

**Testimony of Robert Pickel
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**Before the
Assembly Standing Committee on Insurance**

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Chairman Morelle and Members of the Committee:

Thank you very much for giving ISDA the opportunity to testify before this committee regarding regulation of the credit default swap (CDS) market. From our meetings with you and your staff, it is very apparent that you understand both the complexity of this market as well as its importance to the State of New York. Thank you for holding this hearing to discuss these timely and important issues.

Information 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 860 member institutions from 57 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.

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 (available only to ISDA members); 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.

Information about CDS

According to ISDA's semi-annual survey at mid-year 2008, the notional amount outstanding of CDS decreased by 12 percent in the first six months of the year to \$54.6 trillion from \$62.2 trillion. This reduction represents the efforts of the industry to clean up outstanding trades through a process known as "tear-ups", whereby trades between counterparties which are still on the books but effectively cancel one another out are removed, or "torn up". This reduction in outstanding trades represents a significant achievement for the industry in addressing operational issues, and is but one example of efforts being undertaken, in coordination with regulators, to help ensure the operational infrastructure of the OTC industry is sound and able to withstand any challenges.

It may also be useful at this point to speak for a moment about "notional" amounts. These figures are inevitably cited to promote unease about the size of the OTC market. It is helpful to note that 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. For example, according to the DTCC (a private organization which processes payments under derivatives contracts) when Lehman Bros. failed the "notional" amount of CDS which referenced Lehman was roughly \$72 billion dollars. However the actual money that exchanged hands was 7% of that total, or a little over \$5 billion.

It is also worth noting that the failure of Lehman Bros. as well as other high profile failures among large financial market participants, provided a very real test of the strength of the CDS, and OTC derivatives more generally, to withstand major shocks. Lehman was a major dealer in the OTC business, and Fannie Mae and Freddie Mac were two of the largest issuers of debt in the world. In these events thousands of CDS were settled using the results of auctions held to determine final settlement prices. In the case of Lehman, parties unwound their total exposure as a counterparty under all OTC derivatives with Lehman. In all cases these contracts were settled, and the markets continued to operate. Indeed, in the current turmoil credit default swaps have at times been the only markets which have continued to function and to provide investors and companies a means to hedge credit risk and express a view on the market.

CDS Benefit the Broader Economy

Credit default swaps (CDS) benefit the broader economy by facilitating lending and corporate finance activity, which is especially crucial in today's tight credit environment. They perform a valuable signaling function and allow investors to express a view on the market.

CDS provide a simple device for banks and other lenders to hedge the risks associated with lending to a particular company, group of companies or industry. Generally speaking, CDS hedge the risk that a borrower will default. Fundamentally, if a lender can be sure it will be made whole regardless of whether a borrower defaults, it is more likely to lend. CDS also free capital for further lending activity by, among other things, enabling lenders to effectively manage its regulatory capital requirements or by increasing a lender's credit limit with respect to a specific borrower or industry. 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 businesses. CDS thus significantly expand companies' access to capital from bank lending.

CDS also serve a valuable signaling function. CDS prices produce better and more timely information about the companies for whom a CDS market develops because CDS prices, unlike the credit ratings published by rating agencies, rely on market-based information about a company's financial health. CDS prices reveal changes in credit conditions, giving insight to bankers, policymakers, investors and others about credit in real time, making it easier to manage and supervise traditional banking activities. The recent trend of basing term loan pricing on CDS spreads as opposed to credit ratings illustrates the increasing value lenders place on CDS pricing information.

CDS has remained the only credit products consistently available to allow companies and investors to transfer credit risk and express a view on credit performance; while cash, securities and money markets have seized up, CDS have continued to function. Illiquidity in the financial markets would likely be worse if companies and investors did not have a healthy CDS business available.

CDS are an efficient means of hedging risk or adjusting positions; they remain an accurate indicator of credit quality, are highly liquid, and have been the best way to express a view on credit in troubled times when cash and securities markets have seized up.

