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Before the  
Committee on Agriculture  
U.S. House of Representatives

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Mr. Chairman and Members of the Committee:

Thank you very much for inviting Blackbird Holdings, Inc. to testify at this hearing about the "Derivatives Markets Transparency and Accountability Act of 2009". We are grateful to the Committee for asking for our views as it seeks a wide perspective on the benefit and drawbacks of legislation affecting privately negotiated derivatives. For more than two decades, swaps and related derivatives contracts have made an important contribution to improvements in risk management at banks, in the financial sector, and in the economy. The benefits of these transactions are sufficiently important that any measures adopted by the committee or the Congress should not reduce the availability or increase the cost of these valuable tools.

**About Blackbird**

Blackbird Holdings, Inc. is a privately held corporation headquartered in Charlotte, North Carolina. It was founded by swap traders from JP Morgan & Co. who developed an electronic trading platform for the negotiation of interest rate and currency swaps. Our innovative technology has been patented three times by the U.S. government. The benefits of electronic trading have already been achieved in the execution of most types of financial transactions, including foreign currency, equities, U.S. Treasury bonds and corporate bonds, and futures contracts. When swap contracts are executed electronically in greater numbers, swaps will have greater transparency, and accurate electronic records will be created at the moment the trade is executed so that error-free straight through processing, including accurate record-keeping, will be a hallmark of the business. Blackbird is still a small company, but we are global, and we help swap counterparties find each other and execute swaps either across our electronic platform, or through our people in Singapore, Tokyo, London, and New York.

I have served as Chief Executive Officer of Blackbird since 2001. Before that, I served for 25 years at JP Morgan & Co., Inc., where I was a Managing Director and worked in the derivatives business for 15 years. During that time, I served for four years as Chairman of the International Swaps and Derivatives Association, and for two years as Vice Chairman, during more than a decade that I served on its board of directors. ISDA represents participants in the privately negotiated derivatives business, and is now 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 swaps and related contracts to manage efficiently the financial market risks inherent in their core economic activities. As a result, I was involved in discussions about all federal swaps legislation between 1988 and 2000.

## Why Swaps?

The moment that companies open their doors to do business, they become exposed to financial and other risks that they must manage. Changes in foreign currency rates can affect the volume of their exports; interest rate volatility the level of investment returns, and commodity price fluctuations the cost of raw materials—or sales revenue. Managing these risks was an essential part of decision-making in business and finance before swaps were developed, and would remain so if swaps did not exist.

Custom-tailored swap transactions were developed to make it easier to manage these risks. They allow a party to shed a risk that he does not want to take, in return for assuming another risk to which he would rather be exposed, or for making a cash payment. By tearing apart and isolating the strands of risk that are entwined in traditional business and financial transactions, they make it possible to manage risks with greater precision, and allow businesses to focus on the things they do best. A company that sells hamburgers around the globe can use swaps to shift its exposures to interest rates and foreign currencies to other parties, and concentrate on managing its operations, raw materials costs, and real estate holdings, if it believes that these are the source of its comparative advantage. Similarly, the counterparties to its swap trades believe that they are better able to manage the interest rate and currency risks being shed by the other enterprise.

## Benefits of Swap Activity

As thousands of swap counterparties make individual decisions about which risks to take and which to transfer to others, several useful things happen. First, the risk profiles of the firms improve every time they make a correct decision. This strengthens them, and makes it possible for them to serve their customers better and grow more rapidly. A bank that has a strong relationship with a borrower might find that the size of its loans to that customer was becoming so great that its loan portfolio was becoming poorly diversified. By entering into credit default swaps, the banker can transfer enough of the loan risk to make room for more loans to its customer, strengthening its business relationship and helping credit to flow. That's good for business, jobs, and the economy.

Second, as thousands of swap transactions have been executed in the past three decades, bankers and finance professionals have gained access to new information about financial risks. This allowed better measurement and management of risks, first in swap portfolios and, as time passed, in the other financial portfolios. I watched that process take place in the 1980s as the risk management techniques developed on the swap desks of ISDA member banks, including my own, were adopted by the managers of the same risks that had long been embedded in other financial portfolios at their institutions, including the portfolios of loans and deposits. This process was so constructive that swap professionals were asked in 1993 by the Group of Thirty, to write down their best principles and practices for managing financial risks. The report that we produced was disseminated through the global banking system and other parts of the financial world, and was also used by banking supervisors and financial system regulators to improve their supervisory practices. As Paul Volcker, the Chairman of the Group of Thirty wrote in the introduction to our report, "...there can be no doubt that each organization's conscious and disciplined attention to understanding, measuring, and controlling risk along the lines suggested should help ensure that the risks to individual institutions and to markets as a whole are limited and manageable."

