“Navigating the New Market Landscape”
Remarks by Robert Pickel
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Good morning… I’m Bob Pickel, CEO of ISDA, and I’d like to welcome all of you today to our 2009 regional conference.

As you can see from this slide, the theme of our conference this year is “Navigating the New Market Landscape.” There’s no question that events of the past 18 months or so have indeed significantly changed the environment in which we operate. What we want to do today is to look at these changes from a few different perspectives…from a public policy perspective, from a risk management perspective, from a financial innovation perspective. This will help us to more clearly see where the industry is headed. I’m not sure we will have all the answers today, but I do expect that there will be some stimulating discussion that will benefit all of us.

The Current State of OTC Derivatives

I’d like to kick off this discussion with a brief look at our business overall. I think by any measure, our business largely remains solid. According to our most recent market survey, released this morning, the total notional outstanding of interest rate, credit and equity swaps was up slightly at June 30th 2009 from year-end 2008. Interest rate and equity swap notionals both increased about 2 percent.

Notionals, as you know, is one measure of activity and not risk. So it’s worth noting that the net mark to market exposure of all swaps outstanding is less than 1 percent of the notional amount.

CDS notional outstandings are down, as expected, due largely to portfolio compression. This decline should not be confused with a drop in trading volume, but instead to the industry’s efforts to streamline our business and reduce risk.

What’s behind the continued resiliency of our business? It’s clearly the need for customized risk management tools by companies around the world. You may recall a survey we conducted earlier this year of the Fortune Global 500 companies. Just over 94 percent of the sample -- 471 out of 500 companies -- report using derivatives to help manage their risks. That includes all of the companies on the list that are based in Switzerland, the U.K., Japan and the Netherlands. It also includes 97 percent of the US companies and 90 percent of the German firms on the list.

One of the reasons that activity remains solid is the strong infrastructure that we have put in place over the past 25 years. This has enabled the business – and in particular the CDS business – to function very well during the financial crisis.

As you know, CDS activity remained robust during the credit crunch and the market remained open throughout the crisis. In fact, it may have been the only credit product consistently available to allow companies and investors to transfer risk. In many instances, it was the only tool in the credit risk management toolbox that allowed firms to mitigate credit risk.

In addition, over the past year, there have been over 40 credit events in the CDS market. This means that over 40 companies that were reference entities experienced a credit event. And in all of these situations, the events were handled smoothly, with no major disruptions.

Privately negotiated derivatives today play an important role in the global economy. They do not eliminate risk, but they do enable one firm to shed the risks it does not want to another firm that is better able to manage them. And they are an important source of employment, value creation and innovation for our financial system.

Credit default swaps, for example, facilitate lending and corporate finance activity by allowing lenders to hedge the risk that a borrower will default, thereby freeing up capital to lend further. They also allow lenders to increase internal credit limits to specific borrowers. And they enable potential borrowers to transfer risk, thereby making them more attractive customers for financial institutions. All of this, of course, underscores the importance of fundamental credit analysis and credit risk management in today's financial markets.

CDS also serve a valuable signaling function. CDS prices produce better and more timely information because they rely on market-based information about a company's financial health. The recent trend of basing term loan pricing on CDS spreads as opposed to credit ratings illustrates their increasing value as a price information tool. And lastly, CDS allow investors to express their view on market conditions. This is an essential part of the market's price discovery function.

What Improvements Are Underway?

We in the privately negotiated derivatives industry do recognize our responsibility to strengthen and improve our industry. This in fact is ISDA's mission: to identify and reduce sources of risk in our business.

Let me assure you that it is a mission we are intensely and constantly focused on. The industry is being extremely proactive on operational and infrastructure improvements, working cooperatively with regulators and policy makers globally.

Towards this end, consider just a few of our major initiatives:

Centralized clearing is now a viable counterparty risk management option for CDS, and major dealers have committed to its use in major centers. It's important to note that while the industry is committed to clearing, we remain neutral as to any particular clearing solutions provider. We've been working since 2005, independent of regulatory oversight, to implement a central clearing house for credit derivative transactions. Since March, over $2 trillion of CDS have been cleared in North America and Europe. Earlier this month, ISDA and 15 large derivatives dealers publicly committed in a letter to the Federal Reserve Bank of New York that the firms would submit 95% of new eligible credit default swap trades for clearing beginning in October 2009.

Moreover, we are exploring options to use central clearing for other asset classes. Central clearing is already well established for interest rate swaps. In the September 8th commitment letter to the New York Fed, the industry took this a step further. The 15 dealers committed individually to clearing 90 percent of new eligible interest rate swap trades beginning December 2009.

We've also increased operational efficiency through industry-wide compression or 'tear-up' efforts. I mentioned this before…our portfolio compression efforts have helped to significantly reduce the notional amount of CDS outstanding, as reported in our market survey results issued today.

