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Introduction

Thank you very much for inviting ISDA to testify before the Senate Banking Committee's Subcommittee on Securities, Insurance and Investments. 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 830 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. It is our pleasure to present this testimony on "Reducing Risks and Improving Oversight in the OTC Credit Derivatives Market."

About Credit Derivatives

The vast majority of credit derivatives take the form of the credit default swap, which is a contractual agreement to transfer the default risk of one or more reference entities from one party to the other. One party, the protection buyer, pays a periodic fee to the other party, the protection seller, during the term of the contract. The protection buyer is entitled to protection on an agreed upon face value of reference entity debt. If the reference entity experiences a credit event (such as a bankruptcy or a failure to pay), the protection seller is obligated to pay the protection buyer the notional amount of the contract, typically in exchange for debt of the reference entity as specified in the contract. The protection buyer does not have to have any exposure to the reference entity's credit in order to be compensated upon the occurrence of a credit event. The settlement procedure can be either physical settlement, in which the buyer delivers defaulted debt to the protection seller and receives the par value in return, or cash settlement, in which the protection seller compensates the buyer for the difference between par and the recovery value of certain obligations of the reference entity. Standard market practice is to select physical settlement, though in most cases this is now modified by the auction process discussed below.

The economic result of a CDS transaction can be illustrated as follows: the protection buyer effectively takes on a short position in the credit risk of the reference entity, which thereby relieves the buyer of exposure to default. By giving up reference entity credit risk, the buyer effectively gives up the opportunity to

profit from exposure to the reference entity. In return, the buyer's risk is minimized as it is protected by the fact that it will receive its expected economic return absent default of both the reference entity and the protection seller. The protection seller, in contrast, takes on a long position in the credit risk of the reference entity, which is essentially the same as the default risk taken on when lending directly to, or investing in a bond issued by, the reference entity. The main difference between the two is the need to fund the making of a loan or the purchase of a bond but not a sale of protection under a CDS.

In addition to credit default swaps, which make up about 95 percent of credit derivatives outstanding, there is one other type of credit derivative worth mentioning. A total return swap transfers the total economic performance of a reference obligation from one party to the other, and works as follows. The total return payer might own a particular bond and agree to pay the total return on that bond to the other party. The total return is generally equal to interest plus fees plus the appreciation or depreciation of the reference obligation. The total return receiver, for its part, will pay a money market rate plus a negotiated spread, which is generally independent of the reference obligation performance. If a credit event or a major decline in market value occurs, the total return will become negative, so the receiver will end up compensating the payer. The end result of a total return swap is that the total return payer is relieved of economic exposure to the reference obligation but has taken on counterparty exposure to the total return receiver.

Credit derivatives arose in response to two needs in the financial industry. The first need was to hedge credit risk or, to put it in the language of finance, to take a short credit risk position. Prior to the existence of credit derivatives, lenders had a limited number of ways to protect themselves if the financial condition of a borrower were to deteriorate. One was to take collateral, which might not be effective in many cases of financial distress, or by selling the loan, which normally requires the consent of the borrower.

A second need was diversification of credit risk. Financial economists have long noted the benefits of applying a portfolio approach to investments by means of diversification, but practical considerations made diversification difficult to achieve. Relationship considerations, for example, posed an obstacle to diversifying by deliberately reducing exposure to major clients. Buying protection by means of credit derivatives provides solutions to both of the foregoing problems. By allowing banks to take a short credit position, credit derivatives enable banks to hedge their exposure to credit losses. And by hedging selectively, a bank can reduce its exposure to certain entities, thereby attaining its diversification objective without jeopardizing the client relationship.

Credit Derivatives Facilitate Hedging and Diversification

Two features of the market have enhanced the ability of credit derivatives to fulfill the two needs of hedging and diversification. The first feature is standard legal transaction documentation, the most recent being the 2003 ISDA Credit Derivatives Definitions. Along with other ISDA derivatives documentation, these definitions facilitate transactions and enhance legal certainty, which is a necessary condition for derivatives activity. The second is index trading, that is, buying and selling protection on a diversified index of entities instead of a single firm. By providing additional opportunities for investors to take positions in credit risk, index trading has vastly increased the liquidity of credit derivatives activity. The result is that banks and other firms seeking to hedge credit risk can do so more efficiently and at a lower cost. This greater efficiency in turn means that credit risk can be more widely and deeply dispersed in the economy so that the costs of default are felt less acutely in any one sector.

The Infrastructure for Credit Derivatives Continues to Improve

(a) Novations

ISDA has made continuous efforts to improve the legal documentation for credit derivatives. The ISDA 2003 Credit Derivatives were quickly adopted by the market; since then ISDA has published a series of other documents to cover new products and to adapt the documentation framework to the increasing use of automation in the market place.

