ISDA Annual General Meeting
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Opening Remarks
Scott O'Malia, Chief Executive Officer, ISDA

Hello, welcome back to the third and final day of our virtual AGM.

I'd like to take this opportunity to say a big thank you to all our sponsors – we really appreciate your support. I'd also like to thank our speakers – and, of course, all of you for tuning in over the past couple of days.

Now, I talked on Monday about one important lesson of the coronavirus crisis: that a digital future for derivatives is absolutely possible and within reach. But we can't forget another important lesson – the resilience of financial markets during the pandemic. This, to me, is one of the big success stories of the past year.

Let's recall what happened during the early part of the pandemic. Markets tumbled, and liquidity became scarce amid a scramble for cash, prompting central banks to inject trillions of dollars into the financial system. Despite the volatility, most markets remained open and infrastructure continued to function, enabling firms to continue to access financing and manage their exposures.

During this period, financial institutions played a vital part in helping the various central bank measures flow through to the real economy by extending credit to customers, enabling access to capital, and providing intermediation and risk management services.

Like all market participants, this was an incredibly busy time for ISDA. As the virus evolved into a global pandemic in March 2020, we provided guidance on the small number of market closure events that occurred. We also worked with regulators to secure relief on impending implementation dates – vital changes that enabled financial institutions to remain focused on business continuity, risk management and supporting customers.

There's absolutely no doubt in my mind that the resilience of the financial system and the ability of banks to support their clients through this period of stress was made possible because of regulatory reforms over the past decade. Bank capital and liquidity positions have been drastically strengthened because of Basel III, while counterparty credit risk is much, much lower due to mandatory clearing and the margining of non-cleared derivatives exposures.

As Randal Quarles, the Federal Reserve's vice chair of supervision, has said, banks entered the crisis in a much stronger position than in 2008, which enabled them to "play a central role in the measures to support the flow of credit to the economy".

But while financial institutions were part of the solution in this crisis, there are lessons that can be learned to ensure markets remain resilient in the future. At the same time, new risks and opportunities are emerging, such as those relating to climate change, which we need to respond to.

In my remarks today, I'll briefly sketch out three important areas of evolution for derivatives markets – climate risk and environmental, social and governance (ESG) issues, the capital framework and the post-Brexit landscape. I'll also outline the initiatives ISDA is taking in these areas to ensure markets continue to be safe and efficient.

Climate risk

First, let's look at ESG.

It's clear that climate change poses a very real risk, prompting governments across the globe to set ambitious targets to reduce emissions. The financial sector is exposed in a variety of ways, so it's vital we develop the tools to accurately monitor, price and manage climate risk – something that will require consistent data standards and development of climate risk modelling and scenario analysis.

One thing is certain: financial markets will play an essential role in the shift to a greener economy by mobilizing the estimated $110 trillion in capital needed by 2050 to fund new sustainability initiatives and infrastructure, as well as enabling companies to manage their risk.

As discussed in our ESG panel yesterday, a critical component to the success of this transition is the development of a transparent and resilient carbon market. This was the number-one recommendation in a recent Commodity Futures Trading Commission (CFTC) report on climate risk, which states that financial markets will only be able to efficiently channel resources to activities that reduce carbon emissions if "an economy-wide price on carbon is in place at a level that reflects the true social cost of these emissions".

Establishing a price on carbon will help provide transparent pricing of climate-related financial risks and encourage further development of ESG-related financial products – vitally important in driving investment towards new low-carbon technologies.

Of course, for this market to grow at scale, we need standardization of data, terms and documentation to create efficiencies and minimize costs. This is very much in ISDA's DNA and will be a focus of our work in this space.

ISDA has already published a variety of templates to support trading of emissions and certain types of environmental derivatives, including US and EU emissions annexes. We're currently exploring how we can extend this to other areas. For example, earlier this month we published the ISDA US Renewable Energy Certificate Annex.

As carbon and other ESG derivatives continue to gain traction, and as participants seek greater levels of contractual standardization in specific areas, we will work with our members to identify and address emerging needs to support the development of this market.

Capital

Let me now turn to the capital rules.

This year will see several jurisdictions develop rules to implement the final Basel measures, which include the Fundamental Review of the Trading Book (FRTB) and a revised credit valuation adjustment (CVA) capital framework. As national regulators transpose the global Basel standards into local rules, there is an opportunity to review what happened during the pandemic and consider what impact the changes will have.

