“The Future of the OTC Derivatives Market”
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Good morning… and thank you (name) for your kind introduction. I am very pleased to be part of this terrific conference. BM&F Bovespa has done a wonderful job organizing this event, and I deeply appreciate the opportunity to be here with all of you.

As I am sure you are aware, last month the Financial Times newspaper did a special report on Brazil. The lead story was titled “Dancing through the Economic Crisis,” and it discussed how well Brazil was faring during the current economic and financial downturn. With the world’s 8th largest economy, in terms of purchasing power, and with America’s second largest economy, Brazil is certainly an important engine for global economic growth.

One of the important reasons the FT cited for the country’s relative success was that: “throughout all the turbulence, Brazil’s capital markets have remained unshaken.” Our hosts at BM&FBovespa certainly deserve credit for their role in helping Brazil to successfully navigate through this turbulence. Over the years, important steps have been taken to strengthen the financial trading framework in Brazil, in areas ranging from electronic trading to clearing and depository services. As a result of these actions, it’s no surprise that BM&FBovespa today ranks as the world’s 4th largest exchange measured by market capitalization and 5th largest by trading volume.

There is, of course, a long tradition of derivatives trading in Brazil within BM&FBovespa and its predecessor organizations. Given the Brazilian economy’s size and diversity, this is not surprising. It’s my understanding that exchange trading of derivatives began over 80 years ago in 1917. OTC derivatives trading began far more recently, during the 1990s.

The organization that I represent today, ISDA, has been active with our members in South America and in this country for much of the time that OTC derivatives trading has occurred. We have encouraged and followed the development of the derivatives business as well as its regulatory and legal framework. ISDA has also organized conferences in the country and the region.

This conference comes at a very important time in the global derivatives industry. We are currently in a period of intense scrutiny by policymakers and regulatory or legislative action on a number of fronts in a number of jurisdictions seems likely.

During this period, it seems appropriate – in fact, it seems almost mandatory – that we take both a look back, and also take a look ahead. We need to analyze and assess the events of the financial crisis during the past year and a half and truly discover what happened and why. It seems to me that only then – only after this period of analysis – will we be able to plot our future course.

And that is exactly my focus this morning. I would like to review with you the evolution of the derivatives business, discuss its role during the financial crisis and how it performed during that time. Then I'll cover the many industry initiatives in place to further improve and strengthen the business, along with current public policy initiatives. I'll wrap up by briefly discussing how I see our business evolving in the future.

As I do so, I hope to spark a dialogue with all of you. There are clearly some false assumptions about our business that need to be challenged. At the same time, there are legitimate public policy considerations that need to be addressed. It's critical that we have an accurate understanding of the problem so that we can develop solutions that strengthen rather than weaken the financial system and economic activity.

So let me start with a brief review of ISDA.

Since its founding in 1985, the Association has focused on its core mission: identifying and reducing sources of risk in the privately negotiated derivatives business.

How do we do this? In many different ways:

- Through our pioneering work in documentation;
- By building a legal framework in a number of jurisdictions that helps to ensure the legal certainty of the ISDA Master Agreement and its netting provisions
- Through our on-going efforts to improve the industry's operational infrastructure.
- And by facilitating collateral management and helping firms more effectively manage credit exposures.

In these and in many other ways, ISDA has helped to mitigate and reduce the legal, credit and operational risks of the derivatives business.

In fact, I think it's fair to say that ISDA's contributions over the years are one of the principal reasons behind the industry's growth and stability. They are certainly the primary reason behind the ***Association***'s growth. Today, ISDA stands as a truly global organization with some 830 members from 57 countries on six continents. These members include most of the world's major derivatives dealers, as well as many businesses, governmental entities and other end users.

I think it's important to talk upfront about the different types of derivatives that exist today.

ISDA represents participants in the privately negotiated, or over the counter, derivatives business. These are bilateral contracts between two counterparties, and their terms are typically customized to meet the particular needs of firms.

In fact, it's the ability to custom tailor risk management solutions to meet the particular needs of firms around the world that defines the OTC derivatives business. Without this ability, the industry would cease to exist. The exchange traded market would lose an important source of hedging activity. End-users would not be able to manage their risks as efficiently as they otherwise could.

