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Chairman Peterson, Ranking Member Goodlatte and Members of the Committee, thank you for inviting UBS to participate in this hearing to review the role of credit derivatives in the U.S. economy and the regulatory framework that governs them.

My name is Bryan Murtagh. I am a managing director in UBS Investment Bank's Fixed Income division and am responsible for Fixed Income's transactional risk management function in the Americas. In this capacity, I address legal, regulatory, operational and other issues associated with new businesses, new products and structured transactions, including various forms of credit derivatives.

UBS is a global financial services firm with operations in over 50 countries, including a sizeable presence in the United States, where we employ approximately 30,000 individuals in our Asset Management, Investment Bank and Wealth Management businesses. The views expressed here relate to the Investment Bank.

I understand that the Committee has held several hearings with respect to the nature of the credit derivatives market and its regulation. As the Committee is particularly interested in credit default swaps, I will focus my comments on those instruments.

OVERVIEW OF CREDIT DERIVATIVE MARKET & CREDIT DEFAULT SWAPS

Broadly speaking, credit derivatives are financial instruments that transfer the credit risk associated with a particular financial asset or a reference entity from one party to another party without transferring the underlying financial asset. These instruments are generally traded by financial institutions and certain financially sophisticated corporations and institutional investors (such as hedge funds). As a general rule, retail investors do not participate in the credit derivative market.

Credit default swaps (CDS) are a particular type of credit derivative. Specifically, CDS are privately negotiated contracts between two institutional counterparties in which one of the parties (generally called the "seller of protection") takes on exposure to the credit risk of a third party (generally called the "reference entity") in return for periodic payments from the other transacting party (generally called the "buyer of protection"). If certain types of credit-related defaults (generally called "credit events"), occur in respect to the reference entity, then the buyer of protection may be entitled to transfer qualifying debt obligations of the reference entity to the seller of protection at an agreed-upon price. This so-called "physical settlement" of the CDS transaction results in the seller of protection assuming the risk associated with collecting any amounts owed in respect to the delivered obligation.

Alternatively, the buyer and seller of protection may agree that, upon the occurrence of a credit event, the seller of protection will make a cash payment to the buyer of protection which is calculated based on the trading price of qualifying obligations of the reference entity. This so-called "cash settlement" alternative may be agreed to at the outset of the CDS transaction or may be agreed to upon the occurrence of the credit event.

In recent years, CDS market participants have increasingly relied on the cash settlement alternative to settle large numbers of CDS transactions following the occurrence of a credit event. These cash settlements have been accomplished through so-called auction protocols, in which market participants voluntarily agree to cash settle their CDS transactions based on an auction process. While market participants are not obligated to utilize the cash settlement auction protocol, an overwhelming number of CDS transactions have been settled through these voluntary protocols. This practice has significantly eased the operational pressures associated with the simultaneous settlement of large numbers of CDS transactions which follows the occurrence of a credit event.

Most credit default swaps relate to reference entities that are sovereigns or corporations. Over the last few years a number of indices referencing various segments of the credit market (e.g., U.S. investment grade reference entities, U.S. non-investment grade reference entities, European investment grade reference entities) have been developed and have become the subject of significant trading in the credit default swap market. In addition, there are several kinds of specialized credit default swaps referencing mortgage-backed securities and other asset-backed securities (generally referred to as "CDS on ABS" transactions), but the number of transactions of these types is only a small part of the credit default swap market. Accordingly, my comments focus on CDS relating to corporate reference entities and to the related indices since they represent the overwhelming majority of transactions in the credit default swap market.

It should be noted that CDS transactions expose each of the counterparties (but particularly the buyer of protection) to counterparty credit risk (i.e., the risk that its counterparty will fail to perform its obligations under the relevant swap transaction). As a result, the vast majority of CDS transactions are documented under ISDA master agreements which have been negotiated between the buyer and seller of protection. These master agreements are typically collateralized on a mark-to-market basis and, in some cases, may be subject to additional transaction-specific initial margin requirements depending on the creditworthiness of the parties. The existence of such collateral arrangements mitigates but does not eliminate the counterparty credit risk associated with CDS transactions. Although the terms of each CDS transaction will be individually negotiated by the parties, they will typically rely on certain standardized definitions and market conventions for CDS transactions that have been published by ISDA.

ROLE OF CREDIT DERIVATIVE TRANSACTIONS IN THE ECONOMY

Credit derivatives (including CDS transactions) are important risk management tools in the financial markets and may be used by market participants for hedging or investment purposes. In either application, the key role that credit derivatives play is to effectively and efficiently transfer the desired risk elements from the buyer of protection to the seller of protection.

