ISDA AGM Lisbon 2017
Chairman's Remarks
Wednesday May 10, 10.00am-10.30am

Thanks Scott.

Good morning, everyone.

I'd like to take this opportunity to thank our two keynote speakers this morning for their interesting and insightful remarks.

I'd also like to thank you all for coming to Lisbon for this year's AGM. I'm sure you'll agree with me that the past two days have confirmed what a truly beautiful city Lisbon is. Great architecture, great views – a place steeped in culture and history. Last night's event illustrated that wonderfully.

I hope you'll also agree that we've covered a lot of really interesting ground – from the implications of a changing policy agenda, to the future of bank capital rules.

Underlying those topics are some important themes: the need for financial market resilience, but also for economic growth; the importance of maintaining the progress made in regulatory reform, but also of further improving the framework to reduce unnecessary complexity; the potential for innovative new technologies to drive efficiency, but also the importance of common industry standards that underpin that innovation, and which are at the core of ISDA's mission.

We're going to pick up and run with all of those topics and themes throughout the rest of today. But before we continue, I'd like to play a short video.

VIDEO – How do Derivatives Benefit the Global Economy

So, why am I starting my remarks with a video on something as rudimentary as the benefits of derivatives? Given the audience, aren't I preaching to the converted here?

The truth is that it's often forgotten just how vital this industry is. Sometimes even by us. We sometimes forget to articulate the social value of what we do. It's all too easy to be caught up in the weeds, absorbed in intricate policy or legal details, and to lose sight of this one simple fact: derivatives continue to be used by a whole range of companies because they're useful. Because they help them to manage risk, and create certainty and stability. This ability to acquire certainty, and to adjust and optimize risk-profiles, is immensely valuable.

Every day, companies around the world use derivatives to lock in the cost of issuing debt to finance new investments. Exporters use derivatives to create certainty in the exchange rate at which they can convert future overseas revenues. Pension funds use derivatives to protect the value of pensions for future retirees. Food producers use derivatives to hedge crop and livestock prices. And banks and mortgage providers use derivatives to manage the risk from their loan books, enabling them to keep on lending.

I could go on and on. In each case, the certainty that derivatives bring give those firms the confidence to lend, to borrow, to invest, to grow, to hire. That all contributes to economic growth.

These companies used derivatives before the crisis; they continue to want to use them now. That's because derivatives allow them to run their businesses better. Without them, there's more risk and uncertainty in the system and the gears of the economy seize up.

That is the 'what' of what we do as an industry. But there is a 'how' as well that must not be neglected.

As we know, the financial crisis exposed some weaknesses in how derivatives are traded and managed. A lack of reporting meant there was uncertainty over who had what exposures, which undermined confidence and the willingness to extend credit.

The bilateral nature of the market meant there was a network of interlinking trading relationships, with the big dealers at the center, which led to fears of contagion. While many of those bilateral trades were collateralized, some weren't. Even where they were, there were questions about the frequency of collateral calls and the ability to quickly access that collateral in the event of a default.

On top of all that, banks were found to have insufficient capital or liquidity to withstand a severe market shock.

Regulators and the industry have spent the past eight years addressing those issues. Reporting of all derivatives trades is now required virtually everywhere, and regulators have ready access to that information in their own markets. Clearing of standardized derivatives has quickly gained traction, and now about three quarters of interest rate derivatives notional outstanding is cleared through a central counterparty. Margin requirements are being rolled out for non-cleared transactions. And the largest global banks have raised more than $1.5 trillion in new capital.

The financial system is more resilient as a result. Just think back on what's happened over the past two years. We've seen a succession of shock events – Brexit, the US elections, the unpegging of the Swiss franc, and Ukraine and Crimea. These events have been accompanied by sudden, violent and sometimes unprecedented moves in markets.

Yet despite these moves, at no point has anyone said they're worried about the financial system. Yes, there have been localized issues, but these have been contained. There may have been shocks, but there has not been panic.

Clearly, it's vital that the system continues to function, and – importantly – that people have confidence that it will continue to function. It's critical that companies are able to continue transferring risk, and can do so with confidence that their hedge will not suddenly vanish with the collapse of their counterparty. That gives firms the confidence to borrow and invest, which is vital for economic growth and prosperity.

There is, as I'm sure you've all guessed, a 'but' coming.