In addition to these developments, ISDA has implemented a number of initiatives to improve the resiliency and efficiency of the derivatives industry's infrastructure.

As an example: ISDA successfully launched the Big Bang Protocol earlier this year, which incorporated auction settlement terms into standard CDS documentation. It also incorporated Determinations Committee resolutions into the terms of standard CDS contracts. The Committees are comprised of dealer and buy-side representatives to determine whether credit events have taken place and what obligations can be delivered. The Big Bang Protocol is especially important as more than 40 credit events have been processed globally since October 2008.

Despite widespread dislocations in various financial markets, the industry continues to improve in other key areas, such as electronic processing, collateralized portfolio reconciliation and reduction in outstanding confirmations.

We are also enhancing market transparency in several important ways. We've appointed buy-side participants to join with the dealer community on the ISDA board and on many industry initiatives, such as the Determinations Committees.

We're also working to increase the flow of information on our business to the regulatory community as well as to the general public. Much more information on exposures and activity is available through DTCC's trade information warehouse. ISDA has also made available to all participants a CDS standard model that improves consistency and reduces operational differences regarding the calculation of CDS prices.

More recently, ISDA and industry participants have developed a request for proposals from vendors interested in helping to construct a trade information warehouse for interest rate swaps and for equity derivatives.

One of our most recent initiatives to improve transparency is ISDA CDS Marketplace, a website that brings together information, data and statistics on the CDS business.

ISDA CDS Marketplace was developed with the support of DTCC Deriv/SERV LLC, a subsidiary of The Depository Trust & Clearing Corporation (DTCC), Markit and Moody's Analytics.

The site is designed to enhance understanding of CDS by pulling together in one place key sources of information about the market.

It consists of four main sections:

About the CDS Market – which includes an overview of the CDS market, a summary of how credit default swaps work, key CDS facts, FAQs, and additional resources on the CDS business.

Daily Prices. This section provides daily prices and spread changes for a range of industry indices and single-name reference entities. This includes single name reference entities in North America and Europe with the largest increase or decrease in CDS prices for the most recent trading day.

The next section is Exposures & Activity – which contains information updated weekly on exposures, trading volumes and trading activity. For example, it lists the top 10 single-name reference entities with the most notional outstanding on a net and gross basis. This information is provided by DTCC Deriv/SERV LLC.

Finally, there is a Market Statistics section, which provides an understanding of notional amount, information on the ISDA Market Survey, and other data sources.

Current Public Policy Initiatives

All of these initiatives are part of our ongoing dialogue with policymakers around the world. As I am sure you can appreciate, ISDA continues to maintain active, two-way communications with regulators, supervisors and legislators in many countries and jurisdictions.

Today, there is a broad consensus for a comprehensive regulatory reform plan to modernize and protect the integrity of our financial system.

This includes:

- Appropriate regulation for all financial institutions that may pose a systemic risk to the financial system
- Stronger counterparty risk management, including clearinghouses
- Improved transparency and
- A strong, resilient operational infrastructure

Three Levels of Transparency in the U.S. Treasury Proposal

As you know, the US Treasury recently issued its proposal to amend the derivatives public policy framework. The Treasury proposal provides a framework for the effective use of CDS and other privately negotiated derivatives, while maintaining the benefits they provide to the broader economy. The new framework calls for trades to be cleared or, if not cleared, to be reported to a trade repository.

Broadly speaking, the proposal is an important step forward in bringing greater transparency in three key areas of risk.

These areas include:

First, transparency between and among counterparties regarding the value of the risks they are taking on. Central clearing is the major solution here as the CCP would stand between counterparties on transactions that are cleared through it. I should add here that we believe that clearing is an appropriate solution not only for the dealer community but for the buy-side as well. Toward that end we recently authored a report - that can be found on the ISDA website - to key regulators on the proposals of centralized CDS solutions for the segregation and portability of customer CDS positions and related margin.

It is our goal and commitment to achieve buy-side access to CDS clearing (through either direct CCP membership or customer clearing) with customer initial margin segregation and portability of customer transactions no later than December 15, 2009.

The second area that you see highlighted on the chart is market transparency or transparency for market participants and investors. The solution here is pre-trade price transparency, which can be accomplished in several ways. Electronic execution platforms, for example, would improve price transparency – as would exchange trading. In fact, exchange trading of some of the most standardized derivatives contracts is an initiative some industry participants are currently working on.

The third level of transparency in the U.S. Treasury proposal is better disclosure of risks to supervisors. This can be accomplished by routing all transactions through trade repositories, as well as by benchmarking the industry's continued progress in reducing operational risk.

Current Public Policy Issues

While there is widespread consensus on many key financial industry public policy issues, there are some aspects of the debate that remain unresolved. In short, efforts to strengthen and improve the resiliency of the system have widespread support. Efforts to restrict the availability or impede the proper functioning of the markets are of great concern to ISDA and the industry.

