Opening Remarks of Robert Pickel,
ISDA Executive Vice Chairman,
At 25th Annual General Meeting,
San Francisco, California
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Good morning to all of you.

It's my great pleasure to open ISDA's 25th Annual General Meeting here in San Francisco. It is our third time here in San Francisco, the only city that holds the distinction of a three-time ISDA AGM location. Though something tells me that the Tourist Bureau will not be touting that fact.

This is the first time—and hopefully the last time—that we have held this event with a volcano erupting and disrupting flight patterns. Some members were not able to make it in the end, but with London airports opening yesterday many people—including our staff, our chairman and several panelists—have made it. One intrepid traveler—on a panel later this morning—took the train, plane and automobile route over 40 hours to get here. We always wish you a safe journey home. This year we will also wish you a timely journey home!

As you all know, the OTC derivatives industry is in the midst of some important changes. There's a very large and important role for ISDA to play amidst these changes. It's something you're going to hear a lot about over the next two days.

You're also going to be seeing and hearing from ISDA's new CEO, Connie Voldstad. Connie is a terrific business partner for me and we have complementary strengths that we believe work to the advantage of the association. We are fortunate to have such a proven leader in the global capital markets and in derivatives. Connie built JP Morgan's swaps business and led Merrill Lynch's fixed income business.

I would be remiss if I did not also thank Mary Cunningham, ISDA's chief operating officer, for all of her work…as you can see from our surroundings, this looks to be another terrific annual meeting. With the volcano it has been a particular challenge this year with so many uncertainties. And a lot of the final preparations had to be done without the London team, who only arrived yesterday afternoon.

So thank you, Mary, and the ISDA team.

The Case for Financial Innovation

In recent times, we have seen much criticism of our business, of Wall Street, and even of financial innovation in general. It shows the level of concern that many people have about the impact of the financial crisis.

Fortunately, thoughtful observers have been able to see past the headlines and rhetoric. They understand and appreciate the benefits of financial innovation – and of derivatives activity. It's also true of a number of others in government, finance and academia. As the esteemed

Harvard and Oxford professor Niall Ferguson put it in his most recent book:

"The ascent of money has been essential to the ascent of man. Far from being the work of mere leeches intent on sucking the life's blood out of indebted families or gambling with the savings of widows and orphans, financial innovation has been an indispensable factor in man's advance from wretched subsistence to the giddy heights of material prosperity that so many people know today. The evolution of credit and debt was as important as any technological innovation in the rise of civilization…"

OTC Derivatives Today (Survey)

It's not just the concept of financial innovation that has its admirers. We see support for financial innovation on a more tangible, a more practical level as well.

ISDA's survey of Fortune Global 500 companies, for example: just over 94 percent of the sample -- 471 out of 500 companies -- report using derivatives to help manage their risks.

That includes 97 percent of the US companies, as well as 100 percent of the U.K. and Japanese companies.

In addition to ISDA's research, a broader survey of 6,900 non-financial firms in 47 countries was conducted by professors at Lancaster University and the University of North Carolina at Chapel Hill. It found that 60 percent used financial derivatives. Of the over 2,000 US companies in the survey about 65 percent used OTC derivatives.

OTC Derivatives Today (Quotes)

Even during the most intense period of scrutiny and criticism that we have seen in the past three decades, there continues to be widespread recognition of the benefits of derivatives.

The quotes I have highlighted here are but a sampling…

Leading academics believe that a considerable portion of financial innovation over the last 30 years has come from the emergence of derivative markets…

The EU acknowledges the important role derivatives play in the global economy…

And the Fed acknowledges that OTC derivatives remain integral to the smooth functioning of today's financial markets.

Key OTC Derivatives Issues

Now I mention all of this because it provides important – and sometimes overlooked – context for the debate that continues to center around OTC derivatives today.

Supervisors understand and support the benefits of derivatives. They recognize how derivatives enable financial institutions, corporations, governments and others to better manage their risks.

