

**Testimony of Conrad Voldstad
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Before the
US House of Representatives Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
October 14, 2011**

Chairman Garrett, Ranking Member Waters and Members of the Subcommittee:

Thank you for the opportunity to testify today. I would like to begin my remarks by emphasizing several key points.

- ISDA and our members are deeply committed to safe, efficient OTC derivatives markets that support the health and growth of the real economy. We support the G20's efforts to reduce systemic risk by focusing on improving counterparty credit risk management and transparency in the OTC derivatives markets.
- Much of the Dodd-Frank Act works toward those goals, and we espouse those provisions that do so. Some parts of the proposed regulatory application of this legislation, however, work against or do not support the goal of systemic risk reduction. Furthermore, current regulatory interpretations of some DFA provisions are neither mandated by the Dodd-Frank Act nor called for by policy concerns. They seek, instead, to impose changes to the market's structure without posing any quantifiable benefit. In addition, they would create and codify an uneven and uncompetitive operating environment for firms doing business in the U.S.
- We believe these changes will adversely affect the market's functioning, impose unnecessary costs and limit the ability of firms to effectively manage their risks. The bills you are considering today attempt to fix some of these problems and for that reason, ISDA supports them.

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ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

Over the past three decades, ISDA has helped to significantly reduce risk in the OTC derivatives markets. The ISDA Master Agreement and supporting documentation materials, along with the Association's work in ensuring the enforceability of their netting and collateral provisions, have helped to reduce credit and legal risk. The Association has also been a leader in promoting sound risk management practices and processes.

ISDA, major dealers, buy-side institutions and other industry associations have also worked collaboratively to reduce potential systemic risks in the global over-the-counter (OTC) derivatives markets.

The industry, for example, has proactively worked with clearinghouses to develop a better way for managing counterparty credit risk. Clearing of interest rate swaps began in 2000 and today, over \$300 trillion, representing more than 50 percent of outstanding interest rate swaps volume is cleared. Over \$20 trillion of credit default swaps volume has been cleared. Approximately \$200 trillion of OTC derivatives transactions have been eliminated through portfolio compression.

To improve regulatory transparency, ISDA and market participants have established trade repositories for interest rate, credit default and equity swaps. Trade repositories are also being established for commodity and foreign exchange swaps. These repositories provide global regulators with unprecedented visibility into risk exposures in the OTC derivatives markets.

ISDA and market participants have worked to standardize and automate middle and back office processes in order to strengthen the industry's operational infrastructure.

As these initiatives demonstrate, ISDA and the OTC derivatives markets support and are working to build robust, stable financial markets and a strong financial regulatory framework. This work is on-going and reflects our belief that improving risk measurement and management is and will remain a high priority for market participants.

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Over-the-counter derivatives play an important role in the U.S. financial markets and the U.S. economy. The bills you are considering today will:

- Significantly benefit the U.S. financial markets and the thousands of American firms who use OTC derivatives to manage their risks;
- Help to ensure a fair and level playing field for financial institutions doing business in the U.S. and their customers without impacting the significant work and progress that policymakers and OTC derivatives market participants have made to reduce systemic risk;
- Work towards ensuring that the DFA is implemented in a manner more reflective of its original intent; and
- Eliminate unnecessary and burdensome costs for financial markets participants.

Let me briefly address each of these bills.

H.R. 1838

ISDA supports H.R. 1838, which would repeal Section 716 of the Dodd-Frank Act. Section 716, commonly called the swaps push-out provision, requires banks to separate and segregate portions of their derivative businesses.

As you know, Section 716 currently exempts interest rate, FX, centrally cleared credit default swaps on investment grade names, and precious metal derivatives from its provisions. These areas currently comprise 90% or more of a bank's derivatives business. Those portions of the swaps business that are not exempt from Section 716 (which would include equity derivatives and certain CDS and commodity derivatives transactions) would have to be conducted in separately capitalized affiliates that were legally apart from FDIC-insured banks.

