

**Written Testimony of Acting Chairman Walter Lukken Before the House Committee on
Agriculture**

October 15, 2008

Chairman Peterson, Ranking Member Goodlatte, and other distinguished Members of the Committee, I am pleased to have this opportunity to appear today to discuss risk management for credit default swaps (CDS). The Commodity Futures Trading Commission (CFTC) welcomes the opportunity to discuss over-the-counter (OTC) derivatives and the benefits derived from clearing such products.

OTC Swaps and Regulated Futures Transactions

From the beginning of U.S. futures trading in the mid-1800s until recently, regulated futures exchanges offered the primary means by which commercial entities could manage their physical market price risks. During the 1980s, however, financial institutions began to develop non-exchange-traded derivatives contracts that offered similar risk management benefits. In 1981, the World Bank and IBM entered into what has become known as a currency swap. The swap essentially involved a loan of Swiss francs by IBM to the World Bank and the loan of U.S. dollars by the World Bank to IBM. The motivation for the transaction was the ability of each party to borrow the funds they were loaning more cheaply than the counterparty, thus reducing overall funding costs for both parties. This structure of swapping cash flows ultimately served as the template for swaps on any number of financial assets and commodities.

The development of the OTC swap industry is related to the exchange-traded futures and options industry in that a swap agreement can function as a competitor or complement to futures and option contracts. Market participants often use swap agreements because they offer the ability to customize contracts to match particular hedging or price exposure needs. Conversely, futures markets typically involve standardized contracts that, while often traded in very liquid markets, may not precisely meet the needs of a particular hedger or speculator. The OTC swap market has grown significantly because, for many financial entities, the OTC derivatives products offered by swap dealers have distinct advantages relative to futures contracts.

Yet, these OTC swap transactions are largely unregulated. With respect to the CFTC, the Commodity Exchange Act (CEA) excludes most OTC financial derivatives, including CDS, from its regulatory and enforcement jurisdiction.¹

¹ See, e.g., CEA, 7 U.S.C. §§ 2(d) and 2(g). Section 2(d) excludes from CEA coverage transactions involving an “excluded commodity” (a broad range of interest rate, currency, credit, equity, weather, and other derivatives) that are not executed on a trading facility and are entered into solely by eligible contract participants. Section 2(g) excludes from CFTC regulation transactions involving a commodity other than an agricultural commodity that are not executed on a trading facility if they are entered into solely by eligible contract participants and are subject to individual negotiation.

Section 2(d)(2) also excludes transactions involving an excluded commodity that are executed through an electronic trading facility by eligible contract participants trading on a principal-to-principal basis, or by certain authorized fiduciaries or investment managers. Finally, under Title IV of the Commodity Futures Modernization

Credit Default Swaps

The current financial crisis is requiring policymakers to rethink the existing approach to market regulation and oversight. Many observers have singled out OTC credit derivatives, including CDS, as needing greater scrutiny and transparency.

OTC credit derivatives emerged in the mid-1990s as a means for Wall Street financial institutions to buy insurance against defaults on corporate obligations. Specifically, OTC credit derivatives are bilateral off-exchange instruments that allow one party (the protection buyer) to transfer credit-related risks associated with the actual or synthetic ownership of a “reference asset” to another party (the protection seller) for a price.² The reference asset associated with an OTC credit derivative may be a corporate debt obligation (such as a bond or a bank loan), a sovereign debt obligation, an asset-backed security (such as commercial mortgage-backed securities), or any other obligation or debt. Credit derivatives transfer the credit risks attendant to the actual or synthetic ownership of a reference debt obligation.

The most common credit derivative product is the CDS. Under a CDS, the protection seller promises to compensate the protection buyer for the economic loss associated with a material decline in the value of a reference asset that is triggered by the occurrence of a pre-determined “credit event,” such as a filing for bankruptcy or default on a debt payment by the issuer of the reference asset. In some CDS contracts, the protection buyer pays the protection seller a “periodic premium” for the protection.³ If a triggering credit event occurs, then the protection buyer would receive a full lump-sum payment that is some fraction of the par value of the reference asset, to compensate the buyer for the asset’s devaluation. In turn, the protection buyer would deliver the devalued asset to the protection seller.

The estimated notional amount of CDS transactions has nearly doubled every year since 2001 to reach an estimated peak of \$62 trillion in 2007, before receding 12 percent to \$54.6 trillion as of June 30, 2008.⁴ In all likelihood, this number somewhat overstates the actual size of the CDS market because many traders hold offsetting positions that have not been netted against each other. Nevertheless, the size of total CDS positions is substantial.

