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THE BOND MARKET ASSOCIATION

***Statement of Micah S. Green***
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***Before the***
***Committee on Agriculture***
***United States House of Representatives***

***Hearing to Review Eurex's Pending Application for Designation as a U.S. Futures Exchange***
***November 6, 2003***

Good afternoon Chairman Goodlatte and members of the committee. Thank you for the opportunity to testify today on the important question of Eurex's application to become a U.S. futures exchange. My name is Micah Green. I am president of The Bond Market Association (TBMA), which represents securities firms and banks that underwrite, trade and sell debt securities. The membership includes all primary dealers in U. S. government securities as recognized by the Federal Reserve Bank of New York and all major dealers of municipal and corporate bonds, federal agency securities, mortgage- and asset-backed securities and money market and funding instruments. We have offices in Washington, New York and London.

The Association does not take a position with respect to the merits of Eurex's application to open a U.S.-based futures exchange. It is our view the Eurex application should be given full and fair consideration by the Commodity Futures Trading Commission (CFTC) and evaluated solely on Eurex's ability to satisfy established legal and regulatory requirements. We do not believe an exchange's country of origin should be a factor in determining compliance with statutes and regulations. Indeed, one of the principal goals of the Commodity Futures Modernization Act of 2000 was to promote competition among exchanges and to recognize the role that technology has played in the evolution of the markets.

The Association's members are firm believers in free and fair financial markets. Competition helps ensure issuers of fixed-income securities are able to borrow at the lowest interest rates possible. The same holds true for competition among exchanges that facilitate trading in financial products. Fair competition leads to greater efficiencies that are realized by market participants in the form of lower costs and risk.

Financial futures are an integral part of the financial markets that play a sometimes unnoticed, but critically important, role in the global economy. Any development that brings users of financial futures greater choice, and therefore better pricing and efficiency, will have a positive effect on the overall economy. More efficient financial markets mean lower borrowing rates for individuals, corporations and government. Investors benefit with better pricing and liquidity.

### The Role of Financial Futures in the Bond Markets

Bonds are essentially loans. When investors purchase bonds, they buy the right to a stream of interest payments and the repayment of the bond's face value at maturity. The "issuer" of a bond—the borrower—is obligated to make the interest payments on specified dates. When the bond matures, the issuer must repay the face value or principal amount of the security.

Investors can choose among bonds issued by a variety of governmental bodies and corporations. U.S. government securities are issued by the Treasury Department to fund the operation of the government and federal agencies issue bonds to support low-cost mortgage loans and other investments. State and local governments issue municipal bonds to fund schools, roads, drinking water systems, airports and a variety of other public infrastructure. Corporations issue corporate bonds to finance capital investments in new plants, equipment and technology.

There are a number of different participants in the bond market, from underwriters and dealers to issuers and investors—all of whom use and benefit from a strong and active financial futures market.

### Issuers

Issuers include any entity with a need for financing and the capacity to attract investors. For federal, state and local governments, who are unable to raise equity capital by issuing stock, bonds are one of the only sources of long-term capital available to finance investment. For corporations, bonds can prove a lower cost source of capital than bank borrowing, and an attractive solution to the financing of long-term projects.

Issuers sometimes use financial futures to lock in a borrowing rate if present market conditions are favorable but the need to actually issue interest rate-sensitive securities will not occur until a point in the near future.

### Investors

Because the investor knows the return on a bond held to maturity, they may consider it a safer investment than a stock. The return on stocks is based on dividends and capital appreciation. Investors cannot be certain the company will pay a dividend or how the market will value the stock over time. Investors cannot be certain how the market will value a bond over time either, but they can remain confident the bond will continue to produce coupon payments and ultimately a principal payment.

Bond portfolios, however, are sensitive to short-term changes in interest rates. An investor may wish to limit this risk by using financial futures to create a position that offsets some or all of their bond exposure. Alternatively, investors can use futures contracts to leverage the return—and risk—of their portfolios, since futures make it possible to control a large volume of securities with a relatively small initial cash investment.

