Testimony of Robert Pickel
Chief Executive Officer,
International Swaps and Derivatives Association
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About ISDA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 850 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements; securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives. Among other types of documentation ISDA produces definitions related to credit default swaps.

About Credit Default Swaps

Credit default swaps (CDS) are privately negotiated contracts which require one party to pay another in the event a third party cannot pay its obligations. To use an example, an investment fund that owns a large number of bonds issued by a corporation may want to protect its investors against the possibility that the corporation goes bankrupt. The investment fund would then seek a counterparty, usually a commercial bank, an investment bank or other financial institution, that is willing to enter into a CDS contact. Under the terms of this contract the investment fund agrees to periodically make payments to the counterparty, usually every six months for a specified time period such as five years. The counterparty (e.g. the bank, investment bank or financial institution) agrees to pay the full amount on bonds or loans issued by the corporation if there is a "credit event". Parties to a CDS contract are free to choose what constitutes a "credit event"; under standard ISDA documentation credit events include an issuer's bankruptcy, the acceleration of payments on its obligations, default on its obligations, the failure to pay its obligations, the restructuring of the issuer's debt or a repudiation or moratorium on payment on its obligations.

Credit derivatives like CDS serve multiple uses. As in the example above a CDS can be used by the owner of a bond or loan to protect itself against the risk that the borrower won't make good on its promises. A CDS can also be used to hedge against other risks related to the potential default of a borrower. For instance, an auto parts company that is heavily reliant on one auto manufacturer as its primary customer might seek to protect itself against the risk that manufacturer will go out of business. One way to do so would be to purchase credit protection (through a CDS) on that company. Though not a perfect hedge, such protection could at least help limit the fallout from that customer's bankruptcy.

CDS can also be used to express a view about the health of a particular company or the market as a whole. An investment fund might believe that there will be a large number of corporate bankruptcies in the future. In order to meet its fiduciary duty to invest its clients' money prudently the fund might seek to generate returns during those bankruptcies by purchasing credit protection on one or more companies the fund believes are most likely to default. Use of credit derivatives in this manner is similar to someone who sells wheat futures or buys put options on a security when they don't own the underlying wheat or shares. In each case the idea is to maximize profits from a decline in prices.

Recent Market Turmoil

Beginning in the summer of 2007 investors became aware of growing problems in certain securities backed by residential mortgages. In particular, it appeared that home loans made to borrowers with lower credit scores were experiencing higher-than-expected rates of default. This occurred simultaneously with an increasingly steep drop in the value of homes in the US. Thus mortgage loans were defaulting and the value of the homes that secured the loans were falling below the value of the loan itself.

Some of these mortgage loans had been sold by lending banks and repackaged as securities called "collateralized debt obligations," or "CDOs". Although CDO and CDS are similar abbreviations, they are very different products. As described above a CDS is a privately negotiated contract between two parties. A CDO, on the other hand, is an investment security that can be bought and sold freely on the market. Like other securities in the US, CDOs are subject to the disclosure and other requirements of the securities laws; nevertheless it appears that these CDOs, widely sold to investors throughout the US and the world, were fundamentally mis-priced. Worse, in some cases the structures of the CDOs themselves were extremely complicated and apparently not well understood.

As mortgage defaults increased and housing prices fell, the value of these CDOs became increasingly unclear. The secondary market for CDOs disappeared as buyers were unwilling to purchase securities backed by assets which were declining in value. When markets lack buyers it becomes difficult to determine the fair value of an asset; banks, investment firms, institutional investors and others were required to mark down the value of their portfolios. On paper these institutions themselves appeared to be rapidly losing value.

The Role of CDS in the Market Turmoil

From ISDA's conversations with regulators and market participants it appears that the role of CDS in the recent market turmoil can be described as follows:

First, CDS make the pricing and extension of credit more efficient. If a lender can be sure it will be repaid regardless of whether a borrower defaults, it is more likely to lend. There are many reasons that the last ten years have seen a world flooded with cash: loose monetary policy on the part of central banks; oil countries seeking to invest wealth generated by high energy prices; tremendous economic growth in emerging markets like India, China and Brazil. Experience demonstrates that, in retrospect, many loans were made that never should have been made.

Second, many credit derivatives require counterparties to post collateral in order to guarantee payment. Under any derivative contract both parties guarantee they will make payments to each other based on the value of some other asset or index thus both parties face risk both in terms of the price of that asset as well as the risk that their counterparty will be able to make its required payment. It is because of this last type of risk, called "counterparty credit risk," that a derivative contract counterparty may be

required to increase the amount of collateral it gives to the other party to the contract if the first party experiences a change in its financial condition. For instance, a triple A rated company will generally be required to post less collateral than a single A rated company. But if that triple A rated company faces a ratings downgrade, it may be required to post more collateral.

In a typical situation a party that sells protection under a CDS contact is guaranteeing that it will pay the value of bonds issued by a third party. If that third party's financial condition worsens the counterparty that bought protection will require that the protection seller post more collateral. If this happens at the same time the protection seller has also suffered a deterioration in financial condition, it will be required to post still more collateral. Improperly managed, a derivatives counterparty could face a situation akin to a run-on-the bank, where as its financial condition worsens it becomes subject to more and more collateral calls until it can no longer meet its obligations under its derivatives contracts. This risk is not new or confined to derivatives markets; many financial contracts have a "material adverse change in condition", or MAC, clause that functions similarly. Swap participants have long been aware of this risk; the need for careful management was highlighted 15 years ago in a document outlining good risk management practices for the Group of Thirty, the widely cited "Derivatives: Practices and Principles." Nevertheless for counterparties that fail to follow good practices the consequences can be significant.