But at the same time, they are concerned about a set of key issues. I think this quote from an EU Commission Communication last year gets to the heart of their misgivings:

"The characteristics of OTC derivative markets – the private nature of contracting with limited public information, the complex web of mutual dependence, the difficulties of understanding the nature and level of risks – increase uncertainty in times of market stress and accordingly may undermine financial stability."

Current Industry Initiatives

Put simply, supervisors today are mostly focused on one key goal: reducing systemic risk. And they aim to achieve this goal by:

- Making sure that an effective regulatory framework is in place;
- Strengthening counterparty risk management;
- Improving transparency; and
- Building a robust operational infrastructure.

We at ISDA completely endorse these initiatives. What's more, the industry is working intensely in key areas to achieve them:

- We're working to clear those products that can be cleared;
- We're building centralized data and trade repositories; and
- We're increasing operational efficiency by reducing backlogs and increasing our use of technology.

After an investment of millions of dollars and hundreds of thousands of man hours, we have made very significant progress in each of these areas. And more progress is right around the corner.

ISDA's Key Accomplishments

ISDA has played, and is playing, an important role in these strategic initiatives and in building a stronger, safer derivatives market.

One of the ways in which we're doing this is by bringing a greater degree of standardization to market practices and conventions. Our Big Bang and Small Bang Protocols, Restructuring Supplement and Determinations Committees were important steps in this effort.

The ISDA Industry Governance Committee continues to drive the Fed commitment process and plays a vital role in driving and coordinating continued improvement in our business.

We've broadened the Association's governance and board membership with buy-side participants.

We've developed and promoted advancements in collateral management.
And we're working in many ways to improve transparency, from driving the development of trade repositories to bringing greater visibility to the information available on our markets.

Initial Progress in Central Clearing

Let's look now at central clearing.

Today, more than $200 trillion of interest rate swaps have been centrally cleared. Some $7 trillion of CDS has also been cleared. Most of the cleared CDS volume is, not surprisingly, index transactions, as these are the most commoditized, standardized types of trades. Portfolio compression has reduced outstanding notionals by $100 trillion, of which some two-thirds is CDS notional.

The growing use of central clearing facilities reflects the fact that dealers see and want the benefits of clearing. Let me repeat: dealers want clearing. In fact, every derivatives clearinghouse has been fostered by dealers, and the interdealer market will see the biggest pickup in cleared volume as we move forward.

If current trends continue, the amount of notional that has been cleared could easily double in the next couple of years.

But even with this progress it's important to note that we will never be able to clear all derivatives activity. Progress will be faster in some areas – the most liquid, standard products – than in others.

Clearing Commitments

As you know, major dealers have -- with the strong encouragement of the New York Fed and other global regulators-- established and publicly committed to benchmarks for clearing OTC derivatives trades.

I'm happy to say that firms are meeting or exceeding their targets. While there are immense challenges to be addressed with regards to central clearing, the performance to date demonstrates the industry's commitment to clearing what can be cleared…namely, the most liquid, standardized trades.

Toward that end, more than 90 percent of new interdealer, clearing-eligible IRS and CDS are being submitted to CCPs, and firms committed to actually clearing 85% of our collective CDS trading and 90% of IRS.

And there are strong commitments to take further steps to clear a significant number of existing transactions.

Portfolio Compression

As I mentioned, another way in which we're working to improve risk management is through portfolio compression. This enables firms to reduce risk and cancel out economically offsetting transactions.

In the past few years, portfolio compression has enabled firms to significantly reduce the level of notional outstanding by approximately $100 trillion, of which $65 trillion is CDS.

You can see the effects of portfolio compression on the CDS market in this chart. It's helped cut the notional amount of CDS outstanding by more than half.

It's unfortunate but sometimes the reason for this decline in notional is misunderstood. Far from being a negative, portfolio compression is obviously a positive for individual firms and for the CDS business as a whole. It reduces the operational burdens that firms face. I expect that we will see more such activity in the future in the CDS and other derivatives markets. In fact, clearing will open more opportunities for compression.