For example, most but not all of the proposals being floated recognize the continued need for customized OTC derivatives. It is obviously of great concern to ISDA and our member organizations that any future public policy framework retains for firms the ability to customize risk management tools to address particular business and financial needs. It's become clear over the past two decades that the customized nature of OTC derivatives provides important benefits to the economy and the financial system. This needs to be preserved going forward.

Given their inherent nature – as flexible risk management tools designed specifically to meet particular needs – it follows that not all OTC products can be cleared through central counterparty clearing facilities. No doubt there will be a robust discussion as to exactly what constitutes a standardized versus a customized derivative. That's a discussion that we in the industry are currently engaged in and are working hard to define.

It's less likely, however, that there's sufficient room to agree that ALL OTC products trade on an exchange. In fact, mandating that ALL interest rate swaps or credit default swaps be traded on an exchange is likely to result only in 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.

The bottom line here is simply this: retaining customization of derivative products is absolutely essential to helping thousands of firms around the world preserve their ability to more effectively manage risk. While continued standardization of operations is important there will always remain risks that can not be properly managed through an off-the-shelf product. We continue to urge regulators to keep this important fact in sight as they work on their reform proposals.

Another issue that is raising a lot of questions within the industry is the proposal by some to ban speculative CDS trading. Such a ban would restrict the ability to buy protection only to owners of specific bonds or loans. It could also restrict the ability to sell protection to firms that are short the debt. Firms that were trying to hedge economic exposure to, or express a view on the creditworthiness of a particular reference entity, would not be able to do so using CDS.

The drawbacks to this approach are substantial.

First, fewer firms would be willing to sell CDS protection, which would likely cause the price of using CDS to increase. It would also cause the supply of credit to ***decrease*** as firms became more cautious about taking on risk they could not hedge. The end result is likely to be 1) less economic activity, 2) more risk, not less and 3) higher cost to credit provision.

There's another important role that CDS play in the global economy today that would be distorted by the ban on naked shorting. Consider that central bankers now use swaps prices to understand interest rate expectations and help them make decisions about monetary policies. As I mentioned before, the U.K. Government's 2008 Credit Guarantee Scheme is priced off of the five-year CDS spread. Rating agencies have begun to track the information about the credit quality of borrowers that is contained in the price of credit default swaps to identify changes in market opinion. The fact is, CDS help provide a more accurate view of the price of credit and the creditworthiness of borrowers. But to have that view, you need to have liquid, robust, two-way markets.

There's one additional point that I would like to touch on regarding our discussion of public policy issues. It's the very real need for policymakers to coordinate their efforts globally. This is important both to ensure consistency of purpose and approach in different jurisdictions as well as to minimize duplication of effort across borders. ISDA strongly encourages policymakers to take similar and consistent approaches towards any new regulatory paradigm, in order to keep derivatives flexible and robust for the businesses that use them to manage risk.

OTC Derivatives: The Road Ahead

So where does all of this leave us? Where is the privately negotiated derivatives market headed?

First and foremost, it's my belief that the need to better manage risk will continue to drive demand for OTC derivatives…and that they will remain vital risk management tools. These custom-tailored, bilateral contracts are used by more counterparties in more countries in more ways than ever before.

There is in fact a robust infrastructure for CDS and other swaps that has been developed over the past 25 years by ISDA, industry participants and policymakers around the world. The growth, strength and success of the business could not have been achieved without it. And the financial system would now be weaker but for its existence.

If I look to the future of our business, I see many potential areas of growth. From the volatility of the real estate markets to the long-term focus of pension fund management, from the risk that weather poses to economic activity to the risks of mortality…there will continue to be efforts to better understand, assess, analyze and ultimately to manage risk. Derivatives will play an important part of that process.

The same is true for companies, financial institutions and other firms operating in the BRIC countries – Brazil, Russia, India and China – as well as in other geographies. Clearly use of derivatives needs to be accompanied by prudent risk management practices and processes. But I think we will see derivatives activity continue to grow in these regions.

The framework that ISDA and the industry have put in place in the derivatives industry has enabled the business to flourish. Thousands of companies around the world use derivatives today to better manage risk. However, there's a lot of additional work ahead to make our business and our financial system stronger and more resilient, and ISDA intends to lead and participate in these initiatives in a constructive way.

As we move forward, we will continue to be guided by a few enduring principles that have served our Association and our industry well since our founding in 1985. We will, as always, bring the incredible talent and resources of our global membership base to address the issues we face. We will remain proactive in identifying and reducing the sources of risk in our business. And we will remain committed to working on a broad number of fronts – risk management, operations, trading practices, legal, technology – to further strengthen our industry's robust and resilient infrastructure.

Thank you again for your time and attention. I hope you will find today's conference interesting and useful.

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