This appears to be what happened in the case of AIG. AIG was one of America's largest corporations, an insurance company regulated under the laws of the State of New York as well as a thrift holding company supervised by the Office of Thrift Supervision. AIG was highly rated by SEC licensed rating agencies, who considered it well capitalized. Many of AIG's derivatives counterparties apparently did not require it to post collateral; in particular AIG Financial Products, a wholly owned subsidiary of AIG active in the derivatives business, did not routinely post collateral. When on September 16, 2008, AIG's credit rating was downgraded, its creditors, including counterparties to derivatives contracts, demanded the company post more collateral than it had available. AIG was unable to meet its contractual obligations and sought assistance from the US government.

While the market value of AIGs contracts has declined, and its collateral requirements have increased, we are not aware that they have been called upon to make payments following defaults on significant numbers of obligations. An increase in the market value of mortgage backed securities, or merely the performance of the mortgages underlying the mortgage backed securities it has guaranteed, would reduce AIG's difficulties substantially. To our knowledge AIG has performed on all of its obligations.

The Performance of Credit Derivatives in the Current Market

The last several weeks have seen five major credit events. On September 15 Tembec Inc., a Canadian forest products company, filed for bankruptcy in the US. This filing was largely lost in the cavalcade of bankruptcies and credit events that followed: Fannie Mae and Freddie Mac, two of the world's largest issuers of debt, were taken into government conservatorship. Shortly thereafter Lehman Bros., one of the largest OTC derivatives dealers, filed for bankruptcy. Then Washington Mutual likewise filed for bankruptcy protection.

All of the above companies were referenced under a large number of CDS; with the exception of Tembec they also tended to be counterparties to a large number of other types of derivatives trades. Despite defaults by these firms, the derivatives markets, and in particular the CDS market, has continued to function and remain liquid. This is true even while the other parts of the credit markets have seized-up and the equities markets continue to decline precipitously. Credit derivatives remain one of the few ways parties can continue to manage risk and express a view on market trends.

The failure of Lehman Bros. provided a test case for managing the default of a major derivatives dealer. Despite dire predictions and erroneous press reports, OTC derivatives transactions are designed to deal with the failure of any market participant, even a major dealer. Starting in the late 1980s, Congress acted to amend the bankruptcy and banking insolvency statutes to ensure that the failure of a major counterparty to a qualified financial contract, such as a swap agreement, would not spread systemically and threaten other market participants. Thus, under US law the counterparties to a failed firm like Lehman Bros. are able to net-out payments owing to and from the bankrupt counterparty without having to wait for a bankruptcy judge to resolve all claims. Additionally, counterparties are allowed to foreclose on collateral the failed party posted. In this way a derivatives counterparty is protected against suffering large losses because the other party to the contract can't meet its obligations.

The bankruptcy of Lehman Bros. shows the strength and resiliency of this system. The failure of this large Wall Street firm has not caused the failure of its derivatives counterparties; that risk was contained because of the prudent structure of insolvency law in the US and the apparently sensible collateral requirements of Lehman's counterparties.

In addition to the resiliency of the derivatives markets in the face of the failure of a major counterparty, the credit events involving Fannie and Freddie likewise demonstrate the strength of the business. As noted above Fannie and Freddie were two of the world's largest issuers of debt and likewise two of the largest objects of CDS protection. When the US government decided to place these GSEs in conservatorship, the credit event provisions of the standard ISDA documents were triggered. That meant that thousands of CDS trades on Fannie and Freddie needed to be settled. Likewise, Lehman was also the object of thousands of CDS trades which needed to be settled in light of that company's bankruptcy.

As has occurred in previous credit events ISDA held an auction to determine the cash price of the outstanding debt of Fannie, Freddie and Lehman. These auctions, occurring on October 8 (in the case of the GSEs) and October 10 (in the case of Lehman) were done according to well established procedures and resulted in the successful settlement of the outstanding CDS trades on the three companies. As has occurred in the case of previous credit events, participants in the CDS business have seen their trades settled in an orderly fashion and according to swap participants' expectations

Conclusion

As this testimony makes clear, both the role and effects of CDS in the current market turmoil have been greatly exaggerated. There is no question that CDS facilitate lending and corporate finance and, as such, have impacted and been impacted by recent events. However to say that CDS were the cause, or even a large contributor, to that turmoil is inaccurate and reflects an understandable confusion of the various financial products that have been developed in recent years. There is little dispute that ill advised mortgage lending, coupled with improperly understood securities backed by those loans, are the root cause of the present financial problems. It is also true, however, that recent market events clearly demonstrate that the regulatory structure for financial services has failed. Laws and regulations written in the 20th century, in many cases designed to address markets which existed in the 18th century, need to be changed to account for 21st century markets and products. An in-depth examination of US regulatory structure is self-evidently warranted.

In this examination it is ISDA's hope that the facts surrounding OTC derivatives, and the role they continue to play in helping allocate risk and express a view on market activity, will highlight the benefit of derivatives and of industry responsibility and widely applied good practices. Derivatives have

continued to perform well during a greater period of stress than the world financial system has witnessed in decades. In the wake of failures of major market participants, both counterparties and issuers of debt, CDS participants have settled trades in an orderly way precisely according to the rules and procedures established by Congress and market participants. In this respect CDS activity has been a tremendous success. We are confident that policymakers and market participants alike will find their prudent efforts in helping build the infrastructure for derivatives over the last twenty five years have been rewarded.