ISDA Safe, Efficient Markets

ISDA AGM Miami 2018
Chairman's Remarks
Thursday April 26, 9.00am-9.20am

Good morning, everyone. Welcome to Day 2.

I'd like to get the ball rolling this morning with a small quiz – so please get your ISDA AGM apps at the ready. On the screen behind me, you'll see a simplified description of two real examples of how people have protected themselves against uncertainty.

A: A farmer receives a loan and has to make regular interest payments. The farmer is protected against having to make interest payments on the loan in the event of a failure of a harvest, or because the crops don't grow because of flood or drought.

B: A farmer is protected against the failure of a harvest because of drought. In the event of low rainfall, the farmer receives payment.

The first question is quite simply: which came first? Is it A or B? Or did they happen at roughly the same time?

You'll find that first question on your app, so please vote now…..

….Let's have a look at the results.

Well done to all of you who thought A.

Next question: how many years separated them?

Was it:
A: Five years or less
B: 10 years
C: 25 years
D: 100 years
E: 500 years
F: More than 500 years

…And let's have a look at the results.

The answer is actually F – more than 500 years.

In fact, those two examples of risk mitigation – which, on the face of it, look pretty similar – are actually separated by more than 3,500 years.

The more recent is a very simplified description of a weather derivatives trade put on by the government of Malawi in 2008. The other is from one of the earliest codes of law, from ancient Mesopotamia, dating from about 1754 BC.

Here's the full version, freely translated from the original Sumerian:

If any one owe a debt for a loan, and a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain, he washes his debt-tablet in water and pays no rent for this year.

For the history buffs among you, this was one of 282 laws carved into a 7.5 foot stone slab called the Code of Hammurabi, named after a Babylonian king.

There's a picture of the stone slab on the screen. Which leads me onto my final poll question. Which of the figures at the top is Hammurabi? The one standing on the left, or the one sitting down?

…Let's look at the results.

Well done to those of you who voted for the figure on the left. The carving actually represents Hammurabi receiving the laws from the seated Babylonian god of justice. Now, most historians will tell you that this is an illustration of the divine right of kings. But squint at the picture from a modern perspective, and in the image of the king being a supplicant before the incarnation of justice, you might see a very early expression of the concept we know as the rule of law. And tell yourself that, if today we see far, it is because we stand on the shoulders of those who came before us.

The code itself deals with everything from trade, to property rights, to theft to divorce – and it sets out some pretty gruesome punishments for those who break the laws. This is where the expression 'An eye for an eye, a tooth for a tooth' came from. *Lex Talionis*, to the legal buffs among you.

Most relevant for us, the code recognizes the risk and uncertainty that exists in economic exchanges, and enables that risk to be transferred and shared. Along with rules on the sale and purchase of assets at an agreed price for delivery at a future date, it shows risk mitigation techniques have been around quite literally since the dawn of recorded civilization.

Glance through history, and you'll find similar examples time and time again. In ancient Rome, in 16th century Europe, through to the present day. Derivatives on FX, for example, were being traded in the Netherlands in the mid-1500s. A market developed in tulip futures in the Netherlands in the 17th century. A rice futures contract was launched in Japan in the early 18th century. The first official US futures exchange was set up in 1848.

Whenever there have been large settlements of people, and trade has occurred between them, tools have existed to allow people to alleviate uncertainty, transfer risk and enhance profitability. These tools are intrinsically linked with the act of economic exchange. As cities have grown, global trade has flourished and legal systems have matured, the scope and sophistication of these tools have developed. But the concept and basic techniques have remained more or less unchanged for thousands of years.

So, ours is not a new market. It emerged hand in hand with trade and commerce because it serves a real economic and social need – it enables society to prosper and it allows individuals to transfer risks appropriately. That need exists today, and will continue into the future. We mustn't lose sight of that.

We therefore have a responsibility to ensure those who need to access our market can continue to do so in a cost-effective and efficient way. And we have duty to pass a safe and robust derivatives market over to future generations, just as we inherited a functioning market from the generations before us.

We take that responsibility very seriously at ISDA, and we're constantly looking at how to best position the marketplace for the future. More than 30 years ago, a group of market practitioners came together under ISDA to create the standardized Master Agreement, still a landmark document. Over time, ISDA and its members have added standard asset-class and product definitions, and a standard initial margin model. More recently, we've worked on e-confirmations and the legal aspects of smart contracts, so that achieving contractual certainty no longer requires you to carry around a seven-foot tall, two-ton slab of basalt.

