Testimony of Robert Pickel
Chief Executive Officer,
International Swaps and Derivatives Association
Before the
Subcommittee on Capital Markets, Insurance, and Government Regulation
Committee on Financial Services
United States House of Representatives

June 9, 2009

Mr. Chairman and Members of the Subcommittee:

Thank you very much for inviting ISDA to testify today. We are grateful for the opportunity to discuss public policy issues regarding the privately negotiated, or OTC, derivatives business. Our business provides essential risk management and cost reduction tools for a broad swath of users. Additionally, it is an important source of employment, value creation and 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 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, investment managers 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 underscore ISDA's and the industry's strong commitment to identifying and reducing risk in the privately negotiated derivatives business:

- We believe that OTC derivatives offer significant value to the customers who use them, to the dealers who provide them, and to the financial system in general by enabling the transfer of risk between counterparties.

- We recognize, however, that the industry today faces significant challenges, and we are urgently moving forward with new solutions rather than remaining stuck in the status quo.

- We have delivered and are delivering on a series of reforms in order to promote greater standardization and resilience in the derivatives markets.

- These developments have been closely overseen and encouraged by regulators, who recognize that optimal solutions to market issues are usually achieved through the participation of market participants.

- As ISDA and the industry work to reduce risk, we believe it is essential to preserve flexibility to tailor solutions to meet the needs of customers. Efforts to mandate that privately negotiated derivatives business trade only on an exchange would effectively stop any such business from being conducted. Requiring exchange trading of all derivatives would harm the ability of American companies to manage their individual, unique financial risks and ultimately, harm the economy.

Mr. Chairman, let me assure you that ISDA and our member firms clearly understand the need to act quickly and decisively to implement the important measures that I will describe in the next few minutes.

* * *

About OTC Derivatives

OTC derivatives exist to serve the risk management and investment needs of end-users. These end-users form the backbone of our economy. They include over 90% of the Fortune 500, 50 percent of mid-sized companies and thousands of other smaller American companies.

The industry employs thousands of individuals, most of whom function in middle and back office capacities, handling legal, documentation, collateral and operational issues.

It is important to understand that an OTC derivative – whether it's an interest rate swap or a credit default swap -- does not in and of itself create risk. It's merely a transaction that shifts risk from one firm, or counterparty, to another.

The development of OTC derivatives has followed the development of the American economy. For centuries, foreign exchange transactions 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.
Credit derivatives first appeared in the mid-1990s as a tool to help banks diversify the credit risk in their loan portfolio. Since then, they have grown into a vital risk management and diversification tool.

In each case, the need for these privately negotiated derivatives products was driven by the needs of end-users. Their growth was a direct function of their utility to end-users. If end-users did not want these products, they would not exist.

* * *

Understanding Notional Amounts

Before I discuss current regulatory and industry initiatives, there is one aspect of the OTC derivatives markets that bears some explanation.

As you may know, the industry's size is usually measured in notional amounts outstanding. The reason for using notional amounts is that it is relatively simple to identify and gather. In addition, it is consistent over time; that is, the notional amount for a deal does not change except in limited cases.

While it is a useful measurement tool, notional amount overstates the level of activity in the OTC derivatives markets. More problematic, however, is the dramatic misinterpretation of notional amount as a measure of risk. In fact, notional amounts are only loosely related to risk.

In the OTC derivatives markets, a firm will often enter into one contract to offset exposure from another contract. As it does so, it doubles the level of notional outstanding. But it does not increase the level of risk in the system.

Statistics compiled by the Depositary Trust and Clearing Corporation's Trade Information Warehouse illustrate this point. The Trade Information Warehouse is a global repository and post-trade processing infrastructure for over-the-counter (OTC) credit derivatives. According to data that it makes publicly available, there is currently about $5.6 billion of credit default swap protection on Johnson & Johnson. However, after stripping away all offsetting positions that firms may have, the net notional value of CDS on the company is $900 million.

Looking at the CDS business in aggregate, there is currently about $28 trillion in gross notional outstanding. However, on a net basis, according to DTCC, the level of exposure is $2.5 trillion, or less than 10 percent of the notional.

Obviously, this $2.5 trillion is still a large number, but please keep in mind what it represents: every reference entity on which every CDS contract is based would have to default for payouts to be that high.

* * *

Current Regulatory and Industry Initiatives

Last month, Treasury Secretary Geithner announced a comprehensive regulatory reform proposal for the OTC derivatives markets. The proposal is an important step toward much-needed reform of financial industry regulation. ISDA and the industry welcomed in particular the recognition of industry measures to safeguard smooth functioning of our markets.

The Treasury plan proposes to require that all derivatives dealers and other systemically important firms be subject to prudential supervision and regulation. ISDA supports the appropriate regulation of financial institutions that have such a large presence in the financial system that their failure could cause systemic concerns.

Most of the other issues raised in the Treasury proposal – and the questions you have asked of the panelists today -- were addressed in a letter that ISDA and industry participants delivered to the Federal Reserve Bank of New York earlier this month.

