of a transaction that the transaction is to be submitted to CCTC for clearing.

Based on current scheduling and consultation with regulators, TCC intends to launch CCTC's clearing services by the end of this year. The first products CCTC expects to clear include untranched CDX North American Investment Grade, High Yield and Crossover

[7] As noted above, CCTC's proposed structure and operations remain in development and will be subject to comprehensive federal and New York state supervision as well as industry consultation. As a result, while we anticipate that the foregoing description will remain accurate, logistical, operational and regulatory considerations may affect CCTC's ultimate clearing structure.

indices. Over the following year, CCTC anticipates that it will expand the range of CDS contracts eligible for clearing, starting with additional CDX indices (including tranches), iTraxx indices, and, subsequently, single name CDS.

OTC Clearing Generally

A number of clearinghouses currently provide clearing services for bilaterally negotiated OTC contracts. By and large, each of the services is substantially similar in overall structure to the clearing service expected to be provided by CCTC. Each requires the submission of trades with matched economic terms so the clearinghouse maintains a matched book. Each provides for a central counterparty, a central counterparty guaranty, margining and other credit support requirements applicable to all participants. Although variations exist in these clearing models, TCC does not, however, believe that these variations are consequential as a practical matter.

CONCLUSION

We believe TCC's clearing initiative has the potential to significantly reduce counterparty credit risk, deliver important operational efficiencies and make a constructive contribution, in combination with other public and private sectors initiatives, to financial market stability. TCC welcomes an ongoing dialogue with this Committee, Congress and the supervisory community in connection with this initiative.