And the 'but' is that banks need to be able to provide the financing and risk management services that are so crucial for economic growth, in a way that is economically viable and sustainable.

In theory, you can make the system safer and safer by adding more and more capital. The more capital held within the system, the more resilient it is to shock.

But capital is neither a free nor an infinite resource. Progressively increasing the capital requirements of an activity eventually leads to an inflexion point, where the cost of the capital is no longer proportionate to the risk and return of the activity. That encourages that capital to be reallocated elsewhere. If the amount of capital required for market risk and credit risk activities is disproportionate, then capital is quite naturally allocated away from lending, market-making and intermediation. Without access to financing and risk management solutions, economic growth suffers.

This is not a hypothetical scenario – we've seen this situation unfold in past years as banks selectively retrench from intermediation. Forthcoming measures from the Basel Committee could push us further past that inflexion point.

According to ISDA studies, new trading book rules will result in an increase in market risk capital of between 1.5 and 2.4 times, on top of the increases that have already come into effect since the crisis. That's a lot of extra capital – and it will have the biggest impact on business lines that are important to end-user financing and hedging.

The exact impact will depend on the ability of banks to use internal models to calculate market risk capital. But the rules, as they stand, make it very difficult for banks to get approval to use them.

As part of the Basel Committee's Fundamental Review of the Trading Book, banks have to show their internal models are closely aligned with those used for front-office pricing and valuation.

Now, having some kind of process in place to test the validity of internal models makes sense, and should provide greater confidence that the models used by banks are robust and transparent.

But the way the so-called P&L attribution test is currently drafted is unclear, and the requirements are untested and will be difficult to implement. This means there's a very real prospect that even reliable models will fail the test – forcing banks to adopt the less risk-sensitive standardized approach, which will result in higher capital requirements.

The extent to which banks can model risk factors is also a big concern. For a bank to include a risk factor in its internal models, it must show that risk factor has at least 24 observable prices over a year, with a maximum of one month between observations.

On first consideration, that doesn't sound unreasonable. After all, an accurate model needs accurate data. But putting these requirements into practice will be extremely difficult. For one thing, there's a lack of clarity on what actually constitutes an observable price. For another, banks might have data in some areas but not in others. Or a risk factor might have 24 observable prices, but suffer from a lull in trading activity over the summer or winter months each year, making it ineligible.

ISDA is leading industry efforts to agree a common interpretation of the requirements, and to map out a practical way of applying them. The ultimate aim is to pool data across the industry, enabling banks to fill the gaps in their own data. But there's some question over whether regulators will endorse a data pooling solution as part of FRTB compliance.

This will be crucial. It's difficult to see how internal models for market risk will work without some form of industry data pooling. Without it, a large universe of risk factors might not qualify for inclusion in internal models, which will result in higher capital requirements. In fact, an ISDA impact study last year showed that non-modellable risk factors comprise a whopping 35% of the internal models approach capital charge.

Both of these measures chip away at the risk sensitivity of the capital framework. And they're not the only ones. They come on top of the leverage ratio – meant as a non-risk-sensitive backstop to capital requirements – and the proposal to introduce output floors.

The former is increasingly becoming the primary driver for bank capital, rather than being a backstop. Here in Europe, for example, the EBA has reported that the leverage ratio acts as a primary constraint for 75% of the largest banks.

That's having a noticeable impact on bank behavior already. Certain low-risk, low-return businesses – repo, for instance – are becoming less economic given the level of capital that institutions have to hold, meaning some banks are pulling back from that product. Essentially, the level of capital is no longer appropriate to the risks posed by this business.

Client clearing has also become more economically challenging. That's because there's no recognition given to segregated client margin under the Basel version of the leverage ratio – even though the very purpose of that collateral is to reduce the clearing member's exposure in the event of a client default. This lack of recognition increases the amount of capital needed to support client clearing activities.

According to an ISDA study, leverage ratio exposure for client clearing increases by a massive 85% if the exposure-reducing effect of initial margin is ignored. The end result is that it has become more difficult for clearing members to provide this service. A number of firms have scaled back as a result, which could create clearing access issues in the future, particularly for smaller firms. This seems to be in direct conflict with the objectives of market regulators to encourage clearing.

Output floors add another – in our view unnecessary – backstop, which further distorts the link between risk and capital.

The impact will be particularly keenly felt by European banks. According to an ISDA/IIF study, the simple mean percentage increase in credit risk-weighted assets for European banks from the introduction of a 70% floor would be double the increase for US banks.

