Testimony of Joseph P. Bauman
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Subcommittee on International Trade and Finance of the United States Senate Committee on Banking, Housing and Urban Affairs
"Growth and Development of the Derivatives Market."
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Mr. Chairman and Members of the Subcommittee:

My name is Joseph Bauman. Throughout my career I have been involved in the derivatives business, and I am currently a consultant to participants in the derivatives industry. In my career I have worked for Chemical Bank, Citibank and Bank of America. I also served as Chairman of the International Swaps and Derivatives Association and was a member of its Board for ten years. Although this is my first testimony before this Subcommittee, I have testified previously on matters related to the derivatives markets before other congressional committees and subcommittees.

In the many roles I have played in the industry and in the several institutions for which I have worked, I have observed the phenomenal growth in the derivatives business. While there are many reasons for that growth, I believe that the regulatory framework in the United States for swaps and other privately negotiated derivatives, with the components of market discipline and legal certainty, has been among the most significant factors contributing to that growth. It is those factors that I would like to highlight for the committee.

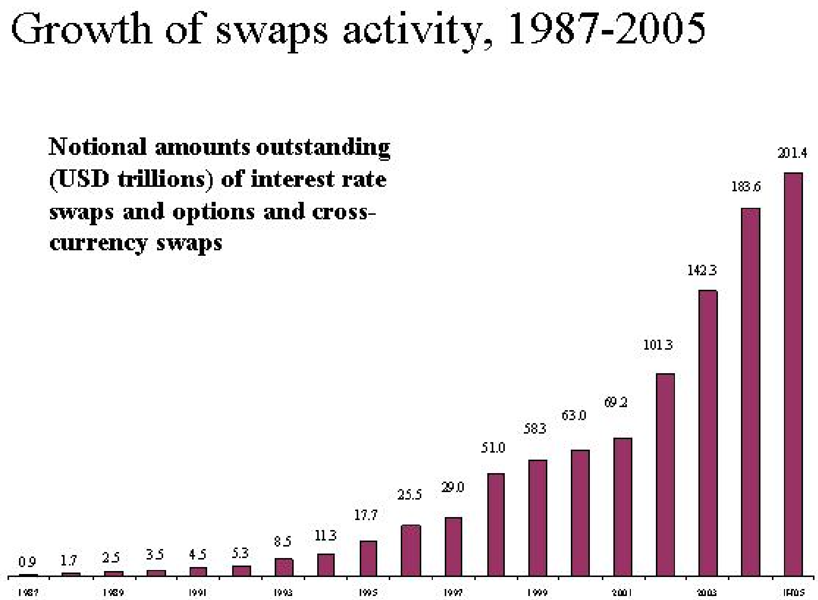
Role of Derivatives in the Economy

Derivatives play a critical role in our economy. By allowing corporations to take certain types of risk out of their operations, derivatives allow those businesses to plan with greater certainty and to better withstand unexpected economic developments. As Federal Reserve Chairman Alan Greenspan noted in testimony before this Committee three years ago, “on balance they [financial derivatives] have contributed to the development of a far more flexible and efficient financial system—both domestically and internationally—than we had just twenty or thirty years ago.” Derivatives afford a means for a company, say an airline, to manage risks not intrinsic to the business itself, such as jet fuel price fluctuations. The airline can hedge the risks to those price fluctuations by entering into swaps or options which ensure that, regardless of developments in the oil or jet fuel markets, the manufacturer is guaranteed a certain price for its jet fuel needs or limits its exposure to rising prices. In other words, derivatives allow a business to focus on its core operations (in this example, flying planes and running an airline) while minimizing the chance that something completely outside of its control (fluctuations in jet fuel prices) will undermine its planning. Airlines, such as Southwest, actively manage this risk, which is, in part, a reason for their ability to thrive in the current difficult climate for airlines. In fact, an article in this past Sunday's New York Times highlighted that Southwest Airlines' fuel cost hedging contracts had protected it from spikes in the price of fuel and contributed to its profitability.

Growth of the OTC Derivatives Business

Derivatives (and in particular, privately negotiated derivatives) have become an indispensable part of most large and medium sized businesses’ financial management in the last twenty years. ISDA has published figures on outstanding notional amounts in the interest rate and currency derivatives business since 1987 and in recent years has published similar information for credit derivatives and equity derivative. The chart below shows the growth in that business. I should emphasize that these figures demonstrate the growth in trading *activity*. It is important to keep in mind that the notional amounts reported are not a reflection of outstanding exposures or risk. Figures published by the Bank for

International Settlements indicate that, on a net basis, outstanding counterparty credit exposures on interest rate and currency products are less than 1% of notional amounts outstanding.



