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July 13, 2007

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
Twentieth Street and Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable John C. Dugan
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Dear Chairmen Bernanke and Cox and Comptroller Dugan:

We are writing with respect to the June 2007 report, Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, but Were Successfully Addressed after Joint Regulatory Action, which was prepared by the U.S. Government Accountability Office (GAO) in response to our request letter dated June 6, 2006. Our inquiry grew out of press reports that the exponential growth in trading volume in credit derivatives had outstripped the clearance and settlement infrastructure. In May 2006, Alan Greenspan said that he was "frankly shocked" at the trading mechanics which he referred to as "appalling" and "unconscionable." (See "Greenspan Expresses Concerns on Derivatives, Medicare Costs," Wall Street Journal, Friday, May 19, 2006.)

Against this backdrop, we asked GAO to study and report on technology woes in credit derivatives, including (1) the nature and causes of large backlogs in credit derivatives confirmations and the steps being taken to address them; and, (2) U.S. financial regulators' oversight of the operational risk that dealers faced, including the adequacy, resiliency, and security of related information technology systems. The Committee on Energy and Commerce has Rule X jurisdiction over interstate and foreign telecommunications, including all telecommunication and information transmission technology, and homeland security-related aspects of the foregoing, including cybersecurity.

In the 41-page report that we release today, GAO notes that the credit derivatives market has grown dramatically in recent years, increasing from an estimated notional amount of nearly $1 trillion outstanding at year-end 2001 to over $34 trillion at year-end 2006 (p. 7). Trading volume in credit derivatives more than doubled around this period, with the average number of trades conducted at large firms increasing from 644 trades a week in 2004 to 1,450 trades a week in 2005 (p. 11). The 14 largest dealers, which include U.S. and foreign banks and securities broker-dealers, collectively executed around 130,000 trades a week in 2005.

The GAO report found that, by the end of September 2005, 14 of the largest credit derivatives dealers had, in aggregate, over 150,000 unconfirmed trades, with 63 percent of these remaining unconfirmed for more than 30 days, and 41 percent outstanding for more than 90 days (p. 11, Table 2). Unconfirmed trades allow errors to go undetected at dealers and later could result in losses, legal disputes over contract terms, and incorrect measurement and management of market or credit risk, a situation that an official from the United Kingdom's regulator for credit derivatives dealers characterized as "an accident waiting to happen" (p. 2).

Against this backdrop, GAO found that the delays in confirming trades largely resulted from (1) dealers and end-users relying on inefficient manual processes that could not adequately keep up with the rapidly growing volume and (2) the difficulty of confirming trade information after some end-users began frequently assigning their side of existing trades to new parties without notifying the original dealer.

According to GAO, the Depository Trust and Clearing Corporation (DTCC) started to work with several dealers as early as 2002 to create an automated system to electronically compare, match, and confirm credit derivative trades. Deriv/SERV was launched in late 2003, 15 dealers and 7 end-users signed up by mid-2004, but wider use lagged due to untrained staff and lack of necessary technology. As few as 15 percent of credit derivative trades were being confirmed electronically during 2004, but, after DTCC expanded Deriv/SERV's capabilities, 46 percent of trades were confirmed electronically by September 2005, a still disappointing amount (p. 12).

As for trade assignments, they have provided greater market liquidity and price discovery, but they also complicate the confirmation process, according to dealers and regulators who talked to GAO. Trade assignments accounted for 13 percent of dealers' trading volume in September 2005 but 40 percent of their total confirmations outstanding for more than 30 days at the end of September 2005 (p. 13). Dealers told GAO that they typically detected unilateral assignments through payment errors, and it could take a dealer as many as 90 days or more to detect a unilateral assignment through a payment error, a far from ideal situation (p. 14).

GAO found that confirmation backlogs and unilateral assignments increased dealers' operational risks, potentially hampering their ability to effectively manage other risks (pp. 14-18). Dealers took varied steps to mitigate this problem (pp. 16, 17). Only two of the dealers interviewed by GAO admitted that they had suffered a $1-million-or-more loss as a result of error stemming from confirmation backlogs, but characterized the losses as immaterial (p. 16).

