Testimony of the
Securities Industry and Financial Markets Association
Before the
New York State Assembly Standing Committee on Insurance
Hearing on
New York's Regulation of the Credit Default Swap Market
December 5, 2008

Chairman Morelle and members of the Committee on Insurance, the Securities Industry and Financial Markets Association[1] (SIFMA) appreciates the opportunity to submit testimony for the record of the New York State Assembly Standing Committee on Insurance hearing on New York's regulation of the credit default swap (CDS) market. CDS play an important role in the financial markets, allowing financial institutions and non-financial firms alike to manage and diversify their exposure to credit risk, while also enhancing liquidity in other financial markets. The derivatives market contributed heavily to New York's financial services leadership according to the 2006 Bloomberg-Schumer global competitiveness report: *Sustaining New York's and the US' Global Financial Services Leadership*[2].

Many questions have been raised about CDS and their role in the current state of the financial markets. In turn, federal regulators and the private sector continue to work on solutions to improve the transparency and efficiency of the CDS market. One important initiative is the creation of a central clearinghouse for CDS that will reduce operational and counterparty risk. Federal regulators are currently reviewing clearing facility proposals that will enhance the ability of regulators to monitor activities in the CDS market. SIFMA believes the issues in the CDS market can best be addressed by these initiatives rather than by individual state regulation. As New York Insurance Department Superintendent Eric Dinallo told members of the House Agriculture Committee on November 20, it would be counterproductive to have multiple regulators of the credit default swaps market.[3]

The Role of Credit Default Swaps in Our Economy

A credit derivative is a financial instrument aimed at transferring credit risk between two parties. Both financial and non-financial firms use credit derivatives to hedge credit risk, or the risk that an entity's financial condition may weaken and affect its ability to repay

[1] SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C. and London. Its associated firm, the Asia Securities and Financial Markets Association, is based in Hong Kong.
[2] McKinsey: *Sustaining New York's and the US' Global Financial Services Leadership, 2006*
[3] "New York Regulator Halts Plans to Oversee CDS Market." Reuters. November 20, 2008.

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outstanding obligations. Financial institutions, such as banks, securities firms and insurance companies, are inherently exposed to credit risk through their role as a lender, whether by providing lines of credit, buying or selling bonds or other types of financial transactions. Non-financial firms are exposed to credit risk via relationships with business partners, for example a manufacturer that has a significant relationship with a supplier whose possible failure would adversely affect the manufacturer's business.

Among the various types of credit derivatives, credit default swaps (CDS) are the most commonly used product and they play an important role in our economy. For example, the availability and use of CDS has increased liquidity in credit markets. Because they enable banks and other institutional lenders to efficiently manage credit exposure in their portfolios, CDS make it possible for these lenders to provide more liquidity to particular companies than they otherwise would if they did not have the option to hedge in the CDS market. CDS also provide a convenient and accurate measure of the relative riskiness of companies and other economic entities. CDS represent pure credit risk, isolated from the other risks that are inherent in bonds and other financial instruments, such as interest rate risk. As such, CDS spreads, the prices quoted by swap dealers for CDS covering a particular creditor's obligations, send prompt and clear signals to the market when there are credit risk changes. The mainstream financial press frequently cites increases in CDS spreads as evidence that particular companies are in financial distress.

Credit default swaps can also be used to protect against a broader basket or index of credit risks. Index credit default swaps work similarly to single-name CDS, except that they cover the credit risk of multiple reference entities typically 100 companies. The protection buyer pays a fixed fee to the protection seller in return for compensation if any of the reference entities covered experience a credit event. Index CDS may reference borrowers in particular geographic area, credit rating categories and/or particular economic sectors, such as manufacturing or biotech. These types of CDS[4] can be a more efficient and less costly means of hedging a portfolio against a more general economic or industry specific downturn.

Growth of the CDS Market

The first CDS contract was introduced in 1995. In subsequent years the CDS market experienced tremendous growth as firms utilized CDS to isolate and realign credit risks. A criticism of the CDS market has been that since CDS contracts are privately negotiated contracts which are traded Over-the-Counter (OTC), data on the aggregate size of the market and actual risk exposures has been limited. Recently, in an effort to provide greater

[4] CDS can also be used for purposes other than hedging. CDS can also be used to express a view about the health of a particular company or the market as a whole. Under a CDS, the buyer of credit protection does not need to own the actual debt obligation. An investor with a positive view on the credit quality of a company can sell protection in return for quarterly payments. An investor with a negative view of the company's credit can buy protection for a relatively small periodic fee and receive a payment if the credit event occurs. CDS can also serve as a way to access maturity exposures that would otherwise not be available, access credit risk when the supply of bonds is limited, or invest in foreign credits without currency risk.

transparency and with the support of SIFMA, the Depository Trust & Clearing Corp. (DTCC), which operates a central registry or warehouse of CDS trades, began publishing data on those CDS transactions. This data includes gross notional positions for warehouse records, aggregate number of warehouse contracts and the top 10 single names in terms of net positions.

A common misconception of CDS however continues to be that gross notional market size gives an indication or measure of actual risk. According to a recent survey by the International Swaps and Derivatives Association (ISDA), the estimated notional amount of CDS transactions has nearly doubled every year since 2001, reaching an estimated peak of $62 trillion in 2007, before decreasing to $55 trillion as of June 30, 2008.[5] Estimates of market size are often misleading as they are calculated using notional values, or the underlying amount of total contracts traded, and not net risk. Because the same contracts often traded a number of times, those contracts are counted each time they exchange hands, which has no relationship to actual risk, and leads to a highly distortive market.

