ISDA European Policy Conference 2017
Opening Remarks – Scott O'Malia, ISDA CEO
Thursday September 28, 2017: 9.30am-9.45am

Good morning, and welcome to our European public policy conference.

Today's event comes at an ideal time. MIFID II – one of the most complex and far-reaching pieces of financial legislation ever developed – will come into effect in a matter of months. At the same time, the European Commission is reviewing the European Market Infrastructure Regulation, or EMIR, with the objective of removing unnecessary complexity and cost, and reducing the compliance burden on end users.

This is on top of other proposed amendments to the Bank Recovery and Resolution Directive and to the supervision of clearing houses, and changes to key market benchmarks.

These are all extremely important developments, and I look forward to hearing the insights of our keynote speakers this morning: Patrick Pearson, head of unit for financial market infrastructure at the EC, and Kay Swinburne, vice chair of the Economics and Monetary Affairs Committee at the European Parliament.

Over the course of this conference, we will assess the significant amount of work that has been done to make the financial system safer, more transparent and resilient. We'll also consider how the framework can be further enhanced to ensure the thousands of companies that use derivatives to hedge their risk can continue to access this market efficiently. We'll look at how the rules can be streamlined to reduce unnecessary complexity, while maintaining safety and soundness. We'll also discuss the opportunities for improved cross-border harmonization.

Last week, we published several important whitepapers to help inform debate on these issues. This includes a paper that sets out solutions for improved CCP security, a proposal for cross-border equivalence determinations, and analysis on the quantity of margin that has been exchanged to improve safety and resilience of the derivatives markets. Today, we published a new paper that focuses on another important issue – the challenges posed by proposed amendments to the BRRD.

In my remarks this morning, I will address three key issues. First, I'll look at the progress made to reform the derivatives market, and argue that now is the time to take a long hard look at the rules to see where we can make them more effective and less costly. Second, I want to highlight the importance of cross-border recognition. Third, I'd like to touch on some outstanding challenges – specifically, the need to establish unambiguous and predictable recovery and resolution strategies for CCPs, and the need for a clear, workable transition strategy for benchmarks.

Progress Made in Reform

The G-20 reforms, and legislation like EMIR and Dodd-Frank in the US, was virtually unprecedented in scope, and have brought significant change to the market.

To emphasize the scale of the improvement to systemic stability, let's look at one specific policy area – capital. Since the crisis, the largest global banks have raised over $1.5 trillion in new capital. The size of that number can make your head spin, so let's put it in context. $1.5 trillion is roughly the GDP of Canada, the 10th largest economy in the world.

New rules have also been introduced that require all non-cleared trades to be backed by high-quality collateral. Our margin survey published last week quantifies the impact of these rules. As of March this year, the largest dealer banks held nearly $1 trillion in collateral on their non-cleared trades. These requirements are being phased in for other derivatives users too, which goes a long way to mitigating counterparty credit risk and reducing the risk of losses.

But given these changes, and the amounts involved, it makes sense that we now take the time to fully assess whether the capital and margin framework is appropriately calibrated and risk sensitive.

Elsewhere, more and more standardized trades are being cleared through CCPs – 88.5% of interest rate swap traded notional in the second quarter of this year was cleared. Today, the market is clearing far beyond what is mandated, including non-deliverable forwards and inflation swaps.

But given this increase in clearing volumes, it has become vitally important that a comprehensive mechanism for CCP resilience, recovery and resolution is put in place. I will come back to this point later.

The Case for Review

It's clear that a great deal has been achieved to help make the financial system safer and more resilient. But it's equally clear we should strive to ensure the rules are appropriate, and complexity and duplication within the framework are eliminated. This unnecessarily increases the cost and compliance challenges for derivatives users. These costs impact liquidity and risk management, so it's important we get the balance right.

The EC's review of EMIR has highlighted areas where specific, targeted improvements of the rules will result in reduced cost and operational complexity for end users, without undermining safety and soundness.

Among other things, the EC has suggested changes to the reporting rules so responsibility for reporting transactions with a non-financial entity not subject to the clearing obligation would fall entirely on the financial counterparty. The review also proposes a removal of the requirement to report historical trades.

We agree with the overall objectives of the EMIR review, and support many of the proposals that have been made. However, we believe other targeted amendments would further improve efficiency and eliminate remaining areas of complexity for end users.

For example, we would strongly urge regulators to go further with their changes to the reporting rules by introducing an entity based approach, where sole responsibility for reporting is assigned to a single counterparty in all cases. This would bring the EU in line with other major jurisdictions, reduce complexity for end users, and improve data quality and consistency.

Other targeted modifications would also improve efficiency of the framework, including recalibrating the definition of 'financial counterparty' to avoid disproportionate and damaging consequences for the securitization market, and harmonizing EU margin requirements for physically settled FX swaps and forwards with the treatment in other jurisdictions. In the short term, a delegated act is required to change the January deadline for variation margin posting on these instruments to avoid European firms being put at a competitive disadvantage and, more broadly, negative effects for inward investment in Europe and investment by EU firms throughout the world.

