

Introductory Remarks
Robert G. Pickel, Executive Vice Chairman, ISDA
2011 ISDA Annual Europe Conference
Shaping the Future of Derivatives
September 20, 2011

Good morning, welcome, thank you.

Those of you who know me know that I have more than a passing interest in technology. I often buy the latest gadgets--original iPod, the iPad and other things you've probably never heard of or that died a quick death. I dictated this speech and edited it on my iPad. And now I am reading it to you using a Teleprompter app.

I suppose I have passed on my interest in technology to the next generation. My son is a software engineer at Google. He's always involved in something top secret, with code names like Dump Truck. And even though he's explained to me any number of times what he does, I am still not sure I could describe it. I suppose people might say the same thing about me, and what I do for a living.

Not surprisingly, my interest in technology spills over into some of the things we do at ISDA. You probably know that we launched a new look to our logo with a tag line--safe, efficient markets--and a new brochure and website. You may not really notice it, but even the ISDA logo is slightly tweaked. I remember one of our board members once saying to me that we could not make any major changes to that because people know I-S-D-A.

I had an idea for a logo and tagline that would have been a little more technology oriented. But, of course, Steve Jobs and Apple probably would have sued the heck out of us.

Earlier this year we also launched a new look for our website, which uses the new logo and tagline throughout. Here's a snapshot of the newly designed home page. We hope you've all managed to visit there and find it useful. We're always interested in your feedback, so if you have any comments or suggestions please drop us a line.

We've also launched this week something we call the Daily Lead, compendium of headlines and links to stories related to the derivatives business. We have a sample of it up on the screen. We sent an email about this to our entire database, so if you haven't received it, check to make sure it's not in your spam folder. Or drop us a line and we will be sure to provide a link. We think it will be a great way to start your day. Or end your day. Or read over lunch. Given the global reach of ISDA, it could be any time of the day when the Daily Lead hits someone's inbox.

One of the things Connie and I have launched is something we call derivatiViews, which you see up on the screen. It's essentially a blog where we talk about issues affecting the derivatives world. We realize a blog is a little bit last year and that we really should be tweeting. But we weren't about to limit ourselves 140 characters! These articles are short thought pieces about issues of concern to us and, we believe, to our membership. And, with all due modesty, we've managed to build up a pretty good body of work so far.

The pieces are attributed to both of us even if one of us took the lead in drafting a piece. It's kind of like Lennon and McCartney. You may recall McCartney typically wrote the more poppy and sometimes sappy songs and Lennon more often wrote the introspective, rock 'n roll songs. Don't worry. That's where the comparison ends. It's just to say that Connie and I each have our own interests and styles, but the views are very much shared by both of us.

Connie's interest is research, analytics and the markets. In particular, in the pieces he has authored, we try to put some numbers to the analysis, something that has been sorely lacking in the regulatory debate so far. My pieces tend to focus on legal issues, documentation and regulation in general. Once a lawyer, always a lawyer.

It's fair to say that an overarching theme of our pieces has been to question the kind of black and white analysis we all too often see. Clearing good, bilateral risk management bad. We think that it's far more subtle and nuanced than that and that the future really lies in many areas working together effectively--exchange traded, electronic trading, OTC, clearing, master agreements, collateral. It's very important to consider all of this in a holistic, integrated way.

So for instance Connie recently wrote a piece suggesting that as we move forward with clearing for other market participants, such as nondealer financial entities, we should consider the possibility that alternatives such as greater utilization of collateral and more standardization of the collateral terms could be a more optimal path. We say that because the goals of systemic risk reduction might be achievable at a lower cost than the initial margin that is likely to be required for cleared trades.

Our suggestion would preserve netting benefits, improve reporting and eliminate the costs of multiple clearinghouses and do everything a clearinghouse does except require initial margin. We believe that because mandatory initial margin is extremely expensive relative to the potential savings, it may be best to negotiated it bilaterally.

Now we know that, certainly in the United States and potentially in other jurisdictions, clearing will be an important part of the future and we fully endorsed that. We just raise the clearing vs. collateral question for consideration.