Although U.S. and foreign regulators had been aware for some time of confirmation backlogs at individual dealers, according to GAO, none of the regulators oversaw all of the dealers or had data on the size of the backlog problem industrywide (pp. 4, 31-35). The regulators did recognize in Spring 2005 that individual dealer efforts to address the practice of unilateral assignments were unsuccessful and that greater automation was needed (p. 18).

The GAO report found that the Federal Reserve Bank of New York (FRBNY) exercised strong leadership in calling the 14 major credit derivatives dealers and regulatory representatives from the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the United Kingdom's Financial Services Authority, the German Financial Supervisory Authority, and the Swiss Federal Banking Commission to a meeting in September 2005 to address these problems (pp. 19-20). In October 2005, the dealers sent the FRBNY a letter that outlined steps to be taken, including (1) reducing confirmation backlogs and (2) increasing the use of electronic confirmation systems. GAO reports that, under the agreement, dealers provide their individual data to Markit Group which, in turn, aggregates the data across dealers to protect confidentiality and provides regulators with aggregate data in a monthly report. The FRBNY hosted follow-up meetings in February 2006 and September 2006. In March 2006, the dealers sent the FRBNY a letter committing to further improvements, including (1) ensuring that all trades with standardized terms that were eligible for automated processing would be processed electronically, and (2) working with DTCC to create a central depository to store electronically the details of all credit derivatives contract terms.

As a result, GAO reports that the 14 dealers reduced their total number of confirmations outstanding from 153,860 in September 2005 to 37,306, or by about 76 percent, by the end of October 2006 (p. 20, and p. 21, Figure 3). The dealers collectively reduced by 94 percent the total number of confirmations outstanding over 30 days, even though monthly trading volume in credit

derivatives generally increased during this period (p. 22, Table 3). After October 2006, 4 additional foreign dealers joined the original 14 dealers in providing data to Markit Group. As shown in Table 4 on page 23 of the GAO report, this resulted in an increase in the total number of outstanding confirmations over 30 days in comparison to the level at the end of October 2006, especially in March 2007.

The 14 dealers committed to electronically confirming all trades that could be so confirmed, i.e., contracts with standardized terms, within 5 business days. The GAO report found that, at the end of October 2006, about 90 percent of the total trades were eligible to be confirmed electronically, and about 94 percent of those eligible trades were in fact electronically confirmed (p. 25). Of these, 84 percent on average were confirmed within the stipulated 5 business days. In addition, the industry has taken steps to help ensure that new products do not create backlogs. We applaud these results and the ongoing efforts.

GAO also found that , as a result of widespread adoption of the International Swaps and Derivatives Association voluntary Novation Protocol and automation of the assignment process, the number of unconfirmed assigned trades outstanding for more than 30 days declined from around 39,500 at the end of September 2005 to around 940 at the end of October 2006, even though the number of trades being assigned during this period generally increased (pp. 26-27, Figure 5). During this same period, the share of assignments confirmed electronically has increased from 24 percent to 82 percent, a remarkable improvement.

The GAO report says that bank regulators and SEC review the security and resiliency of the dealers' information technology systems, including those that are used for credit derivatives (pp. 32, 35), but the GAO report does not discuss the result of any of these examinations. In a separate March 2007 report, GAO found that significant progress had been made by critical securities markets organizations to improve the markets' capabilities to prevent and recover from attacks, and to improve the security and resiliency of their information technology and telecommunications systems, while noting that a number of challenges remain. We acknowledge receipt of your June 29, 2007, joint response to that report, commend you for your undertakings, and ask to be informed if progress lags.

