Testimony of Robert Pickel
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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 allowing ISDA to testify at this hearing regarding the "Derivatives Markets Transparency and Accountability Act of 2009". We are grateful to the Committee for seeking a broad range of views as it considers legislation addressing the bilaterally negotiated or OTC derivatives industry. It is worth noting at the outset that these markets have continued to perform their important risk management function during the current market turmoil. It is our hope that policymakers will keep in mind the relative health of OTC derivatives throughout the market downturn as you consider measures which might profoundly change the way these markets function.

About ISDA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 800 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.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements; securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives. ISDA continues to provide clarity and certainty to the risk management industry through our collaborative initiatives with market users and policymakers worldwide.

OTC Derivatives and the Current Market Turmoil

As I noted before this Committee in December, the roots of the current global financial crisis lie in imprudent lending decisions, particularly with respect to residential housing but also extending to other areas including consumer receivables, auto finance and commercial development. These imprudent decisions were reinforced by credit ratings of securities composed of these loans which proved to be grossly overconfident, and by faulty risk management practices of some of the institutions investing in those securities. These securities should not be confused with derivatives.

One thing that should by now be clear is that OTC derivatives were not the cause of the current financial crisis. In fact, had the Commodity Futures Modernization Act of 2000 (CFMA) not been passed we would find ourselves in exactly the same financial crisis we are in today. Indeed the crisis might be

worse, as the CFMA created legal certainty for OTC derivatives and thus allows market participants to hedge risk through privately negotiated risk management contracts. It is worth noting that the OTC derivatives market has continued to function despite the recent market turmoil. This has enabled companies to hedge risks that, without a well functioning OTC derivatives market, would have had a significant adverse financial impact on them. The derivatives markets have remained open and liquid and fulfilled their hedging purposes while other asset prices have collapsed.

OTC derivatives serve a very valuable purpose: they allow companies to manage risks, like interest rate risk, foreign exchange risk, commodity price risk and credit risk. The financial system and the economy as a whole are stronger and more resilient because of OTC derivatives, and those that disparage their use, or confuse them with asset backed securities and collateralized debt obligations (or CDOs, an acronym that leads to some confusion with the straightforward credit derivative instrument CDS) which have proved illiquid and difficult to value in the current crisis, threaten to damage a sector of the financial services industry that remains healthy.

Some point to the large outstanding notional value of OTC derivatives as somehow representing a source of concern. It is important to understand first that notional values represent an underlying quantity upon which payment obligations are calculated. For example two parties may agree to an interest rate swap with a notional value of $10 million. Under that contact one party will pay to the other a fixed rate of interest on that $10 million, while the other will pay a floating rate of interest on that same amount. At no point do the parties exchange $10 million, and at no point is $10 million dollars at risk. Nevertheless, when referring to notional amounts of OTC derivatives, that is precisely what people are doing: notional amount refer to hypothetical amounts of money, not money that is actually at risk.

However there is an even more fundamental point to be made about notional amounts: to the extent they represent actual money at risk, they are representing *risk that is being hedged*. Notional figures indicate how much protection parties have purchased against some underlying, uncontrollable risk. In general policymakers have concluded that encouraging risk management is sound public policy, and so it would seem to still be the case today. OTC derivatives are a way for businesses to obtain protection against market events that they cannot control.

It is also worth remembering that the overwhelming majority of OTC market participants are collateralized to protect themselves against loss. Standard industry practice requires counterparties to secure one another against the possibility that the other party will fail to make its required payments. The ability to access this collateral in the event of default is protected under federal law, and this has proved to be an important way to minimize the fallout of insolvency in the current market.

The Draft Bill

The Agriculture Committee has a great deal of experience with the OTC derivatives market. Going back to the earliest days of OTC derivatives this Committee helped create the framework for legal certainty which underpins the health and success of the US OTC derivatives business. The Futures Trading Practices Act of 1992 gave the CFTC exemptive power and directed the agency to use this authority to exempt swap agreements. When the Commission acted in ways which called into question the viability of that exemption this Committee adopted an amendment in the 1999 Agricultural and related agencies appropriations act which reinforced the enforceability of OTC derivatives and prevented the CFTC from challenging their exemption under the law. In 2000, of course, this Committee led the way in adopting the Commodity Futures Modernization Act which most clearly established the legal framework for the

US OTC markets. And as recently as last year this Committee reaffirmed that framework when it passed the CFTC Reauthorization Act of 2008.

This legacy of leadership has helped create a thriving, vibrant risk management industry which even today, amidst the wreckage of the global financial meltdown, continues to employ thousands of Americans and provide tax revenue to the States and federal government. However portions of this bill would severely harm these markets and prevent them from functioning properly in the United States while also impairing the ability of American companies to hedge their risks.

More importantly the consequences of certain of the provisions of this bill would harm many mainstream American corporations. Many American corporations use OTC Derivatives to hedge their cost of borrowing or the operating risks of their business. Many of those who do business overseas need to hedge their foreign currency exchange rate exposure. Some American corporations may also hedge their commodity or credit exposure. The current wording of the bill would have a disastrous effect for the large majority of these corporations by taking away basic risk management tools that American corporations use in the day to day management of their of business.