Further Progress in Central Clearing

So that gives you a snapshot of where we stand with regard to central clearing. I think you'll agree that there's been a lot of progress and that we are deeply committed to further advancing this effort.

In particular, we are focused on two principal areas. The first is broadening the set of OTC derivatives that are eligible for clearing. The second is broadening the number and type of market participants that can clear.

As we look to expand clearing, we certainly need to take into account risk, liquidity, default management and other factors. These are all important considerations. But at the end of the day we should continue to see a larger percentage of outstanding volume migrate to central clearing facilities. We should also see additional opportunities to reduce notional outstanding through portfolio compression.

Full Regulatory Transparency (The goal)

Let's turn next to our second strategic initiative: improving transparency.

Let me be very clear here and say at the outset: our goal is to provide supervisors with a complete view of our market. The fact is that much activity—particularly of regulated firms—has been visible, but only to one regulator in one jurisdiction. What we seek to achieve is regulatory visibility across transactions, firms, counterparties and the market as a whole. Regulators will be able to see specific risk concentrations and can sort the data any way they want.

We're building this transparency through central trade data repositories – one for credit, one for interest rate swaps and one for equities. All trades that are cleared and uncleared will be recorded in these repositories. It will in effect be a single source of information about the market. This is a huge – and hugely important – undertaking for the industry, one that requires significant investment of time and resources.

But when we have completed the task, we will no longer have issues like we did after the Lehman bankruptcy, when market participants and others worried about firms' exposure to that credit event. One need only look back a few years at the bankruptcy that had many people worried—General Motors. When GM went bankrupt a year ago, it was handled smoothly and uneventfully, in large part because of steps the industry had taken. That included the readily available information on net notionals that DTCC provides. And no longer will firms like AIG be able to amass so much exposure virtually unnoticed. With enhanced regulatory visibility, these two situations could simply never happen again.

Full Regulatory Transparency (CDS Trade Repository)

I know many of you are probably familiar with the CDS trade repository that was established by DTCC. It's been up and running for some time, and we've seen in recent weeks just how valuable it can be. Following the concerns aired about exposure on sovereign debt, supervisors were able to look into the CDS repository to examine how much net exposure there was, and what the recent trading activity looked like.

I think this visibility played an important role in enabling regulators to see that CDS really played no role in the sovereign debt crisis in Greece. The information was very helpful indeed and it can only be more beneficial for regulators going forward.

Full Regulatory Transparency (CDS Positions)

So I want to encourage all of you to take some time to look at the data that DTCC collects and publishes. There's really not enough awareness and understanding of how transparent the market has become and we need to do a better job of getting that message across. And we will soon see additional levels of transparency for interest rates and, later, equity.

I would also encourage you to look through ISDA's CDS Marketplace website, which is a portal of information on the CDS business. There's single name and index price data, market research, data on clearing and portfolio compression – kind of a one-stop shopping mall for the CDS market. Again, it's part of our effort to improve the transparency of the business. It's interesting to note that it has attracted thousands of visitors from over 100 countries around the world.

Full Regulatory Transparency (Efforts underway)

So far I have been speaking about regulatory transparency – providing supervisors with information on trading activity and risk that they need to ensure financial stability.

In our recent regulatory commitment letter, we also agreed to perform work on another type of transparency – price transparency.

Today, I think it's pretty well agreed that given its size and liquidity, price transparency in most of the OTC derivatives markets is comparable to or greater than the underlying cash markets. That's why we believe that we do not need – and derivative end users are not asking for – mandatory exchange trading.

It is true that in less liquid market segments price transparency could be improved. Efforts are underway with global regulators to determine the right mix of pre- and post-trade price transparency that would provide additional information to clients without reducing liquidity and thereby increasing costs to users.