The Benefits of Clearing of OTC CDS Transactions

Recent events have uncovered the risks that certain CDS transactions pose to the financial system. American International Group, an insurance company, reportedly issued CDS

Act of 2000 (CFMA), an exclusion from the CEA was created for certain individually-negotiated swap agreements offered by banks to eligible contract participants.

² In the OTC market, the terminology “protection seller” and “protection buyer” is used to refer to the seller and the buyer of a credit derivative.

³ CDS pricing is based on (i) the probability that the issuer of the reference asset will experience a credit event, and (ii) the expected recovery rate for the reference asset. Credit events are defined in Article IV of the 2003 International Swaps & Derivatives Association’s (ISDA) *Credit Derivatives Definitions*. These definitions and standards are well established, and they have been adopted for widespread use in the OTC market.

⁴ ISDA News Release, Sept. 24, 2008 (available at <http://www.isda.org/press/press092508.html>).

transactions covering more than \$440 billion in bonds, leaving it with obligations that it could not cover in the current market conditions. This CDS exposure factored into the Federal Reserve's decision to provide an \$85 billion conditioned loan to the ailing company to prevent its failure and a possible contagion event in the broader economy.⁵ Clearly, there are major risks associated with these products that need further review.

The dispersed and non-standardized nature of many OTC instruments makes finding a regulatory solution a challenging task. But policymakers must strive to increase the transparency of these transactions and find ways to mitigate the systemic risk created by firms that offer and hold these off-exchange instruments. While wholesale regulatory reform will require careful consideration, centralized clearing is one immediate and proven solution that could help mitigate the risks associated with these products.

Clearing mitigates counterparty risk by substituting the credit of the clearinghouse for the credit of the counterparty. In addition, clearing: (1) addresses the assessment of market risk and price transparency by publishing a settlement price each day for each product; (2) increases liquidity by enabling participants to offset positions against entities other than the original counterparty; and (3) facilitates order processing by establishing standard procedures and deadlines. For these reasons, this solution has been advocated by CDS market participants and the President's Working Group on Financial Markets (PWG). The PWG first recommended providing clearing solutions for OTC derivatives in a 1999 report to Congress.⁶

Clearinghouses have been available for many years as a means for mitigating the risks associated with exchange-traded financial products. Whether securities, options, or futures, centralized clearinghouses ensure that every buyer has a guaranteed seller and every seller has a guaranteed buyer, thus minimizing the risk that one counterparty's default will cause a systemic ripple through the markets. The clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members.

Clearing would enable parties to a CDS transaction to focus solely on obtaining the best price for the transaction, without regard to whether the parties executing opposite them are capable of performing their obligations. Because the clearinghouse would serve as the central counterparty to all transactions, parties could close out their positions without having to seek out the original counterparties to their trades.

Clearing would also strengthen the infrastructure of CDS trading by facilitating more timely and accurate post-trade processing. For many years, post-trade processing of OTC derivatives has been a decentralized, paper-based process. As a result, the enormous growth in trading volume led to massive backlogs in confirming trades. Various initiatives have been undertaken to improve the trade processing of CDS transactions, and progress is being made toward resolving the backlogs; however, much work remains to be done. By contrast, as evidenced by the performance of U.S. futures clearinghouses, efficient and accurate trade

⁵ Indeed, it now appears that AIG may be the beneficiary of up to an additional \$37.8 billion in federal aid.

⁶ Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets, November 1999.

processing is a hallmark of clearing. Adopting a clearing regime for CDS would prevent such backlogs from developing in the future.

Centralized clearing addresses the root problems the markets are confronting today—the constriction of credit due to fear of default. Indeed, for futures contracts—the standardized on-exchange cousin of OTC derivatives—clearing has worked extraordinarily well in managing credit risk. The first independent U.S. futures clearinghouse was established in 1925, and this model helped launch others. Today, the world’s largest derivatives clearing facility is located in the United States and routinely moves billions of dollars per day in mark-to-market settlements, including a record \$12.7 billion on January 23, 2008, without any disruption. In 2007, that same facility traded a record 2.2 billion derivative contracts valued at more than one quadrillion dollars.

For regulated futures exchanges, the clearing and settlement mechanism serves to lessen the likelihood that large losses by a trader will cause a contagion event. At least twice daily, futures clearinghouses collect payments from traders with losing positions and credit traders with profitable positions. This twice-daily “mark to market” prevents the buildup of significant losses. Importantly, no U.S. futures clearinghouse has ever defaulted on its guarantee.