Does that mean that European banks are riskier, or under-capitalized? Or does it reflect a fundamental difference in assets, which would be distorted by the introduction of an output floor?

There are, in fact, a number of structural reasons for this difference – not least, that European banks hold higher levels of mortgages and corporate loans on their balance sheets than US banks. That's because of the role played by Fannie Mae and Freddie Mac in the US mortgage market, and the fact that US capital markets are more developed and play a larger direct part in corporate borrowing than in Europe.

Another reason is that European regulators have been more encouraging in the use of internal models – subject, of course, to regulatory approval and supervision. This has allowed European banks to use internal models to closely match capital with the risk of their assets. The standardized approach, in contrast, is a much blunter tool and, more often than not, will result in higher capital requirements.

We understand that regulators are keen to address any unjustified variability in bank internal model outputs. But we think there are better ways of doing this than imposing a one-size-fits-all floor that reduces the risk sensitivity of the whole framework. It could be achieved, for instance, through greater consistency in model inputs, or through testing procedures, such as the ECB's ongoing targeted review of internal models.

Moving to a non-risk-sensitive structure – either through floors, a conservatively calibrated leverage ratio, or restrictions on internal models – has several implications for the way banks allocate capital.

Importantly, being required to hold capital greater than is warranted by the risk of a certain asset or business makes it difficult for banks to generate a sufficient return on equity. To put that another way, the bank isn't making enough of a return to justify the capital being consumed for a particular asset or business line. The cold, hard truth is that banks need to be profitable in order to provide these services on a sustainable basis.

A bank could try and reduce costs, but there's a limit to how far you can save your way to an acceptable ROE. Ultimately, you need to increase your return on assets. That's when you start seeing a change in capital allocation. The economically rational decision is to aim for the highest-return for a given amount of capital. In other words, banks become more asset sensitive and less risk sensitive. Of course, those assets offer higher returns for a reason – they're riskier. But that wouldn't be reflected in the capital that banks have to hold under a blunter, less risk-sensitive framework.

With banks all subject to the same standardized models, they'll have the same view on what assets and businesses to target. That lack of diversity and herd behavior is not healthy for the financial system. It means less choice for consumers in terms of the products and services on offer. And it means crowding on those assets seen as providing value.

It doesn't end there. With everyone focusing on the same assets, returns on those assets will fall – prompting firms to move further along the risk spectrum in search of higher returns.

That's not a good set of incentives to have, because the economically rational choice leads to undesirable outcomes. Recognition of these issues is what drove the Basel Committee to adopt a risk-based capital framework in the first place. By providing incentives in the form of more appropriate capital levels, based on the specific risks of the assets each bank holds, it encouraged firms to invest in cutting-edge risk management systems.

Those models, and the Basel II framework more generally, were shown to be deficient in several areas during the crisis. But that does not mean risk sensitivity as a concept is flawed and should be ditched or heavily restricted. After all, there's no need to drain an entire lake to catch a fish. Risk sensitivity is not only the right way to go – it's the safest way for banks to allocate capital.

This isn't just an industry view. Apprehension about having a non-risk-sensitive framework is also shared by many in the regulatory community. Looking back to last year's AGM in Tokyo, JFSA Commissioner Mori raised concerns about the consequences of adding layer after layer of capital. To quote his remarks:

"We had better think carefully about whether thick walls are enough to attain our dual goal of financial stability and growth. In 1944, the Japanese heavy battleships Yamato and Musashi had the thickest walls, but we know that they were not resilient against air power."

Our first keynote speaker this morning, CFTC Acting Chair Giancarlo, has also made some recent comments on achieving the appropriate incentives. And European regulators have been vocal on the need for risk sensitivity in the capital framework.

I hope that you've all by now read the interview with the European Commission's Olivier Guersent in our newly relaunched ISDA Quarterly magazine. But in case you haven't, he makes a strong argument on the importance of risk sensitivity. Without it, he says, the capital rules would treat different risks in the same way across banks. That would lead to the inefficient allocation of resources, and would mean the balance sheet of a risky bank becomes indistinguishable from the balance sheet of a non-risky bank.

A focus of European attention has been the proposed inclusion of an output floor. European resistance to this was cited in the press as one of the main reasons behind the Basel Committee's announcement in January that it needed more time to finalize its latest set of measures. The changing of personnel in the US following the elections was cited as another reason for delay.

