

Testimony of Donald P. Fewer  
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Before the Committee on Agriculture  
U.S House of Representatives  
On Derivatives Markets Transparency and Accountability Act of 2009

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Mr. Chairman Peterson, Ranking Member Lucas and Members of the Committee:

Good morning. My name is Donald P. Fewer, Senior Managing Director of Standard Credit Group, LLC, a registered broker/dealer and leading provider of execution and analytical services to the global over-the-counter interdealer market for credit cash and derivative products. I was fortunate enough to have consummated the first trades between dealers at the markets inception in 1996 and have participated in the market's precipitous growth and development as well as its challenges. I would like to thank this Committee for the opportunity to share my thoughts on the draft legislation on Derivatives Markets Transparency and Accountability Act 2009, as it applies to the over-the-counter market generally and the credit derivatives market specifically.

The Committee's draft legislation comes at a pivotal time. The consequences of the crisis paralyzing global credit markets will have significant and long term effects on credit creation, intermediation and risk transfer. I believe that legislation that attempts to address derivative market accountability and transparency should reflect a clear understanding of credit market dynamics, particularly credit risk transfer. With this in mind, I would like to address five areas of the draft legislation that does not meet this pre-requisite:

- Central Counterparty Clearing and the Role of Organized Exchanges
- Exchange Execution of OTC Credit Derivative Products
- Transparency and Price Discovery
- Underlying Bond Ownership Requirements of CDS
- Unintended Consequences of Inappropriate Regulatory Action

## **Central Counterparty Clearing, Credit Risk Transfer Derivatives and the Role of Organized Exchanges**

There has been significant criticism of the over-the-counter derivative products market, particularly credit derivatives, as the root cause of our global crisis. While much disparagement is based upon misinformation and misunderstanding, effective regulation directed at supporting the proper functioning of the credit risk transfer market is critical. Use of central clearing facilities of organized exchanges will not only work to eliminate counterparty credit issues in OTC bilateral derivative contracts, it will undergird and strengthen the OTC derivatives market infrastructure. The role of organized exchanges, in providing CCP services, can be the mechanism by which new capital and liquidity providers participate in the credit risk transfer market. The use of CCPs by all market participants, including “end users” (i.e., hedge funds, asset managers, private equity groups, insurance companies, etc.) should be encouraged by providing open and fair access to key infrastructure components including but not limited to exchange clearing facilities, private broker trading venues and contract repositories. OTC trading venues will provide voice and electronic pre-trade transparency, trade execution and post-trade automation. This view of providing access to all market participants, sell side and buy side, to an open platform centered in CCP, will stimulate credit market liquidity by re-connecting more channels of capital to the credit intermediation and distribution function. The use of exchange CCP facilities will have a significant effect by enabling participants to free up posted collateral and recycle trading capital back into market liquidity.

However, the proposed legislation, which expands the role of organized exchanges beyond CCP to include exchange execution of OTC credit derivative products, will be disruptive and lacks a clear recognition of the already well established and economically viable OTC market principles.

### **Exchange Execution of OTC Credit Derivative Products: Disruptive and Unnecessary**

Given the size and establishment of the OTC derivatives market, migration toward exchange execution has been and will be minimal apart from mandatory legislative action. With regard to CDS, the failure to migrate to exchange execution is because the credit derivatives market is characterized with a higher degree of standardization than other forms of OTC derivatives. It has been argued that the lack of standard product specifications of OTC derivatives is a market flaw and should be remedied by mandated exchange listing and execution. This argument is inaccurate. CDS contracts utilize standard payments and maturity dates. Credit derivatives participants have adopted a higher degree of standardization because credit risk is different from other types of underlying risks. Unlike interest rate

swaps, in which the various risks of a customized transaction can be isolated and offset in underlying money and currency markets, credit default swaps involve “lumpy” credit risks that do not lend themselves to decomposition. Standardization, the most significant attribute of exchange traded products, is therefore a substitute for decomposition. Recent work on reinforcing CDS market standards will result in upfront payments and the establishment of annual payments that will resemble fixed coupons. These changes will simplify trading and reduce large gaps between cash flows that can amplify losses. Most importantly, enhancing these standards will build a higher degree of integration between CDS and underlying OTC “cash” debt markets that cannot be replicated on an exchange. This aggregation and dispersion of credit risk between OTC cash and derivative markets will be critical to the development of overall debt market liquidity going forward. Other mechanisms implemented by the OTC market include post-default recovery rate auction and trade settlement protocols, novation and portfolio compression methodologies. All of these functions performed exceptionally well during the market turbulence of last year. A regulation that would force exchange execution of CDS products would be harmful and disruptive to the credit risk transfer market.

It has also been argued that the “opaqueness” of the OTC derivatives market is a detriment to market transparency and price discovery and exchange listing and execution is required to increase the integrity and fairness of the market place. With respect, this position does not reflect current market realities.