Just as significant, the clearing process provides transparency to regulators. When transactions are cleared, government and exchange regulators receive daily trader and pricing information, which helps them to police for manipulation and fraud and to uphold the integrity of the market.

Current Regulation of OTC Derivatives Clearing

Clearing has been proven to work for OTC derivatives. After Enron’s demise in 2001, the OTC energy derivatives markets “locked up” because many energy companies lacked the requisite financial standing to back their off-exchange trades. In response, the New York Mercantile Exchange (NYMEX) sought and received approval from the CFTC in 2002 to clear OTC energy products for the first time. Today, a significant number of OTC energy derivatives are cleared through regulated clearinghouses, which has reduced systemic risk and allowed regulators a greater window into this marketplace. Clearing for OTC products now extends beyond just energy products to financial products such as forward rate agreements and foreign currency swaps.

Under existing law, any derivatives clearing organization (DCO) that is registered with the CFTC may clear all OTC derivatives without further registration or subjecting itself to any additional regulatory requirements.⁷ Pursuant to the CEA, the CFTC regulates DCOs and has the statutory mandate to ensure the financial integrity of transactions subject to the CEA and to

⁷ The CFMA added Section 409 to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), 12 U.S.C. § 4422, which governs the clearing of OTC derivative instruments by multilateral clearing organizations (including DCOs). Section 409 of FDICIA prohibits a person from operating a clearing organization for OTC derivative instruments except if that person is registered with the CFTC or the SEC, or is supervised by certain approved foreign financial regulators, or unless that person is a type of banking organization.

avoid systemic risk. The CFTC relies on the 14 core principles for DCOs set forth by Congress in the CEA, 7 U.S.C. § 7a-1, as a means of evaluating whether DCOs comply with U.S. law.

In analyzing compliance with these principles, the CFTC looks to the controls and tools utilized by a clearinghouse, including: (1) appropriate membership standards and continuing oversight of members; (2) collection of position reports from large traders; (3) daily mark-to-market of all open positions; (4) collection of an appropriate amount of performance bond (sometimes referred to as “margin”), which serves to cover any losses that cannot be met by the market participant; (5) periodic stress-testing of open positions; (6) an ability to liquidate all of a market participant’s open positions quickly; and (7) availability of other financial resources for use by the clearinghouse to cover any member default. Any clearinghouse seeking to clear CDS transactions will need to show in its proposal that it can bring such tools to bear.

While DCOs do not need pre-approval from the CFTC to clear OTC derivatives, any such initiative would be required to comply with the relevant core principles set forth in the CEA, and the CFTC would review it for compliance with those principles. In addition, the CFTC would need to approve in advance any request by a DCO to commingle funds associated with “cleared-only” OTC derivatives with the DCO’s customer segregated funds. The customer funds underlying exchange-traded futures and options are required to be held in a separate account and to be segregated from the funds of the clearing member and of the DCO. The CEA and CFTC regulations prevent any other funds from being held in the segregated account absent permission from the CFTC. This is a critical customer protection feature that is designed to ensure that customer funds for exchange-traded futures and options are protected and available for withdrawal or transfer even if the clearing firm in question experiences severe financial distress or goes into bankruptcy. In appropriate circumstances, the CFTC has permitted DCOs to commingle customer funds associated with “cleared-only” OTC derivatives with customer funds associated with exchange-traded futures and options in the segregated account. The CFTC has permitted such treatment only when it has concluded that the benefits of permitting such commingling outweigh the risks.

Separate from clearing, the creation of a trading platform for CDS products also could be beneficial because it would enhance pricing transparency, liquidity for the product, and order processing. However, the utility of some of these customized off-exchange instruments might be lost if they become sufficiently standardized to be listed on a multilateral exchange trading facility. For example, two major U.S. derivatives exchanges listed credit derivatives products in 2007, but neither product was able to gain a significant market share.

In closing, the CFTC, in conjunction with other financial regulators, will continue to seek ways to provide clearing solutions for OTC derivatives. Last month, in its swaps report to Congress, the CFTC recommended the further use of clearing for OTC derivatives. There are several private sector clearing initiatives currently being considered by Federal regulators, and it is imperative that policymakers work cooperatively and expeditiously to conduct their due diligence and allow appropriate programs to begin operations promptly. While comprehensive financial reform might take time, encouraging centralized clearing is one immediate step that can reduce risk in the markets and benefit the U.S. economy.

Thank you for your leadership on this critical issue. We look forward to participating fully in Congressional and regulatory efforts to address these issues and to implement policies and practices that serve the public interest.