As the EMIR review continues, market participants are grappling with another vital piece of European regulation – MIFID II. This regulation will have a huge impact on vast swath of market activities and participants. Given its significant footprint and complexity, it is important that regulators continue to engage with the industry and provide clarity where necessary to help implementation. Regulators must also provide further clarity on the status of third-country operations of EU firms under MIFID II.

Cross-border Harmonization

That brings me onto the second part of my remarks.

Derivatives markets are global. This gives companies the ability to efficiently and cost-effectively manage their currency, interest rate, credit, equity and commodity exposures. For this to function effectively, regulators must coordinate to ensure the various sets of rules work on a cross-border basis.

To be effective, regulatory harmonization must be executed in both word and deed. It's not enough for regulators to say their rules are comparable – they must follow through to recognize comparable regimes. Without recognition, firms are forced to comply jurisdiction by jurisdiction.

Currently, the market is waiting to see if EU and US regulators can find common ground on trade execution prior to the implementation of the MIFID II regime in January. A failure to do so would reinforce the fragmentation of derivatives markets and damage cross-border trading flows between the US and Europe. Last year, we published a paper on the similarities between the US and EU trade execution regimes. We believe this provides a clear roadmap to recognition and substituted compliance.

Last week, we published a paper that argues the appropriate test of a cross-border framework should be risk-based. This framework is aligned with the objectives of the G-20 and is consistent with the intent of EMIR. We propose to focus comparability assessments only on those rules that relate to risk – for example, capital and margin requirements, the alignment of clearing mandates, and regulatory reporting of derivatives.

CCP Safety and Soundness

Earlier, I mentioned, the largest global banks have increased the amount of capital on their balance sheets by $1.5 trillion. This added protection doesn't just help banks – it also adds to the safety and soundness of clearing. Clearing is a foundational part of the risk management tools deployed to improve safety and soundness of the derivatives market. But we can't ignore the fact that a CCP concentrates that risk as well.

The failure of a clearing house is exceptionally unlikely. However, these entities are systemically significant institutions, and regulators across the world need to fully implement mechanisms to recover, and potentially resolve, a failing CCP. To guarantee contractual and operational certainty, regulators need to continue working together to establish clear and transparent processes for recovery and resolution that work on a cross-border basis.

Last week, we published a series of recommendations on the appropriate next steps to protect against a CCP failure, but also on the steps needed to recover and potentially resolve a CCP.

To some extent, this important issue has recently been over-shadowed by debate on CCP location following the UK's Brexit vote. The question of whether a national regulator should impose a location requirement on a CCP is clearly controversial and would increase costs and fracture market liquidity. For our part, we think regulators should not be distracted from the importance of establishing globally consistent resilience, recovery and resolution strategies for CCPs. This is critical to ensuring the continued safety and efficiency of the cleared derivatives markets.

Benchmarks

I've discussed one important challenge. I'd now like to turn to another – the importance of a well-defined and transparent transition strategy for benchmarks.

The FCA's announcement in July that it would no longer compel or persuade banks to make LIBOR submissions from the end of 2021 has focused attention on how to ensure a smooth switch to alternative risk-free rates.

The scale of this challenge is immense. LIBOR serves as a reference rate for hundreds of trillions of dollars in notional of derivatives contracts. It's also a common reference rate for loans and mortgages, many of which extend far beyond the end of 2021.

This is not something that can be left to the last moment. And it's not something that can left to chance.

ISDA has been involved in several public-private sector groups set up to choose preferred alternative risk-free rates, and that work is now switching to transition. Success will rest on the ability to build liquidity in these new alternative risk-free rates, and to develop a whole ecosystem of cleared, exchange-traded and OTC products around it. Clear communication, coordination and market education will also be critical.

We are working with our members to flesh out each step of the transition process and identify the issues that need to be addressed. We're also working to identify fallbacks to certain key IBOR rates and incorporate them into derivatives documentation. These fallback rates would then automatically apply if an IBOR reference rate ceases to exist.

It's important the industry gets engaged with these issues now. We have to get this right. You'll hear much more from us on this topic in the months ahead.

Conclusion

The progress made since the crisis is extremely impressive and must be preserved. Higher capital standards, clearing, margining and reporting have made our industry safer and more transparent.

The focus should now be on strengthening the reforms by highlighting areas where they could be more efficient and less burdensome for end users. That includes getting results on cross-border recognition, and refining existing regulation to cut costs and complexity. We believe many requirements are too complex and costly, especially for non-systemic entities that access these markets to manage risk and raise capital. Our economies will be stronger if we get this balance correct.

We need to move forward with the regulatory work to ensure we focus on the safety and soundness of CCP operations and get better clarity on the application of resources in both a recovery and resolution. Continued private-public sector engagement to develop a clear, coordinated transition strategy for benchmarks is also a critical priority.

We will have numerous panels with market and regulatory experts who will discuss all of these important topics in much greater detail. Thank you for coming and I hope you enjoy the day.

Thank you.