OTC derivatives obviously differ from exchange traded derivatives…and both of these financial instruments are often lumped together with CDOs or collateralized debt obligations. These CDOs are actually securities and are sometimes called derivative securities.

There are, of course, important differences between the different types of products. They are used for different purposes by different types of end-customers…though in the case of exchange and OTC derivatives, firms typically use one market to hedge their exposure in the other.

It's important to keep in mind that the primary purpose of OTC derivatives is to transfer risk. That's what they do; 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.

In addition to providing essential risk management tools for a broad swath of users, the OTC derivatives business plays an important role in the growth and functioning of the world economy. It is 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 reduce risk, thereby making them more attractive customers for financial institutions.

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.

The market's liquidity and usefulness in pricing credit is demonstrated by The U.K. Government's 2008 Credit Guarantee Scheme. Firms participating in the plan will pay a fee based on their five-year CDS spread.

And lastly, CDS allow investors to express their view on market conditions. This is an essential part of the market's price discovery function.

OTC derivatives are today widely used around the world. ISDA recently conducted a survey of Fortune Global 500 companies, and just over 94 percent of the sample -- 471 out of 500 companies -- report using derivatives to help manage their risks.

All five Brazilian companies in the Fortune Global 500 use OTC derivatives. That puts Brazil in the company of countries like Switzerland, the U.K., Japan and the Netherlands; 100 percent of the Global 500 companies from those countries also report using OTC derivatives. Germany and the US are right behind at 97 and 90 percent respectively. In Asia, OTC derivatives usage is also growing amongst South Korean and Chinese firms.

If you look at usage by asset class, the largest number of companies – 441 – report using FX derivatives, followed by interest rate swaps at 416 companies. 240 companies said they use commodity derivatives, 143 used equity derivatives and 101 reported using credit derivatives.

In addition to ISDA's research, a broader survey of 6900 non-financial firms in 47 countries was conducted earlier this decade by professors at Lancaster University and the University of North Carolina at Chapel Hill. It found that 60 percent used financial derivatives, with FX derivatives being the most common, used by 45 percent of the total. Of the 2076 US companies in the survey about 65 percent used OTC derivatives. There were 16 Brazilian companies included in the survey, and 81 percent used at least one type of OTC derivative.

Because of the important role they play in enabling firms to more precisely manage risk, the derivatives business has grown significantly in a relatively short period of time.

At the end of 2008, the OTC derivatives market totaled about $450 trillion in notional amount.

Now $450 trillion is a large number, but let's look at what it really means. And as we do so, I hope it becomes clear to everyone that notional is not a measurement of risk. Notional is a measure of activity. It is not and never has been an accurate measure of exposure or risk. In fact, it grossly overstates the risks of the business.

So then why does the industry use notional? It's a good question. The truth is, notional is relatively simple to identify and gather. In addition, it is consistent over time; that is, the notional for a deal does not change except in limited cases that are not likely to have a significant effect on the overall measure.

So it's important **not** to mistake gross notional as an expression of risk. But what figures do provide a more effective risk measurement? The Bank for International Settlements reports two numbers that are more closely related to risk than are notional amounts.

The first is gross market value, also called replacement value, which is the estimated amount that could be received or paid for unwinding a transaction. The gross market value of derivatives transactions is estimated at between 2% and 6% of notional. That's roughly $9 to $27 trillion of the $450 trillion in notional outstanding.

The second is net credit exposure, which represents the current value of contracts that have a positive market value after taking account of legally enforceable bilateral netting agreements.

In other words, it measures netted credit exposure between counterparties. Net credit exposure is estimated to be 1% or less of notional. That's about $4.5 trillion.

Collateral, of course, further reduces credit exposure. And as I will show on the next slide, collateralization is a trend that continues to grow in the OTC derivatives market.

ISDA annually conducts a margin survey that tracks and measures collateral usage and practices. And according to the most recent research, collateral coverage is widespread and it continues to grow, both in terms of trade volume subject to collateral agreements and of credit exposure covered by collateral.

The number of reported collateral agreements in place grew to almost 151,000, of which about 87 percent are ISDA agreements.

For all OTC derivatives, 65 percent of trades are subject to collateral agreements, compared with 63 percent last year and 30 percent in 2003. Among large dealers, the median coverage is 87%.

