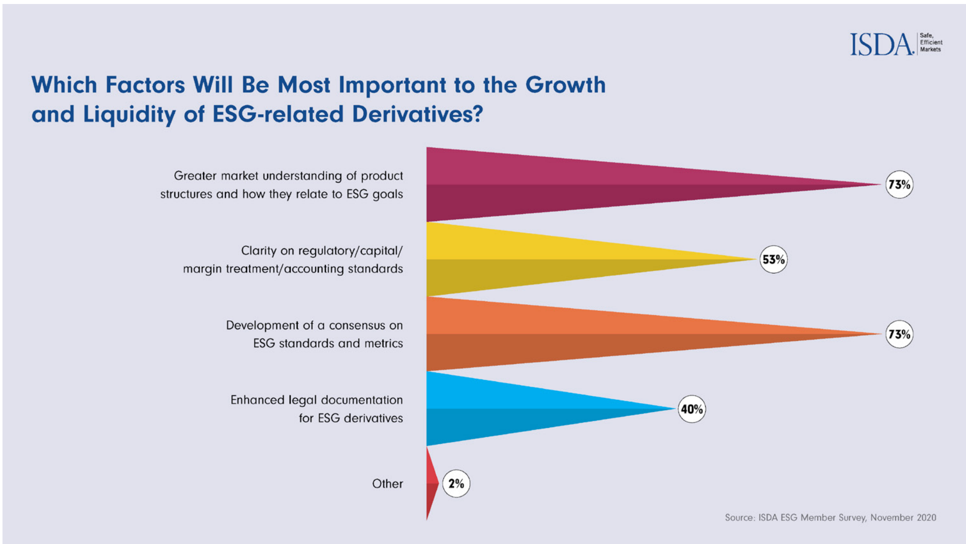
IQ In brief

Day two of ISDA's virtual Annual General Meeting on May 11 featured sessions on implementation of the phase-five margin requirements, developing China's derivatives market, benchmark reform in Japan and environmental, social and governance issues

Derivatives Vital for Green Transition, says Litvack

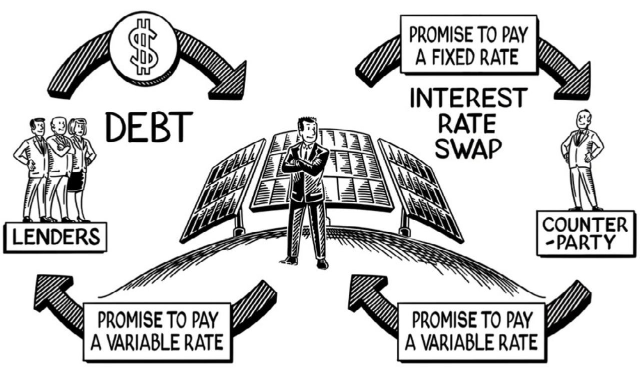


Financial markets will help countries achieve net-zero carbon emissions targets by channelling trillions of dollars in investment to new sustainability initiatives and infrastructure, and derivatives will enable firms to manage the risks associated with this shift, says Eric Litvack, ISDA's chairman.

Speaking at the start of the second day of this year's ISDA Annual General Meeting, Litvack said derivatives are being used in a variety of ways to enable firms to meet environmental, social and governance (ESG) targets.

"Conventional derivatives can be used to hedge the interest rate, FX and credit risk associated with green financing and investments, but a variety of new sustainability-linked derivatives has also emerged that link payment obligations with ESG performance and impact. Like all derivatives, the central purpose is to manage and optimise risk, which creates certainty and stability. That certainty gives firms the confidence to borrow, lend, invest, expand and hire," he said.

According to a survey of ISDA members at the end of last year, approximately 80% of respondents expect ESG derivatives markets to see strong or moderate growth over the next decade. Asked to identify factors that will influence that growth, participants identified greater understanding of product structures and how they relate to ESG goals and development of a consensus on ESG standards and metrics (see chart).