### **Transparency, Execution and Post-Trade Automation: The Work of OTC Markets**

The over-the-counter market has a well established system of price discovery and pre-trade market transparency that includes markets such as US Treasuries, US Repo, EM sovereign debt, etc. OTC markets have been enhanced by higher utilization of electronic platform execution. Private broker platforms will interface directly to CCPs and provide automated post-trade services. This was clearly demonstrated in the wake of Enron’s collapse and the utilization of CCP facilities by the leading over-the-counter energy derivatives brokers to facilitate trading and liquidity. It is clear to all market participants that financial dislocation and illiquidity will persist across many asset classes and geographies for some time. As alluded to earlier, the unique nature of the OTC market’s price discovery process is absolutely essential to the development of orderly trade flow and liquidity in fixed income credit markets. We are entering a period with an abundance of mispriced securities where professional market information and execution is required. OTC price discovery throughout the term structure of credit spreads will require a more focused and integrated execution capability between OTC CDS and cash, utilizing key component inputs from equity markets and the various constituents of the capital

structure (i.e., senior and subordinated corporate bonds, loans, etc.). This type of exhaustive price discovery service can only be realized in the over-the-counter market via execution platforms that integrate derivatives and cash markets across asset classes (i.e., debt, equities, emerging markets, etc.). This will be critical to the repair of credit market liquidity globally.

The implementation of a central trade repository, (i.e., DTCC), that is publicly disseminating detailed information of the size, reference entity and product break-down of the credit derivatives market on a weekly basis will serve to strengthen public confidence in disclosure and transparency of the CDS market.

### **Underlying Bond Ownership Requirements: The Virtual Elimination of the Inherent Value of CDS**

The draft legislation fails to recognize the underlying risk transfer facility of the “plain vanilla” credit default swap by requiring bond ownership for credit default swap purchases. Limiting CDS trading to underlying asset ownership will cripple credit markets by stripping from the instrument the risk management and credit risk transfer efficiencies inherent in its design. The basic use of a credit default swap enables a credit intermediary (i.e., commercial bank) to trade and transfer credit risk concentrations while being protected from an event of default at the senior unsecured level of the reference entities capital structure. For example, a financial institution servicing a large corporate client is required to offer commercial lending, corporate bond underwriting, working capital facilities, interest rate management services, etc. In addition, the financial institution provides a market-making facility in all of the secondary markets for which it underwrites a client’s credit (i.e., senior, junior and convertible bonds, loans, etc.) All of these above services expose the financial institution to counterparty risk to the corporate customer. The credit risk transfer market optimizes the use of capital by enabling financial intermediaries to efficiently hedge and manage on and off balance sheet (i.e., unexpected credit line draw-downs, “pipeline” risk, etc.) credit risk. Credit derivatives therefore play a critical and vital role to credit intermediation and market liquidity. The implementation of the use of CDS in requiring bond ownership will counteract and work directly against the credit stimulation initiatives currently under consideration by Congress in the Economic Stimulus Bill H.R.1.

## Unintended Consequences of Inappropriate Regulatory Action

TRACE – an example of disruptive regulatory action

Goldman Sachs recently reported that the value of cash bond trading has fallen each year over year for the past five years. The value of cash bond trading stood at \$12,151bn in 2003 and declined to \$8,097bn in 2008. The CDS market achieved CAGR exceeding 100% since 2004 and stood at \$62tn year end 2007. The inter-dealer market experienced firsthand the decline in secondary market bond turnover and that decline can be correlated directly to the implementation of **FINRA's Trade Reporting and Compliance Engine (TRACE)** reporting system. TRACE led directly, as an unintended consequence, to the deterioration of OTC inter-dealer investment grade and high yield bond trading volume. While TRACE was anticipated to facilitate the demand for "transparency" its implementation revealed the lack of depth in understanding the OTC corporate bond market structure and created an inadvertent level of disclosure that devastated the economic basis for dealer "market-making". The lack of a liquid secondary market for corporate debt throughout the term structure of credit spreads dramatically reduces the risk tolerance to underwrite new debt. The underwriters and dealers' facility to trade out of and manage bond risk was so restricted that the unintended consequence was to damage the secondary bond market. This is most notable in the U.S High Yield bond market. It is not coincidental that the U.S High Yield bond market reported zero new deal issuance for the month of November 2008. Almost half of U.S. companies have below-investment grade credit ratings, making the \$750 billion junk-bond market a critical, if not sole source of financing for an increasing number of corporations large and small all across America.

### Loss of Money and Capital Markets to Off-shore Financial Centers

The United States is at significant risk to lose the flow of money and capital market trading activities to off-shore financial centers more conducive to over-the-counter market development. While American financial institutions have been the originators of financial innovation that enabled the free flow of capital across international markets, the United States is declining as a recognized financial capital globally. Legislation that creates a regulatory environment that prohibits capital market formation will push market innovation and development to foreign markets, which would be welcoming.

Mr. Chairman, Mr. Ranking Member and Members of the Committee, I appreciate the opportunity to provide this testimony today and would urge that you continue to reach out to the dealer market for its input. I am pleased to respond to any questions you may have. Thank you.

