Testimony of Robert Pickel
Chief Executive Officer
International Swaps and Derivatives Association
Before the
Committee on Agriculture
U.S. House of Representatives

September 17, 2009

Chairman Peterson and Members of the Committee:

Thank you very much for allowing ISDA to testify at this hearing to review proposed legislation by the U.S. Department of Treasury regarding the regulation of over-the-counter derivatives markets.

About ISDA

ISDA, as you may know, represents participants in the privately negotiated derivatives industry. Today it ranks as the largest global financial trade association by number of member firms. ISDA was chartered in 1985, and today has over 850 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

A Broad Consensus for Key Reform Concepts

Let me state very clearly at the outset of my remarks: Today, there is a broad consensus for a comprehensive regulatory reform plan to modernize and protect the integrity of our financial system. ISDA and the privately negotiated derivatives business support many of the key public policy concepts contained in the Administration's proposal. 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

What's more, we are not waiting for legislation or additional regulation to demonstrate our support and commitment to these principles. We are actively doing so today. One example can be seen in the use of central counterparty clearing facilities. To date, more than $2 trillion of credit default swaps contracts have been cleared. And earlier this month, ISDA and 15 large derivatives dealers publicly committed in a letter to the Federal Reserve Bank of New York that the firms would submit 95% of new eligible credit default swap trades for clearing within 60 days, by October 2009. A copy of the letter is attached.

Mr. Chairman and committee members, let me assure you that ISDA and our members intend to maintain the scope and the scale of the progress that we have made thus far. Since its inception nearly 25 years ago, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Our focus is on continuing – and enhancing – our efforts in this area as we move forward. The depth and breadth of our activities in derivatives documentation, netting, collateral, risk management, capital, operations and technology underscore our intense global commitment to further reducing risk.

There are, however, certain aspects of the bill that work against its broad public policy goals. These include:

- The scope of firms that would be subject to the legislation;
- The parameters for determining when an OTC derivatives contract is standardized and when it can be cleared;
- Mandatory clearing and exchange trading of standardized OTC derivatives.
- Capital requirements for cleared swaps

These provisions would reduce or restrict the availability of customized risk management tools without contributing in any significant positive way to the Treasury's goals of reducing risk and ensuring financial stability. As a result, they would make it more difficult for American companies to effectively manage their business and financial risks. Resources that could have been allocated more productively to generate growth in revenues and profitability would instead be devoted to less efficient and effective risk management activities.

The Need for Privately Negotiated Derivatives

As Secretary Geithner has previously testified before this committee, "One of the most significant developments in our financial system during recent decades has been the substantial growth and innovation in the markets for derivatives, especially OTC derivatives." In his remarks, Secretary Geithner also noted that derivatives today play a critical role in our financial markets, and they bring substantial benefits to our economy by enabling companies to manage risks.

Today, privately negotiated derivatives are widely used by American companies. According to research we have conducted, nearly all of the Fortune Global 500 companies based in the U.S. use derivatives to manage their risks. A broader survey of 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. Of the 2076 US companies in the survey, about 65 percent used OTC derivatives.

The reason why derivatives are so widely used is clear: American companies want and need these customized risk management tools to manage the risks that arise in the normal course of doing business. For companies that do business overseas, those risks include fluctuations in the relative value of foreign currencies. For companies that issue debt to fund their growth, the risks may include changes in interest rates and consequently in interest payments. For companies that rely heavily on commodities – such as airlines -- those risks include changes in the current and future prices of fuel.

Key Issues in the Treasury's Proposal

While there is consensus regarding many of the key concepts in the Treasury's proposal, certain of its provisions raise serious questions for dealers in and users of derivatives. These provisions, as outlined below, would reduce or restrict the availability of customized risk management tools for American companies. At the same time, these provisions offer no significant offsetting benefit; in other words they would not meaningfully contribute to the Treasury's goals of reducing risk and ensuring financial stability.

