Exchequer Club Luncheon

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Scott O'Malia, CEO, ISDA

Thank you for that kind introduction.

Good afternoon – it's a real privilege to be here today and to share ISDA's perspective on financial policy developments and future challenges.

Since its inception in 1960, the Exchequer Club has developed a well-earned reputation for the thoughtful and professional exchange of information and opinion on the economy and financial services.

In the 10 years that have passed since the financial crisis, and as we approach new looming challenges – like the LIBOR reforms, new margin rules for non-cleared derivatives and Brexit – this kind of high-level dialogue has become ever more critical to the smooth functioning of global markets. I applaud your continued commitment to this cause – long may it continue.

Three years ago, I relocated to London, having previously lived in Washington for over 20 years. It's always good to be back on home territory again. I absolutely love working in Washington's policy circles, with over 16 years in the Senate, a couple of years in the private sector and five years with the CFTC – which coincided with some of the most tumultuous years in financial markets.

When I was nominated for the CFTC in 2008, people had two reactions. First, most had never heard of it; second, it was recommended that I get a hobby to keep myself busy. Then the financial crisis hit, and it ended up being the busiest four years in the history of the Commission as we debated and voted on dozens of draft and final rules. The passage of the Dodd-Frank Act and subsequent rule-makings have now transformed the US regulatory framework. Consistent with the G-20 objectives, similar regulatory reforms have been executed across the globe.

After joining ISDA in 2014, I moved to London. People often ask me how the two cities compare. Both are great, in their different ways. Washington has its great baseball and hockey. London has its soccer and cricket. While I don't miss the extremes of winter blizzards and summer humidity here, it's a bit difficult to get used what my kids call the 100 days of darkness – December, January and February. The sun rises late, and drops early.

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But I think the greatest difference between London and Washington is the political environment. It may be hard to believe, but the debate over Brexit makes Washington seem like a model UN debate.

I'm kidding, of course. Both places have plenty of challenges. But during my time at the CFTC, I do think it's fair to say that commissioners on both sides of the aisle worked very hard and generally worked together to implement a new regulatory structure for derivatives. As a minority commissioner, I understood my role and fought hard to articulate my position, using all the tools at my disposal. The process provided me a voice and a seat at the table.

The CFTC completed a tremendous amount work, and the industry was consulted and was engaged throughout the entire process. Market participants have been diligent to implement the rules within the timelines and have conscientiously adhered to the regulations. In fact, the industry has come up with several transformational solutions that were borne out of the regulations.

Now, 10 years on from the financial crisis, there has been significant reform to the derivatives market, making it much safer, transparent and more robust. But I think there isn't enough appreciation of what has been achieved and what still remains to be done.

In fact, there is remarkably little substantive debate at the political level about the main elements of derivatives regulatory reform, either here in the US or in other key jurisdictions around the world. This lack of engagement and familiarity results in an unwillingness to focus on the details of the regulations, or to question whether any recalibrations are required.

To be fair, I do believe regulators are more focused on understanding how markets are adapting to the new regulatory structures. But more work remains to be done on addressing market fragmentation, ensuring the rules are risk appropriate and reducing operational challenges.

To ensure this audience is fully aware of where things stand on financial regulation and the challenges still facing the market, I'd like to describe the results of the reforms, and then highlight where I think additional attention is required.

To refresh your memory, there were five key pillars of regulatory reform, based on a set of commitments made by the G-20 in 2009 and 2011.

- The clearing of standardized derivatives;
- Reporting of all derivatives to a trade repository;
- Trading of standardized contracts on exchanges or electronic trading platforms where appropriate;
- Margining of non-cleared derivatives; and
- Reforms to bolster the regulatory capital framework.

In all five areas, progress has been unmistakable.

In clearing, 88% of interest rate derivatives notional traded in 2018 and reported to US trade repositories was cleared. Approximately 83% of credit derivatives traded notional was cleared. In fact, ISDA analysis shows that market participants are clearing more than what is required under the CFTC's clearing mandate, highlighting the benefits of clearing.

In reporting, regulatory standards have been introduced in 21 of the 24 Financial Stability Board jurisdictions, and regulators now have more data at their disposal to understand the derivatives market and identify systemic risk than ever before.

When it comes to trading, 56% of interest rate derivatives and 79% of credit derivatives notional traded in 2018 and reported to US repositories was traded on a SEF.

New margin rules for non-cleared derivatives are being phased in, contributing to a reduction in systemic risk. As a result of these rules, over $1.7 trillion of collateral was exchanged between market participants on their non-cleared derivatives trades as of the end of 2017.

And on capital, the large internationally active banks have added approximately $2.2 trillion of Tier 1 capital to their balance sheets since 2011, making them much more resilient to market stress. To put that in context, that's more than the GDP of Brazil.

ISDA and our members are very proud of this progress, and we recognize that it has been achieved through unprecedented levels of cooperation – at both the political and regulatory level and the industry level. We aren't advocating turning the clock back on regulatory reform – nor do we believe there would be any support in the industry for such a move. We recognize these reforms have helped make the derivatives markets safer and more efficient.

