Testimony of Robert Pickel
Chief Executive Officer,
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Before the
Committee on Agriculture
U.S. House of Representatives

December 8, 2008

Mr. Chairman and Members of the Committee:

Thank you very much for inviting ISDA to testify at this follow-up hearing regarding credit derivatives. As you know from our previous meeting ISDA and the OTC derivatives industry are proud of the strength the OTC infrastructure has demonstrated during the recent turmoil, while at the same time being committed to working with Congress, regulators and within the industry to strengthen these markets still further.

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.

The Role CDS Play in the Credit Markets

Credit default swaps (CDS) benefit the broader economy by facilitating lending and corporate finance activity, which is especially crucial in today's tight credit environment. They perform a valuable signaling function and allowing investors to express a view on the market.

CDS provide a simple device for banks and other lenders to hedge the risks associated with lending to a particular company, group of companies or industry. Generally speaking, CDS hedge the risk that a borrower will default. Fundamentally, if a lender can be sure it will be made whole regardless of whether a borrower defaults, it is more likely to lend. CDS also free capital for further lending activity by, among other things, enabling lenders to effectively manage its regulatory capital requirements or by increasing a lender's credit limit with respect to a specific borrower or industry. Ultimately, CDS increase liquidity in the banking industry because they enable banks to manage the credit risk inherent in lending. Because CDS limit the bank's downside risk by passing it on to parties that seek such exposure, banks are able to lend more money to many more businesses. CDS thus significantly expand companies' access to capital from bank lending; indeed, without this risk management option credit markets might be even more tightly constricted than the presently are.

CDS also serve a valuable signaling function. CDS prices produce better and more timely information about the companies for whom a CDS market develops because CDS prices, unlike the credit ratings published by rating agencies, rely on market-based information about a company's financial health. CDS prices reveal changes in credit conditions, giving insight to bankers, policymakers, investors and others about credit in real time, making it easier to manage and supervise traditional banking activities. The recent trend of basing term loan pricing on CDS spreads as opposed to credit ratings illustrates the increasing value lenders place on CDS pricing information.

CDS has remained the only credit products consistently available to allow companies and investors to transfer credit risk and express a view on credit performance; while cash, securities and money markets have seized up, CDS have continued to function. Illiquidity in the financial markets would likely be worse if companies and investors did not have a healthy CDS business available.

CDS are an efficient means of hedging risk or adjusting positions; they remain an accurate indicator of credit quality, are highly liquid, and have been the best way to express a view on credit in troubled times when cash and securities markets have seized up.

Central Counterparty Clearing and DTCC Trade Information Warehouse

For more than two decades, ISDA has maintained an active and collaborative dialogue with public policymakers and supervisors including financial regulators, legislators, and governments around the globe to establish a sound policy framework for swaps activity. Since 2005, market participants have been working towards implementing a central clearing house for credit derivative transactions. Building on these efforts, ISDA and its members have worked together with the President's Working Group and other regulators towards achieving this objective. As a result of these efforts, central counterparty clearing of CDS (CDS CCP) is near, with the goal of commencing operations before the end of 2008.

A well-regulated and prudently managed CDS CCP can provide benefits to the market by reducing the systemic risk associated with counterparty credit exposures and providing enhanced liquidity and price discovery by means of standardization and centralized trading. Additionally, there is the probable reduction of economic and regulatory capital and likely increased transparency.

In addition to the ongoing efforts on the CDS CCP front, market participants along with the Depository Trust & Clearing Corporation (DTCC) have taken a significant step towards addressing market concerns about transparency by publishing, on a weekly basis, aggregate market data from DTCC's Trade Information Warehouse (Warehouse). The market data consists of outstanding gross and net notional values of CDS contracts registered in the Warehouse for the top 1,000 underlying single-name reference entities and all indices, as well as certain aggregates of this data on a gross notional basis only.

ISDA continues to support the development of options for participants in CDS to undertake their business in the most prudent and efficient manner and to the highest standards of commercial conduct. We welcome the development of clearing and settlement arrangements which would provide the benefits of choice and flexibility to participants within the sound industry framework developed by ISDA over 20 years ago; a framework that benefits from the significant counterparty credit risk mitigation of legally enforceable netting and collateral arrangements.

Recommendations of the President's Working Group

On November 14 the PWG announced a series of policy objectives for the OTC industry. The PWG broke their recommendations into four broad categories: 1) improve the transparency and integrity of the credit default swaps market; 2) enhance risk management of OTC derivatives; 3) further strengthen the OTC derivatives market infrastructure; and 4) strengthen cooperation among regulatory authorities. ISDA agrees with these four objectives, and believes that continuing to pursue the improvements industry and regulators have worked on over the last several years is key to ensuring the OTC derivatives industry in the US remains healthy and competitive.

Within those four broader objectives the PWG lists a number of specific recommendations. These can be separated into recommendations for policymakers (e.g., "Regulators should establish consistent policy standards and risk management expectations for CCPs or other systemically important derivatives market infrastructures and apply those standards consistently"); recommendations for industry (e.g., "Market participants should adopt best practices with respect to risk management for OTC derivatives activities, including public reporting, liquidity management, senior management oversight and counterparty credit risk management"); as well as recommendations of an operational nature (e.g. "Details of all credit default swaps that are not cleared through a CCP should be retained in a central contract repository"). These recommendations provide a helpful framework for policymakers and industry alike to discuss while reviewing and reforming the current regulatory structure. Of particular importance from ISDA's perspective is the PWG's statement acknowledging the continued need for bi-lateral, custom tailored risk management contracts. As the PWG states: "Participants should also be able to bilaterally negotiate customized contracts where there are benefits in doing so, subject to continued oversight by their prudential supervisors." While some have posited that all OTC derivatives contracts should be made to trade on-exchange, as the PWG notes there will continue to be the need for customized OTC transactions.