Further, 66 percent of OTC derivative credit exposure is now covered by collateral compared with 65 percent last year and 29 percent in 2003.

So let me sum up by saying that while notional amount is the statistic we use to measure activity, it's not a good measure of exposure. The net credit exposure of derivatives is about 1% of the notional amount – some $4.5 trillion – and most of that exposure is collateralized.

So that gives you a snapshot of the global OTC derivatives market, in terms of its notional amount and the underlying exposure. I'd now like to focus in on one particular aspect of this market that has received a lot of attention in the past year or so: the credit default swaps business.

As you can see from this slide, the CDS market grew quite quickly until recently. Since then, it's contracted sharply. What exactly is going on here?

Two things. First, starting in 2008 the notional amount outstanding of the CDS market did start to decrease. That's largely because of the industry's efforts to reduce their CDS portfolios by eliminating trades that offset each other. It's what we in the industry call portfolio compression. By cancelling out economically offsetting transactions, firms reduce the cost and operational workload of managing those transactions.

So portfolio compression is a positive for individual firms and for the CDS business as a whole. But sometimes, people will look at this chart and misinterpret it and say, the CDS market is shrinking. They'll see the numbers and think, wow, the CDS market has been cut in half.

Which leads me to my second point: the decline in the size of the business is **not** due to a decline in activity. If anything, I think CDS activity during the financial turmoil in the third and fourth quarters of 2008 and early 2009 was robust.

Even after portfolio compression, the notional amount outstanding of CDS remains large: about $26 trillion at midyear. As I mentioned, however, the notional number doesn't accurately represent the risks of the business. For that, we need to look more closely at the net notional outstanding.

In this chart, we compare the two figures – the gross notional and the net notional. As you can see, the overall gross notional is $26 trillion and the net notional is less than 10 percent of that, or $2.5 trillion.

What's the difference between the two numbers?

Gross notional is simply the sum of all the CDS contracts bought or sold. For example, if I sold $10 million of protection on IBM, and then bought $10 million of protection on IBM to offset this exposure, that would be reported as $20 million of gross notional.

Net notional, by contrast, is the sum of the net protection bought by net buyers. In the example I just gave, the net notional would be $10 million. I sold and then bought the same amount of protection on the same firm, so economically I have no exposure. The only exposure in this case is at the firm that sold me protection.

Net notional is an important concept and just to be clear, it represents 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.

As you can see, there's quite a difference between gross and net notional. And consider also that the net notional represents the total possible losses if every reference entity were to default. It also does not take into account recovery rates in the event of a default, and it is before netting and collateral.

My point here is that the real exposure of the CDS market is a fraction of the notional amount we hear quoted so often. It's currently $2.5 trillion. And keep in mind that this figure represents the total amount that would be paid if every reference entity in the world were to default, and it assumes that the recovery rates on those defaults would be zero.

I think misunderstandings about the size and the risk of the CDS market is probably the major reason there are so many misperceptions about the business and its role during the financial crisis.

If we're going to build a strong, resilient financial system, and an appropriate public policy framework, it's important that we address these misperceptions.

For example, did CDS cause the financial crisis? Did they pose systemic risks? How has the CDS market performed during the market turmoil? What improvements are underway to strengthen the business?

I think it's clear at this point that the answer to this question – Did CDS cause the financial crisis – is no. The root cause of the financial crisis is generally believed to lie in housing finance. Too many mortgage loans were made to too many borrowers who could not repay them. Many of the loans were sold to investors around the globe as mortgage backed securities. Some of those MBS were packaged into securities called collateralized debt obligations.

Making matters worse: Default assumptions on those mortgages were incorrect and as a result the securities were incorrectly priced. As a major correction in the price of credit took hold, demand shrank, supply grew, prices fell and eventually markets froze. Participants in the financial markets became wary of doing business with and extending credit to each other.

None of this, of course, has anything to do with derivatives or credit default swaps.

OK, some might say, CDS may not have caused the financial crisis…but didn't they make it worse? Didn't they pose systemic risk issues that almost brought the financial world to its knees? Bear Stearns and Lehman are frequently cited as examples.