As swap transactions are executed, the prices of these deals reveal the beliefs of thousands of individuals about the future course of interest rates, or the creditworthiness of borrowers, which are collected and distilled in the price of the deals. This information can be used even by parties who do not

enter into the transactions. Central bankers now use swaps prices to understand interest rate expectations and help them make decisions about monetary policies. 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, and alert their analysts to changes in the condition of companies that they rate, so that they can drill down on potential problems and strengthen the quality of their ratings. If credit default swaps had existed a decade earlier, to sound a tocsin of warning, current problems in the financial system might not be so grave.

Of course, no type of financial transaction or system of risk management can prevent all investment losses. The good judgment of financial professionals remains the essential element in sound financial management. Swaps simply make it easier and less expensive to create the risk management profile that a company prefers.

You might expect a business that does so much good for so many people to grow quickly, and the swaps business has. While I have been a participant in the swaps business, I have seen it grow by roughly 25% per annum for more than 20 years. As a result, there are now according to the BIS almost \$684 trillion of swaps outstanding, mainly on interest rates and currencies. As of January 27, there were some \$28 trillion of credit default swaps outstanding. It is worth noting that, even when other financial activities become illiquid, the swap business tends to be resilient. Credit default swaps dealers, for example, indicate that there has been liquidity in swaps even when traditional cash markets have become illiquid at times in the past year.

### **Public Policy for Swaps in the United States**

These are important benefits. They exist in part because Congress has legislated carefully and wisely with respect to swaps on at least five earlier occasions since 1988. We all want to preserve benefits like these, and I am grateful to you for identifying in legislation now before the committee several policy ideas that have been floated in recent months, and for your careful consideration of those ideas at this hearing. With careful action, this committee can continue to play an essential role in building a sound framework for swap activity.

The policy consensus about swaps that is embodied in the statutory and regulatory framework reflects the fact that swap activity arose not in the exchange traded, centrally cleared business of standardized futures contracts regulated by the Commodity Futures Trading Commission, but in the banking sector. Swap contracts are custom-tailored transactions that are often designed to match the exact cash flows that a corporation wants to hedge; this makes them harder to construct, to value, and to transfer, than the futures contracts regulated by the CFTC, in much the same way that a bank loan is different from a corporate bond. This is why the first policy adopted by the CFTC with respect to swaps, in its May 1989 Swaps Policy Statement, after more than 18 months of study, was that swaps are not appropriately regulated as futures. That original CFTC Policy reflects a policy consensus that has lasted two decades, reaffirmed and strengthened by the 1991 CFTC Statutory Interpretation, the 1992 Futures Trading Practices Act, and the Commodity Futures Modernization Act enacted in 2000 and signed into law by President Clinton, as well as other legislation. That is why swaps are defined in federal law as banking products.

A robust, innovative American financial services business has been built on the foundation of this policy consensus. I am concerned that provisions in the legislation before the committee would undermine that foundation and weaken a business that helps the American economy, and the world.

## Management of Credit Risk in Swaps Transactions

One area of the legislation that would have that effect is the section requiring clearing of privately negotiated derivatives. Like every commercial and financial contract, swaps contain credit risk. One party must be confident that his counterparty will perform according to the terms of the contract.

Financial institutions are able to manage this credit risk in different ways. In the banking system, where swaps originated, credit risk is managed by experts who analyze the quality of each counterparty, including its financial strength, the quality and character of management, even the legal and political risk of the country where it is based. In doing this, bankers and their counterparties often rely on private information available to them in their special role as creditors. The techniques used to manage the credit risk of swaps are usually the same ones used to manage the risk of other privately negotiated credit contracts such as bank loans or bank deposits, and they can include the posting of collateral so that if a counterparty defaults on a trade, the non-defaulting party will be able to enter into a new, replacement transaction at no additional cost. Of course, if a counterparty is not satisfied with the amount or quality of the information he receives, or the credit enhancement techniques available, he is not required to enter into any swap deal.

Financial institutions have developed a number of ways to manage credit risk in privately negotiated derivatives, appropriate to their capital levels and those of their clients.

First, there are different ways to document transactions. The simplest method is to use an exchange of confirmations, one for each transaction. This approach makes no attempt to reduce risks by netting, it simply relies on well drafted confirmations and good credit judgment in the choice of counterparties.

Risks are reduced by netting under bilateral master agreements, either for single products—interest rate swaps against interest rate swaps, --or reduced further by including other derivatives under the master. Netting across products—foreign exchange options against credit default swaps, for example—reduces potential exposures even more than single product netting. The ISDA Master Agreement is used around the globe to achieve this purpose.

As you can see, we are starting to build a sort of continuum of approaches, in which increasing the numbers of transactions netted against each other results in greater netting benefits. Multilateral netting of credit risks is another step along the continuum, in which a multilateral clearinghouse substitutes its own credit for that of others, and has a bilateral relationship with each of them. In each bilateral relationship, the credit exposure at any moment in time is the net value of the transactions.

