Chicago Mercantile Exchange

An Introduction to
CME Interest Rate Products

What Are Futures and Options?

Futures contracts are standardized, legally binding agreements to buy or sell a specific product or financial instrument in the future. The buyer and seller of a futures contract agree on a price today for a product to be delivered or settled in cash at a future date. Each contract specifies the quantity, quality and the time and location of delivery and payment.

The value of a futures contract is derived from an underlying financial measure or market, such as interest rates, equity index levels, foreign exchange rates, or commodity prices – hence the term *derivatives*. As the value of the underlying measure or market changes, the value of the futures contract based on that measure or market also changes. Institutions and individuals that face financial risk based on the movement of the underlying measure or market can buy or sell futures that will change in value to offset that financial risk. Such transactions are known as *hedging*. Institutions and individuals also buy and sell futures hoping to profit from price changes. These transactions are considered *speculation*.

CME also offers investors options on futures. Options can be thought of as insurance policies. The option buyer pays a price for the right – but not the obligation – to buy or sell a futures contract within a stated period of time at a predetermined price. The combination of options and futures – both risk-management tools – can give market participants the leverage of futures and the more limited risk of options. Options provide the opportunity to limit losses while maintaining the possibility of profiting from favorable changes in the futures price.

Global Leadership in the Financial Marketplace

CME is the largest and most diverse financial exchange in the world for trading futures and options – handling nearly 800 million contracts worth more than $460 trillion in a single year. Founded in 1898, we serve the risk-management needs of customers around the globe by offering the widest range of benchmark financial products available on any exchange, traded via our CME Globex electronic trading platform and on our trading floors.

Our innovative products cover major market segments – including interest rates, equities, foreign exchange, commodities and alternative investment products – and improve the way these markets work for customers everywhere. In addition, our clearing house matches and settles all trades and guarantees the creditworthiness of every transaction that takes place in our markets.

Overview of CME Interest Rate Products

CME interest rate products enable banks and other lenders worldwide to hedge interest rate risks, and in turn help to reduce the overall cost of borrowing and financing. Without these tools, potential lenders would be less willing to lend or would only be willing to lend at higher rates to offset the possibility of adverse shifts in interest rates. CME interest rate products enable lenders to manage that risk. As a result, institutions that use CME interest rate futures products are able to increase their lending and pass some of the efficiencies, in terms of lower costs, onto their commercial and consumer clients.

CME trades more short-term interest rate futures and options than any other exchange in the world. Averaging more than 1.6 million contracts traded daily, CME interest rate futures products represent an annual notional (underlying cash) value of $400 trillion. Participants in the cash or over-the-counter (OTC) interest rate markets use CME products to manage interest rate risks ranging from 30 days to 10 years.

The cornerstone of the CME interest rate product line is CME Eurodollar futures, the world's most actively traded futures contract. A benchmark for investors globally, CME Eurodollar futures provide a tool for hedging fluctuations in interest rates on U.S. dollars deposited in overseas banks. The majority of CME Eurodollar futures trade electronically. In addition, options on CME Eurodollar futures, such as CME Mid-Curve options, are the most actively traded exchange-listed interest rate options in the world. Their liquidity offers traders and hedgers an even greater opportunity to take advantage of their views on the direction of U.S. interest rates. Other products in the CME interest rate suite include CME 1-Month LIBOR futures, 2-, 5- and 10-year CME Swap futures, and CME 3-month Euroyen futures. These products offer risk managers additional latitude in hedging other portions of the U.S. yield curve and in hedging Japanese yen-denominated interest rate risk. For a complete list of CME interest rate products, see page 8.

Why Use CME Interest Rate Products?

Participants in the CME interest rate futures market take a view on the market's direction – some see interest rates rising in the future while others anticipate that they will fall. Someone who wants to protect against higher rates in the future will want to pay a fixed rate and receive a floating rate in an interest rate swap. Correspondingly, someone who anticipates a decline in rates may want to receive fixed interest rate payments and pay floating rates. Both sides are seeking a way to minimize risk and maximize profits; they are hedgers. A speculative market also exists for interest rates, consisting of traders seeking opportunities to profit from interest rate adjustments or market volatility.

For example, a bank may have variable rate sources of funds but commercial banking customers who are demanding fixed rate loans. With CME interest rate futures, the bank can create futures positions to hedge its variable interest rate risk. Eurodollar futures prices move inversely to rates. When rates rise, futures prices fall and when rates fall, futures prices increase, similar to the price behavior of notes and bonds. If a bank needs to hedge against rising interest rates they can sell CME Eurodollar futures and conversely if they need to protect against a fall in rates they can buy futures.