

Speech by Craig Donohue
for the
CFA Society Of Chicago

Gordon, thank you for that kind introduction and thank you also for inviting me to be with you today. While this is obviously an extremely busy time for us at CME Group, I am glad to have the opportunity to talk with you about what is happening in financial markets right now, where we see further problem areas and – perhaps most important – what needs to be done to strengthen our financial markets for the future.

This is a pretty sophisticated audience but it might be good to start with what CME Group is. In many respects, we are like an insurance company. We offer hedging and risk management products that allow investors, borrowers, lenders and commercial companies to protect against price risks in everything ranging from interest rates to equities, foreign exchange, commodities, energy and many other instruments.

We are, by most objective measures, the largest financial market in the world. Last year, we facilitated the trading of more than 2 billion futures and options contracts exceeding \$1 quadrillion in value. As important, we are one of the best functioning parts of our global financial marketplace.

For over a century, CME Group has protected customers and ensured financial integrity by guaranteeing the performance of every transaction on our exchange. No customer has ever suffered losses as the result of a clearing member default at CME Group. In large part, it is a reflection of our commitment to the following principles:

- Full transparency of activity, prices and exposures;
- Competition by market makers that reduce transaction costs for market users;
- The separation of trading counterparties from credit counterparties;
- Market regulation and supervision that deters and/or punishes improper behavior;
- Central counterparty clearing that guarantees the performance of any transaction, backed up by a \$7 billion financial safeguard system;
- A twice daily mark-to-market regime or “pay-as-you-go” system; and
- The most effective customer protection system in the world that segregates client positions, funds and property – even from the claims of the bankruptcy trustee in the event of a clearing member insolvency.

I think it is fair to say that the past few weeks have been some of most tumultuous and difficult times that we have seen in financial markets – perhaps ever.

Much of the focus, deservedly so, has been on the fundamental causes of this crisis – namely the subprime meltdown and the residential and commercial real estate markets. In the last few weeks

however, it has become clear that these problems have spilled over into virtually every other area of our financial markets and real economy and we now see tremendous dislocations in credit and lending markets, as well as equity, interest rate, foreign exchange, energy and commodity markets.

One area that I would like to spend some time on is the emerging risks we face in the credit default swaps market. Credit default swaps allow investors to either bet on the chance of a debt default - or protect themselves from that risk if they own the underlying corporate bonds.

Essentially one party – a hedge fund or insurer, for example – pays an annual fee to another in exchange for a promise that they will be compensated in a default. Credit risk is therefore syndicated out among numerous investors, rather than concentrated in the hands of fixed income investors.

The CDS market has grown rapidly in recent years, with gross exposures of approximately \$60 – \$70 trillion and where outstanding CDS contracts sometimes dwarf the underlying "cash" bonds by a factor of 10 or more.

While defaults have been rare in the last several years, the current financial crisis is triggering wide scale downgrades and credit events and we are seeing failures of both debt issuers as well as trade counterparties in the CDS market.

Serious concerns are now emerging about whether counterparties can actually meet their performance obligations in these contracts, without suffering new losses. In the case of AIG'S downgrade alone, they had to raise an additional \$13 billion in collateral to backup their \$446 billion in CDS trades. It has similarly been reported that market participants had to come up with an additional \$140 billion to support CDS obligations on Lehman Brothers following their bankruptcy filing.

The CDS market will be severely challenged in the coming weeks as billions of dollars worth of contracts on now-defaulted derivatives on Fannie Mae, Freddie Mac, Lehman Brothers and Washington Mutual are settled.

Because of the opacity of this market, it is still not clear how many contracts have to be settled and whether payouts on the defaulted contracts are concentrated with any particular financial institutions or market participants.

I think these problems can be solved. Unlike the characteristics of CME Group and other regulated futures markets, the over-the-counter derivatives markets are largely opaque, unregulated and operationally risky, due to lack of automated systems and straight-through processing capabilities, and essentially lacking in many of the prudential financial safeguards that I spoke of earlier.

Given the widespread lack of confidence in the OTC derivatives markets today, I believe there are several essential elements that these markets need in order to increase transparency and thereby restore the confidence of the investing public and government regulators.

First, we need more product standardization, price transparency and central counterparty clearing.

Many contracts can be standardized and traded in a manner that promotes price transparency. This would enhance liquidity, broaden the range of trading counterparties and significantly reduce bilateral credit risks or concentrations.

By acting as the counterparty to every trade, CME Clearing virtually eliminates counterparty credit risk, meaning that for every trade completed on our exchange, we guarantee the financial soundness of both parties – regardless of who they traded with.

Second, OTC derivatives markets need independent and objectively determined prices or marks.

Subjectivity, moral hazard and lack of transparency in accounting and reporting of exposures has been a significant factor in the current financial crisis as firms have had to write down difficult-to-value and increasingly illiquid assets.

CME Clearing is market neutral. We do not have a portfolio being traded or cleared, so we do not have a stake in a particular settlement practice or price. As the guarantor of every transaction, our only vested interest is in making sure market participants fully collateralize the true risk of their positions. Mark-to-market not mark to myth.

Third, they need automated versus manual processes that ensure a timely confirmation of transactions.

Trade processing is typically manual, leaving it open to delays and errors. In the CDS market, in 2005 the New York Fed set dealer guidelines for reducing the backlog of unconfirmed trades, many of which had been outstanding for more than 30 days.

In contrast, at CME Group – where we handle more than 2 billion trades annually worth more than \$1 quadrillion – trade confirmations happen within milliseconds on our CME Globex electronic trading platform.

Fourth, the OTC market needs a mark-to-market system that cleanses losses out of the system and ensures confidence and liquidity for market participants, basically erasing debt on an hour-to-hour basis.

At CME Group, all positions are marked-to-market twice a day with performance bond requirements adjusted as needed based on volatility and market events. This effectively means that losses can't accumulate or go unnoticed.

Fifth, OTC markets need better customer protection mechanisms.



Centrally cleared futures markets have tended to engender more confidence than OTC markets, even during times of market stress. In large part, that is because of our superior customer protection mechanisms. For example, in the cases of REFCO, Bear Stearns and Lehman Brothers, where their parent companies became bankrupt, insolvent or impaired, we've seen strong and continuing customer confidence in the broker/dealer or FCM entity underneath the holding company because they know that segregation and bankruptcy protections have worked for many decades – time and time again.

I believe we are about to enter a new era in U.S. financial markets where transparency, market integrity and central counterparty clearing safeguards will take on greater importance .

As our new market models evolve, it is important that we not forget the lessons we have learned from the unprecedented events of recent weeks.

We have a unique opportunity ahead to reshape financial markets and regulation for the 21st Century. At CME Group, we are very proud of our track record of success and we look forward to helping strengthen these other market segments.

Thank you for letting me be with you today. I'd now be happy to open the floor for any questions.....