Stronger Infrastructure (Aged Confirms)

Let's move now to the industry's third strategic initiative: building a robust, resilient infrastructure for our market.

It was only a few short years ago that operational issues were at the top of the regulatory agenda. Derivatives processing was too manual, inefficient and cumbersome. This is an area that we have been discussing at these annual meetings for much of the past decade, with our original operations plan that highlighted these issues. In the end, it took the intervention of the New York Fed to provide the push for major firms to tackle these issues.

The industry responded to this challenge, devoting more resources to clearing backlogs, and increasing use of automation and technology.

The results of this effort are clear for both dealers and the overall market. Today, there is less than one business day's worth of aged confirmations outstanding for the three major OTC derivatives product classes – CDS, IRS and equity swaps. We can see in particular the very sharp improvement in equities and rates – from more than 3 days backlog two years ago to less than a day at year-end 2009. For CDS, the backlog is about a quarter of a day.

We've committed to regulators that we'll get aged confirms for each of these three product types reduced even further.

Stronger Infrastructure (E-confirmations)

As I mentioned, one of the key drivers behind this improved performance is the industry's increased use of automation and technology.

This chart graphs electronic matching rates of eligible confirmation events. As you can see:

- E-confirmations for eligible CDS transactions are approaching 99%

- For interest rates, it's increased from less than 45% to over 80%
- For equities, it's gone up from around 20% to over 85%

This is all in a span of about three years – three years during which the industry committed substantial amounts of human and financial capital in order to generate a significant level of improvement.

Current Public Policy Issues

So in each of our three strategic initiatives – clearinghouses, transparency and infrastructure – our progress has been significant and sustainable. And there's no let up in sight for our efforts.

There are, however, some aspects of the public policy debate that remain of concern. 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.

For example, it is obviously of great concern to ISDA and our member organizations that any future public policy framework retains the ability to customize risk management tools. This needs to be preserved going forward – a fact that a large number of end-users also agree with.

Given their inherent nature, 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.

There's simply no room for debate, however, when it comes to the idea that <u>ALL</u> OTC products must trade on an exchange. In fact, mandating that <u>ALL</u> swaps be exchange traded will only increase costs and risks for the thousands of companies that use them.

Why? Because immediate price reporting on an exchange – particularly of large trades or more illiquid products – makes it less likely that dealer firms will bid on those transactions. This adversely impacts liquidity, pricing and risk management.

And to what effect? Very little, in our view. Exchange trading, it must be remembered, has nothing to do with reducing systemic risk or credit risk. The trade repositories that we're building will already provide regulators with complete transparency. End-users already have liquidity and easy access to competing dealer prices either by phone or electronically. We continue to urge regulators and legislators to keep these important facts in sight.

Mandates, by definition, reduce flexibility. We firmly believe that a less <u>flexible</u> system is a less <u>safe</u> system.

Another issue that is raising a lot of questions within the industry is the proposal by some to ban CDS trading that they consider speculative. The drawbacks to this approach are substantial.

Firms that were trying to hedge economic exposure, or express a view on the creditworthiness of a particular reference entity, would not be able to do so using CDS. The ability of the CDS market to provide accurate prices of credit and the creditworthiness of borrowers would also be adversely affected.

New York Fed President William Dudley recently offered these thoughts in a speech he gave: “Asset bubbles occur more frequently when it is difficult to short the asset." Speculation—particularly on the short side—may indeed have an important role to play in the proper functioning of 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.

And our global reach, represented by our membership joining us here in San Francisco, puts us in a strong position to engage in that global debate and to be a resource to regulators around the world.

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 like you 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, access, analyze and ultimately to manage risk.

Derivatives will play an important part in that process. The steps we are taking today will strengthen our market and ensure it remains innovative and robust in the decades to come.

Thank you for all the support you continue to provide to the association, to Connie and me and to our incredible staff around the world.

It’s great to have you here. We look forward to two days of interesting discussion of the many important issues we face today.

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