

**Testimony of Robert Pickel
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Before the
House Financial Services Subcommittee on Capital Markets, Insurance and the GSEs
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Chairman Kanjorski, Ranking Member Garrett and Members of the Committee:

Thank you for the opportunity to testify today regarding credit default swaps ("CDS") and government debt. The International Swaps and Derivatives Association, or ISDA, was chartered in 1985 and has over 820 member institutions from 56 countries on six continents. Our 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.

Introduction

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives. Among other types of documentation, ISDA produces definitions related to CDS.

The Role of CDS

CDS provide a simple device for banks and other lenders to hedge the risks associated with lending to a particular company, industry or other counterparty, including government entities. A CDS is a derivative contract based on one or more assets (e.g., a corporate loan or bond), in which the protection buyer pays a fee, typically on a quarterly basis, through the life of the contract in return for a payment by the protection seller upon the occurrence of a pre-specified credit event relating to a company (e.g., bankruptcy). If no pre-specified event occurs during the life of the transaction, the seller will retain the quarterly payments as compensation for assuming the risk.

Although not nearly as widespread as CDS related to corporate exposures, many institutions also use CDS to hedge the risks associated with lending to a sovereign nation or other governmental entity. Sovereign CDS are similar to corporate CDS, but they are based on government-issued debt and subject to a different set of credit event triggers, such as the government's moratorium on payment of its debt. A significant portion of corporate CDS trading is based on indices, while sovereign indices have only recently been developed.

In addition to providing basic credit risk protection, sovereign CDS have become more widely used in recent years because they can provide significant value to hedgers of country-specific risk and can increase liquidity in the underlying debt. They also have often been the best way to express a view on credit in troubled times when cash and securities markets have seized up. When credit is perceived to be overpriced, market participants may look to buy protection. Conversely, when credit is perceived to be underpriced, market participants may look to sell protection.

Risk Mitigation

Generally speaking, CDS, whether related to corporate or sovereign debt, help to mitigate credit risk for investors and lenders. Unlike corporate CDS, however, sovereign CDS can also provide effective hedges against the broader economic risk related to a particular country. As the International Monetary Fund ("IMF") noted recently, "Sovereign CDS is not only 'credit insurance,' but another tradable instrument in the risk management tool kit."¹ As a result, investors may use sovereign CDS for a variety of risk management purposes. For example:

- *International banks* that extend credit to corporations and banks located in a particular country may use sovereign CDS to hedge credit or counterparty exposures or to provide country-level risk diversification.
- *Investors* in the debt or equity of companies in a specific country may use sovereign CDS as a "proxy hedge" against potential systemic shocks that would reduce the value of their positions. It is our understanding that earlier this year proxy hedgers were significant buyers of Greek sovereign CDS because individual Greek bank CDS were much less liquid.
- *Investors* with large real estate or other corporate holdings in a country may similarly use sovereign CDS.
- *Portfolio managers* may use sovereign CDS to hedge against country, liquidity and market risk related to a portfolio comprising debt or equity positions and to better diversify their portfolios.
- *Large banks*, which typically do not require highly-rated sovereign entities to post collateral for swap arrangements may use sovereign CDS to hedge against the risk posed by these uncollateralized exposures.
- *Banking supervisors and Central Banks* use the price signals provided by the CDS market to assess default risks in the financial system.

¹ Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System, International Monetary Fund, April 2010. p. 51

Liquidity

Ultimately, CDS increase liquidity in the banking industry because they enable banks to manage the credit risk inherent in lending. Because CDS limit the bank's downside risk by passing it on to parties that seek such exposure, banks are able to lend more money to many more entities. CDS thus significantly expand borrowers' access to capital from bank lending, and reduce the cost of that borrowing.

Market Transparency

CDS also serve a valuable signaling function. CDS prices produce better and more timely information about the entities for which a CDS market develops because CDS prices, unlike the credit ratings published by rating agencies, are more sensitive to market-based information about an entity's financial health. CDS prices reveal changes in credit conditions and can provide insight to bankers, policymakers, investors and others about credit in real time, making it easier to manage and supervise traditional banking activities. The trend toward basing term loan pricing on CDS spreads as opposed to credit ratings illustrates the increasing value lenders place on CDS pricing information. While this signaling function provides additional useful information regarding an entity's financial health, it is important to note that sovereign CDS spreads closely track government bond spreads, whether by reference to LIBOR or to other sovereigns.

Market participants and the general public have ready access to publically available data to evaluate the CDS market. The financial press provides extensive information regarding CDS activity and the amount of outstanding CDS and weekly transaction activity for the 1,000 largest names (including sovereign CDS) are publicly available through the website of the Depository Trust Clearing Corporation's ("DTCC's")

Trade Information Warehouse.² Separately, policymakers have access to data on a transactional level to enable them to monitor and evaluate market activity.

Size of the Sovereign CDS Market

The sovereign CDS market is much smaller than the government bond market. Gross sovereign default protection equals \$2 trillion in notional value, or 6 percent of the overall global government bond market of \$36 trillion. Actual net sovereign CDS notional amounts³ are much smaller, \$196 billion or 0.5 percent of government debt.⁴ Similarly, the sovereign CDS market is much smaller than the corporate CDS market, which includes many index trades. Among single name trades, sovereigns are approximately 15 percent of trades on a gross basis and less than 20 percent on a net basis.

Although these numbers appear on their face to be extremely large, it is important to note that "notional" amounts are not truly reflective of the risks posed by this type of financial instrument. For example, the notional amount of a derivative contract refers to an underlying quantity upon which payment obligations are calculated. Notional amounts are an approximate measure of derivatives activity and reflect the size of the field of existing transactions. For CDS, this represents the face value of bonds and loans on which participants have written protection; the exposure under a CDS contract is in fact a fraction of the notional amount. For example, according to the DTCC when Lehman Bros. failed

² See, www.dtcc.com/products/derivserv/data/index.php.