It is difficult to see how Section 716 reduces systemic risk. This is particularly true given that firms face regulatory reporting requirements for all transactions, including transactions exempt from and covered by Section 716. Such regulatory reporting will help to ensure that exposures can not build up unnoticed in the financial system. Separately, forcing the derivatives business outside of the better-capitalized, better-regulated bank into new standalone subsidiaries could actually increase risk to the system. Section 716 will also increase risk as it leads to greater inefficiencies and the loss of exposure netting as it requires firms to conduct swaps across multiple legal entities.

While it is clear that Section 716 brings no real risk-reducing benefits, it is also clear that it has several disadvantages. It will tie up additional capital that might better be used to support investment and employment. It would also create higher funding and operational costs for the financial institutions that are required to implement it. Those financial institutions currently include only firms doing business in the U.S., as there is no similar law or regulation in place in any major foreign jurisdiction. These firms will be at a competitive disadvantage to their non-U.S. counterparts. American customers of these firms would therefore face higher costs, or will seek out lower cost non-U.S. firms to assist with their risk management initiatives and transactions. Customers will also need to evaluate the strength and capital of each Section 716 subsidiary that they may do business with, rather than that of the parent company, which will also impact their competitiveness. Section 716 also complicates the ability of financial institutions to net their exposures and to most efficiently manage their risks.

Finally, we would note that due to a drafting error, certain non-U.S.-based firms with significant U.S. operations and U.S. employees may be put at a competitive disadvantage with respect to Section 716, as they do not have the benefit of certain statutory exemptions now enjoyed by U.S.-based firms. ISDA believes the Section 716 exemptions should be extended to U.S. branches of foreign banks. This inarticulate drafting is just one of the many problems with Section 716, all of which support the need for significant action such as the repeal proposed by H.R. 1838.

H.R. 2586

ISDA and our members also support HR 2586, which would refine the definition of swap execution facility (SEF) in Title VII of the Dodd-Frank Act by requiring flexibility in the

interpretation of SEFs. In so doing, the bill would correct a number of flaws in the current proposed regulatory interpretation and better align the proposed rules with Congressional intent. These flaws have the potential to significantly and adversely affect the dynamics of the swaps market by reducing liquidity and choice and by increasing costs and ultimately risks for OTC derivatives markets participants.

One other important issue relating to the ways in which market participants can enter into and execute swap transactions would also be addressed by H.R.2586. ISDA believes the definition of a SEF under DFA is flexible: a SEF is "a trading system or platform in which multiple participants have the ability to execute swaps by accepting bids and offers made by multiple participants ... through any means of interstate commerce, including any trading facility." This leaves the definition of a SEF open to a relatively broad interpretation, not the narrower one that the CFTC and, to a somewhat lesser extent, the SEC appear to be considering. This view echoes that of The International Organization of Securities Commissions, which in its recent report on the trading of OTC derivatives, found that "[b]ased on the benefits to be gained from increased trading on organized platforms, the Task Force recommends that a flexible approach to defining 'exchanges or electronic trading platforms' for the purposes of addressing the G-20 objectives be taken in order to maximize the number of standardized derivative products that can be appropriately traded on organized platforms."

Among the most significant flaws in the proposed regulatory interpretation is the fact that the law can be, and is being, implemented differently in the SEC and CFTC proposed rules and the ways in which they address the request-for-quote (RFQ) systems. The latter mandates that RFQs be sent to five market participants and the former mandates they be sent to one. This divergence in approach means that different regulatory requirements will be imposed inconsistently on different, yet ultimately very similar, segments of the market, which will have an obviously harmful effect and create significant market and compliance inefficiencies.

Furthermore, while both proposed rules appear to go beyond that required by or contemplated in the legislation, the CFTC's proposed treatment of RFQ systems is particularly problematic. As noted above, the DFA defines a SEF as a "trading system in which multiple participants have the ability to execute swaps by accepting bids and offers made by multiple participants." Allowing a requester to direct an RFQ to the number of recipients that it chooses, rather than a number arbitrarily selected by a regulatory agency, does not deprive the requester of the ability to go to multiple participants and, in many instances, will allow for the most efficient and least costly execution. The statute permits this approach. The SEC agrees and permits an RFQ to be made to a single recipient, so long as the SEF has the capability of permitting RFQs to multiple recipients.