As I mentioned, changes to the capital and liquidity rules over the past decade have undoubtedly increased the resilience of the banking sector and made it more able to withstand stress. Since 2011, for example, internationally active banks have added about €2 trillion in common equity tier-one capital to their balance sheets.

However, the current rules were shown to be highly procyclical during the extreme market volatility of last year. According to analysis of 20 banks compiled by ISDA, the Global Financial Markets Association and the Institute of International Finance, there was a sharp increase in trading book risk-weighted assets (RWAs) during the first quarter of 2020, at the height of the coronavirus crisis. CVA RWAs increased by more than 45%, while counterparty credit risk and market risk RWAs rose by 20% and 22%, respectively.

Ballooning RWAs could have severely curtailed the ability of banks to provide intermediation services and support the economy. Fortunately, regulators took a flexible approach and provided temporary relief to smooth the procyclical impact – but it's a reminder of the importance of an appropriate, risk-sensitive and non-procyclical capital framework.

While the new FRTB framework has been designed to reduce procyclicality in market risk capital requirements, our analysis shows it is unnecessarily conservative. National authorities should take the opportunity to ensure the rules are calibrated appropriately and will not inadvertently choke off the supply of credit to the real economy when it's most needed – all the more important as we continue to recover from the economic damage caused by the pandemic.

As local regulators develop their rules, ISDA will provide input, data and analysis where necessary, with the aim of achieving a coherent and risk-appropriate capital framework that takes the lessons learned from the pandemic into account.

We're also helping banks with their implementation through our Standardized Approach Benchmarking initiative. This has been a terrific success to date, enabling 58 banks to compare their approach with an industry standard. So far, the focus has been mainly on benchmarking the FRTB standardized approach, but we're extending into other areas of the framework, helping more and more banks achieve a consistent interpretation and implementation of the rules.

Post-Brexit landscape

Finally, I'd like to touch on the post-Brexit landscape.

One of the lessons of the COVID crisis was the stresses that emerge when liquidity dries up. It's therefore important we don't create avoidable barriers that limit the ability of firms to tap into the widest possible pool of counterparties.

Unfortunately, the lack of equivalence between EU and UK trading venues has made it much more difficult for entities in those jurisdictions to trade with each other.

As it stands, EU entities trading derivatives subject to the EU derivatives trading obligation (DTO) are required to execute those transactions on an EU or EU-recognized trading venue, while UK firms must trade derivatives subject to the UK DTO on a UK or UK-recognized venue. Without equivalence, in-scope trades between EU and UK counterparties can only take place on US swap execution facilities (SEFs), which are recognized by both jurisdictions.

In fact, analysis shows US SEFs have already captured a large slice of euro- and sterling-denominated interest rate derivatives business, as you can see on this chart.

Those firms not willing or able to use SEFs have no choice but to trade only with counterparties on local venues, resulting in split liquidity, less choice and potential pricing impacts.

Following action by the Financial Conduct Authority, UK firms are at least able to trade DTO products with EU clients on EU venues, so long as certain conditions are met. However, the situation is more challenging for EU banks, which are unable to trade with clients and other banks that continue to use UK venues.

This is not ideal for anyone, including EU banks that want to maintain client business on UK venues. We continue to believe that trading venue equivalence is the only way to comprehensively solve this issue. Given EU and UK trading venue rules are virtually identical, we can’t see any technical or legal reason why equivalence isn’t possible, so we continue to urge regulators to take action.

Equivalence for clearing houses is even more important, as a mass shifting of exposures from one central counterparty to another would cause severe market disruption and fragmentation that would disadvantage European banks. While a temporary equivalence determination is in place until mid-2022, we believe EU clients should be able to clear where they choose, based on risk, liquidity and pricing. Equivalence is the best approach to maintain financial stability – and is justified given the similarity in the rules.

Conclusion

I’d like to close my remarks by reiterating the point I made at the start – derivatives markets continued to function throughout a period of extreme stress last year, and played a vital role in the transmission of central bank support to the real economy.

As our market continues to evolve, ISDA’s priority will be the same as it’s always been: to ensure the foundations are in place for safe, efficient markets.

Thanks again for attending this year’s virtual AGM, and I look forward to seeing all of you in person next year in Madrid.