STATEMENT OF CHRISTOPHER EDMONDS
CHIEF EXECUTIVE OFFICER,
INTERNATIONAL DERIVATIVES CLEARING GROUP
BEFORE THE
CONGRESSIONAL SUBCOMMITTEE ON CAPITAL MAKRETS, INSURANCE, AND GOVERNEMENT SPONSORED ENTERPRISES
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Good morning Chairman Kanjorski, Ranking Member Garrett, and Members of the Committee. I appreciate the opportunity to testify today on behalf of International Derivatives Clearing Group, LLC (IDCG). The effective regulation of the Over-the-Counter (OTC) derivatives markets is essential to the recovery of our financial markets.

IDCG is an independently managed, majority owned subsidiary of The NASDAQ OMX Group. IDCG operates the International Derivatives Clearinghouse (IDCH), a Commodity Futures Trading Commission (CFTC) regulated clearinghouse that is approved to act as a central counterparty for interest rate swap (IRS) futures contracts and other fixed income derivatives.

IDCG was conceptualized in late 2007 with the purpose of offering a clearing service for OTC interest rate swaps. Pairing with the global leader NASDAQ OMX Group, IDCG built a clearinghouse capable of clearing interest rate swap futures contracts which are economically equivalent to OTC interest rate swap contracts. IDCG filed a clearing organization application with the CFTC on August 22, 2008 and received approval four months later, on December 22. This approval took place during arguably one of the most trying times in the history of our financial markets, and we commend the CFTC for the thorough and diligent review of our application.

I am certain each of you has heard many stories and versions of the current economic crisis. Some are self-serving explanations trying to influence how this pitfall in financial history will be remembered. While these opinions have their place in the debate, I would encourage each member to use one test to determine the best reforms to ensure future generations are not forced to confront these issues again.

I sit here today in an environment where some of the leaders of the financial industry have failed to protect the end-users. Today's financial system is not open to all players, the rules of engagement do not apply to all, and there are significant barriers to innovation. Unless the work of the Committee, this Congress, the current Administration, and all of the participants in the debate yields a system that protects the smallest eligible market participant in a manner consistent with the largest market participant, the system will fail again. There has been a lot of debate around the use of central counterparties (CCPs); I, however, assure you not all central counterparties are the same. Ultimately, market competition will determine where business lands, but I encourage members of this Subcommittee to stay focused on the simple fact that when it comes to clearing, all counterparties must enjoy the same level of access and play by the exact same rules.

There has been much fanfare over the handling of the Lehman default. While it is true that some counterparties were part of a system that provided some minimal protection, this system was far more a club and far less a macro solution. Unfortunately, this system did not protect the end-users. The Federal Home Loan Bank (FHLB) System lost hundreds of millions of dollars[i]. Many county governments and even the New York Giants[ii] suffered losses as well. These are real world examples of why the main thing regulation needs to do is protect the smallest market participants. This system simply failed the most critical type of user – the end-user.

I have defined the victims; let me also offer a quick overview of the macro systemic risks. In the world of interest rate swaps, the sell-side or dealer community has a distinct advantage over the end-users of these products. This advantage developed due to the lack of transparency or consistent rules of engagement in the market. Make no mistake, healthy dealers are needed in this system, however, their health need not be at the expense of end-users of the products. In markets where CCPs exist today, all dealers have a significant presence and produce significant profits. Equities are the largest example of such a market; likewise, when CCPs were introduced in the energy markets in the earlier part of this decade, dealers saw an increase in the number of counterparties and their opportunities for transactions. You have heard and will continue to hear why transparency is negative for the market, but it is only a near-term negative for those who are currently disproportionately advantaged by the lack of transparency. In equities over the past 30 years, and energy over the last decade, history has proven two things: first, transparency does create more opportunities, and second, the dealer community has the intellectual horsepower to generate significant profits from the increased opportunities – as do all market participants. In the wake of the release of the widely referenced letter of June

2, 2009 to the Federal Reserve Bank of New York, many – myself included – marvel at how the same entities that helped create the financial crisis are now explaining how the market should be reformed.

While I wish I could report to you today that the financial markets are evolving in the right direction from a systemic risk perspective, that is simply not the case. Let me explain what we have found with respect to counterparty risk concentration. IDCG offers a product that is the economic equivalent to the interest rate swap (IRS) product that trades in the OTC market. Since some have continued to confuse the costs of clearing services, we began to offer what we call shadow clearing. This way, end-users can quantify the actual cost of moving their portfolios into our CCP environment. We now have over $250 billion dollars in shadow clearing, and our data has shown significant concentration risks exist in the IRS world. In fact, two of the largest four participants were required to raise significant capital as a result of the recently completed stress tests.[iii]

Just last week before this same Subcommittee, Federal Housing Finance Agency Director, James Lockhart acknowledged an over-concentration of counterparties has developed during the past year.

The OTC Market

The OTC market is vast by any measure and broad in its reach. Currently, when one is looking to approximate the scope of the OTC market, the figure often cited is the total notional amount outstanding. In its most recent report, the Bank for International Settlements (BIS) placed this figure at a staggering $592 trillion. While this is an important guide to the total volume of transactions that may need to be replaced in the event of default in the bilateral environment, total notional amount outstanding can be a misleading measure of the risk inherent in the OTC market.