On the same day the PWG announced its policy objectives, it also released a Memorandum of Understanding among the Federal Reserve, the Commodities Futures Trading Commission and the Securities and Exchange Commission related to regulation of central counterparties. This Memorandum is an important step in ensuring that regulators do not work at cross-purposes while working to facilitate the creation of a central clearinghouse. It would be unfortunate were the creation of a CDS clearinghouse to be unnecessarily delayed because of a lack of agreement among federal regulators.

Other Industry Developments

According to ISDA's semi-annual survey at mid-year 2008, the notional amount outstanding of CDS decreased by 12 percent in the first six months of the year to $54.6 trillion from $62.2 trillion. This reduction represents the efforts of the industry to clean up outstanding trades through a process known as "tear-ups", whereby trades between counterparties which are still on the books but effectively cancel one another out are removed, or "torn up". This reduction in outstanding trades represents a significant achievement for the industry in addressing operational issues, and is but one example of efforts being undertaken, in coordination with regulators, to help ensure the operational infrastructure of the OTC industry is sound and able to withstand any challenges.

It may also be useful at this point to speak for a moment about "notional" amounts. These figures are inevitably cited to promote unease about the size of the OTC market. It is helpful to note that the notional amount of a derivative contract refers to an underlying quantity upon which payment obligations are calculated. Notional amounts are an approximate measure of derivatives activity and reflect the size of the field of existing transactions. For CDS this represents the face value of bonds and loans on which participants have written protection; the exposure under a CDS contract is in fact a fraction of the notional. For example, according to the DTCC (a private organization which processes payments under derivatives contracts) when Lehman Bros. failed the "notional" amount of CDS which referenced Lehman was roughly $72 billion dollars. However the actual money that exchanged hands was 7% of that total, or a little over $5 billion.

As the Lehman settlement illustrates the transfer of payments under CDS contracts is nowhere near the jaw dropping amounts often popularly portrayed. And the Lehman settlement further illustrates the ability of the market to settle payments even when the failure occurs at a very large and important market participant. While work remains in addressing operational issues within the industry the Lehman settlement has reassured many about the ability of the OTC market to handle a very large and systemically significant credit event.

Issues Related to the Global Nature of CDS

As the Members of this Committee well know from your recent fact-finding mission, the European Commission is very interested in these same issues. In both public and private conversations they have stated their belief in the need for a "European clearing solution," regardless of what is done in the United States. Given that Europe is the largest global center for OTC derivatives activity actions taken by regulatory officials there will likewise have a tremendous impact on market participants in the United States.

As policymakers on both sides of the Atlantic debate how to address clearing and OTC operational issues it is important to bear in mind the global nature of these products. If a multi-national financial institution is required to clear OTC contracts in each jurisdiction in which it enters into CDS contracts it is likely to incur significant costs. Depending on how great these costs are, onerous requirements in one jurisdiction could lead to a multinational choosing to book all of its derivatives business in just one jurisdiction. Thus for cost-effectiveness purposes there exists the possibility that only one jurisdiction will become the center for a "global clearing solution". Alternatively, firms may find they can clear in each jurisdiction provided there is linked clearing across platforms. As policymakers consider various approaches to addressing and facilitating clearing it would be beneficial to maintain maximum flexibility in terms of where and how firms choose to clear. In this regard the efforts undertaken to date by the NY Federal Reserve and other regulators to encourage clearing should serve as a model. This process has encouraged industry initiative while at the same time working to remove unnecessary obstacles to the development of clearing options. Further, it builds upon the flexibility already extant in US law which provides that a clearinghouse may be regulated by the CFTC, SEC or a federal banking regulator. Having multiple clearing options, across jurisdictions and regulatory bodies, will allow the market to choose any ultimate "global clearing solution". This result is likely to be best in terms of operational efficiency, cost effectiveness and ensuring the continued health of the CDS market.

Conclusion

The current stress which the global economy is facing has placed severe burdens on market participants and the operational infrastructure of the entire financial services industry, as well as spreading harm to businesses, workers and consumers. While the roots of the market turmoil lie in imprudent lending decisions there are lessons to be learned across markets and products. With respect to CDS, in general the market has held up extremely well under the strains of multiple failures of large market participants and issuers of debt. Thus far the auction and settlement process have performed effectively, and the collateral and netting arrangements among market participants have likewise operated as intended. Nevertheless the current turmoil has exposed the need for market participants to increase the speed with which they implement operational improvements to which they have already committed, as well as to commit to examining what further improvements might be necessary. ISDA looks forward to continuing to work with this Committee, the Congress and regulators to help ensure that the strength and liquidity the CDS market has shown in this environment continues in the future. Thank you.

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Robert G. Pickel is the Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association, Inc. Previously, Mr. Pickel was the general counsel of ISDA, serving in that capacity since November 1997.

Prior to joining ISDA, Mr. Pickel was assistant general counsel in the Legal Department of Amerada Hess Corporation, an international oil and gas company, from 1991 to 1997. He has also worked at the law firm of Cravath, Swaine & Moore in New York and London, where he represented ISDA in a variety of matters.

Mr. Pickel serves as a member of the Board of Directors for The Institute for Financial Markets, a member of The Bretton Woods Committee and a member of the board of the Capital Markets Law Journal. Mr. Pickel graduated from Williams College and received his law degree from New York University.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

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1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: NONE **Amount:** ______

Source: ______ **Amount:** ______

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

Source: NONE **Amount:** ______

Source: ______ **Amount:** ______

Please check here if this form is NOT applicable to you: ______

Signature: Robert G. Pickel

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