Central Counterparty Clearing and DTCC Trade Information Warehouse

For more than two decades, ISDA has maintained an active and collaborative dialogue with public policymakers and supervisors including financial regulators, legislators, and governments around the globe to establish a sound policy framework for swaps activity. Since 2005, market participants, independent of regulatory oversight, have been working towards implementing a central clearing house for credit derivative transactions. Building on these efforts, ISDA and its members have worked together with the President's Working Group, the Federal Reserve, the SEC and other regulators, towards achieving this objective. As a result of these efforts, central counterparty clearing of CDS (CDS CCP) is near, with the goal of commencing operations before the end of 2008.

A well-regulated and prudently managed CDS CCP can provide benefits to 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. Additionally, there is the probable reduction of economic and regulatory capital and likely increased transparency.

In addition to the ongoing efforts on the CDS CCP front, market participants along with the Depository Trust & Clearing Corporation have taken a significant step towards addressing market concerns about transparency by publishing, on a weekly basis, aggregate market data from DTCC's Trade Information Warehouse (Warehouse). The market data consists of outstanding gross and net notional values of CDS contracts registered in the 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.

ISDA continues to support the development of options for participants in CDS to undertake their business in the most prudent and efficient manner and to the highest standards of commercial conduct. We welcome the development of clearing and settlement arrangements which would provide the benefits of choice and flexibility to participants within the sound industry framework developed by ISDA over the past 20 years; a framework that benefits from the significant counterparty credit risk mitigants of legally enforceable netting and collateral arrangements.

New York State's Role in the CDS Marketplace

As a center of financial commerce and home to many of the world's largest financial institutions, New York plays a significant role in the CDS marketplace. State regulatory bodies, via their authority over institutions domiciled or conducting business in the state, oversee institutions that utilize credit derivatives. These state regulatory bodies, in accordance with state law and to the extent not preempted by federal law, may undoubtedly regulate any financial activity, including credit derivatives. The New York State Insurance Department, for example, as the primary regulator for most United States financial guaranty insurance companies (FGIs), may monitor CDS issued by an entity it regulates so long as it has the requisite power and such regulation is not preempted by federal law. Indeed, the Insurance Department in Circular 19 provides an outline of prudent recommendations with respect to CDS issued by FGIs, such as the Superintendent's recommendation to increase the amount of financial reserves that FGIs would be required to maintain in order to engage in certain CDS transactions.

Additionally, New York has played an important role in spurring national discussion concerning a comprehensive regulatory structure for the CDS market. These hearings are an important step in those ongoing discussions. It is important to note, however, that product specific state regulation of a global product such as CDS will fail to address the underlying concerns driving such regulation; instead, they would place New York, and perhaps the United States, at a competitive disadvantage vis-a-vis other national and international jurisdictions. As Superintendent Dinallo recently stated, "The best outcome is a holistic solution for the entire credit default swap market." That holistic solution resides at the federal and international level.

Economic Costs of a Reduced CDS Business in New York

Inappropriate state regulation may prove costly as the credit derivatives industry is a significant source of strength for New York's economy. Recently, ISDA conducted an informal survey of major credit derivatives dealers with New York based operations. Based on our survey, we estimate that the revenues produced by CDS trading and prime brokerage in New York to be approximately \$15 billion annually. We also estimate that these activities provide New York City with roughly 18,000 jobs paying a total annual payroll of about \$5 billion. Moreover, the Comptroller of the State of New York has previously estimated that each such job creates two additional jobs in New York, mostly in the areas of retail and professional services.

The OTC derivatives industry has been a wellspring of growth and revenue for the New York economy; indeed, it is yet another example of how our State has taken cutting edge technology and new ideas and transformed them into high paying jobs and career opportunities for New Yorkers. In order to continue to nurture such growth and innovation we must continue to cultivate a regulatory environment that doesn't place New York at a disadvantage compared to other jurisdictions.

Conclusion

Credit default swaps, and OTC derivatives in general, play an important role in the markets and New York's economy. We are grateful to this committee for holding these hearings to explore how to ensure New York continues to benefit from these innovative financial markets. Going forward ISDA looks forward to continuing to work with the State Assembly, state and federal regulators to ensure these markets continue to operate in a safe, healthy and sound manner, consistent with good public policy. Thank you very much.