A more useful number (BIS publishes this number for this very purpose) is the gross market value which represents the cost of replacing all open contracts at prevailing market prices. This is the counterparty credit exposure that central clearing addresses. As of December 2008, BIS estimated the gross market value of all OTC derivative contracts to be $34 trillion, an increase of 114% from the previous year. Within that total, the gross market value of all USD OTC interest rate derivative contracts was $10.2 trillion, an increase of 217% from the previous year. While this does not represent a single measure of risk in the market, it is representative of the exposure currently borne by participants. The OTC market has grown to the size it is because of the immense benefit that it brings to increasing the efficiency of our economy and financial system. The systemic risks in the system, however, have become too large to ignore any longer. OTC markets have also been characterized by a lack of adequate regulation and an absence of price transparency, which have, in turn led to poor judgments being made on the nature of risk itself. An unfortunate victim of these market dynamics is Jefferson County, Alabama. Because of the opaqueness of the OTC market, experts believe that Jefferson County was overcharged by approximately $100 million for arranging derivative contracts designed to lower borrowing costs on sewer debt[iv]. In addition to overpaying for these contracts, these interest rate swap contracts have actually significantly increased their borrowing costs. Now Jefferson County is on the precipice of bankruptcy[v]. For further evidence of these flawed market practices, one needs to look no further than the collapse of Lehman Brothers and the massive infusion of taxpayer dollars into the financial system.

We need to be focused on preventing similar abuses which have cost taxpayers hundreds of billions of dollars. The best way to accomplish this goal is through the proper regulation of the instruments, the methods of transaction, and the participants – all of which contributed to this great economic crisis.

Centralized Clearing

Of the many solutions proposed to solve the aforementioned problems, the best is central clearing. A clearinghouse minimizes counterparty credit risk among participants by acting as a buyer for every seller and a seller for every buyer. The clearing house employs a number of risk management techniques to ensure that it has sufficient resources to replace the market risk of a participant if they default. These resources come from margins levied against each participant, a mutual risk pool with contributions from all participants, and the clearinghouse’s own capital. This approach acts in a number of ways to reduce the systemic risk in the market;

- Bankruptcy: Segregated funds treatment of client’s money in a futures clearinghouse has proven effective. Bilateral credit arrangements do not protect end-user’s cash when there is a bankruptcy situation. This was dramatically demonstrated by FHLB's losses resulting from the Lehman Brothers default.

- Mutual Risk Pool: The potential for knock-on effects from a default are reduced because the loss is borne by all participants, in a share commensurate with their own positions in the market, rather than in total by one participant.
- Netting: With Netting, only the net market risk of a participant needs be replaced in a default, rather than the multiple offsetting transactions currently present in the OTC market.
- Great Operational Efficiency: Facing a single counterparty simplifies the market. The number of bilateral credit arrangements was estimated to be over 150,000 in International Swaps Derivatives Association's 2009 Margin Survey Results, compared to the few hundred arrangements that would be necessary against a handful of clearing houses.
- Total Position Margining: With a CCP, liquidity demands of each user are calculated daily across the entire portfolio. This reduces liquidity demands from multiple bilateral collateral arrangements, to a single demand from a central counterparty based on market risk.

It is important to note that no CFTC regulated clearinghouse using these risk management techniques has ever failed as a result of a default, or series of defaults. Some have suggested that the cost of central clearing limits the efficiency of the market; this is simply not true. Given the efficiency gains by consolidating the many hundreds of thousands of bilateral arrangements to a central counterparty, clearing is not only a systemically better alternative, but also likely a cheaper one. As well, from a public policy perspective, an appropriately applied margin requirement, under the supervision of a strong regulator, acts as a natural deleveraging discipline in the market.

Transparency

Transparency of pricing through exchange trading brings further benefits to the broader financial system. By requiring OTC derivatives to be traded through exchanges, transactions are executed in the most economically efficient ways. This has the potential to significantly reduce the cost of OTC participants who are hedging their risk. Transparency also translates into a direct savings for taxpayers. When these prices are made public, the opacity of the OTC market no longer obscures the fair market value of these contracts. This is particularly true in the IRS market where the most simple and standard of products, vanilla IRS, provide the backbone of valuation for the more exotic and bespoke products. In this way, even those products which are considered unsuitable for exchange trading or central clearing still incur substantial benefit from applying these tools.

Some participants have expressed concerns that the costs of clearing would outweigh the benefits. I answer those concerns in two ways; first, most simply, the costs of not clearing are far more daunting, you need only ask the institutions I have already mentioned who sustained substantial losses in the Lehman collapse if the costs of clearing are prohibitive. I think the answer is unmistakable. The second point is that the dealer banks are already charging their clients for the credit risk inherent in bilateral OTC contracts; it would be imprudent for them not to. This charge is wrapped up in the transaction costs and unlike true collateral, is not necessarily returned to the client once the risk is reduced. Rather, it is retained by dealer bank as profit. I suggest it would be far better to see and make decisions on the fees for individual services in a transparent manner; this concept is the corner stone of our financial market system and regulation.