1) The scope of firms that would be subject to the legislation.
The legislation defines two types of firms that would be subject to its provisions: "swaps dealers" and "major swap participants." Both definitions are overly broad and would include firms that are in no way systemically significant. In so doing, the legislation would penalize such firms and may well prevent them from either dealing in or using derivatives.

Let me explain: in the proposal, a swap dealer is defined as including any person engaged in the business of buying and selling swaps for such person's own account, through a broker or otherwise. This definition includes all dealers, regardless of their size or trading volume. It treats a firm that acts as a dealer in 10 swaps a year the same as a dealer that does 10,000.

Similarly, the term major swap participant is essentially defined as any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles. This definition is so broad that it would include financial entities that are not systemically significant.

It would also include non-financial end-users of derivatives. These corporate end-users would as a result be subject to the nation's banking and financial regulatory framework, which would impose significant costs, divert key resources and decrease the competitiveness of such firms.

2) The parameters for determining when an OTC derivatives contract is standardized.
A key component of Treasury's proposal for OTC swaps is its requirement that standardized swaps be cleared. The proposal does not define the term standardized. Instead, it would require that, within six months of the proposal's enactment, the SEC and CFTC jointly define "as broadly as possible" what constitutes a standardized swap. Additionally, the proposal provides that acceptance of a product by a clearinghouse for clearing would create a presumption that the relevant product is standardized.

Both of the proposal's methods for determining if an OTC derivatives contract is standardized are flawed and need to be revised. With regard to the former method, the need for consistency amongst policymakers regarding what is standardized and what is not argues for broader participation by federal regulators in this process. Regarding the latter method, because of commercial considerations, the willingness of a clearinghouse to accept a transaction for clearing should not create a presumption of standardization.

In addition, it's important to keep in mind that while standardization is an important goal in the OTC derivatives world, it's also important to retain customization of derivative products. American businesses pervasively use customized contracts to manage operational risks, and it is critical that Congress preserve these companies' ability to do so. Customized products exist only because end users find them useful, and indeed *necessary*, in their day-to-day operations. In fact, the privately negotiated derivatives business has grown because standardized contracts are only of limited use in hedging. Initiatives that would seek to standardize the terms of all OTC swaps are counterproductive. Product uniformity is not beneficial to American companies when they have risks unique to their businesses and need customized risk management tools to mitigate these risks, and when accounting rules require customized products that are closely tailored to an end user's specific risks.

3) Mandatory clearing and exchange trading

The Treasury proposal would require that standardized OTC derivatives contracts be cleared and traded on an exchange of alternative swap execution facility.

Not all standardized contracts can be cleared. Contracts that are infrequently traded, for example, are difficult if not impossible to clear even if they contain standardized economic terms. That's because the ability of a central counterparty clearing facility to clear a contract depends on such factors as liquidity, trading volume and daily pricing. Standardized, illiquid contracts are hard to price daily, which makes it difficult for the clearinghouse to calculate collateral requirements consistent with prudent risk management. As a result, clearing of OTC derivatives contracts should not be mandatory.

To the extent that policymakers do adopt mandatory clearing requirements, ISDA and our members believe that a clearly defined framework for so doing is essential. This framework should be constructed by federal regulators, who should proceed by notice and comment and endeavor to ensure that the requirement would promote consistent international standards, choice of clearinghouses, economic efficiency, fungible treatment of cleared contracts, and clearinghouse interoperability. The framework for a mandatory clearing requirement should only include standardized inter-dealer transactions in which at least one of the dealers is systemically significant.

ISDA and our members believe that mandatory exchange trading should not be required in any circumstance. Mandating that OTC derivatives contracts trade on an exchange would undercut their very purpose: the ability to custom tailor risk management solutions to meet the need of end-users.

In addition, exchanges provide three general purposes, all of which the OTC derivatives industry is meeting in other ways. First and most important is central clearing, which the industry is now well along on and is committed to continued progress. Second is position and risk transparency, which we are achieving through centralized trade repositories as well as central clearing facilities. And the third is price transparency, which is also being achieved through a combination of increased cleared trading volume and electronic platforms.

