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**Before the**
**Committee on Banking, Housing and Urban Affairs**
**United States Senate**

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Mr. Chairman and Members of the Committee:

Thank you very much for allowing ISDA to testify at this hearing. We are grateful to the Committee for the opportunity to discuss the privately negotiated derivatives business and more specifically, the credit default swaps market. This business is an important source of innovation for our financial system – it is one that employs tens of thousands of individuals in the United States and benefits thousands of American companies across a broad range of industries.

## 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.

In my remarks today, I would briefly like to:

- Describe how CDS contracts works and the benefits they provide;
- Clarify the level of exposure in the CDS business;
- Discuss the robust infrastructure that industry participants have developed to support the CDS business;
- Review the role of CDS in today's financial crisis; and
- Outline my views on the evolution of the regulatory framework for privately negotiated derivatives.

As I cover these topics, I hope to clarify some key misperceptions regarding the CDS business:

- The first is that, even in the face of a significant increase in defaults and the collapse of major financial institutions, the CDS business has continued to function. Credit derivatives have remained available as a means to manage risk in today's financial markets;

- Second, as recent events have proven out, the risks related to the CDS business have been widely misunderstood;

- Third, the CDS business operates within a robust infrastructure that incorporates time-tested standards, practices and principles;

- Fourth, CDS are not responsible for today's financial crisis; and

- Finally, the CDS industry continues to work with policymakers to improve and evolve how we do business.

**How Credit Default Swaps Work**

Credit default swaps are simple financial transactions negotiated between two counterparties. They enable firms to transfer and more effectively manage risk.

In the real world, CDS play an important role in the growth and functioning of our nation's economy:

- CDS facilitate the flow of credit to American businesses;

- CDS lower borrowing costs for American companies; and

- CDS provide vital information to the market about the creditworthiness of borrowers.

OTC derivatives exist to serve the risk management and investment needs of end-users such as the businesses that are the backbone of our economy and the investors that provide funds to those businesses. The development of OTC derivatives has followed the development of the American economy. For centuries, foreign exchange transaction have facilitated trade and helped American businesses expand; they were one of the original banking powers recognized in the National Bank Act of 1863. The first OTC derivative linked to interest rates was transacted in the early 1980's between IBM and the World Bank, helping IBM raise funds on more favorable terms. Today, over 90% of the Fortune 500, 50 percent of mid-sized companies and thousands of other smaller American companies, use OTC currency and interest rate derivatives. Credit

derivatives first appeared in the mid-1990s as a tool to help banks diversify the credit risk in their loan portfolio, and they have grown into a vital risk management and diversification tool. In each case the need for these products was driven by the needs of end-users, and their growth was a direct function of their utility to end-users. If end-users did not want these products, they would not exist.

It might be helpful to provide an example of the needs that credit derivatives address. Imagine a bank that wants to lend more to American companies in a particular sector of the economy, or a particular geographic region, but that does not have relationships with those companies. That bank could enter into a credit derivative transaction with a bank that does have loans to those companies, whereby the first bank would sell protection to the second bank on those companies, taking on some of the second bank's credit exposure to those companies in exchange for periodic payments. This transaction benefits both banks: the first bank diversifies its loan portfolio and earns income and the second bank is able to lend more money to those companies and deepen its relationship with them. Equally importantly, this transaction also benefits the companies themselves. It expands their funding sources and thus allows them to get better rates on their borrowings.

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 by purchasing protection in the form of a CDS on that company.

These credit derivatives, so-called single-name credit default swaps because they provide default protection on a single entity, were the foundation of the credit derivatives market and still constitute the vast majority of the market. These trades help American companies raise money more cheaply, and they help American investors diversify risk and seek out attractive investment opportunities. To that end, Warren Buffett wrote this year in his letter to Berkshire Hathaway shareholders that he has started to use single name CDS to sell protection and that he would like to enter into more such transactions. The utility of such credit derivatives to investors and to companies is what makes them so valuable to the American economy.

**Growth and Size of the CDS Business**

Because of the important role they play in enabling firms to more precisely manage risk, the CDS business has grown significantly in a relatively short period of time. The most common measurement of the size of the CDS business is notional amount. For CDS, this represents the face value of the bonds and loans on which participants have written protection.