Below are a few selected provisions of the legislation which bear particular mention:

Section 6: Trading Limits

This section requires the CFTC to establish position limits for all commodity futures contracts traded on an exchange or exempt commercial market which offers significant price discovery contracts. These position limits would be required to be established for all commodities, including financial commodities. As an initial matter we question whether it is necessary to establish position limits for financial commodities given that the markets are broad, liquid and have an effectively limitless supply.

The section would effectively eliminate the hedge exemption for entities which use the futures market to gain exposure to certain asset classes, or which facilitate risk management by other entities which cannot or choose not to use the futures markets. The effect of this provision would be to severely limit the use of the hedge exemption and thus access to the futures markets. This would likely result in more costly hedging, increased volatility, reduced liquidity and a deterioration in the price discovery function of futures markets. It is also of note that this provision is based on the unproved, and if several credible studies are to be believed disproved, theory that speculation creates higher prices.

Section 11: Over the Counter Authority

This provision authorizes the CFTC to impose position limits on OTC transactions if the agency determines that the transactions have the potential to disrupt a contract traded on a futures market, or the underlying cash market. As stated above, there is a lack of credible evidence or academic studies to support the proposition that derivatives markets cause imbalances in cash markets. Supply and demand inexorably determine prices. In addition, this provision allows the CFTC to order otherwise regulated institutions such as banks and broker/dealers to terminate their privately negotiated contracts. This seems to represent an unwarranted intrusion into the jurisdiction of other federal regulators. Lastly, as OTC derivatives contracts are privately negotiated agreements between two counterparties this provision effectively gives the CFTC the authority to cancel private contracts. This fundamentally undermines legal certainty, would make it difficult for parties to calculate how much capital to hold against such contracts and would likely cause a significant decrease in OTC activity.

Section 13: Clearing

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. The provision gives the CFTC the authority to provide exemptions from this requirement 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.

Clearing can provide benefits and in appropriate cases should be encouraged. However it is not clear what justification there is for a requirement that all OTC derivatives should be cleared. To the contrary, since the advent of the OTC market bi-lateral credit arrangements have been used to settle contracts smoothly and efficiently. These arrangements have been supported by federal law and policy, which promotes netting and close-out of bilateral agreements in the event of the bankruptcy of a counterparty. These arrangements have been tested both in the market and in the courts and have been successfully used to settle thousands of OTC trades. During the current market turmoil we have witnessed the failure or default of a major OTC dealer (Lehman Bros.), two of the largest issuers of debt in the world (Fannie and Freddie), and a sovereign country (Ecuador). Indeed, on an almost weekly basis there are failures which call into action the carefully crafted settlement provisions of ISDA documentation. In every case the contracts have settled according to their terms and according to market expectations, with net settlements changing hands being much smaller than media pundits had anticipated (in Lehman's case, approximately $5bn changed hands in respect of CDS contracts). There is simply no evidence suggesting anything other than that the bi-lateral credit arrangements contained in standard ISDA documentation work extremely well. While clearing should be encouraged, and market participants continue to work with federal and international regulators to create a viable clearing solution for OTC derivatives, mandating clearing of all OTC derivatives is unwarranted.

Section 16: Credit Default Swaps

This provision makes it unlawful to enter into a CDS unless the person entering into the transaction would experience a financial loss upon the occurrence of a credit event. This provision would effectively eliminate the CDS business in the United States.

As written the provision would make it impossible for sellers of protection to hedge their own risks. Most dealer firms, which by and large are federally regulated banks, run a hedged portfolio which seeks to minimize their losses in the case of a loss on a particular contract. Thus for CDS, a dealer firm will seek to ensure that if it has to pay out protection under a CDS contract it will within its own portfolio have a hedged position to minimize its loss. This provision would mean that a dealer could not hedge its risks. Therefore the only participants in the CDS market would be counterparties which each had perfectly matched risks which they sought to hedge. The number of such persons is likely to be extremely small.

This provision would also have the effect of turning all CDS into insurance contracts as it requires parties to a CDS to show a loss. As such under most state insurance statutes a party to a CDS would be required to be regulated by state insurance law, thus bringing federally regulated institutions under the authority of local state authorities.

As noted above this provision would effectively end the CDS business in the US. As noted in this testimony and elsewhere the credit derivatives market has continued to function throughout the downturn, providing a way for market participants to hedge credit risk and express a view on market conditions. Limiting access to credit derivatives would create disincentives to lending at a time when

federal authorities are seeking to promote lending in order to restart the economy. It is difficult to see what public purpose would be served by destroying these currently healthy and important markets.

Conclusion

OTC derivatives markets play an important role in the US and world economy. Despite hyperbolic reports to the contrary they did not cause the market meltdown, and in fact have helped mitigate the effect of the downturn for many institutions. To the extent some participants in the markets have suffered losses related to derivatives, or failed to adequately secure themselves or their counterparties against the possibility of losses, this reinforces the need for sound risk management practices and a careful review of the actions of regulators charged with overseeing these institutions. OTC derivatives remain an essential element in returning our financial system to full health, and harming these markets is not in keeping with that goal.

This Committee is to be commended for addressing these questions and seeking answers to help right our economy. But to the extent oversight of OTC derivatives markets needs review and reform it should be part of a larger dialogue on reform of the financial system in general. Acting hastily is likely to have unintended consequences and prove counterproductive.