### Brokers and Dealers

Bond dealers are securities firms or departments of commercial banks engaged in the underwriting, trading and sale of debt securities. Investment bankers work with the issuer to develop the structure and price of a bond issue. Structure includes elements such as the bond's maturity and the coupon it will pay. Pricing a bond issue entails gauging investor interest in the deal and adjusting the yield, so it is attractive for both the issuer and the investor.

Besides using the financial futures markets to hedge interest rate risk in their securities inventories or other investment positions, brokers and dealers often use their expertise to speculate on future interest rates or currency movements using financial futures. This type of trading adds liquidity to the futures markets and increases the likelihood all market participants can find competitively priced futures contracts.

### Market Making and the Need for Hedging with Financial Futures

Bonds generally do not trade on a centralized, organized exchange or trading system like stocks. Rather, the bond market is a decentralized, over-the-counter (OTC) market. When an investor wants to sell a bond in the secondary market, he or she usually sells the bond to a dealer. The dealer then attempts to resell the bond to another investor. This function is known as "market-making." The time between when a dealer buys a bond and when the dealer sells the bond, the bond is said to be in the dealer's "inventory." During the time that the bond is in the dealer's inventory, the dealer faces a risk the bond's price will fall before it can be sold to another investor and that the dealer will incur a loss on the transaction. An active and liquid market depends on the willingness of bond dealers to put capital at risk by buying and selling bonds aggressively. (A liquid market is one in which a given asset can easily be bought or sold.)

Bond dealers also use a technique known as hedging to protect the value of their bond inventories from market swings. Hedging is a way to mitigate risk associated with trading. It involves taking a trading position that offsets another position so that when one position falls in value, the other rises to countervail the loss. Take the example of a dealer who purchases $1 million in 10-year Treasury notes in order to fill the demand of a customer to sell the security. If market interest rates should rise after the dealer makes the initial purchase, the face value of the bonds in inventory will fall and the dealer will realize a loss. To protect against such a turn of events, the dealer can hedge the position by buying or selling futures contracts in order to create an off-setting position. If the dealer wanted to hedge their position, they would purchase government bond futures contracts to sell the same amount of 10-year notes. As the dealer sells off the inventory, they can also sell off, or unwind, the futures contracts that serve as a hedge.

What is most important to the bond dealer in this position is the ability to easily purchase and sell the futures contracts at fair prices and low costs. This is also important for the bond issuers, investors and the financial system as a whole. The deeper and more liquid the futures market, the easier and more economically dealers can hedge their position. This, in turn, encourages dealers to commit more capital to making a market in bonds. Increased dealer activity aids liquidity.

Hedging is important to dealers and others who actively trade bonds and other fixed-income securities. Every day, nearly $800 billion of Treasury, agency, mortgage- and asset-backed, corporate and municipal bonds change hands. In virtually every transaction, one or more bond dealers put their capital at risk in acting as a counter-party and market-maker.

A liquid market appeals to investors who are generally more willing to purchase a bond if they know they can sell it again at a fair market prices should they need to. In an illiquid market, an investor may find there are so few parties willing to purchase a given bond that the best market prices do not reflect the bond's fair value. The easier and cheaper it is for dealers to hedge their trading positions using futures, the more liquid is the cash market for the underlying bond or other financial product. The more liquid a market is, the less risky it is for investors to hold securities in that market. The less risk investors face, the lower return they demand when initially buying securities from issuers. Bond issuers benefit from a liquid market as it generally means investors will demand lower interest rates on the issuer's bonds. Fostering competition among futures exchanges will, in the end, make it less costly for the federal government, states and localities, corporations and individual families to borrow.

## Conclusion

Our fair and open markets for financial futures ultimately benefit participants at every level of the financial markets. More efficient financial markets mean lower borrowing rates for individuals, corporations and government. Investors benefit with better pricing and liquidity.

The Association believes one of the keys to our fair and open financial futures markets is competition among the exchanges that facilitate trading in financial futures contracts. Congress has recognized this, most recently in 2000 with the Commodity Futures Modernization Act, as well as the role technology can play in promoting competition.

The CFTC has long recognized that promoting efficient markets is good public policy. We are confident the CFTC will consider Eurex's application as it would any other submission and make its decision based on the merits of the application. We urge the

Committee to encourage the CFTC to act expeditiously and fairly in evaluating Eurex's application. Thank you for the opportunity to present our views.