Regulation of Credit Default Swaps

Although derivatives markets and products are sometimes described as unregulated or not subject to regulatory oversight that is inaccurate and misleading. Virtually all of the significant participants in the CDS market are U.S. and foreign banks or bank holding company subsidiaries. Banks are subject to extensive regulation by state and federal bank regulators, and bank holding companies are regulated by the Federal Reserve. The broad authority given to these regulators includes the authority to obtain information about bank and bank holding company business activities, transactions and asset portfolios and also the authority to prohibit activities that might threaten the safety and soundness of a bank. The banking regulators establish minimum capital requirements, review risk management and control practices, and conduct ongoing examinations of the institutions they regulate. CDS market participants also are subject to the SEC's antifraud and anti-market manipulation authority under the Securities Exchange Act of 1934 and the Commission has broad investigatory authority to determine whether any person has violated the Act, including the authority to require the production of books and records.

Even though most swap dealers that engage in CDS transactions already are subject to comprehensive oversight and regulation, we strongly support efforts to improve systemic stability, in particular by using a central clearing to reduce counterparty risk. We also strongly support enhanced regulatory oversight of CDS markets and market participants. Recent events have shown that a poorly managed CDS business can threaten not only the financial condition of the firm engaged in that business, but also the stability of other firms and financial markets generally. Additional steps that should be considered include giving a single federal financial regulator additional information gathering authority with respect to clearinghouse facilities and significant market participants, and empowering that regulator to adopt such regulations as might be appropriate to ensure prudent business practices and minimize systemic risk. Because the CDS market is global, we believe that regulation at the federal level, with international consultation and cooperation, is the right approach. Vesting authority in a single regulator would promote consistency in the

[5] ISDA News Release, September 24, 2008 (http://www.isda.org/press/press092508.html)

application of regulations and provide comprehensive oversight of markets and market activity. Accordingly, it is our view that a uniform and standard oversight approach will yield greater benefits to the CDS market than individual state regulation.

CDS Challenges

The extensive growth in the CDS market has not been without some challenges. There have been a number of questions raised about the role of credit derivatives in the current market turmoil. It appears that some participants in the CDS market, who sold credit protection to other firms, were insufficiently capitalized against the risks they faced, had insufficient liquidity to perform under their obligations, and generally applied inadequate risk management practices. However, the CDS markets as a whole have remained open and liquid. U.S. bankruptcy and bank insolvency laws have certainly helped to ensure the smooth settlement of CDS contracts in these challenging times.

As CDS are bilateral contracts, counterparty credit risk is an inherent aspect of the contracts. The protection buyer and protection seller are each exposed to the risk of the other's nonperformance. A protection buyer is at risk that the seller may not perform its obligations if a credit default event occurs. A protection buyer is at risk that the buyer may not make its periodic premium payments. To mitigate these risks, counterparties are typically required to post collateral. Redundant offsetting exposures increase the amount of capital that firms must commit to collateral postings, resulting in an inefficient use of that capital. While market participants were able to mange through the recent CDS settlements, we recognize more can be done to manage counterparty risk issues presented by the volume of CDS transactions. The use of central clearing will go a long way in addressing this issue.

It is also clear that the CDS market faces various operational challenges, including processing transaction documentation, monitoring and managing open transactions, responding to credit events and responding to market participation distress.

President's Working Group Initiatives

Participants in the CDS market generally support the OTC derivatives oversight and infrastructure initiatives announced by the President's Working Group on Financial Markets (PWG) on November 14, 2008.A number of industry participants have been working with the Federal Reserve Board (FRB), the Federal Reserve Bank of New York (FRBNY), the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to develop a central counterparty clearinghouse for CDS. Central clearing is an effective way to reduce and mutualize counterparty credit risk, which in turn will help promote market stability. In addition to reducing counterparty credit risk, the clearinghouse will facilitate regulatory oversight by providing a single location for access to information about the CDS transactions it processes.

We also support the PWG's policy objective of improving the transparency and integrity of the CDS market, although care should be taken to protect information that might adversely affect the competitive positions of market participants. We agree with the steps outlined by the PWG to enhance risk management of OTC derivatives and would emphasize the importance of consistent standards being adopted by different regulatory bodies. The objective of further strengthening OTC derivatives market infrastructure is advisable, although we do not believe that the use of an exchange for standardized CDS contracts[6] should be mandated. We believe that the OTC markets and exchange-traded markets can coexist and that market conditions should determine which market is used in a particular circumstance. We agree that the ability to negotiate customized contracts should be maintained.

We believe the objective of strengthening cooperation among regulatory authorities is important, particularly insofar as it promotes regulatory consistency and efficiency through information sharing.

Conclusion

Credit default swaps are financial instruments that are useful tools for managing credit risk. Their importance to New York's economy is demonstrated by the tremendous growth in the CDS market in recent years. SIFMA looks forward to working with the State Assembly and regulatory authorities on initiatives that will enhance the effectiveness of regulation.

If you have any question regarding this statement, please contact Nancy Donohoe Lancia, State Government Affairs, SIFMA, at 212-313-1233.

[6] An example of a standardized CDS contract is an index-based CDS that references a common group of firms and covers a fixed five-year period.