Of course, the world is much more complex and interconnected today than it was in ancient Mesopotamia, 16th century Europe or even 19th century America. That means there's an onus on us to ensure the market we pass on is tailored to a changing world, and is resilient to events and shocks our ancestors wouldn't even have dreamt about.

A huge amount of time has been spent doing just that. Since 2009, the largest global banks have added about €1.5 trillion of Tier 1 capital to their balance sheets, and further measures finalized by the Basel Committee in December will result in an estimated €85.7 billion in additional capital.

The largest 20 dealers now hold about $900 billion in variation margin for their non-cleared derivatives trades, while about $130 billion is held in initial margin. The amount of initial margin exchanged across the market will continue to climb as margin requirements are phased in for a broader universe of derivatives users. This has significantly reduced the risk of losses that could follow the collapse of a counterparty.

About 88% of the interest rate derivatives notional traded in 2017 was cleared through a central counterparty. And virtually all derivatives transactions are now reported to trade repositories, giving regulators ready access to vital information on risk exposures.

These reforms to improve transparency and resiliency are necessary and important, and we need to be very clear that we do not want to reverse the progress that has been made.

But we also can't lose sight of the fact that these markets have served, and continue to serve, an important need. Companies want to transfer risk and reduce the uncertainty that comes with changing business and market conditions. We need banks to act as intermediaries, and to provide the financing and risk management services that are so intrinsic to economic growth.

Accessibility and efficiency are therefore just as important as resiliency. The ability to withstand extreme and severe shocks cannot be the sole focus, to the detriment of everything else. There needs to be a balance.

In theory, we can make banks bullet proof to even the most severe and improbable shocks by adding layers and layers of additional capital. But that comes with a trade off. Simply put, the higher the capital required for a given activity, the more expensive it is to run that business. If the level of capital is out of synch with the probable risks associated with the business, and the returns aren't enough to offset the cost of capital, then banks have a simple choice: get out of the business, or raise prices. Neither are good for end users.

This isn't a hypothetical concern. Keep making it harder and more expensive to engage in a business, and firms will stop doing it. That closes off avenues for companies to manage their risks in a cost-effective and efficient way.

We've already seen that happen to a certain extent, particularly in client clearing where the leverage ratio has had a significant impact on the economic viability of the business.

Under the Basel framework, banks are required to count customer cash collateral held at CCPs towards their leverage exposure and to ignore the exposure-reducing effect of initial margin. The effect is modest relative to overall bank capital, but at the business-line level, it significantly increases the amount needed to support client clearing activities. Some banks have opted to scale back or withdraw from the client clearing business as a result, which runs counter to the objectives of the G-20 to encourage central clearing.

National policy-makers and regulators such as the CFTC, the US Treasury and the European Commission have recognized this as an issue, and have already proposed alternative treatments. However, the Basel Committee has only agreed to monitor the impact of the leverage ratio on client clearing for two years. This is disappointing. We think the Basel Committee should consider adjustments to rules or calibrations at a global level wherever widespread concerns result in the risk of divergence – and there's clearly risk of divergence here.

More encouragingly, the Basel Committee has committed to review aspects of the new market risk framework, and has delayed implementation until 2022. As previously calibrated, the Fundamental Review of the Trading Book, or FRTB, would have led to an increase in market risk capital of between 1.6 and 2.5 times, on the top of the increases that have already come into effect with previous reforms. That would have hit bank intermediation activities hard, restricting their ability to provide the financing and hedging services that are so important to a vibrant economy.

In its consultation paper issued last month, the Basel Committee proposed some important technical modifications to key parts of the rules. Specifically, changes were proposed to the P&L attribution test metrics in response to concerns that the test was not an accurate measure of the performance of the internal models used by each trading desk. A new traffic light approach has also been introduced to smooth transition to the standard approach for those trading desks that do fail the test, avoiding the risk of a sudden jump in capital requirements.

Other positive revisions include the recalibration of risk weights for rates, equities and FX, and the introduction of FX triangulation, enabling combinations of currency pairs that comprise liquid underlying currencies to be deemed liquid under the standard approach. Also important is the recognition of data pooling schemes under the non-modellable risk factor requirements.