I understand the concerns that have been voiced about CDS and the risks that some thought they posed during the very difficult March to September period last year. There was a great deal of uncertainty in the markets and throughout the economy as a whole. Policymakers were working 24/7 to mitigate and prevent a global financial meltdown. Industry leaders had to confront problems they had never encountered – and probably had never imagined – before.

This is why the industry is so committed to working constructively with policymakers to strengthen the system and increase its resiliency. We all have an important role to play in this process.

An important part of the process is ensuring that we all have the right information…that we not only have our facts right but that we have the right facts.

So let's look at them…and as we do so we can see that Bear's problems stemmed not from their CDS portfolio, but from a lack of confidence from its lenders, who refused to roll over their short-term funding of the company. In a sense, it was a classic liquidity squeeze: a balance sheet that relied on short-term financing to fund long-term illiquid positions.

It was only 18 months ago, but if you can remember back then, the principal issue regarding CDS in the Bear Stearns situation was whether Bear had too many CDS trades with too many counterparties…the fear was that if it failed, it could bring down other firms.

The interesting thing is that over the ensuing few months…from March to September…that fear was replaced. By the time of the Lehman debacle, the issue was not Lehman's viability as a counterparty, it was the level of CDS protection that had been written on Lehman as a reference entity.

I well remember the uncertainty that hung over the markets as everyone wondered exactly how much exposure there was at Lehman. Eventually, as you may know, Depository Trust published data showing that the net notional amount of CDS protection on Lehman was some $5 billion. The Lehman default went relatively smoothly. Certainly there were no major issues from a CDS perspective.

The failure of Lehman as well as other high profile failures provided a very real test of the strength of the CDS market, and OTC derivatives more generally. In all of these instances, the ISDA framework greatly reduced counterparty credit risk enabling efficient contract settlement and allowing the CDS, and OTC market generally, to operate smoothly. But at the same time, the uncertainty and lack of information in the markets impeded financial activity and helped to freeze important sectors of the cash markets.

I think this is an important point that often gets overlooked: the CDS business has functioned very well during the financial crisis.

CDS activity has 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.

In fact, earlier this year, the Senior Supervisor's Group, which consists of senior financial supervisors from the U.S., U.K., Germany, Japan, France, Switzerland and Canada, assessed how well firms manage their credit derivatives activities and positions following a credit event. The report they issued noted that "according to all surveyed participants, (the credit events) were managed in an orderly fashion, with no major operational disruptions."

There is an American movie that came out a few years, starring Bill Murray, the comedian. It's called "What About Bob?' and in the movie the Bill Murray character, Bob, keeps popping up in the lives of one family. No matter what they do or where they go, Bob is always part of the picture.

So it is with AIG. There's not a discussion that goes by about the CDS market without these three words coming up…what about AIG?

So let's ask ourselves, ***what about AIG?***

AIG is clearly the Achilles heel of the CDS business in today's public policy discussions. The fact is, AIG's Financial Products subsidiary took on too much exposure to subprime mortgage debt…and they did so using CDS. Not only could they have taken on the same type and level of exposure in other ways, they actually did – through their securities lending operation.

So that's just a simple fact. But here are some other facts about AIG as well. First, AIG took on way too much risk, notwithstanding how they did so, they took on too much risk with not enough capital, liquidity, collateral and risk management in place. As a result, when the ratings on the reference entities that AIG sold protection on were downgraded, the company's own ratings came under pressure, and the company was forced to post ever increasing amounts of collateral that it could not raise.

Despite impressions to the contrary, it's clear that AIG was in fact regulated. Its supervisors apparently knew how much mortgage risk it was taking on in its credit protection and securities lending business. They also knew that AIG included ratings triggers and collateral requirements in its contracts in order to gain additional counterparty capacity.

It's worth noting here that a hedge fund would not have been allowed to build up such a large, uncollateralized positions with so many counterparties. In fact AIG Financial Products operated far less conservatively than most hedge funds or, for that matter, other businesses engaged in similar activities.

In short, the AIG issue was a collective risk, liquidity and collateral management failure, facilitated by poor supervision and an overreliance on rating agency models. AIG was clearly an outlier in many of its business practices and polices.

One U.S. Congressmen put the situation in perspective during a recent committee hearing when he said: "…we must not be overwhelmed by the fact that one high profile financial institution, AIG, made a bad investment decision, using derivatives to guarantee mortgages that went sour."