Likewise there have been concerns raised that moving to an exchange environment would stifle creativity in the OTC market for bespoke structures. I argue the opposite; a greater depth of liquidity in the instruments used to hedge these structures, clearer indications of their component prices, and a greater understanding of the risks involved would lead to greater creativity and acceptance of the products.

Furthermore, the exchange trading of products eases the regulatory burden, by providing the timely reporting of trades, immediate price dissemination, as well as electronic audit trails. These tools are invaluable for regulators tasked with preventing manipulation and fraud in financial markets.

Market Access

The most important aspect in the design of centralized clearing is mutualization of risk amongst the greatest number of market participants. Central clearinghouses should be required to have fair and open access criteria that allow any firm that meets its objective, prudent standards to participate under the same rules of engagement. This in turn increases the number of participants which reduces systemic risk. The risk involved in derivatives traded in this manner is better distributed. Central clearing gathers strength from greater transparency, more competition, and, for the larger market participants, the benefits of netting multiple risk exposures. Limiting the number of participants severely dilutes centralized clearing's value proposition. As mentioned previously, limiting clearing to a select group of participants does not provide any benefits to the end-users, like the Federal Home Loan Bank System.

Fundamentally, central clearing means that more parties are backing a transaction rather than a few. This is in contrast to the bilateral world, where all parties are only as strong as the weakest link in the chain. In an improperly mutualized system, this argument still applies. Recent academic research has confirmed this effect, clearly demonstrating the greatest benefits from clearing are achieved when the greatest number of participants in the largest markets is able to access a cleared solution. There is no better example of this than the USD IRS market.

In addition to the benefits that a greater number and diversity of participants bring to the clearing solution, it can also have a significant impact on the liquidity available in the market. In a market with a high concentration of liquidity providers the commercial balance is tipped in favor of these few institutions. I have already mentioned our shadow clearing service, which has demonstrated the presence of this kind of imbalance in the USD IRS market. Further evidence of this concerning situation can be seen in the BIS concentration statistics. The Herfindahl Index, which measures market concentration, is at its highest level in published history for USD IRS. Perhaps more concerning is how the US market has fallen behind other major markets, notably Europe, in this regard and now demonstrates a higher concentration than much smaller markets such as Sweden and Japan where you would expect a natural bias towards a smaller number of participants. The market is desperate for a more diverse base of liquidity to bring transaction costs back to pre-crisis levels and to provide a buffer to the extreme volatility that has been present in financial markets since the summer of 2007. Only an All-to-All solution will deliver this liquidity in a prompt and efficient manner.

Conclusion

IDCG welcomes the direction taken by Secretary of Treasury Timothy Geithner in his statements on regulatory reform of OTC derivatives and sees this as an important first step in the direction of much needed reform of the broader financial industry. While no one would argue that all OTC derivatives are suitable for clearing, we at IDCG believe that the vast majority of the volume of transactions are not only suitable, but demand to be cleared given the current environment. While any potential legislation should be careful not to force all contracts or all users onto exchanges or into clearing houses, it should also be careful not to restrict the creative talents and commercial power of the people gathered in this room from being able to help the financial system out of its current predicament.

The IDCG solution employs a set of exchange traded futures contracts rich enough to replicate existing OTC market practices but without introducing additional complexities to the way the product behaves or is priced. This, combined with a rigorously tested and regulated clearing model enables market participants, both current and future, to minimize individual counterparty credit exposure. By bringing this solution in an open "All to All" model, the reduction in systemic risk and increase in price and valuation transparency can be achieved at the broadest level. We stand ready to offer this solution today to market participants who want to move our financial system forward from the crisis experienced over the past two years. IDCG is providing a private industry response to the current financial crisis, and our mission has never been more relevant than in today's difficult economic environment.

Mr. Chairman, thank you for the opportunity to appear as a witness today.

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[i] Press release. FHL Banks Office of Finance. 9 Oct. 2008. FHL Banks Office of Finance. 9 Oct. 2008 <http://www.fhlb-of.com/analysis/press_rls/FHLBLehman100908.pdf>.

[ii] Bloomberg. 12 Dec. 2008. Aaron Kuriloff. 13 Dec. 2008 <http://www.bloomberg.com/apps/news?pid=20601079&refer=home&sid=ay72YnXojdqk>.

[iii] Press release. Board of Governors of the Federal Reserve System. 07 May 2009. Board of Governors of the Federal Reserve System. 07 Mar. 2009 <http://www.federalreserve.gov/newsevents/bcreg20090507a1.pdf>.

[iv] Bloomberg. 26 Apr. 2008. Martin Z. Braun. 26 Apr. 2008 <http://www.bloomberg.com/apps/news?pid=20601087&sid=a8LMiiucBPHA&refer=home>.

[v] Bloomberg. 29 May 2009. Kathleen Edwards. 29 May 2009 <http://www.bloomberg.com/apps/news?pid=20601103&sid=aMDlrt.HFtVQ&refer=us>.