The success of the market and the entrance of new market participants such as investment managers and managed funds has led to the increasing use of novations, a process in which one party to the contract assigns or novates its rights and obligations to a third party. After concerns were raised as to whether proper notifications to the remaining party in the trade were being widely shared, in 2005 ISDA developed a Novation Protocol, which has proved extremely successful in reducing the number of outstanding confirmations due to novations.

(b) Hardwiring the Auction Mechanism Into Standard Documentation

Standard credit derivative documentation currently provides for physical settlement of transactions following the occurrence of a credit event involving the reference entity on the trade. As the volume of outstanding transactions has grown over the last several years, the prospect of an orderly settlement through delivery of bonds and loans has been thrown into doubt. In eight of the last nine credit events over the last three years, ISDA has published a protocol to allow parties to amend their outstanding trades to facilitate cash settlement while preserving the option of physical settlement. (A protocol was not necessary for the other credit event, as that

occurred in relation to a reference entity that was traded under ISDA's loan CDS documentation, in which the auction mechanism has already been hardwired.) Under the revised terms an auction has been conducted to establish a price for one or more deliverable obligations. Each of these auctions has produced an outcome that has been generally accepted in the market as an appropriate valuation of deliverable obligations.

Over the course of the last year some, such as the President's Working Group and the New York Federal Reserve, have called for incorporation of the auction protocol into the standard ISDA credit derivative documentation. Participation in the auction by adherence to the protocol is a voluntary process and, while the vast majority of active market participants have participated in the process, some have expressed concern that one or more major market participants could choose to stay outside the protocol and auction process. As the robustness of the auction process is enhanced by greater participation, the broad-based consensus that has existed for previous auctions could be compromised, producing an auction result that might not be as widely accepted as previous auctions.

ISDA has anticipated incorporation of the auction mechanism into its standard credit derivative documentation, using the experience of past credit events to make minor modifications to the mechanism. The mechanism has not been utilized for a credit event in Europe or for a credit event involving a very large reference entity with a large number of outstanding obligations. While the mechanism would no doubt benefit from being tested in those circumstances, it is clear now that it is more important to incorporate the mechanism into the standard documentation so that the vast majority of market participants are committed to follow the process.

ISDA and a group of the major credit derivatives dealers are actively working on the process of incorporating the auction mechanism embodied in the ISDA CDS settlement protocols into the ISDA Credit Derivatives Definitions. ISDA has shared the dealer group's position on the issues with key buy side representatives. The process will also be opened out to the full ISDA membership so that the views of the entire market can be taken into account. It is anticipated that the process will be complete by year-end.

(c) Automating Transaction Information

The rapid growth in the credit derivatives market has increased the need to automate post-trade activities. Financial products Markup Language (FpML), the technical standard for electronic messaging covering the OTC derivatives lifecycle, which is developed under the auspices of ISDA, is widely used in the industry. Currently a high percentage of trades (>90%) are confirmed electronically and the industry continues to strengthen the infrastructure. One example of this is the continuous developments of the Trade Information Warehouse, a central repository

managed by the Depository Trust & Clearing Corporation (DTCC) that keeps the legally binding version of all trades and to which all market participants submit their trades. The Trade Information Warehouse will be used for centralized payment settlement of all trades and will facilitate more efficient processing of post-trade events, including settlement of credit events.

(d) Portfolio Compression

Starting in May, ISDA has facilitated discussions among a working group comprising dealer and some end-user firms to explore methods that could be used to reduce the current gross notional CDS market size to better reflect the true net risk position. Portfolio Compression, as the process is called, allows for the replacement of a portfolio of trades with the same reference entity and maturity with two trades, while keeping the risk profile identical. The process offers tangible benefits to CDS market participants through potential capital savings and a reduction in operational risk by decreasing the number of trades.

In order to execute portfolio compression in the single-name CDS market, ISDA coordinated and recently completed an RFP process to select a central platform for this service. Initial compression cycles will take place in August and September of 2008. The dealers are committed to full implementation of portfolio compression in an accelerated timeframe.

Conclusion

The market for OTC derivatives has grown rapidly, thanks both to the usefulness of these products as a risk management tool and to the strong legal and operational infrastructure that currently exists for OTC derivatives. While continued innovations will challenge existing frameworks, and while market participants and regulators alike will need to continue to be vigilant, there is no question that the infrastructure for OTC credit derivatives is strong and improving.

Thank you very much for allowing ISDA to testify; I look forward to answering any questions you might have.