While the dealers have made significant progress under the watchful eyes of U.S. and foreign regulators, more remains to be done to reduce backlogs and improve the technology infrastructure of the credit derivatives market. We note, in particular, the discussion in the GAO report of ongoing efforts to address the risks of unconfirmed nonstandardized trades (p. 28), as well as confirmation backlogs in the market for over-the-counter (OTC) derivatives based on equities (pp. 36-37), and the ongoing work of the DTCC to automate trade processes other than confirmation and thus reduce operational risks (p. 29). In a November 2006 letter to FRBNY, 17 dealers committed to working with industry organizations to improve the efficiency of the equity

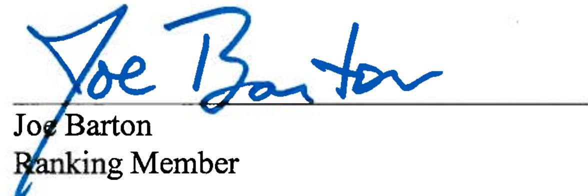
derivatives market, in part through the greater adoption of automation (p. 37, footnote 47). At the end of March 2007, the number of unconfirmed equity derivative trades outstanding more than 30 days rose to around 43,000 trades, according to GAO, mostly as a result of the inability of manual processes used by dealers and end-users to keep pace with the increase in trading volume. The dealers agreed to continue to provide the U.S. and foreign regulators with standardized data not only on credit derivatives but also on OTC equities, interest rates, foreign exchange, and commodity derivatives. We intend to follow up on these technology matters as needed.

We commend these efforts. We believe that they represent a case study in effective and timely intervention by regulators and cooperation by major dealers to avert a crisis with potential repercussions for the whole economy. As Steven Pearlstein warned last month in the Washington Post (Wednesday, June 13, 2007 at D7): "The recent decline in home prices and the meltdown in the market for subprime mortgages are the first signs that air is coming out of the credit bubble. Already, those factors have shaved half a percentage point off the economic growth rate. And you can be sure that there will be a much larger impact on jobs and incomes from a broad decline in stock and bond prices, a sharp tightening of credit and the turmoil that both of those will create in the murky derivatives markets." Steven Rattner wrote in an op-ed article, "The Coming Credit Meltdown," in the Wall Street Journal (Monday, June 18, 2007 at A17): "The bigger--and harder--question is whether the correction will trigger the economic equivalent of a multi-car crash...." We sincerely hope not. If so, however, it is imperative that the market's technology infrastructure is prepared to weather the storm.

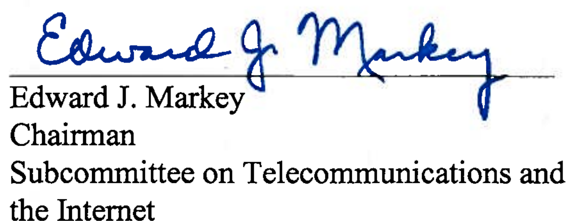
We are transmitting a copy of this report to the Chairman and Ranking Member of the House Committee on Financial Services, which has jurisdiction over financial markets, for any action they deem appropriate. We pledge our cooperation with our sister committee.

Sincerely,

John D. Dingell
Chairman



Joe Barton
Ranking Member



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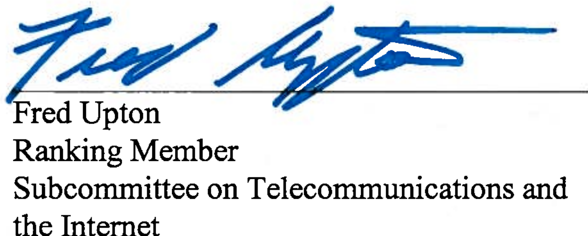
Chairman
Subcommittee on Telecommunications and the Internet



Fred Upton
Ranking Member
Subcommittee on Telecommunications and the Internet

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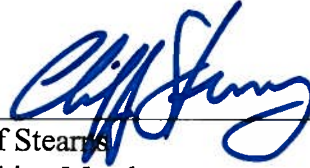
Consumer Protection



Cliff Stearns
Ranking Member
Subcommittee on Commerce, Trade, and
Consumer Protection

cc: The Honorable Barney Frank, Chairman
Committee on Financial Services

The Honorable Spencer Bachus, Ranking Member
Committee on Financial Services