ISDA strongly believes the capital framework should be risk-sensitive, appropriate and coherent. Crucially, it should aim to avoid any detrimental impact on market liquidity, and ensure banks are able to continue to lend to the real economy and provide crucial hedging products to end users. As pointed out in the video we watched earlier, providing financing and risk management services helps set the foundations for economic growth.

The EU is so far the only major jurisdiction to publish a draft proposal for implementing the remaining Basel rules. Those proposals contain targeted amendments to the Basel measures that recognize the role banks play in financing the economy, as well as the need for consistency between market and prudential reforms.

Take the leverage ratio, for example. Unlike the current Basel framework, the European proposals recognize that client initial margin is segregated, as well as risk reducing. As a result, they don't require banks to count this margin towards leverage ratio exposure. This is less likely to damage the ability of clearing members to offer client clearing services, and should allow greater clearing access for derivatives end users.

The EC has also taken steps to prevent disproportionate capital requirements for trading book positions, including those related to market-making activities, by proposing a 65% scalar on market risk capital requirements during a three-year phase-in period. This is a recognition that the Basel Committee is still working on the calibration of its trading book regime, and the scalar accordingly aims to attenuate any unnecessary sudden and unwarranted increase in capital that could hurt market liquidity.

This is helpful, but we believe more work needs to be done on ensuring a proper recalibration of both the standardized and internal model approaches under the FRTB. We also think further thought needs to be given at the Basel level to the eligibility test for using internal models.

Elsewhere, the European proposals will help end-user hedging by making derivatives more economically viable. Take the NSFR. While the Basel Committee introduced a 20% required stable funding add-on for derivatives liabilities, and strict requirements on the recognition criteria for margin received, European regulators have taken a more consistent and nuanced approach – by allowing for the recognition of high-quality liquid asset collateral, for example. This will help allow counterparties like pension funds to continue accessing liquid derivatives markets.

These types of targeted changes were deemed necessary to ensure banks are able to play their part in fostering deeper and more liquid capital markets in Europe – a key objective of the EU capital markets union.

They are also aimed at stimulating bank lending and growth – as acknowledged by M. Guersent in the ISDA magazine interview.

We're supportive of the overall aims of the EU amendments, and many of the specific proposals. But we also believe reaching agreement on a single global capital framework is of the utmost importance.

It serves no one's interest to have a Basel agreement that lacks global consistency and coherence. At best, a lack of harmonization would increase compliance costs for internationally active firms. At worst, it creates impediments for firms to trade across borders, reducing the efficiency of markets. It also generates an unlevel playing field, which may facilitate the build-up of concentrated risk positions in certain jurisdictions.

With that in mind, we urge the Basel Committee to make adjustments to frameworks or calibrations generally whenever widespread concerns result in the risk of regulatory divergence. Those amendments should be made with an eye on economic growth by making the rules proportionate and risk sensitive.

The push for economic growth and job creation is very much in line with the objectives of the new US administration. So we're hopeful that a global agreement is very much achievable.

I'll close by referring back to the video we watched at the start of my remarks.

Derivatives are useful. They make it easier for companies to raise financing and to hedge their risks. The certainty that hedging provides gives them the confidence to invest, expand, hire and grow.

It's vital that banks are able to provide these services. That requires a framework that sets capital at a level appropriate for the risk of a given product or business.

We strongly encourage the Basel Committee to continue to conduct impact studies to monitor the effects of the capital framework before all the rules take effect. These studies should not only look at overall capital, but also gauge the impact on specific business lines and products. They should also assess the effects across the derivatives ecosystem. What impact is the regulatory framework having on the ability of end users to access hedging products, for instance?

At ISDA, we strongly support safe derivatives markets. And the industry has done its bit, alongside regulators, in making the system safer over the past eight years. But we also support *efficient* derivatives markets. Both are critical to a healthy financial system and a strong and growing economy.

Before we break for coffee, I'd just like to thank you all once again for coming to Lisbon, and thank you for all the time, effort and resources you and your institutions contribute to ISDA. It's because of you, and the input you all provide to our working groups, that ISDA can represent our industry effectively.

I'd also like to thank the ISDA staff on behalf of the Board – and I would ask you to join me in this – for all their hard work over the year, and for putting on yet another great AGM.

Thank you.