It should be emphasized that while certain elements of a typical credit default swap transaction are standardized, one of the most important features of the CDS market is the ability of counterparties to customize the economic terms of their transactions. The ability to customize CDS transactions to match specific hedging requirements or desired exposure characteristics distinguishes credit default swaps from futures contracts and other exchange traded financial products, which generally do not permit product customization.

CDS are frequently used by bond investors and bank lenders to hedge themselves against the default risk of an issuer/borrower. For example, a bank that desires to hedge a portion of its illiquid credit exposure to a customer may be able to transfer a portion of that credit exposure by entering into a CDS transaction with a derivatives dealer, which may in turn retain such credit exposure or hedge it with other market participants that are seeking to gain credit exposure to the customer. Although credit default swaps are most frequently employed to hedge default risks relating to bond or loan positions, CDS can also be used to hedge against the default risk associated with other types of claims or obligations. For example, a manufacturer can use credit default swaps to hedge against the potential losses on accounts payable that it might suffer if a key customer goes bankrupt and fails to pay its account payable balances.

Credit default swaps can also be used by market participants to express an educated view on the creditworthiness of a particular reference entity, based on such market participant's research, analysis and mathematical modeling. A market participant may sell credit protection if it believes the reference entity's creditworthiness is likely to improve or may buy protection if it believes the reference entity's creditworthiness is likely to deteriorate. Changes in reference entities' perceived creditworthiness will be reflected in its credit spreads which will result in gains or losses in the CDS transaction. It should be noted that such gains and losses are not dependent upon the actual occurrence of a credit event and may be realized by terminating the CDS transaction prior to its scheduled expiration date or entering into a new offsetting transaction.

U.S. REGULATORY FRAMEWORK

The U.S. regulatory framework for over-the-counter (OTC) derivatives has been the subject of considerable discussion since the mid-1990s. Based principally on the institutional nature of the OTC derivative markets' participants, the current U.S. regulatory framework applicable to credit default swaps is based primarily on oversight and supervision of market participants – particularly OTC derivative dealers. As a result, conduct in the credit default swap market is regulated indirectly through the supervision of derivative dealers by their primary regulators. In addition, credit default swaps, like all securities-related swap transactions, are subject to the antifraud and anti-manipulation provisions of U.S. securities laws. The significance of the applicability of the U.S. securities laws to credit default swaps should not be under-estimated. In our experience, derivative dealers are very sensitive to the need to manage their trading activities in a manner that ensures compliance with these laws.

Consistent with their regulatory and supervisory responsibilities over OTC derivative dealers, various U.S. regulatory agencies, together with regulatory and supervisory authorities from other countries,[1] initiated a series of initiatives in 2005 to improve market participants' management of their OTC derivative operations and risk management practices. It should be emphasized that the need to address the operational risks associated with rapidly expanding OTC derivative markets and credit default swaps was identified by the dealer community in the 2005 Report of the Counterparty Risk Management Policy Group II -- well before the onset of the current crisis in the credit markets.

As a result of these initiatives, UBS and other major credit derivative dealers have made a series of commitments to a growing group of global regulators which are designed to: (i) reduce the systemic and operational risks in the credit default swap market; (ii) strengthen the credit default swap market infrastructure; (iii) improve the transparency and integrity of the credit default swap market; and (iv) generally enhance risk management

[1] These regulatory and supervisory agencies included the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, the New York Banking Department, and the Securities and Exchange Commission, as well as the U.K.'s Financial Services Authority, Germany's Federal Financial Supervisory Authority and Switzerland's Federal Banking Commission

practices in the credit default swap market. These efforts have been extremely successful and have been expanded to include major buy-side market participants. To date, the specific improvements include: (i) a reduction in trade confirmations remaining unsigned or unacknowledged for more than 30 days by 92% (even though trade volumes have increased by 300% over the same period); (ii) the adoption of a protocol requiring that market participants request original counterparty consent before assigning trades to a third-party; (iii) the adoption of an online matching and confirmation platform for credit default swaps by the Depository Trust & Clearing Corporation and the commitment of the dealers to use it or another electronic confirmation platform for the great majority of trading activity; and, (iv) the creation of an electronic "trade information warehouse" (also by the Depository Trust & Clearing Corporation), which serves as a central repository containing the details of credit default swap transactions and facilitates the processing of various events in the lifecycle of a CDS transaction.

