



Statement of  
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Before the  
United States Senate  
Subcommittee on Securities, Investment and Insurance  
Of The  
Committee on Banking, Housing and Urban Affairs  
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I am Craig Donohue, CEO of CME Group Inc. (“CME Group” or “CME”). Thank you Chairman Reed and Ranking Member Allard for inviting us to testify today.

I will not belabor the basic facts. Suffice to say that these are critically important products. The CDS market has grown precisely because credit derivatives are an extremely useful innovation that permits dispersion and realignment of credit risks. However, the trading, confirmation, risk management and settlement systems have not kept pace with the rapid growth in trading and the sophistication of market participants and their trading strategies.

There are solutions that can increase transparency and reduce risk within the CDS market. The transparent price discovery and multilateral trading and clearing mechanisms of an exchange model allow for monitoring risks on a current basis, reducing systemic risk and enhancing certainty and fairness for all participants. At the same time, it would offer regulators the information and transparency they need to assess risks and prevent market abuse. An exchange model would reduce the information asymmetries in today’s CDS market and protect the broader financial markets.

Let me provide a few specific examples of the problems, and the solutions that an exchange-based model would offer:

- First, CDS markets are opaque: best price information is not readily available, as it would be on a centralized marketplace. Efficient and accurate mark-to-market practices are hindered by the lack of transparency in the CDS market. Disagreements are common, leading to subjective and inconsistent marks and

potentially incomplete disclosure to investors of unrealized losses on open positions. Earlier this week, Toronto Dominion Bank announced a nearly \$94 million loss believed to be related to credit derivatives indices and index tranches that had been incorrectly priced by a senior trader. Traders often generate their own marks in the credit derivatives market due to the perceived unreliability of some end of day pricing services. In an exchange-based model, with transparent and reliable end of day marks and market data dissemination to all credit derivatives market participants, portfolio based valuation errors of this type are much less likely to occur.

- Second, risk assessment information is inadequate, and risk management procedures are inconsistent across the market. Precise information on gross and net exposures is not available. The true consequences of a default by one or more participants cannot be measured – exactly the sort of systemic risk brought to light by the Bear Stearns crisis, which caused major disruptions in the market. As Bear Stearns faltered, credit spreads for most dealers widened, volatility increased and liquidity declined. Intervention became necessary.

Transparent market information combined with risk management protocols enforced by a neutral clearinghouse could have mitigated this outcome. Risk managers would have accurate and timely information on their firms' positions, exposures and collateral requirements. The clearinghouse and regulators would be able to manage concentration risks within a particular portfolio, and stress-test the consequences of a major default.

- Third, gross exposures for bilateral CDS transactions are far larger than necessary, adding to the risk of a cascading series of failures across the markets. Adjusting exposures through novated trades is overly complex and time consuming – such trades often remain unconfirmed for weeks.

The benefits that an exchange model would bring to this market are substantial. Centralized electronic trading would offer scalable, efficient mechanisms to market participants and bring price transparency to the entire market, improving accounting practices and public reporting. Such systems would permit nearly instantaneous trade confirmation. An experienced clearinghouse could substantially reduce systemic risks. The CME Clearinghouse currently holds more than \$60 billion of collateral on deposit and routinely moves more than \$3 billion per day among market participants. We conduct real-time monitoring of market positions and aggregate risk exposures, twice-daily financial settlement cycles, advanced portfolio-based risk calculations, monitor large account positions and perform daily stress testing. Our clearinghouse has a proven ability to scale operations to meet the demands of new markets and unexpected volatility.

We are not here today to ask that Congress mandate one solution. Much has been said recently about TCC's proposal, though public information has been limited. We believe there are alternative structures that could better suit the needs of all market participants. In the case of CDSs, there is a risk that regulatory uncertainty, or a forced regulatory outcome, may not adequately address the needs of this market. We are prepared to work with the Federal Reserve, the CFTC and the SEC to resolve uncertainty and establish effective regulatory oversight.

We recommend that financial markets regulators be encouraged to foster an open environment in which various solutions can compete. The best path will be one that permits multiple offerings to compete, with cooperative oversight from regulators. We cannot be certain which approach will best suit the needs of the market and serve the public's interest in financial stability and effective oversight. The CDS market requires product structures, rules and regulatory oversight that are suited to the needs of all participants. That may not occur if centrally traded and cleared credit products must be fitted within regulatory frameworks that were developed for different markets or to meet different policy goals.

I thank the Subcommittee for the opportunity to share CME Group's views, and I look forward to your questions.