Source: International Swaps and Derivatives Association

<u>Role of Market Discipline</u>

Market discipline is the most important factor influencing how derivatives activity functions, and is beneficial from the standpoint of both market stability and providing a high quality of service to end-users. First, market discipline benefits market stability because firms operate in an environment in which they understand that they are accountable for both the profits and the losses that result from their decisions. The result is sound risk management practice and high credit quality. Second, market discipline benefits end-users because of the importance of competition and reputation. Competition among dealers ensures that, if end-user concerns are not addressed, another dealer stands ready to step in and do so. And reputation—which takes years to build but can be destroyed in seconds— is of great importance because it provides clients a means of quality assurance in an environment when you only have one chance to get a deal right.

It is also worth pointing out that, since the privately negotiated market is limited to firms qualifying as “eligible contract participants” on the basis of either asset size or income, there is no ‘market regulator’ for over-the-counter derivatives activity in the same sense as there is in the United States for securities (Securities and Exchange Commission) or futures (Commodity Futures Trading Commission). At the same time, the majority of the derivative dealers are regulated, most of them as banks or as securities firms, either in the U.S. or across a large number of other jurisdictions. Since the vast majority of transactions are either between two dealers or a dealer and an end user, this insures that those major institutions are subject to the appropriate oversight for their business focus.

The Importance of Legal Certainty

OTC derivatives are built on a foundation of bilateral, privately negotiated contractual relationships. Anything that calls into question any piece of that foundation can have serious adverse effects on the willingness of parties to engage in transactions. One of ISDA’s principal achievements has been the establishment of a sound contractual and documentation framework that facilitates the ability of parties to engage in these transactions. ISDA’s Master Agreement, supported by legal opinions from over 40 countries on the enforceability of its core provisions, is the global standard for documenting OTC derivatives transactions. ISDA has worked with legislatures and regulators around the world to enact laws that recognize the enforceability of these core provisions. Efforts here in the United States have led to several significant changes in laws relating to these core provisions, including most recently the changes to the Bankruptcy Code and bank insolvency laws that became effective on October 17 of this year.

ISDA's efforts on the contractual framework would be for naught if the fundamental right of parties to enter into these privately negotiated transactions was thrown into question by the legal or regulatory framework in which the parties operate. For example, ISDA has worked to change laws in various countries that were it not for these changes, would treat these transactions as unenforceable gaming contracts and not the legitimate hedging tools that they are.

In the United States, a major focus of ISDA's efforts has been the recognition, confirmed in the Commodity Futures Modernization Act ("CFMA"), that swaps are not appropriately regulated as futures under the Commodity Exchange Act ("CEA"). If swaps were futures   then swap transactions would be considered unenforceable as illegal off-exchange futures. Throughout my tenure on the ISDA Board, which ended just prior to enact of the CFMA, the potential of a court determination that swaps were futures was a significant concern for the industry. The substantial growth of the business during that time period was, in no small part, due to the consistent view of regulators, including the CFTC, and the intent of Congress, as embodied in the 1992 Futures Trading Practices Act ("FTPA"), that swaps were not appropriately regulated as futures.

It is worth highlighting that the only action inconsistent with those longstanding policies was the release of a CFTC concept release in 1998 raising questions about the possible need to regulate OTC derivatives. Congress acted promptly to prevent the CFTC from proceeding with that initiative and directed the President's Working Group on Financial Markets to produce a report on OTC derivatives. That report, published in 1999, served as the basis for the many achievements in the CFMA.

The experience of the 1998 CFTC concept release demonstrates that concerns about legal certainty are neither academic nor speculative. It is also instructive as an example of the need for Congress, regulators and the industry to remain vigilant to ensure that Congressional intent continues to be carried out. Despite the policies embodied in the FTPA and the position of the CFTC over the ten years preceding the concept release, suggestions that the CFTC might consider changes in that regulatory treatment through administrative action raised alarm bells throughout the industry, the President's Working Group and Congress.

Because of the continuing potential for an adverse court ruling or a change in administrative determination creating legal uncertainty of the status of swaps and other privately negotiated derivative transactions, participants in these transactions, both dealers and end users and both U.S. and foreign firms, welcomed the 1999 report of the President's Working Group and the efforts of Congress in 2000 to provide clarity on this issue.