At first, this might sound different from the banking model, because futures exchanges operate multilateral clearinghouses. But the difference is mainly one of scale. Every bank serves as a central counterparty for its inter-bank trading partners and its clients. So, in this sense, every swap dealer bank using netting provisions under the ISDA Master Agreement is a clearinghouse.

Each swap dealer assesses the likelihood that his counterparty will default, and his own ability to withstand such a default. In doing so, he is mindful of his own capital base, and the capital strength of his counterparty. Where capital is not high relative to risk, it is more likely that one or both swap counterparties will demand collateral from the other.

Now we have a more complete picture of credit risk mitigation schemes for derivatives. Each scheme has characteristics appropriate to its participants. On one end of the continuum are banks and

insurance companies, with traditionally strong capital cushions. At the other end are margin-reliant entities including futures exchange clearinghouses.

### **A Clearinghouse for Swaps?**

It should be clear at this point that creating a new clearinghouse for swaps, or for one type of swaps like credit default swaps, or forcing swaps into some other clearinghouse, would not exactly make order out of chaos. A good deal of order already exists. It is the order that markets bring to human affairs, giving participants the opportunity to choose, and to change their choices. Today swap participants can choose among several different methods to handle credit risk. We can keep the contracts on our own books, netting them against other contracts, taking collateral to support the risk as appropriate, or we can submit them to a third party clearinghouse. A system like this allows us to make the right judgments for ourselves and our counterparties, as capital positions change and the mix of clients changes. Every bank changes its mix of business along the continuum, every day.

For this reason, Section 13 of the bill is troubling. This section requires that all currently exempted and excluded OTC transactions must be cleared through a CFTC regulated clearing entity, or an otherwise regulated clearinghouse which meets the requirements of a CFTC regulated derivatives clearing organization. While the provision authorizes the CFTC to provide exemptions from the clearing requirement, it can only grant the relief under limited circumstances, provided that the transaction is highly customized, infrequently traded, does not serve a significant price discovery function and is entered into by financially sound counterparties.

Driving swap activity into a central clearinghouse would be undesirable for several reasons. First, it would create a central choke point for activity that is, today, distributed across multiple locations. If a single swap dealer has processing problems or other difficulties, they affect only the dealer's clients. If a central clearinghouse were to have problems, they would affect the entire system's derivatives flows.

Second, the same is true of the credit risk of such a central entity. Pulling the credit risk of swaps out of the institutions where they reside today, and forcing them into a central counterparty, risks creating a new, "too-big-to-fail" enterprise that represents a new risk to taxpayers.

Third, a centralized, collateral-reliant scheme would tend to reduce market discipline. Because parties to bilateral netting agreements retain some individual credit exposure, they must assess their counterparties' credit standing, giving them an incentive to control their positions carefully. The resulting widespread awareness of credit risk makes the financial system safer. In contrast, clearinghouse arrangements tend to socialize credit risk. Our financial system today shows the ill effects of a reduction in market discipline, and federal policies should increase it, not reduce it.

Fourth, one reason for this is that credit discipline encourages financial institutions to strengthen their capital bases.

Finally, building a central clearinghouse may be an expensive proposition, requiring new capital of its own. In contrast, increased use of bilateral cross product netting under ISDA Master Agreements can be accomplished at low cost. The marginal cost of adding another transaction to an ISDA bilateral master agreement is zero. No other technique offers such substantial risk reduction at such a low cost.

Since, as I indicated above, every swap dealer bank serves as a clearinghouse for its swap trading partners and clients, the provision would have the effect of limiting the ability of banks to engage in this segment of the banking business without the approval of the CFTC. I do not know of any reason to

unwind the policy consensus for swaps to adopt such a policy. The netting and close out arrangements that are in use among swap counterparties are the result, in part, of careful work by Congress to establish the enforceability of netting agreements under bankruptcy law. These arrangements have been used in the marketplace and tested in the courts and have managed the credit risk of hundreds of thousands of swap transactions. In the last 12 months alone, the failure or default of a major swap dealer, Lehman Brothers, two of the world's largest debt issuers, Fannie Mae and Freddie Mac, and a sovereign country Ecuador, in addition to the more routine failures of other counterparties have been successfully resolved using these arrangements. In every case the well drafted netting and close out provisions of the ISDA Master Agreements have done what they were supposed to do. Simply put, these arrangements work well, and there is no evidence to support a statutory requirement for clearing of all swap agreements through CFTC-approved central counterparties.

### **Conclusion**

The privately negotiated derivatives business – and the bilateral infrastructure, documentation, and netting that support it – have been called “no less than the creation of global law by contractual consensus.” It is a system that works. It is a system that has well served the economy and the financial markets in the US and around the world. It is a system that has benefitted thousands of companies, financial institutions and sovereigns. And it is a system that has an important part to play as we work toward a solution to today's economic weakness and financial markets uncertainty. Great care should be taken to optimize – and not weaken -- this innovative and important system.