"This will be a big focus for ISDA in the year ahead. As well as advocating for consistent taxonomies and reporting standards, we'll explore where there is a need for standardisation in documentation, market practices and operational processes," said Litvack.

ISDA documentation is already being used as a basis for ESG derivatives, and templates exist to support the trading of emissions and certain types of environmental derivatives. At the start of May, ISDA also published a new US Renewable Energy Certificate (REC) Annex, reflecting increased interest in trading products that help companies meet renewable energy and emissions-reduction targets.

"As this market grows, we'll work with members to identify other areas where standard terms, documents and definitions are necessary," said Litvack. IQ

Watch ISDA's new whiteboard animation on the role of derivatives in ESG markets: bit.ly/3eCKLdZ

China's Draft Futures Law Heralds Netting Breakthrough

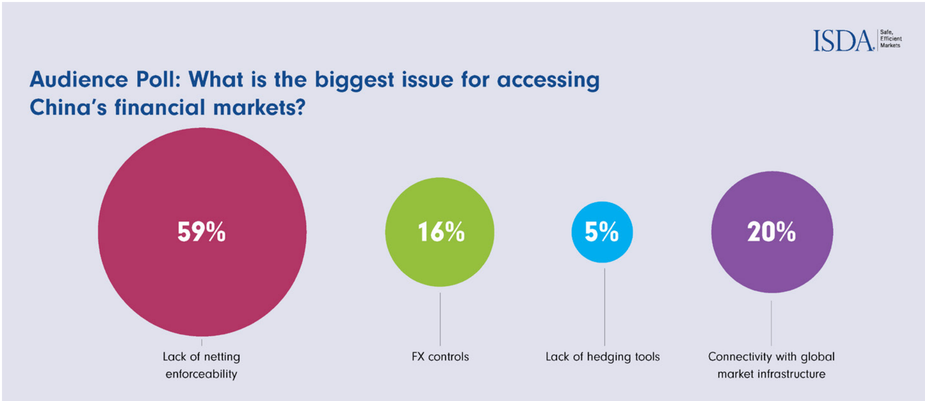
The draft Futures Law published by the Standing Committee of the National People's Congress of China on April 29 could be a seminal milestone for China's derivatives markets if it leads to the explicit recognition of close-out netting, according to senior regulators and market participants.

"The draft Futures Law was submitted to the National People's Congress for deliberation last month and it is out for public consultation now. It is clearly stated in the draft that netting shall not be invalid or cancelled because any party enters into bankruptcy proceedings. Although the draft will go through several rounds of deliberation and amendment, it is a great breakthrough in the legislation on netting," said Li Lixia, section chief in the law and regulation department at the China Banking and Insurance Regulatory Commission.

Speaking at the start of a panel sponsored by DBS on the second day of the ISDA Annual General Meeting, Lixia recognised that close-out netting would cut down transaction costs, improve efficiency and reduce systemic risk. The move to recognise the enforceability of close-out netting has the support of the Chinese courts and judicial authorities, she added.

"We are confident to say there is a broad consensus among the legislators, the judiciary authorities and the financial regulators on the key steps of close-out netting," Lixia explained. "As a step forward, we will continue closely following up the progress of legislation. We will instruct Chinese banks to manage derivatives counterparty risk exposure to their qualified Chinese counterparties on a netting basis, and we also plan to release policy guidance or interpretations on close-out netting in due course."

ISDA has consistently advocated for the enforceability of close-out netting as an indispensable foundation for safe and efficient derivatives markets and has worked with legislators all over the world to enshrine netting in domestic legislation.



"A functioning derivatives market requires a robust and predictable legal framework, which must include enforceability of close-out netting. By allowing parties to combine their obligations into a single payment, netting mitigates the credit risk associated with derivatives and means a default is less likely to be disruptive to the financial system. It also encourages more active participation by both foreign and domestic firms, supporting liquid and efficient capital markets," said ISDA chief executive Scott O'Malia in his opening remarks before the panel.