One of my focuses has been on something near and dear to ISDA's heart--netting. As clearinghouses proliferate across jurisdictions and across asset classes, there is the potential for netting to be less efficient than it currently is. The fragmentation we are seeing on the clearing front may limit the opportunities to maximize the multilateral netting that takes place in a clearinghouse. At the same time, it may undermine bilateral netting, which has been the single most powerful means of reducing risk in the derivatives world.

Also, other requirements such as those in the United States regarding the spin out of certain lines of business into non-bank affiliates, will inevitably lead to less efficient utilization of netting. And we certainly believe that as netting becomes less efficient we are actually increasing risk.

In fact turning back to my technology interest, it's worth considering the two different models and how they work in the marketplace. One we might call the hub and spoke model, the clearing model. The other we might call the network model, the OTC model. This is something I have been thinking about for awhile, and I was intrigued to see Craig Pirrong, who will chair our clearing panel this morning, also identify this as a worthwhile theme for analysis.

Under the hub and spoke model each particular party deals with a central counterparty so they are each connected with that CCP--but less so with each other.

In the OTC world we have many different nodes all connected in multifaceted ways. We realize that this very interconnectedness may raise concerns, and we certainly want to make sure that both the connections between those nodes and the nodes themselves are as strong as possible.

In the OTC world, the way we ensure that those nodes are as strong as possible is through capital and through effective risk management. The nodes are in effect the dealers and they are connected with each other and with their customers through master agreement relationships and collateral arrangements. It's very important to make sure that the nodes are as strong as possible, and that's a clear role for regulation and for regulatory capital.

The way we make the connections between the nodes as strong as possible is through efforts that ISDA has led for over a quarter of century. For instance, the master agreement and its various provisions, particularly close out netting, provide significant protection for parties to reduce risk. In addition, collateral provides an additional level of protection to reduce risk between two parties. The definitions we produce provide robust, effective documentation for individual transactions so that the parties have certainty of the terms of the transactions between them.

Compare this with the hub and spoke structure of the clearinghouse. It has proven to be a very effective means of reducing risk, widely used over the years in the exchange world and increasingly utilized in the OTC derivatives world. We think this structure is appropriate for many types of transactions and we expect to see greater utilization of clearing.

As in the network world, it's important that the central counterparty be as strong as possible given the nature and amount of risk that it will take on through exposure to its clearing members. In addition, the documentation--the terms on which parties clear transactions--must be as strong as possible. That relates to the terms of the clearinghouse and also to the terms of the customer arrangements between the clearing members and their customers engaging in transactions that will be cleared. We have produced, together with the Futures Industry Association, a form of agreement that we believe is an effective way to provide essential protections.

Now I am not suggesting that one or the other model is superior. In fact, they both have their merits and will play a role in shaping the future of OTC derivatives. I would note, however, that in many other areas of the economy and society more generally, the network effect is viewed as optimal.

Take electricity transmission. The grid--just another name for a network--optimizes the generation and transmission of electricity. Sure, plants go down and so do power lines. But the

lesson learned from those experiences is to strengthen the plants and protect the power lines, not to resort to an approach that could result in a single point of failure.

Or take shipping. Distribution centers are dispersed across an area and are connected by sea, air, roads or rail. All points and paths can suffer disruptions or down times, but we don't throw the model out because of that. We work to protect the distribution centers and strengthen the connections between them.

Returning to the technology theme, here too we see the prominence of the network through social networks, where we are the points and the Internet provides the connection. I can't decide whether the cloud is a hub and spoke model or a network model. Of course, that may be because I can't figure out what the cloud is.

So in the derivatives world what model should prevail? Hub and spoke? Or network? It's not so black or white. We believe that each model has its strengths. The important thing is that the transactions we put into each structure are appropriate for that structure. That is why we focus on the more standardized contracts going into the clearinghouse while we allow more customized trades to utilize the OTC network approach. And it's why we raise the question of just how far, and for how many parties, we should take clearing. The bottom line is that these two models working together can, we believe, be the most effective means of managing risk.

At ISDA we plan to be an integral part of all these developments. We'll do so in two ways. Sometimes we'll be the hub--for our members' views and activities. We'll be your central clearinghouse of information and ideas, best practices and documentation. At other times we will be a node in the global derivatives network, adding value to our combined efforts. Whichever way we are working, you can be sure that your continued support is essential. As always, thank you for that support and for all of your hard work on behalf of ISDA.