Most recently, dealers and major buy-side institutions committed to new initiatives which were set out in a letter to the global regulators on October 31, 2008. Significantly, these commitments were accompanied by a detailed memorandum summarizing the progress that has been made since 2005 and the plans for future enhancements to the operational infrastructure supporting different segments of the OTC derivative market (e.g., credit, equity, interest rate, commodities). These commitments include: (i) global use of central counterparty processing and clearing to significantly reduce counterparty credit risk and outstanding net notional positions; (ii) continued elimination of economically redundant trades through trade compression; (iii) electronic processing of eligible trades to enhance the issuance and execution of confirmations on the trade date; (iv) elimination of material backlogs in confirmation processing; and (v) central settlement for eligible transactions to reduce manual processing and reconciliation of payments.

PRESIDENT'S WORKING GROUP POLICY OBJECTIVES & MEMORANDUM OF UNDERSTANDING

On November 14, 2008, the President's Working Group on Financial Markets (the "PWG") announced a series of policy initiatives designed to further strengthen the oversight and infrastructure of the OTC derivative markets, which included: (i) a statement of policy objectives for OTC derivatives (the "Policy Objectives"); (ii) a summary of the progress that has been made by dealers in addressing operational risks associated with OTC derivatives; and, (iii) a memorandum of understanding regarding the development of central counterparties for credit default swaps.

Broadly speaking, the Policy Objectives include: (i) establishment of central counterparties and central trade repositories for CDS and possibly other OTC derivative transactions; (ii) public reporting of certain transactional information regarding standard CDS transactions; (iii) maintenance of additional information regarding standard and nonstandard CDS transactions; and, (iv) establishment of consistent standards and best practices for centralized counterparties, dealers and other market participants. UBS supports the Policy Objectives and would note that they are consistent with the ongoing efforts of the U.S. and international regulators and major credit derivative dealers to improve the operational practices and infrastructure supporting the credit default market.

At the same time, UBS believes that it is critical that the regulators and other stakeholders continue to work in close collaboration with the dealers and other market participants to implement these Policy Objectives. Without such consultation, there is a danger of harm being done to the credit default swap market. For example, price reporting should be implemented in a manner that does not reduce market liquidity or result in the publication of misleading information. Similarly, a broad-brush requirement that all eligible contracts be cleared through a central clearinghouse could in some instances hamper derivative dealers' ability to manage counterparty risk.

While UBS strongly supports the ongoing development of stronger market infrastructure, including the ongoing initiatives to bring further "electronification" to the credit default swap market, it is important for these initiatives to be allowed to develop in a thoughtful and iterative manner, particularly with respect to such projects as the development of centralized counterparties, central contract repositories and exchanges and similar trading platforms for standardized credit default swap contracts. In addition, it is critical that the market infrastructure preserve the ability of market participants to customize transactions to meet their hedging or investment needs.

CENTRALIZED COUNTERPARTY

In its recent announcement, the PWG noted that successful implementation of central counterparty services in the credit default swap market is the PWG's top near-term priority in this market. In general, a central counterparty is an entity that will stand between counterparties to a financial contract, acting as the buyer to the seller and as the seller to the buyer.

This type of central counterparty is already in use in the interest rate swap market, where it is estimated that nearly 50% of U.S. dollar interest rate swaps are cleared with central counterparties. A number of central counterparty clearing initiatives are being developed in the U.S. and in Europe. UBS is supportive of those efforts and believes they will significantly reduce counterparty credit risk in the credit default swap market by allowing market participants to eliminate offsetting transactions.

We understand that the PWG has indicated that any central counterparty will need to satisfy the standards established by the CPSS-IOSCO Recommendations for Central Counterparties. We are supportive of these standards and believe that their adoption will ensure that the central clearing services are efficient and reliable.

CONCLUSION

Credit default swaps are an important risk management tool for financial institutions and generally provide key benefits to the financial markets. As the PWG noted in their November 14th announcement, credit default swaps and other over-the-counter derivatives "are integral to the smooth functioning of today's complex financial markets and … can enhance the ability of market participants to manage risk." We believe that the significant improvements made to the systemic and operational infrastructure for credit default swaps over the last three years, the positive dialogue between the major credit default swap dealers and the relevant regulatory agencies, and the ongoing market infrastructure projects (including the development of central counterparty platforms), demonstrate the financial services industry's commitment to strengthening the credit default swap market and support for the Policy Objectives set out in the PWG's announcement. UBS looks forward to working with the PWG, other market participants, and Congress in enhancing the credit default swap market by developing robust operational practices and infrastructure to support CDS trading.

Mr. Chairman, thank you for the opportunity to share our views with the Committee. I would be happy to answer any questions you or Members of the Committee may have.