The CFTC SEF requirement has raised a number of questions among market participants. To our knowledge there is no objective evidence that supports or that indicates why five is the optimal number of dealers from whom quotes should be requested on a SEF. As noted above, the law itself only specifies that participants have the ability to request quotes from multiple participants. It is widely believed that the requirement will adversely impact the liquidity and ultimately pricing of OTC derivatives markets and, perhaps most importantly, limit the liquidity available to entities using derivatives to hedge and mitigate risk, such as asset managers and corporate end-users. In addition, it does not offer any significant countervailing benefits. The prices of OTC

derivatives transactions that will be cleared -- and which as noted must be traded on a SEF if there is one that makes them available for trading -- are already very competitive. It also should be noted that regulatory visibility into trading patterns and risk exposures can already be provided by trade repositories without any downside.

At this point in the process, the CFTC SEF requirement has no regulatory parallel in the EC or other major jurisdictions. Consequently, the proposal could uniquely and adversely impact U.S. markets and U.S. competitiveness.

There are other potentially negative elements of the proposed SEF regulation that H.R.2586 would also mitigate. The CFTC's proposals regarding the posting of firm and indicative quotes on a centralized electronic screen accessible to all market participants who have access to the SEF is an example. As CFTC Commissioner Sommers has said, "this provision is not mandated by the Dodd-Frank Act and may limit competition by shutting out applicants who wish to offer request for quote services without this functionality."

Finally, while they are not specifically addressed in H.R. 1838, there are others aspects of the proposed regulatory requirements for SEFs that ISDA and market participants believe should be addressed. The proposed rules for real-time reporting of OTC derivatives transactions will be onerous and reduce liquidity in the markets. The end result is increased costs and less efficient and effective risk management for derivatives users. We also believe that the "15 second delay" requirement needs clarification and should not apply to RFQs. We believe it should only apply in the limited circumstance when a dealer is contacted by one of the dealer's customers with an order to execute a trade on an Order Book and it should only apply to two orders being entered on the same Order Book. For any execution platform other than Order Book, it is not clear how the requirement would work or whether it would benefit customers. In addition, ISDA remains concerned with provisions on the SEF proposals such as high block trading thresholds, and the SEC's proposed treatment of off-SEF block trades and its proposed requirement to "sweep the book."

H.R. 3045

I would briefly like to address H.R.3045, which would amend the Employee Retirement Income Security Act of 1974, the Commodity Exchange Act, and the Securities Exchange Act of 1934 to ensure that pension plans can use swaps to hedge risks, and for other purposes. The need for this bill arose because of provisions contained in the DFA that can be read to put a swap dealer in a fiduciary relationship to a retirement plan. Such an interpretation would effectively require a swap dealer to represent both counterparties to a swap transaction, and is legally unworkable. The practical result of this will be that financial institutions will be unwilling to accept the legal risks inherent in such transactions and will limit their activities with pension plans, effectively precluding such pension plans from using OTC derivatives to manage their investments and hedge their risks, which could adversely impact their ability to generate and provide retirement income to their plan participants.