Finally, ISDA and our members believe that end users should not be subject to a clearing or exchange trading requirement, even if they are major swap participants or meet the eligibility requirements of a derivatives clearing organization. End-users are not systemically significant and regulations intended to improve stability and decrease systemic risk should not apply to them.

4) Capital requirements for cleared swaps

The Treasury proposal would impose a capital requirement on cleared swap transactions. ISDA and our members oppose this requirement for several reasons. First, the capitalization of the derivatives clearinghouse is designed to provide adequate protection to swap counterparties. That is the fundamental purpose of the clearing facility. In addition, the clearinghouse imposes its own layer of additional protection in the form of collateral requirements on its counterparties. So in effect there are already two layers of capital: that which with the clearinghouse is capitalized, and that which the clearinghouse imposes on its members when it trades with them.

Conclusion

Let me conclude by saying that ISDA and our members appreciate the opportunity to testify and answer your questions today. We recognize that policymakers today have real and legitimate concerns regarding their twin goals of ensuring financial stability and reducing risk.

We in the OTC derivatives industry share these goals. We have moved very quickly in recent months in a broad range of areas to allay policymakers' concerns. We know that we have more work ahead – and we are committed to taking on these challenges.

At the same time, we believe – and we are joined by thousands of American companies who also believe – that the customized nature of OTC risk management tools provides a substantial benefit…a benefit to our firms, our economy and our country. We must not lose sight of the important role that OTC derivatives play as we work together on financial regulatory reform.

Thank you.

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8 September 2009

The Honorable William C. Dudley
President
Federal Reserve Bank of New York
33 Liberty Street, 10F
New York, NY 10045

Dear Mr. Dudley:

We are writing to inform you of our commitment to increase the usage of central counterparties for clearing, which we believe will significantly reduce the systemic risk profile of the OTC derivatives market. We have set the following initial performance targets as a demonstration of that commitment. We will increase these target levels, which are the first set for central clearing, as we improve our clearing capabilities.

For Interest Rate Derivatives:

- Each G15 member (individually) commits to submitting 90% of new eligible trades (calculated on a notional basis) for clearing beginning December 2009.
- The G15 members (collectively) commit to clearing 70% of new eligible trades (calculated on a weighted average notional basis) beginning December 2009.
- The G15 members (collectively) commit to clearing 60% of historical eligible trades (calculated on a weighted average notional basis) beginning December 2009.

For Credit Default Swaps:

- Each G15 member (individually) commits to submitting 95% of new eligible trades (calculated on a notional basis) for clearing beginning October 2009.
- The G15 members (collectively) commit to clearing 80% of all eligible trades (calculated on a weighted average notional basis) beginning October 2009.

Furthermore, we will issue performance metrics that address both new transactions and the outstanding trade population on a monthly basis. The first report will be issued on the 10th business day of October 2009 and will be in respect of September 2009, and for each month thereafter, the relevant report will be issued as part of the monthly metrics we currently report.

We will continue to work with the regulators to explore means by which we can look to improve submission levels and clearing yields. We will review the performance metrics and targets contained in this letter with the global regulators on a regular basis to ensure that the metrics and targets demonstrate the industry commitment to increased clearing of OTC transactions.

G15 members commit to actively engaging with CCPs and regulators globally to broaden the set of derivative products eligible for clearing, taking into account risk, liquidity, default management and other processes. The G15 members also commit to work with eligible CCPs and regulators globally to expand the set of counterparties eligible to clear at each eligible CCP taking into account appropriate counterparty risk management considerations, including the development of buy-side clearing.

Of course, successful expansion of the sets of eligible products and counterparties is necessarily dependent on several factors, including ensuring proper risk management, CCP capabilities and business choices, regulatory treatment and decisions of non-G15 firms. We commit to work actively with our supervisors and other regulators to remove any of these impediments to our efforts.

Yours sincerely from the Senior Managements of:
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BNP Paribas
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