CDS and Market Distress

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About ISDA

- Founded in 1985; represents participants in the privately negotiated derivatives industry
- One of the largest global financial trade associations, by number of member firms
- Over 830 member institutions from 57 countries on six continents
- Members include most of the world's major derivatives dealers, as well as many businesses, governmental entities and other end users

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About Privately Negotiated Derivatives

- Bilateral privately negotiated contracts
  - Not securities like bonds or notes
  - Counterparty credit exposure

- Simple confusion: CDS vs. CDO and "derivative securities"

- Risk-shifting, not capital raising, tools

- Derivatives continue to be an integral risk management tool among the world's leading companies
  - Over 90% of Fortune 500
  - 50% of mid-sized companies

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George Soros on CDS

- "The issuance and trading of derivatives ought to be strictly regulated as stocks. Regulators ought to insist that derivatives be homogenous, standardised and transparent"
- "Custom-made derivatives only serve to improve the profit margin of the financial engineers designing them"
- "CDS are instruments of destruction that ought to be outlawed"

- George Soros, Chairman, Soros Fund Management

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Congressman Garrett on CDS

- “…it’s important to remember that derivatives did not cause our financial difficulties.”

- “When there have been credit events…each event has been handled in a very orderly fashion by the existing OTC infrastructure.”

- “The participants and infrastructure providers in the OTC markets have accomplished much in recent years to provide stability – from the ISDA Master Agreement to the recent so-called “Big Bang Protocol”, to ongoing efforts to provide a more robust infrastructure for these products.”

- Congressman Scott Garrett, New Jersey

Key CDS Questions

1. Did CDS cause the financial crisis?
2. Did CDS pose systemic risks during the financial crisis?
3. How has the CDS market performed during the market turmoil?
4. What is the true level of CDS exposure?
5. What improvements are underway?
6. What lessons have we learned?

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Did CDS Cause the Financial Crisis?

CDS are NOT the Cause of the Financial Crisis

- Poor lending decisions, principally 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

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Did CDS Pose Systemic Risk During the Financial Crisis?

- Bear Stearns
  - Problems related to a lack of confidence from lenders
  - Classic liquidity squeeze; relied too much on short-term funding

- Lehman Brothers
  - From March to September, market concerns had shifted from counterparty exposure to reference entity exposure
  - Gross notional exposure on Lehman was $72 billion but net notional was $5 billion
  - Bankruptcy created no systemic fault lines

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What is the True Level of CDS Exposure?

Gross vs. Net Notional

Reference Entity	Gross Notional (USD EQ)	Net Notional (USD EQ)
Single-Name	$15.4 trillion	$1.4 trillion
Index/Tranche	$11.9 trillion	$1.2 trillion
Total	$27.4 trillion	$2.6 trillion

Source: DTCC Trade Information Warehouse

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What is the True Level of CDS Exposure?

- Notional Amount
  - Measure of outstandings and activities, not exposure
- Gross vs. Net Notional
- Understanding Net Notional:
  - Every reference entity on which every CDS contract is based would have to default for payouts to be this high
  - Also assumes no recovery rates
- Netting and collateral substantially reduce risk exposures

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But What about AIG?

- The Failure of AIG Reflects Failures in:
  - How the Company Managed its Mortgage Risks & Exposure
  - How Regulators (OTS) Supervised Those Risks
  - How the Company Managed its Collateral & Liquidity
  - How the Rating Agencies Rated Mortgage Risks & Capital Adequacy

- AIG was clearly an Outlier in Many of Its Business Practices and Policies

- …"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."

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How Has the CDS Market Performed During the Market Turmoil?

- CDS business has functioned well
- CDS market remains open – CDS activity robust
  - Only credit product consistently available to allow firms to transfer risk
- In the past year, there have been over 40 credit events
  - All were managed in an orderly fashion with no major disruptions
- CDS serve a valuable signaling function – CDS prices produce better and more timely information

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What Improvements are Underway?

ISDA's Focus: Identify and reduce sources of risk in the privately negotiated derivatives business

- Towards this end, ISDA supports:
  - Appropriate regulation of financial institutions that have such a large presence in the financial system that their failure could cause systemic concerns
  - Initiatives for improving transparency; providing policymakers with information to carry out their authorities under the law
  - Central counterparty clearing of standardized transactions
  - Standardization of trading terms; improvements in the trade settlement process; greater clarity in the settlement of defaults; and a more open industry governance structure

What Lessons Have We Learned?

- 25 Years of hard work is paying off
- CDS business has performed well
- Infrastructure is robust, but more work can be done...
- ... and ISDA and the industry are committed to working together to make further progress

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