TESTIMONY OF
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ALSO APPEARING ON BEHALF OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE

THE ROLE OF CREDIT DERIVATIVES IN THE U.S. ECONOMY

DECEMBER 8, 2008

Introduction

Chairman Peterson, Ranking Member Goodlatte, and members of the Committee:

My name is Don Thompson and I am the co-head of the derivatives legal practice group at J.P. Morgan. I am appearing on behalf of J.P. Morgan and the Securities Industry and Financial Markets Association[1]. Thank you for inviting both organizations to testify at today's hearing.

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington, DC, and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

The Role of Credit Default Swaps in Our Economy

Credit derivatives were developed in the mid-1990s and have experienced significant growth[2] due to their usefulness for purposes of managing and investing in credit risk. Among the various types of credit derivatives, credit default swaps (CDS) are the most widely used product and they play an important role in our economy.

For example, the availability and use of CDS has increased liquidity in credit markets. Because they enable banks and other institutional lenders to efficiently manage credit exposure in their portfolios, CDS make it possible for these lenders to provide more liquidity to particular companies than they otherwise would if they did not have the option to hedge in the CDS market. CDS also provide a convenient and accurate measure of the relative riskiness of companies and other economic entities. CDS represent pure credit risk, isolated from the other risks that are inherent in bonds and other financial instruments, such as interest rate risk. As such, CDS spreads, the prices quoted by swap dealers for CDS covering a particular company's obligations, send prompt and clear signals to the market when the company's credit risk changes. The mainstream financial press frequently cites increases in CDS spreads as evidence that particular companies are in financial distress.

[2] The International Swaps and Derivatives Association estimates the total notional amount of outstanding CDS grew from $8.42 trillion at the end of 2004, to $34.4 trillion at the end of 2006, and to $54.6 trillion as of June 30, 2008. Although these statistics provide an indication of growth in the use of CDS, they greatly overstate net CDS exposure.

Regulation of Credit Default Swaps

Although derivatives markets and products are sometimes described as unregulated or not subject to regulatory oversight, that is inaccurate and misleading. Virtually all of the significant participants in the CDS market are U.S. and foreign banks or bank holding company subsidiaries. (One notable exception, of course, is the AIG affiliate that was an active CDS market participant, but not a bank or bank holding company subsidiary.[3]) Banks are subject to extensive regulation by state and federal bank regulators, and bank holding companies are regulated by the Federal Reserve. The broad authority given to these regulators includes the authority to obtain information about bank and bank holding company business activities, transactions and asset portfolios and also the authority to prohibit activities that might threaten the safety and soundness of a bank. The banking regulators establish minimum capital requirements, review risk management and control practices, and conduct ongoing examinations of the institutions they regulate. CDS market participants also are subject to the SEC's antifraud and anti-market manipulation authority under the Securities Exchange Act of 1934 and the Commission has broad investigatory authority to determine whether any person has violated the Act, including the authority to require the production of books and records.

[3] This AIG affiliate, which has incurred significant losses in connection with its CDS business, was not subject to regulatory oversight in the manner that banks are, nor was it regulated by any insurance regulator.

Even though most swap dealers that engage in CDS transactions already are subject to comprehensive oversight and regulation, we strongly support efforts to improve systemic stability, in particular by using a clearinghouse to reduce counterparty risk. We also strongly support enhanced regulatory oversight of CDS markets and market participants. Recent events have shown that a poorly managed CDS business can threaten not only the financial condition of the firm engaged in that business (*e.g.*, AIG), but also the stability of other firms and financial markets generally. Additional steps that should be considered include giving a single federal financial regulator additional information gathering authority with respect to clearinghouse facilities and significant market participants, and empowering that regulator to adopt such regulations as might be appropriate to ensure prudent business practices and minimize systemic risk. Because the CDS market is global, we believe that regulation at the federal level, with international consultation and cooperation, is the right approach. Vesting authority in a single regulator would promote consistency in the application of regulations and provide comprehensive oversight of markets and market activity.

President's Working Group Initiatives

Participants in the CDS market generally support the OTC derivatives oversight and infrastructure initiatives announced by the President's Working Group on Financial Markets (PWG) on November 14, 2008. In particular, we strongly support implementation of central counterparty services for CDS. My bank, J.P.

Morgan, is an active member of the group of CDS market participants that have been working to establish a clearinghouse for CDS transactions and I believe it will be in operation in a matter of weeks, although full implementation will be phased in over a period of several months. We believe that the development of a clearinghouse for credit derivatives with a central counterparty is an effective way to reduce and mutualize counterparty credit risk, which in turn will help promote market stability. In addition to reducing counterparty credit risk and operational risk, the clearinghouse will facilitate regulatory oversight by providing a single location for access to information about the CDS transactions it processes.

We also generally support the PWG's policy objective of improving the transparency and integrity of the CDS market, although care should be taken to protect information that might adversely affect the competitive positions of market participants. We agree with the steps outlined by the PWG to enhance risk management of OTC derivatives and would emphasize the importance of *consistent* standards being adopted by different regulatory bodies. The objective of further strengthening OTC derivatives market infrastructure is advisable, although we do not believe that the use of an exchange for standardized CDS contracts[4] should be mandated. We believe that the OTC markets and exhange-traded markets can coexist and that market conditions should determine which market is used in a particular circumstance. We agree that the ability to negotiate customized contracts should be maintained.

[4] An example of a standardized CDS contract is an index-based CDS that references a common group of firms and covers a fixed five-year period.

We believe the objective of strengthening cooperation among regulatory authorities is important, particularly insofar as it promotes regulatory consistency and efficiency through information sharing. Minimizing regulatory overlap and duplication results in more effective regulation without the imposition of unnecessary burdens.

Memorandum of Understanding Between Federal Reserve, CFTC, and SEC

We support the objectives of the Memorandum of Understanding between the Federal Reserve Board, the CFTC, and the SEC regarding central counterparties for CDS. Its provisions are designed to confirm that information can be shared by the agencies without waiving confidentiality, that information about customers shared among the agencies is exempt from notice requirements under the Right to Financial Privacy Act, and that the CFTC can keep private any information that would disclose confidential business information. We believe these provisions are appropriate.

Conclusion

Credit default swaps are financial instruments that are useful tools for managing credit risk. Their importance in our economy is demonstrated by the tremendous growth in the CDS market in recent years. We recognize, however, that CDS, like any financial instrument, can be misused or mismanaged. We believe that the industry's implementation of a CDS clearinghouse will reduce risk and we appreciate the encouragement and support that financial regulators have given to our efforts. Additional steps to improve regulatory oversight of CDS activities will further reduce risk and we look forward to working with Members of Congress and regulatory authorities on initiatives that will enhance the effectiveness of regulation without imposing unnecessary limitations on the market or its participants.