Remarks of Conrad Voldstad,
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OBSERVATIONS ON THE CREDIT CRISIS

Good morning, ladies and gentlemen. I am delighted to be here at my first Annual General Meeting as CEO of ISDA. As you may know, I go way back in derivatives, having executed my first interest rate swap in 1983 at JP Morgan. I also helped work on the first ISDA Master Agreement when I headed Morgan's global swap group.

Flash forward more than two decades and I'm still dealing with ISDAs. In fact, I negotiated 8 ISDAs without the benefit of counsel while managing a fixed income hedge fund several years ago. I also executed ISDAs with three firms for my own account. I am sure some of the lawyers in this room might be disappointed by this news, but it does evidence the strength and integrity of the document. That's no doubt why the ISDA Master and related documentation have played such an important role in the OTC derivatives business.

I am not, however, here today to recount ISDA's many successes. Rather, I want to share with you my views on the credit crisis and the state of our industry today. I want to cut through the rhetoric surrounding the debate and take a hard look at some facts.

A quick word about my background. While at Merrill Lynch, we formed the first AAA derivatives product company. In many ways, this was one of the first CDOs, except one had to model the uncertainty of derivative exposure. We actually had to teach the rating agencies how to model credit rating movements over time and how interest rate and exchange rates fluctuations created credit exposure. When I ran global debt markets at Merrill Lynch, I also was asked to join five other professionals from big dealer firms to work full-time on the LTCM unwind. This gave me a good sense of risk management as well as the power of the markets to do the unexpected. I think the credit squeeze in 1998 was calculated to be a five or six sigma event. It was not a hundred year flood but a multi-thousand year flood. Funny how these floods seem to happen every five years or so.

Before starting the hedge fund, I was a consultant for a European bank which executed a synthetic CLO for regulatory capital relief. At the hedge fund itself, we concentrated on directional and relative value interest rate trading. We executed a few CDS to play on government bond swap spreads but mostly did interest rate swaps and options as well as municipal swaps. We closed down the fund in early 2007 and fortunately missed out on the rapidly growing RMBS structured finance business.

But at about the same time, I was recruited to sit on the board of a public credit reinsurer, which gave me a ringside seat to the financial myopia and meltdown of the past couple of years.

The reinsurance industry's business model was to execute reinsurance treaties with the big AAA monolines. You agreed to reinsure a portion of the monoline’s policies. You established limits based upon existing exposures and credit ratings. You could exclude credits and types of products but that basically meant you had to know in advance what the monolines would be underwriting. The Board, of course, would review the new exposures, typically with several months' lag time.

In late 2006 and the first half of 2007, we were deluged with wave after wave of real estate related exposure…HELOCs, Closed End Seconds, subprime, Alt-As, CDOs of RMBS, CMBS and CDOs of CMBS.

As we looked at the risk, we began to worry. Worry soon led to great concern, if not alarm. We saw that HELOCs were 100% securitized. The originator had no skin in the game and HELOC borrowers were certainly not prime. We learned that Closed End Seconds could be used to eliminate the down payment on a home purchase. Subprimes might include NINJA loans while Alt-As might have a large portion of no income verification mortgages.

Then we got a lesson in RMBS CDOs. We took some comfort at first in the "high grade" CDOs. They contained pools of RMBS collateral but also other securities that were rated A or better. But then we found that the A credits in the structure were generally pieces of other RMBS securitizations or of other CDOs. Of course A tranches of securitizations and CDOs are very thin and the loss given default was essentially 100%. We saw the same techniques applied to CDOs of CMBS. We were given $800 million of one CDO and were stunned to see it contained virtually 100% of BBB CMBS tranches. The worst were the mezzanine CDOs, composed of tranches of RMBS pools and tranches of other CDOs rated BBB or worse. Somehow, parts of these were rated AAA and there were even super senior tranches as well. Less than a year from issuance many of these CDO's were being liquidated for 10 cent on the dollar!

What was happening? I started my banking career many years ago in commercial lending and could not believe what I saw.