While using notional amount as a measurement tool for the size of the privately negotiated derivatives business has its benefits, it also has a major drawback. Notional amount greatly overstates the actual exposure represented by the CDS business. One reason for this is because a seller of protection often seeks to hedge its risk by entering into offsetting transactions. Using the example above, if the counterparty that sold $10 million of protection wished to hedge its risk and buy protection, it too would enter into a $10 million CDS contract. Thus, there are now two CDS contracts outstanding with a total notional amount of $20 million. The reality is, however, that only $10 million is at risk.

The Depository Trust and Clearing Corporation recently began publishing market data based on information compiled for their Trade Information Warehouse. According to DTCC, the net notional amount outstanding – which represents the maximum possible net funds transfer between net sellers and net buyers of protection that could be required upon the occurrence of a credit event -- is $2.6 trillion.

This may seem like a large number, and it is. But consider what it represents: the sum total of payouts if all reference entities were to default. This is, to say the least, unlikely. What's more, the average of the net notional amount across the reference entities in the DTCC warehouse is $2.6 billion. And this actually overstates the potential losses, because it excludes any recovery value that sellers of protection might receive. The point here is that the net payout on an individual reference entity basis is manageable. This was aptly demonstrated by the Lehman default, where the amounts paid on settlement were handled with no disruption to the system.

One additional point regarding the size and risks of the CDS business bears mentioning. CDS do not create new risks. They enable firms to transfer risk that already exists. This risk-shifting process is a zero-sum arrangement; what the buyer potentially gains by buying protection, the seller potentially loses by selling protection. The amount that the seller of protection loses is identical to the risk that the buyer originally held.

**CDS Infrastructure**

Privately negotiated derivatives are often referred to as 'OTC derivatives," with the implication being that this is an unregulated business with no structure, standards or principles governing it. As someone who has been involved in building a robust infrastructure for privately negotiated derivatives for virtually my entire professional career, this misperception is perhaps the most frustrating among those that characterize the CDS business.

The truth is, there is a robust infrastructure for CDS and other swaps that has been developed over the past 25 years by ISDA, industry participants and

policymakers around the world. The growth, strength and success of the business could not have been achieved without it.

A case in point: some believe that, in the OTC derivatives business, all kinds of firms can enter into all types of CDS contracts with each other. This is simply not the case. The fact is, banks are the primary market makers in the CDS business, and firms wishing to trade CDS need to have credit lines with them. Of the trades in the DTCC warehouse, virtually all involve at least one dealer and 86% are between two dealers. These dealer banks, in turn, impose a variety of requirements on their counterparties (and vice versa) in terms of the maximum exposure they will take, the imposition of collateral requirements, and so on. Virtually all of the exposure in the CDS business originates within the heavily regulated banking system.

Another example of the industry's infrastructure at work: at the core of every CDS transaction is a contract negotiated and entered into between two firms. The specific terms of the contract – its amount, the premium payment, its duration, etc. – are determined by the counterparties and are codified in a confirmation agreement between them.

Underlying the confirmation is the widely used ISDA Master Agreement, which includes standardized language on definitions and other contract terms. The ISDA Master is widely recognized as a groundbreaking document that has enabled the growth of the risk management industry by enhancing legal certainty and reducing credit risk. It establishes key international contractual standards, and its importance to the global financial community has been described as "no less than the creation of global law by contractual consensus." Reflecting its wide acceptance, the vast majority of derivatives transactions executed annually are documented under the ISDA Master.

In addition to the standardized legal architecture governing privately negotiated derivatives, the industry has also worked to develop sound practices in other areas. These include risk management, the use and management of collateral, and the incorporation of technology into the derivatives business.

The industry's work to further strengthen and improve the infrastructure and platform upon which it operates is never-ending. The industry has, for example, greatly improved transparency through the publication of information in DTCC's trade information warehouse, and significant progress has been made to reduce operational risk in the confirming, settling and clearing of CDS.

**The Role of CDS in Today's Financial Crisis: Bear, Lehman & AIG**

Over the past year, CDS have received a significant amount of attention because of concerns about their role in the current financial crisis. More specifically, issues have been raised regarding whether CDS created the financial crisis

and/or played a significant part in the Bear Stearns, Lehman Brothers and AIG situations.