Less positive was the lack of recognition for seasonality within the non-modellable risk factor rules, and the fact there was no significant change in the capital calculation, particularly for equity idiosyncratic risk.

It's too early to say for sure what the impact of the changes will be, but it's important the measures are fully tested before implementation – and ISDA and its members will look to provide the necessary data during the consultation period. As part of this process, the Basel Committee should consider not only the impact on bank-wide market risk capital, but also the effect on specific business lines and products that are important for financing, investment and risk management.

With the Basel framework all but complete, attention will turn to the work by national authorities to transpose the measures into local regulations. Here, we encourage local regulators to strive as far as possible for global consistency. A lack of harmonization would create impediments for intentionally active firms, reducing the efficiency of markets and increasing compliance costs. I say 'as far as possible', because one should always have in mind Emerson's critique of the bugbear of consistency. We should be mindful of regional differences and be careful not to undermine the availability of efficient risk hedging and financing.

The capital framework isn't the only area where there's a focus on accessibility, efficiency and costs. Regulators in Europe and the US are reviewing rules related to Dodd-Frank and EMIR, with an eye to making them simpler and more efficient. As it stands, there are a number of requirements that are duplicative and unnecessarily complex, and which impose a significant compliance burden on end users for little benefit.

The Code of Hammurabi may have been quite literally set in stone, but the derivatives regulatory framework is not. Nor should it be. It's right that a set of reforms of this scale and ambition should be subject to regular review and assessment. If, through observation, experience and evidence, it's found there are better ways of doing things, then those improvements should be made.

Projects like the CFTC's Project KISS, the Treasury's review of US financial regulation and the EMIR Review are therefore important – and we're fortunate enough to have the architects of two of those projects speaking to us this morning: Craig Phillips at the US Treasury and Chairman Giancarlo at the CFTC. I look forward to hearing their remarks on how these projects are progressing.

For our part, we think there's an opportunity to make specific, targeted fixes to make the rules simpler and more cost-effective, without increasing systemic risk. A key aim should be to harmonize rule sets, both within and across jurisdictions

The regulatory reporting framework is a case in point. There is simply nothing to be gained by maintaining multiple, often inconsistent reporting regimes, each with their own reporting formats and data fields. This not only imposes a significant compliance burden on end users, it's actually self-defeating – it makes it all but impossible for global regulators to quickly and accurately aggregate exposures across derivatives instruments. We welcome the work by the CFTC and CPMI-IOSCO in this area where multilateral coordination is mission critical.

The need for harmonization isn't just a cross-border issue, though – it also applies on a domestic basis. In the US, for example, there a number of areas where CFTC and SEC rules diverge, creating inconsistencies and duplication.

We think this could be addressed by adopting a safe harbor approach. This would allow a firm registering as a swap dealer with the CFTC or as a security based swap dealer with the SEC to comply with the requirements of both regulators. The safe harbor approach would effectively presume compliance with the equivalent rule set of the other agency, reducing the need to build out multiple systems for rules that are similar but not identical. Such an approach should aim to streamline requirements and ensure that customers can benefit from access to capital providers, both foreign and domestic.

Whether it's Dodd-Frank and EMIR or the capital framework, it's critical that we get the balance right. It should be possible to achieve a regulatory framework that is resilient, efficient, sensitive to risk and appropriate. Go too far in layering on new capital, or not fixing problems when they arise, and we risk making it difficult or even impossible for firms to hedge and invest.

I've talked about need to ensure our markets remain accessible to those who need them. I'd now like to turn to some of the changes coming down the line and how we as an industry are adapting to them.

Arguably the biggest change is the work to reform benchmarks. It's been said that LIBOR is the world's most important number. If you think about everything that LIBOR and the other IBORs touch, that's true. From derivatives, to loans, to mortgages, the IBORs saturate financial markets to the tune of more than $370 trillion in notional exposure.

Transitioning to new risk-free rates is therefore not something that is undertaken lightly. The simple fact is that there are very real concerns about the viability and longevity of certain key IBORs given the sharp decline in activity in the unsecured bank funding market. In the case of LIBOR, the FCA has stated very clearly that it won't compel or persuade banks to make submissions after the end of 2021. It's therefore critical we have alternatives up and running by then.