Having said that, we do think it's appropriate for regulators and policy-makers to take a step back to understand the impact of the reforms. For example, are certain requirements imposing unnecessary costs and compliance burdens on end users, for little benefit? Can the rules be fine-tuned so they are more appropriately aligned with risk? Is there a case for recalibrations in certain specific cases? We think the answer is yes in all three cases.

I would like to highlight two examples where review and recalibration of the rules is required – the incentives for clearing and the threshold for the final phase of margin requirements for non-cleared derivatives. I'll also identify two areas where global harmonization and cooperation are vitally important: benchmark reform and Brexit.

Starting with the incentives that are driving derivatives users to clear. Recall that 88% of interest rate derivatives trading volume is now is cleared. A study by the Financial Stability Board shows that capital rules and netting efficiency are primarily driving this behavior. However, there are a number of other regulatory incentives to clear, including the non-cleared margin rules. If these regulatory incentives are calibrated inappropriately and make it overly punitive to trade bilaterally, it could make non-cleared derivatives much more expensive.

This will increase costs for those end users that need customized, bespoke hedges to manage their risks, and drive products not suited to clearing into clearing houses, exposing them to inappropriate risk. We will work with policy-makers to optimize clearing – for risk management and cost efficiency – but also ensure there is a continued healthy market for bilateral trades as well.

Now, let's focus on the current regulatory situation of those non-cleared derivatives trades. In particular, I'd like to focus on systemic risk and whether these rules are appropriately calibrated.

The non-cleared margin requirements are being phased in over five years to 2020, beginning with the largest firms. So far, about 35 banks and one buy-side firm have come into scope – remember that number.

By September 2020, more than 1,100 smaller entities will fall into scope. These firms will have to negotiate new documentation with all their counterparties, set up new custodial arrangements and put in place new margin calculation systems. Despite this, most will not actually be required to post initial margin, because their exposures with each counterparty fall below a minimum threshold.

Now, policy makers largely got this correct. The policy generally exempts those that don't pose systemic risk from exchanging margin. However, this exposes small end users to significant compliance costs for no gain.

We believe the threshold for compliance should be raised from the current $8 billion in aggregate non-cleared average notional amount of non-cleared derivatives to $100 billion. This will exclude a large number of smaller entities, but will have a very minor impact on the amount of collateral held in the system.

The importance of these initiatives extends well beyond the people who work in the derivatives market. Companies all over the world rely on derivatives to manage their risk, whether that means locking in the cost of issuing debt to finance investment, reducing exchange rate uncertainty, managing oil price fluctuations or protecting pensions for retirees. A robust and liquid cleared and non-cleared derivatives market is essential to support corporate financing, economic growth and the creation of jobs.

Given this, it's not surprising that some big looming issues are encouraging those policy-makers worried about economic growth to pause and reflect.

Benchmark reform is one such issue. There is currently about $370 trillion in total notional exposure to contracts referenced to interbank offered rates, or IBORs. That's not limited to derivatives markets – it also touches mortgages, loans, retail deposits and securitizations.

But concern about the ongoing viability of these benchmarks means there is a concerted global effort to adopt new risk-free rates in place of IBORs. We support these initiatives – just think about the systemic implications if one or more of those IBORs ceased to be published, leaving that $370 trillion worth of contracts without a reference rate.

Significant progress has been made, particularly in the US, where a public-/private-sector working group has identified an alternative risk-free rate – SOFR – and is making good headway on implementing a transition plan.

But make no mistake: the scale of the task is huge, and it will have an impact right across financial markets, from the largest trading houses to the smallest retail investors.

At ISDA, we've focused on developing solutions and helping the industry with benchmark reform initiatives. A major focus has been on developing fallbacks for derivatives contracts referenced to certain IBORs – essentially a safety back-up in case a key IBORs ceases to exist.

There's one more looming issue I'd like to mention: Brexit. With just over two months until the UK is set to leave the EU, there's still huge uncertainty about the form of the exit and what this will mean for derivatives users. As a result, there are justified concerns about the potential for disruption in financial markets – not only in the UK and EU, but globally.

Again, ISDA has worked to highlight areas where certainty and clarity are needed, and – as far as possible – developed solutions to help firms continue trading. For instance, we've conducted legal analysis on the impact on outstanding contracts and published new documentation to give firms options in how they trade post-Brexit.

But this issue will likely require coordination and regulatory action to mitigate the impact, particularly in a hard Brexit scenario.

I have given just a flavor of the various issues that confront us in 2019 and look set to keep us busy for some time to come. In all the examples I've mentioned, there is a need for bipartisan cooperation to ensure positive outcomes and maintain safe and efficient financial markets.

Finally, I want to assure you that we at ISDA are doing our part. We meet regularly with regulators and policy-makers all over the world, and on all sides of the aisle, to make sure that the key issues are well understood. Enthused by the tangible progress that has been made in the derivatives market in recent years, we are confident that both the industry and the official sector will rise to the challenges that now confront us.

Thank you for your attention, and I would be happy to take some questions.