It is by now clear that the roots of the current financial crisis lie in imprudent lending decisions, particularly with respect to residential housing, but also extending to other areas including consumer receivables, auto finance and commercial development. These imprudent decisions were in part the result of an "easy money" environment and a mispricing of risk. They were in turn exacerbated by distortions in ratings models that underestimated both the risk of individual securities as well as how closely correlated the risks of those securities were within portfolios.

If CDS did not cause the crisis, did they make it worse? Some industry observers cite the Bear Stearns situation in answering this question. While it may seem far longer, it was only a year ago that Bear Stearns suffered a liquidity crisis that led to its eventual purchase by JP Morgan Chase. As this drama unfolded, there were widespread concerns that Bear's failure as a derivatives counterparty would have systemic implications. The theory was the CDS and other privately negotiated derivatives supposedly created an interlinking web in which a shock from one participant could capsize others.

The fact is, Bear's problems were primarily related to a lack of confidence from its lenders and its resulting inability to secure institutional funding to run its business. It was a classic liquidity squeeze for an institution that apparently relied too much on short-term funding. The role of swaps in this situation was at best cursory.

As for the systemic risk fears related to Bear's role as a swaps counterparty, subsequent events have proven this supposition to be groundless. Lehman was larger than Bear Stearns -- a bigger institution with a bigger derivatives portfolio – and its bankruptcy created no system fissures.

In fact, by the time of the Lehman default in September, the focus had shifted. No longer were market observers especially worried about the failure of a large derivatives counterparty. Concerns centered on the implications of a failure of a reference entity upon which a significant level of credit protection had been sold.

Here, too, however, the fears were overblown. Contrary to rumors, the actual payout on CDS contracts in which Lehman was a reference entity was about $5 billion…far less than some industry critics initially thought. By all accounts, the Lehman bankruptcy and default was processed well by the industry, testifying to its strength and resilience.

Moving now to AIG: Last week, this Committee heard testimony on the regulatory failures that contributed to the terrible situation at AIG. We also heard

Chairman Bernanke express his frustration with AIG, stating that it acted like an unregulated hedge fund.

The truth, however, is far worse. First, it's clear that AIG was in fact regulated. Its supervisors apparently knew how much mortgage risk it was taking on in its credit protection and securities lending business. They also knew that AIG included ratings triggers and collateral requirements in its contracts in order to gain additional counterparty capacity.

In addition, a hedge fund would not have been allowed to build up such a large, uncollateralized positions with so many counterparties. In fact AIG Financial Products operated far more recklessly than most hedge funds or, for that matter, other businesses engaged in similar activities. It is worth noting these practices were contrary to the generally accepted practices advanced by ISDA for the last 20 years.

In short, the causes of the AIG situation are clear. First, AIG's Financial Products subsidiary took on too much exposure to subprime mortgage debt. As the ratings on that debt were downgraded, the company's own ratings came under pressure. Under agreements with its counterparties and customers, AIG was then forced to post ever increasing amounts of collateral with them. In short, AIG took on too much exposure to subprime debt, and failed to appropriately manage its collateral and liquidity. It was a collective risk, liquidity and collateral management failure, facilitated by poor supervision and an overreliance on rating agency models.

**The Continued Evolution of the CDS Business**

As noted previously, the CDS industry is committed to further strengthening and improving how we do business. This includes working with policymakers to address areas of mutual concern.

On November 14 the PWG announced a series of policy objectives for the privately negotiated derivatives 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");

- 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.

**Conclusion**

Both the role and effects of CDS in the current market turmoil have been greatly exaggerated. CDS were not the cause, or even a large contributor, to this turmoil. 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. These risk management problems have in some instances been exacerbated by a failure to appropriately manage collateral and liquidity.

CDS are valuable risk management tools. They facilitate lending and corporate finance and provide an important price discovery function that is useful not only within the CDS business itself but across a much broader spectrum. The business has remained open and liquid throughout the financial crisis, demonstrating its resiliency.

It is ISDA's hope that the facts surrounding privately negotiated derivatives, including CDS, will highlight the benefit of these risk-transfer tools and the robust, sound infrastructure that has developed around them.

At the same time, 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 the US regulatory structure is self-evidently warranted.

In summary, privately negotiated 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