Don't hold off. Don't think this will all go away. Don't assume everything will continue as before. Unless there's a dramatic reversal in unsecured bank lending activity, it's impossible to say whether banks will continue to make judgement-based submissions if they don't have to. It may be end-2021; it may be later. But it's a brave person who predicts the IBORs will persist indefinitely.

The consequences of doing nothing are severe – $370 trillion dollars worth of severe. This is something we all have a stake in. We all need to think now about what this means, and the challenges it will pose. We need to think about how we can transition to new risk-free rates in an orderly way to avoid disruption.

I'm proud of the fact that ISDA has taken a leading role in this space. Earlier this year, we published a benchmark transition roadmap that summarizes the work done so far on the selection and adoption of risk-free rates, in order to increase awareness and understanding. We've also conducted a global survey of market participants to highlight the issues they face and identify possible consensus solutions. That survey will be published during the second quarter.

We're also working on a separate initiative to identify robust fallbacks for derivatives contracts that reference key IBORs. Once finalized, those fallbacks will be incorporated into the ISDA definitions, and will apply if the relevant IBOR is permanently discontinued.

This will be a multi-year effort for ISDA and the broader financial industry. We have to get this done, and we have to do it right.

It's difficult to talk about changes on the horizon without mentioning Brexit. Standing here in Miami, Brexit might seem a bit remote, with little relevance outside the EU and UK. The results of our industry survey, published yesterday, suggest otherwise. On a scale of one to 10, with 10 being the greatest challenge, 44% of global respondents marked Brexit between seven and 10.

The fact is, there are a number of implications that could have broader impact – whether it's the supervision of third-country CCPs, cross-border harmonization issues, or documentation.

At ISDA, our approach to the Brexit debate has been to stay out of the discussion of 'for or against' or 'hard versus soft', which belongs entirely to the political sphere. There are hard choices to be made domestically in the UK, and difficult compromises to negotiate bilaterally between the UK and the EU. ISDA's work has focused entirely on identifying the risks of different possible outcomes and on proposing solutions to those problems.

Our legal team, for instance, has conducted a comprehensive analysis of the possible implications for new and outstanding cross-border derivatives contracts between EU and UK counterparties. Our analysis has indicated that there won't be any impact on the validity of outstanding contracts post-Brexit, but carrying out certain lifecycle events like compression, renegotiation and novation may become more challenging. We've worked to draw attention to this issue, and to advocate for an agreement that will allow lifecycle events on pre-existing trades to continue appropriately.

We've also identified a possible preference by some EU entities to trade under an EU member state law after Brexit, prompting us to work on French and Irish law versions of the Master Agreement.

Whatever the outcome, we've been consistent in advocating for an effective and robust cross-border regime, where comparability determinations are made objectively based on similar outcomes, always respecting the need to ensure market integrity. We have been consistent in advocating for safe and efficient markets. That will continue to be our focus when it comes to Brexit.

These changes are important, and we need to focus on making sure our industry adapts. We need to make sure our market is resilient to stress events. But we also need to make sure it is accessible to those who need to transfer risk.

Our market will undoubtedly evolve, just as it's evolved since those earliest commodity hedges in ancient Mesopotamia. But there will always be an appetite to alleviate uncertainty, transfer risk and enhance profitability. It’s clear that this has been a fundamental component of the economy for thousands of years.

All of us have a responsibility to improve the market where we can, to add to it, to develop it, and then to pass it on to the next generation. Through ISDA, and with your help, we can respond to the changes before us to make our markets better, safer and stronger. We heard about a number of these challenges during the panel discussions yesterday, and today’s panels will dive further into areas of future disruption.

I’d like to finish by thanking all of you on behalf of the ISDA board for attending this conference, and for all the work you do on industry issues. ISDA is only as strong as its membership, and by participating in our various working groups, each of you is contributing to the future of our industry. Thank you.

I’d also like to take this opportunity to thank the ISDA staff on behalf of the membership for their tireless work in bringing the ideas of the working groups to life. The ISDA board recognizes and appreciates all your hard work throughout the year.

Finally, a thank you to my colleagues on the board for the time they give to ISDA and the contributions they make. We have a fantastic mix of people from different industry sectors and geographies on the board, and I think that diversity has served us well in tackling the full spectrum of issues our industry faces, and in keeping ISDA firmly focused on continuously improving safe and efficient derivatives markets that serve the needs of society.

I hope you enjoy the rest of the conference, and enjoy your time in Miami.

Thank you.