H.R. 2779

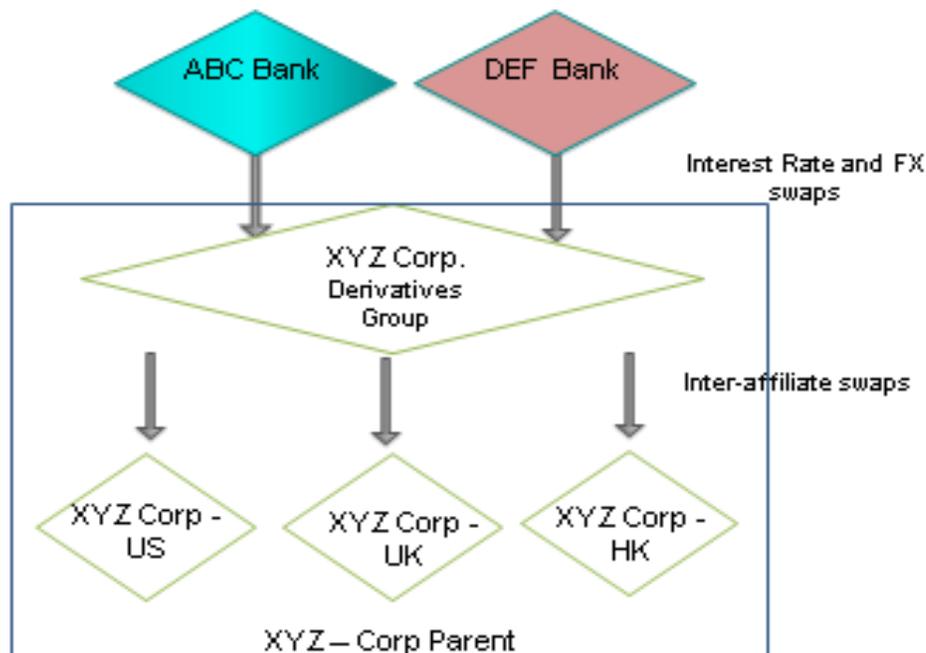
Finally, I would like to address H.R. 2779, a bill that would exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd Frank Act. This is an issue of significant interest and concern to major swaps market participants.

As their name implies, inter-affiliate swaps are transactions between two legally separate subsidiaries. They are commonly used by financial institution dealers in connection with their roles as market intermediaries and by end-users to hedge capital and manage balance sheet risks.

End-users (both financial and non-financial) use inter-affiliate swaps transactions for several reasons: to hedge their capital, manage risks inherent in a particular balance sheet asset/liability mix and manage other related risks arising from their general operations. For example, capital invested in overseas subsidiaries may need to be hedged for foreign exchange fluctuations. A commercial bank whose core lending and deposit taking business causes its balance sheet and earnings to be highly susceptible to interest rate changes will need to hedge for interest rate risks.