Relatively quickly, we decided to reduce risk. If we could. We had one factor in our favor. We saw what the Wall Street firms were doing with their marks and it didn't match up with the marks we saw from the monolines on similar exposures. So we approached the monolines and eventually commuted virtually all our CDOs and a large majority of our RMBS exposure. Today, the company is much smaller, still possessing some structured finance exposure and a good size chunk of long-dated public finance exposure, sitting on a sliver of capital. I am no longer on the Board but do follow its progress.

While we were busy coming to grips with our losses – asking ourselves if smart people could really underwrite this stuff -- we saw several banking titans suffer greatly from the same toxic formula. Each had mountains of super senior subprime CDO exposure. And each of these mountains had as many billions of dollars at risk as Mount Everest had thousands of feet of altitude.

Write-offs and capital raises were coming fast and furious. Numerous banks had "modest" write-offs on their retained exposures, amounting to less than $10 billion. Next came the write-offs on exposures to monolines. The banks saw the monolines had taken on much too much risk and could no longer stand behind their promises. One by one, the monolines disappeared or went into run-off mode. As of this writing, only one is left standing: Assured Guaranty/FSA.

As a bit of a side show, an old friend of mine and I had been working on a project to create a new CDPC, rated AAA, of course, and unique in that it would be able to post collateral on CDS contracts. We partnered with a fine international bank and our counterparts there ran two conservative SIVs in London. I had been familiar with SIVs since the 1980s but was surprised to see how the newer breed had changed its investing strategy from very conservative securities to -- you guessed it -- RMBS. Our counterparts were old school lenders trapped by the liquidity squeeze just as we were nearing a deal with one or two major investors. My friend and I feel fortunate that the investors thought it was not the time to invest in credit. But the experience gave us a great view of the losses banks were taking on SIVs.

While all of this was happening in structured credit, Bear Stearns was rescued and its mortgage assets left with the Fed. The GSEs, which invested solely in real estate, were put into conservatorship and then Lehman fell, mostly because of its real estate exposure.

Then the grand daddy of them all was teetering on the brink. AIG had written protection on hundreds of billions of dollars of CDOs of RMBS as well as protection on corporate loan portfolios (CLOs). AIG had stopped writing protection on RMBS risk at the end of 2005 but in the summer of 2008, the prices of these instruments began to fall significantly. In addition, they were "smart" enough to add subprime mortgages into their bond-lending program. This meant they were long sub prime and could obtain smaller and smaller amounts of cash to finance their positions as this value declined. Within a couple of weeks, Washington Mutual was seized and sold to JP Morgan and Wachovia merged with Wells Fargo. Both were victims of the sub prime mortgage meltdown.

So that's how I saw the world in 2007 and 2008. Very poor real estate lending (or underwriting), perplexing ratings, shoddy securitization practices, some fraud, negligent regulation and a dash of greed at each stage of the process led to massive writedowns. With the banks continually writing off exposures, it became impossible to figure out what their ultimate losses would be. Concern about the banks led to widening credit spreads which led to near panic when Lehman fell.

As the financial conditions of the dealers deteriorated, a dormant risk emerged. That risk had to do with the interconnectedness of the financial system, as exemplified by Lehman and its derivatives portfolio. If a major swap dealer went down, what would happen to the other dealers that had trillions of dollars in notional values of contracts with Lehman? Might they go down as well, creating a cascading or domino effect?

As history has shown, the financial system suffered from the Lehman default, but the losses were contained. They were contained, in large part, due to actions the industry had taken in concert with its regulators, the NY Fed and its global counterparts. Confirmation backlogs had largely disappeared, portfolios of contracts reconciled and largely agreed with respect to valuations. A large portion of Lehman's interdealer interest rate swap book had been cleared through the LCH and the well-practiced unwind process worked well. Government support in the wake of AIG's failure also helped contain these losses and ensured the problems were not exacerbated.

