

The Functioning of Credit Default Swaps in Times of Market Stress

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Seven Basic Principles about CDS

1. CDS add value
2. CDS work
3. CDS are not the cause of the financial crisis
4. CDS are different from other products
5. CDS exposure is not properly understood
6. CDS infrastructure is strong and more developments are on the way
7. CDS should be considered in a comprehensive, holistic set of regulatory reforms

CDS Add Value

- Essential risk management tool that didn't exist at the time of other banking crises
- Means of hedging credit risk that exists in many ways
- Tool that allows investors to express a view on the cost of credit
- Introduce a degree of transparency to the pricing of credit that did not exist before

CDS Work

- Buyer Perspective: They got what they paid for
 - Consider the implications if CDS had not settled smoothly
- Seller Perspective: A perfect storm, perhaps, but credit risk is the exposure they chose to take
 - Role of risk management decisions and policies
- Operational infrastructure
 - Significant progress made

CDS are not the cause of the financial crisis

- Poor lending decisions in housing finance are the root cause
- CDS are risk-shifting tools
 - Companies could -and did- use CDS to manage risk to powerful effect
- CDS not a primary driver behind lending decisions
 - Not a no-cost option

CDS are different from other products

- Bilateral privately negotiated contracts
 - Not securities like bonds or notes
 - Counterparty credit exposure
- Simple confusion: CDS vs. CDO; "derivative securities"
- Risk-shifting, not capital raising, tools

CDS Exposure is not Properly Understood

- Notional Amount
 - Measure of outstandings and activities, not exposure
- Exposure
 - BIS estimates that gross exposure at mid-2008 was 5.5% of notional, up from earlier levels, but still much less than notional
 - Numbers are before effects of netting

CDS Infrastructure is Strong and More Developments are on the way

- Settlements – auction mechanism; hardwiring
- Clearing
- Tear-ups/compression
- Information from DTCC Warehouse
- Focus on operational issues

CDS Should be Considered in a Comprehensive, Holistic Set of Regulatory Reforms

- Global debate
- US focus on broad regulatory reform
- Critical to focus on the causes of the financial crisis and deliver targeted solutions

"I am not at all convinced that voluntarism by the dealers and incremental adjustments of existing regulation will be sufficient to respond to the new risks created by derivatives,"

- *Congressman Edward Markey, New York, 1994*

"...it's not a question of if, but when Congress will act."

- *Congressman Jim Cooper, North Carolina, 1994*

"You can call it whatever you want, but in my book it's gambling."

- *Henry Gonzalez, Chairman House Banking Committee, 1993*

"Your activities are now too important for central banks to ignore. [Officials are concerned] about the impact of your activities on the stability of the financial system. You must expect that the consequences will be closer attention from the authorities."

- *Richard Farant, deputy head of the Bank of England at the ISDA AGM Paris, 1992*
- *Senior Bank of England official, 1992*

"High-tech banking and finance has its place, but it's not all it's cracked up to be. I hope this sounds like a warning, because it is."

- *Gerald Corrigan, President, Federal Reserve Bank of New York, speech, January 1992*