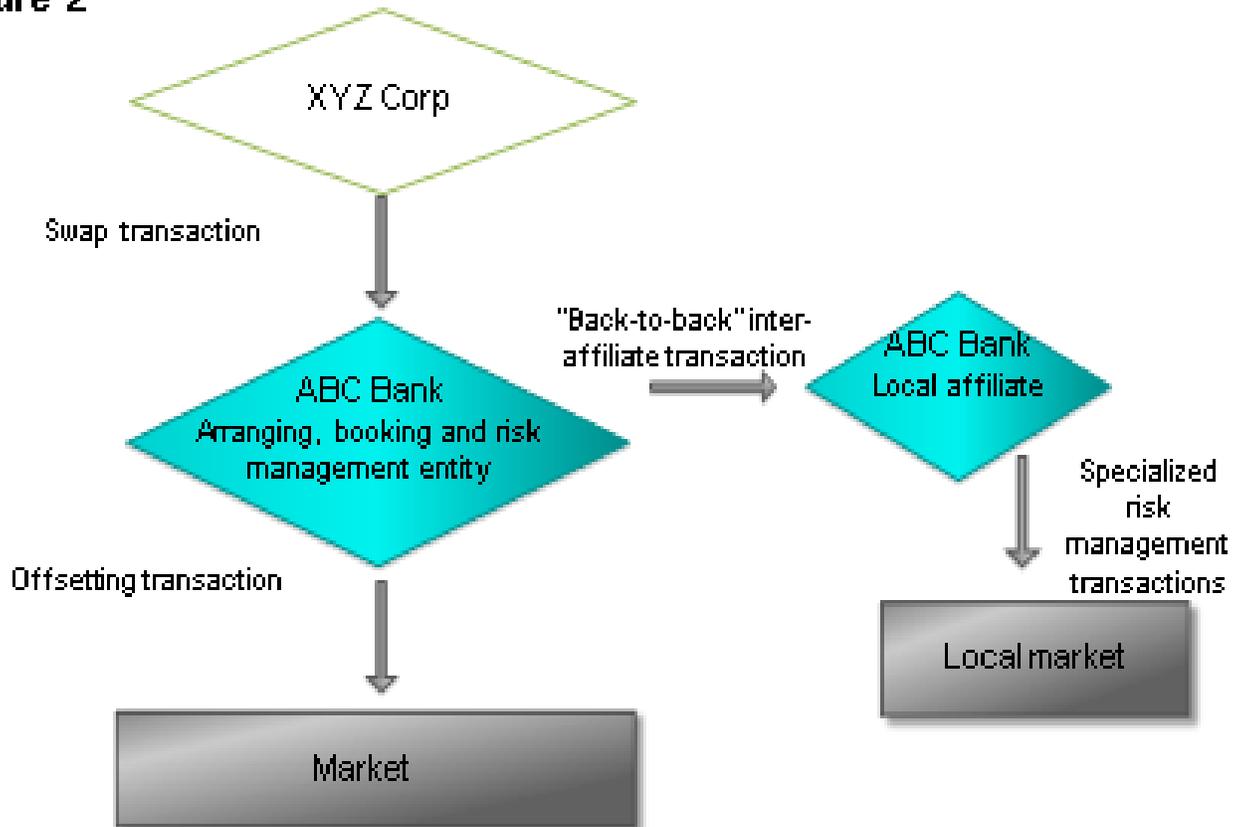
If a firm issues debt overseas, it will need to use interest rate and foreign currency derivatives to lock in costs. Inter-affiliate swaps are key to the effective management of interest rate, foreign exchange, liquidity, capital and balance sheet risks inherent in the general business of financial institutions, just as is the case for non-financial corporations. (Figure 1.)

Figure 1



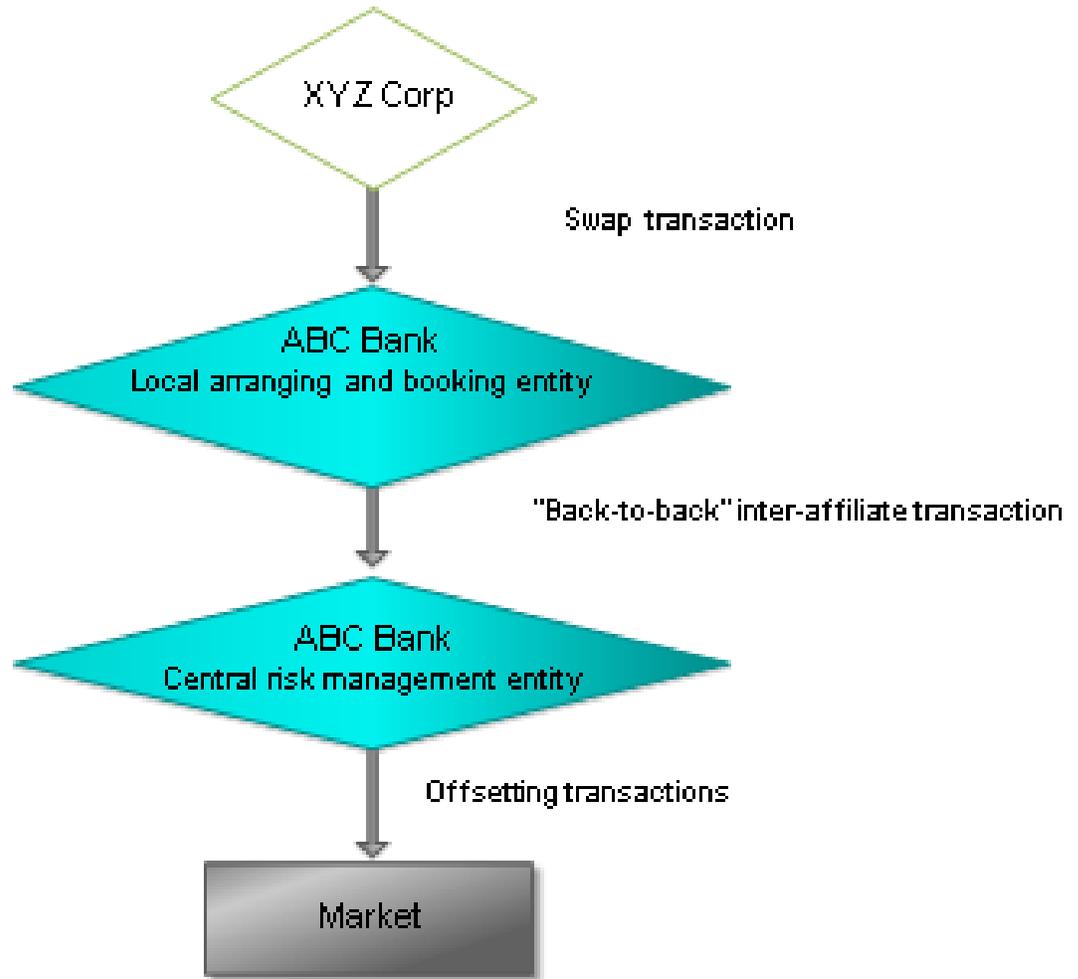
To illustrate how dealers commonly use inter-affiliate transactions: a financial institution will typically deal with swap clients in one of two ways. It will face the client with its central risk managing entity, but where necessary, hedge specialized risks through an affiliate that is permitted by local regulations to hedge that specific risk in the relevant jurisdiction. (Figure 2.)