About 14 months after these events, I joined ISDA. Late November of 2009, to be exact. I found an industry in much better shape than the credit insurance industry I had just left. It was also one that was determined to make itself safer and more efficient. It didn't hurt to have regulators breathing down its back. Legislation was also in process, in the US and around the world.

What surprised me, though, was the gap between the perceptions of the credit crisis and what I viewed as the reality of that situation. Particularly with regard to the role of derivatives. Now I know that what I say might be dismissed as another apology for the industry. So I started analyzing numbers published by Bloomberg on the losses experienced by international banks, insurance companies, and the two US GSEs. I was struck by how strongly it confirmed my initial views.

Bloomberg counted $1.7 trillion of losses among these institutions though the end of 2009. Institutions categorize losses in different ways and we could not be sure that Bloomberg (or anyone else) could do this exercise with 100% accuracy. Of the total $1.7 trillion, approximately $778 Bn of losses appear to be unspecified, probably credit cards, or as additions to loan loss reserves. Of the balance, $686 Bn were exposures to real estate, monolines, CDOs, SIVs and asset backed or auction related securities. The balance consisted of CDS ($65 Bn), corporate ($72 Bn), leveraged loan ($33 BN), trading ($41 Bn) and $59 BN was taken through other comprehensive income.

Fully 72% of the identified losses were of the sort I felt created the crisis. Certainly, little could be laid at the door of plain vanilla derivatives (if we can call the $65 Bn of CDS losses little and only $18 Bn was sold by non insurance companies.) By the way, the largest losers by far are the GSEs, a total of nearly $260 billion as of the date of the analysis.

Finally, let's go back to Lehman. There was a massive unwind of derivative positions when Lehman filed for bankruptcy. I wanted to get a feel for the losses of corporations -- end users -- in the great unwind. I examined the web for the claims of counterparties against LBSF, its derivatives and special products company. I looked only at claims over $20 million and ignored claims made on LBSF by other Lehman entities. In all there were about 275 claims, totaling over $50 Bn. There were hundreds of claims by banks, insurance companies, investment managers and financing vehicles. There were five non financial corporate claimants. Their total claim was less than $250 mm. There was one other claim tied to auction rate securities when the monoline failed.

What do we take away from these two facts? A couple of things.

First, the root cause of the big losses – and the credit crisis itself -- were cash and derivative securities wrapped around bad lending decisions either in plain vanilla or complex forms. The losses of the banks to the monolines will most likely exceed the losses the US government will have with AIG.

How do you resolve the risk issues in the derivatives marketplace? First, the big losses occurred in complex transactions that cannot be cleared. Regulation must be geared to find and regulate the next AIG or the next monoline. In a perverse sense, that will be easier to do, as the monolines are virtually gone and no one will touch CDOs of RMBS.

Second, corporate end-users did not create significant derivative risk nor did they suffer large derivative losses. The case for mandatory clearing of their derivatives activity does not rest on systemic risk. Corporates should be able to manage their risk either through clearing houses, if they are available, or through bilateral contracts.

Third, the interconnectivity of dealers must be addressed. While $50 Bn+ of claims on Lehman did not sink the economy, it certainly did not help and it could have weakened other dealers enough that they would not have survived if AIG defaulted - a delayed domino effect. Furthermore, a large number of Lehman's biggest claimants were derivatives dealers and their claims might have been much smaller if a much larger percentage of its trades had been cleared. That’s why we need to continue our progress in clearing interdealer trades.

Fourth, the issues of trading derivatives on exchanges are unrelated to credit markets. I'd like to wrap up my comments with one thought. Much of the debate over the causes of the financial crisis has so far been based more upon rhetoric and less on facts. There has been no estimate made as to the economic benefits or, more appropriately, the economic costs of regulation. There has been a misguided belief that exchange trading will bring more liquidity and better pricing to one of the most liquid and most efficient markets in the world. There has been some confusion, deliberate or not, about exchange trading reducing the risks of derivatives. One wonders why there is such concern over the exchange trading of derivatives when governments themselves permit their own markets -- the government bond markets -- to be traded OTC.