Experience Under the CFMA

Recognizing the peril presented by a broad interpretation of the reach and scope of the CEA, Congress in 2000 undertook to ensure that privately-negotiated derivatives contracts between sophisticated counterparties would be legally enforceable and subject to the normal rules of contract law, rather than forced into an ill-fitting Federal statutory regime originally designed for agriculture producers. The CFMA created the means by which financially sophisticated parties, called "eligible contract participants," could continue to engage in risk management without fear that their privately negotiated contracts would be unenforceable. ISDA was privileged to help play a role in achieving this historic legislation, and is dedicated to ensuring that the legal certainty created by the law is not undermined.

The five years since the passage of the CFMA have proven the law's wisdom. In those five years privately-negotiated derivatives have continued to thrive and product innovation has proceeded unabated. Even more importantly, thanks in no small part to derivatives; the markets have been able to withstand significant shocks to the financial system. The bursting of the dot.com bubble, the terror attacks of 9/11 and the financial scandals and bankruptcies at Enron, WorldCom, Adelphia and others would, in the past, have created serious economic dislocation and threatened long term prospects for growth. However, through the use of derivatives major market participants have been able to limit their exposure to losses from these types of events, passing on the risks that in the past would have potentially been concentrated in a few institutions and possibly driven one or more of them out of business. While the events creating these shocks may have occurred in any circumstance, modern risk management practices, and in particular the use of derivatives, have saved countless businesses and jobs over the last five tumultuous years by limiting the consequences of these events or spreading the effects to a broader category of risk takers in amounts that, while possibly painful, did not threaten their existence. The legal certainty provided by the CFMA has been an important part of this success.

At various times since enactment of the CFMA, and currently in the CFTC reauthorization debate, there have been efforts to modify the provisions of the CFMA that have provided the fundamental legal certainty intended by Congress. While these efforts have been primarily focused on energy trading, the implications of those efforts go beyond energy trading into other OTC derivative products. The President's Working Group on Financial Markets has consistently opposed attempts to roll back the legal certainty created by the CFMA, much as it did in 1998 in response to efforts to erode the protections provided by Congress and the CFTC at that time. The opposition of America's top financial regulators, evidenced by letters going back to 2002, clearly shows a consensus view that privately negotiated derivatives transactions, far from adding to upheavals in certain commodity markets, in fact help to alleviate problems caused by dislocations and disruptions in those markets.

The CFMA provided clear guidance regarding the scope of transactions subject to regulation under the CEA and, as a corollary, certainty as to the legal status of the institutional over-the-counter derivatives market. And the listed and OTC derivatives markets have each flourished in the aftermath of the CFMA – a testament to the importance of regulatory efficiency and legal certainty.

The CFMA provided broad exclusions and exemptions from provisions of the CEA for many different types of OTC derivative products. Recently, significant concerns have been raised within the financial community regarding developments that threaten to set back this progress. These concerns appear to have been raised by testimony by the former CFTC general counsel before the Senate Committee on Banking, a recent Report of the Senate Agriculture Committee in connection with CFTC reauthorization legislation and a recent judicial decision (in the case of CFTC v. Bradley). As I understand it, these have raised questions regarding the scope of the exemptions and exclusions for over-the-counter derivatives enacted in the CFMA – suggesting that the relevant exemptions and exclusions are somehow limited in scope to the underlying transactions and do not cover the persons engaged in those transactions or their related conduct and activities.

This view, which is clearly contrary to the CFMA, if unaddressed, could resurrect the very legal certainty concerns that led to enactment of the CFMA. Steps by the Subcommittee to clarify this issue should be prominent in the Subcommittee's consideration of CFTC reauthorization and related issues.

The past few years have seen tremendous upheavals in the energy sector, from the California energy crisis to the collapse of Enron to the current price volatility in petroleum based products. There has been little evidence that shocks in one market have spilled over into others. Where in the past shortages and anti-competitive behavior could be expected in the wake of these upheavals, properly functioning markets, reinforced through effective risk transfer made possible by derivatives, have allowed the United States to weather the current period of difficulty more effectively than was the case previously. It would be a grave mistake to tamper with the regulatory framework, including the legal certainty created by the CFMA, in light of the success it has brought in difficult times.

The success of the CFMA is not limited to the legal certainty it provided for OTC derivatives; by and large the CFMA remains a crowning achievement of financial services law. By creating flexible rules for organized exchanges, providing legal certainty for sophisticated market participants and encouraging the growth and development of new financial products, the CFMA has positioned the United States to remain a financial innovator for years to come.