Figure 2



The other way in which a financial institution will typically deal with a swap client is by providing local clients economic access to a variety of products through the customer's choice of a local counterparty. But at the same time, it will manage more centrally the general risk of such products by having that local entity hedge its risk through inter-affiliate swaps with a central risk managing affiliate. (Figure 3.)

Figure 3



Inter-affiliate swaps generally do not raise the systemic risk concerns that Title VII regulation is intended to address because they do not create additional counterparty exposure outside of the corporate group and do not increase interconnectedness between third parties. Inter-affiliate trades, in fact, *reduce* systemic risk by making it possible to increase the use of netting with clients and, by bringing together a diversified portfolio in one entity (e.g., the risk-managing entity), to use more offsets to manage and reduce risk.

Applying the full panoply of regulations under Title VII to inter-affiliate swaps as if they were third-party swaps will not reduce risk to the financial system, increase transparency or improve the market integrity of the financial system. On the contrary, such regulations could balkanize risks within a corporate enterprise, by forcing individual entities with limited portfolios and limited ability to access risk management to manage their own individual risks.

Imposing unnecessary requirements on inter-affiliate swaps will impede efficient, centralized risk management and thus *increase*, rather than decrease, the level of risk within the enterprise and the broader financial system.

Inter-affiliate swaps are not given separate consideration in DFA or in the proposed rules, implying that the rules may apply without taking into account the unique role of such swaps. We note, however, that several of the leading architects of Dodd-Frank specifically stated that the legislation should not apply to inter-affiliate transactions.

For these reasons, ISDA supports H.R. 2779. We note that it would not exempt inter-affiliate swaps from the reporting requirements of the DFA. All such swaps would be reported to the trade repositories as required by law and regulation and as consistent with current industry practice.

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As noted earlier, ISDA and the OTC derivatives industry support regulatory reform that mitigates systemic risk by reducing counterparty credit risk and increasing regulatory transparency. Some of the current legislative and regulatory framework for OTC derivatives markets does not support or works against this important goal. ISDA believes that the remedies contained in H.R. 1838, H.R. 2586, H.R. 2779 and H.R. 3045 are an important step in addressing these problems and ensuring that markets participants are able to effectively and safely manage their risks.