³ Net notional is the aggregate net position (protection bought less protection sold) of each market participant and, in effect, reflects the open interest in the CDS of a particular company, country or index. It is not a measure of the amount at risk, which would typically be a fraction of the net notional, but it does give an indication of the magnitude of net protection bought on a company, country or index. Net notional positions generally represent the maximum possible net funds transfers between net sellers of protection and net buyers of protection that could be required upon the occurrence of a credit event relating to particular reference entities. (Actual net funds transfers are dependent on the recovery rate for the underlying bonds or other debt instruments.)

⁴ Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System, International Monetary Fund, April 2010. pp. 49-50

the "notional" amount of CDS which referenced Lehman was roughly \$72 billion dollars. The actual money that exchanged hands, however, was 7 percent of that total, or a little over \$5 billion.

The one recent experience of a sovereign credit event was when Ecuador defaulted on its debt in December 2008. An auction to value Ecuador debt was held, and CDS related to Ecuador settled uneventfully.

As the above example illustrates, the transfer of payments under CDS contracts is nowhere near the magnitude often popularly portrayed. In addition, market data clearly shows that open CDS positions are a small fraction of total turnover and, in practice, of an issuer's outstanding bonds and loans. For example, the net notional amount of CDS on Greek debt is less than 2 percent of the principal amount of outstanding Greek debt. This reflects the overall role of derivatives generally, to adjust risk positions at the margin. At the same time, for large investors, the mere *availability* of CDS gives them more confidence to take on bond positions, since they can use CDS in the future to hedge against emerging or unforeseen risk.

Oversight of the CDS Market

For years, ISDA has worked with policymakers, financial regulators, legislators, and governments around the world to establish a sound policy framework for swaps activities. In March 2010, ISDA jointly submitted a letter with a number of market participants and industry groups to global financial supervisors. The letter was the sixth in a series that publicly details how the industry will work to further strengthen the robustness of the derivatives market infrastructure, improve transparency and build a more resilient risk management framework. I have included a copy of the letter as an attachment to my written testimony.

As a result of these and other industry efforts, currently 93 percent of the clearable CDS market is cleared through a central clearinghouse, which benefits the market by reducing the systemic risk associated with counterparty credit exposures and providing enhanced liquidity and price discovery by means of standardization and centralized trading.

In addition, as noted above, market participants, along with the DTCC, publish aggregate market data consisting of outstanding gross and net notional values of CDS contracts registered in the DTCC's Trade Information Warehouse for the top 1,000 underlying single-name reference entities and all indices, as well as certain aggregates of this data on a gross notional basis only. The financial press also provides valuable CDS market data on a regular basis.

CDS and Market Manipulation

Over the past several months, the use of sovereign CDS has received scrutiny as some have suggested trading in sovereign CDS could be responsible for putting pressure on government bond markets. The data suggest otherwise.

First, the majority of sovereign CDS investors likely are hedging legitimate economic risks, not speculating, even if they do not own the actual asset referenced in the CDS. With CDS, those who have credit risk can buy protection and transfer the risk to the ultimate sellers of protection, who wish to assume that risk.

Second, the size of the sovereign CDS market remains relatively small compared with the overall government debt market, making it unlikely that CDS trading volumes can have a significant effect on a

country's overall debt spreads. The chart below illustrates that, even among countries under economic pressure, the ratio of CDS to government debt remains low.

Ratio of Net CDS to Gross External Debt (General Government)			
Amounts in billions (as of September 2009).			
Sovereign	Net CDS	Gov't Debt	CDS/Debt (%)
Germany	\$12	\$1,601	0.7
Greece	\$8.3	\$426.8	1.9
Italy	\$22.4	\$2,295.8	1.0
Portugal	\$7.7	\$226.3	3.4
Spain	\$13.1	\$848.1	1.5
U.K.	\$3.4	\$1,108	0.3

Sources: DTCC and the Bank for International Settlements

Third, sovereign CDS may actually serve to moderate downward pressure on troubled countries, as, absent a liquid sovereign CDS market, hedgers of risks attributable to a government bond or other assets related to the country would instead move to short or sell any bonds or other country-related assets, putting additional and more substantial pressure on the country and its economy. Lenders and investors would also likely charge higher risk premiums for corporations and banks located in the country, raising the cost of borrowing for these entities.

Finally, bond and CDS markets are not completely correlated and, in reality, neither may provide a particularly good estimate of the long term probability that the underlying bond issuer will default. Bond spreads are driven in part by liquidity risk (i.e., how hard the bond is to sell), funding risk (i.e. the availability and cost of secured funding for the bond) and the volatility of the bond spread itself. In contrast, CDS spreads include compensation for the liquidity of CDS, and for the volatility of the CDS spread. Both markets are driven by the balance of buyers and sellers, many of whom may not have a

fundamental view of the likelihood of default. Thus while both the CDS and bond markets allow participants to meet economically useful risk taking and risk management objectives, spread movements should not be seen as driven by changes in the perception of the probability of default alone.

It is also important to note that the economic effect of buying a CDS can be achieved by selling underlying bonds short, doing a "reverse repo" on the bond and entering into an interest rate swap to mitigate interest rate risk on the bond.⁵ CDS have proved to be a more efficient and cost effective way to achieve the same effect.

⁵ At the end of the first quarter of 2010, outstanding reverse repos on U.S. debt (government and corporate) totaled \$1.857 trillion.