As you may know, a Fed-industry dialogue was initiated under Secretary Geithner's stewardship of the New York Fed some four years ago. This dialogue has led to substantial and on-going improvements in the key areas of the OTC derivatives infrastructure:

- Increased standardization of trading terms;
- Improvements in the trade settlement process;
- Greater clarity in the settlement of defaults;
- Significant positive momentum toward central counterparty clearing;
- Enhanced transparency; and
- A more open industry governance structure.

In our letter to the New York Fed this month, ISDA and the industry expressed our "firm commitment to strengthen the resilience and robustness of the OTC derivatives markets." As we stated, "We are determined to implement changes to risk management, processing and transparency that will significantly transform the risk profile of these important financial markets…"

We outlined a number of steps toward that end, specifically in the areas of information transparency and central counterparty clearing.

* * *

Central Counterparty Clearing

In terms of clearing, the industry recognizes that it is an important public policy consideration – and that it can provide many benefits to the market, including helping to identify systemic risk.

Today, the industry clears the majority of inter-dealer interest rate swaps. Plans have recently been announced to make the industry's clearing platform available to the buy-side as well.

For credit default swaps, the industry has committed to migrating standardized contracts onto a clearing platform, as per Secretary Geithner's proposal. It is also the industry's goal to achieve buy-side access to CDS clearing (through either direct CCP membership or customer clearing) no later than the end of this year.

While there is widespread recognition of the benefits of clearing, there is also widespread acknowledgement, including in the Treasury proposal, that there is a continued need for customized OTC derivatives. Due to their inherent nature – as flexible risk management tools designed specifically to meet particular needs -- not all OTC products can be cleared.

Nor, for this same reason, can all OTC products trade on an exchange. Here's why: stocks, bonds, commodities – when you buy or sell them, most of the trade terms are fixed. All you really need to do is indicate the name and quantity that you want to buy, and you can execute the trade. But with customized OTC derivatives, the trade terms are determined by the end customer and the dealer to fit a specific need. IBM's financial situation and needs are different from GE's, and GE's are different from John Deere's. There is simply no way to standardize this end customer demand.

In fact, mandating that interest rate swaps or credit default swaps be traded on an exchange is likely to result only higher costs and increased risks to the manufacturers, technology firms, retailers, energy producers, utilities, service companies and others who use OTC derivatives in the normal course of business. It will put American businesses at a significant disadvantage to their competitors around the world.

* * *

Information Transparency

I would next like to discuss the issue of information transparency.

The Treasury proposal is designed to ensure that regulators would have comprehensive and timely information about the positions of each and every participant in all OTC derivatives markets.

This new framework calls for trades to be cleared or, if not cleared, to be reported to a trade repository. ISDA and the industry support this framework, as it would provide policymakers with access to the information they need to carry out their authorities under the law.

As stated in the Fed letter, we favor implementing data repositories for non-cleared transactions in the OTC derivatives markets. When combined with the information available from clearinghouses, this should – as the Treasury proposal noted -- enable the industry to meet its recordkeeping and reporting obligations.

Any efforts taken beyond these measures would appear to be duplicative and may add to the cost of doing business. As a result, any such proposals should be carefully scrutinized to see whether and how they add value beyond the provisions of the Treasury proposal and the industry's commitment to the New York Fed.

One additional issue that has been raised in the recent policy debate is whether standardized contracts that can be cleared should also be traded on an exchange. The industry's view on this is two-fold.

First, we believe that the public policy goals of greater transparency as discussed above will be met in a clearinghouse/non-cleared trade repository environment. In this sense, requiring standardized contracts to be exchange traded would not produce any additional information for or benefits to policymakers.

It could, however, increase the costs of doing business for industry participants. That is why we have long believed that market forces are best positioned to determine the most efficient and effective way to trade OTC contracts. It's possible that there are some contracts that would prove to be very successful if they traded on an exchange. It's also possible that electronic execution systems may increase in popularity due to the benefits they offer. These, however, are properly choices for market participants.

* * *

Summary and Conclusion

ISDA and the OTC derivatives industry are committed to engaging with supervisors, globally, to expand upon the substantial improvements that have been made in our business since 2005.

We know that further action is required, and we pledge our support in these efforts. It is our belief that much additional progress can be made within a relatively short period of time. Our clearing and transparency initiatives, for example, are well underway, with specific commitments aired publicly and provided to policymakers.

As we move forward, we believe the effectiveness of future policy efforts will be driven by how well they answer a few fundamental questions:

- First, do they recognize that OTC derivatives play an important role in the US economy?

- Second, do the policy efforts enable firms of all types to improve how they manage risk?

- Third, are the policy efforts based on a complete understanding of how the OTC derivatives markets function and their true role in the financial crisis?

Mr. Chairman, and committee members, the OTC derivatives industry is an important part of the financial services business in this country and the services we provide help companies of all shapes and sizes.

Let me assure you that we in the derivatives industry do recognize the challenges that we face as we seek to enact a comprehensive and prudent system of regulatory reform. As I have indicated, we are fully committed to working with legislators and supervisors to address the key issues ahead.

Thank you for your time.

# # #