We in the privately negotiated derivatives industry do recognize our responsibility to strengthen and improve our industry. As I mentioned, this 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:

We've added centralized clearing as a counterparty risk management option for CDS, and committed to its use by major dealers 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, approximately $1.7 trillion of CDS have been cleared in North America. Approximately €38 billion of CDS have been cleared in Europe since July.

Moreover, we are exploring options to use central clearing for other asset classes. It probably goes without saying that central clearing is already well established for interest rate swaps.

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 by approximately half.

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 in April, 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 ehat 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.

For example, electronic matching rates of eligible confirmation events increased from 69 percent in 2007 to 85 percent in 2008 for equity derivatives, 70 percent to 78 percent for interest rate derivatives and 96 percent to 98 percent in CDS.

In terms of confirmation backlog reductions, aged confirmations continue to steadily decline. Equity derivatives, for example, show 1.3 business days' worth of outstanding confirmations in 2008, compared with 2.4 days for 2007. Interest rate derivatives decrease from 1.3 to 0.7 days and CDS decrease from 0.3 to 0.1 days.

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 Committee.

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. This would be similar to what you have here in Brazil and also to what DTCC provides for CDS.

There are today a vast number of initiatives and improvements underway by many different participants in the OTC derivatives industry. While we as the industry association should and do remain neutral on individual vendors, this chart attempts to categorize and summarize them in four key areas, which you can see broken down in the boxes in the left column: central clearing, electronic execution, matching and confirmation, and trade repository.

Across the top, the initiatives are categorized by asset class: from left to right, equity derivatives, FX, rates, credit default swaps and commodity derivatives.

The white bars indicate options that currently exist in these areas. The blue coloring indicates those that are underway.

As you can see, there are a significant number of options currently available in the execution and confirm areas. That's not surprising: these are where the industry has devoted much time and resources over the past 2 or 3 years.

As I mentioned before, we're also making a lot of progress in central clearing. In terms of trade repository, DTCC currently offers a robust solution for CDS. We expect to see substantial progress in other asset classes. As I noted, we've recently issued an RFP for a trade information warehouse for interest rate swaps.

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.

Exposures & Activity – which contains information updated weekly on exposures, trading volumes and trading activity.

Market Statistics. This section provides an understanding of notional amount, information on the ISDA Market Survey, and other data sources.

As we look closer at the Daily Prices section of the website, we see that it lists the single name reference entities in North America and Europe with the largest increase or decrease in CDS prices for the most recent trading day. A CDS price chart is also available by clicking on each reference entity. This CDS price information is supplied by Moody's Analytics.

The Exposures & Activity section lists the single-name reference entities with the most notional outstanding on a net and gross basis. This information is provided by DTCC Deriv/SERV LLC, a subsidiary of The Depository Trust & Clearing Corporation.

As you can see, the Federative Republic of Brazil is included in these Top 10 CDS Positions, along with a number of other sovereigns such as Italy, Spain, Germany, Greece and Austria.

The net notional amount of CDS outstanding on Brazil is roughly $9.8 billion as of August 1. That's the maximum payout that would be made by protection sellers if Brazil defaulted on its debt, and it's before recovery values. By the way, the gross notional amount is $119 billion. It's a big difference, as mentioned earlier.

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

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. This is similar to the process that exists in Brazil today; I understand that a central registry and trade reporting system has existed here for several years.

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 to the Supervisors of major OTC derivatives dealers on the proposals of centralized CDS solutions for the segregation and portability of customer CDS positions and related margin.
It is our goal 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.

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.

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 OK…that's a discussion that we in the industry will be happy to have and we believe there is enough room to find agreement.

It's less likely, however, that there's sufficient room to agree that all OTC products trade on an exchange. In fact, mandating that 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 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. What happens when supply decreases and demand does not? Prices rise…and that's what would happen to interest rates paid by borrowers. The end result is likely to be less economic activity and more risk, not less.

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 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.

So where does all of this leave us? Where is the privately negotiated derivatives 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 board number of fronts – risk management, operations, trading practices, legal, technology – to further strengthen our industry's robust and resilient infrastructure.

Thank you again for the opportunity to be here. I very much appreciate your time and attention.