ISDA has worked closely with Chinese authorities in recent years and important progress had been made, but the publication of the draft Futures Law with explicit recognition of netting enforceability marks a big leap forward. The draft legislation is open for public consultation until May 28, and ISDA is working with its members to prepare a response.

Andrew Ng, group executive and head of treasury and markets at DBS, said he has been trading Asia derivatives since 1986 and described this as "probably the most exciting moment" in the development of a big derivatives market in the region.

"In order to grow this market, you need to have depth, liquidity and market makers. At the same time, you also need to be open to product innovation. I guess this is not something you can change overnight, but given the sheer size of the Chinese financial market, I think you have a lot of things you can do in different asset classes, so I am bullish," said Ng.

ISDA is developing a whitepaper that will explore the important next steps for China's derivatives markets once netting has been achieved. The findings and recommendations will be shared with policy-makers in the coming weeks and the paper will likely be published in the second half of the year.

"The implementation of close-out netting is one of the many building blocks in the process of liberalising China's derivatives markets, but also its overall capital markets as well. With a more mature derivatives market, China can further move forward towards rebalancing its capital funding from a bank-led model to a more capital-market-driven model, with the main intermediary providing loans from the capital markets," said Jennifer Cosco, managing director and co-head of the office of government affairs, Asia Pacific, at Goldman Sachs. IQ

Watch ISDA's whiteboard animation on close-out netting: bit.ly/3usQjx9
Find out more about China's draft Futures Law: bit.ly/2SLxyHr

EC's McGuinness Confident of Strong Relationship With UK

One of Europe's most senior and influential financial services policy-makers has expressed optimism that the EU and UK will be able to build a stable and balanced relationship on financial services, despite the challenges that have arisen since the Brexit transition period ended on December 31, 2020.

Delivering a keynote address on the second day of the ISDA Annual General Meeting (AGM), Mairead McGuinness, European commissioner for financial services, financial stability and capital markets union, acknowledged that Brexit "was and is a fragmenting event", but said the European Commission (EC) is working to build a cooperative long-term relationship with the UK.

"We will have to manage our significant level of interconnectedness with the UK strategically and we should strive for good cooperation with the UK, but we also need to avoid dependency that would translate into financial stability risks or reduce our regulatory autonomy," said McGuinness.

The EC has made clear that it does not intend to extend a temporary equivalence decision for UK central counterparties when it expires in mid-2022. EU institutions have been urged to reduce their exposure to UK clearing houses, despite the systemic risk, market function and competitive implications. McGuinness defended the EC position in her remarks at the AGM.

"We have the current situation where a significant amount of risk to the EU financial system is in London, and this is concerning to us as it is simply not sustainable in the long run. The City of London became a hub and indeed was allowed to grow because it was part of the EU single market. All of that has changed since January 1, and in the months and years to come, the EU and UK will chart our own separate courses," she said.

Capital implementation

McGuinness also gave an overview of the EC's wide-ranging agenda on financial services regulation, which includes capital requirements, benchmark reform and sustainable finance. The EC's commitment to complete the implementation of Basel III in line with its international commitments has not changed as a result of the coronavirus crisis, she said.

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>
> **Mairead McGuinness, European Commission**

"The current crisis has made it even clearer that well capitalised banks are key to financial stability and, in many ways, help mitigate the impact of periods of significant economic and financial stress. It was thanks to the reforms we adopted in the wake of the global financial crisis that our banks entered the COVID-19 crisis period with strong capital and liquidity, so together with work by fiscal, monetary and supervisory authorities, this has allowed our banks to be part of the solution and to keep credit flowing to businesses and households," said McGuinness.

While committing to honour the EU's international obligations on capital reforms, McGuinness said the EC would consider the specific features of the EU banking sector and the EU economy, and would seek to maintain risk sensitivity in the framework, while avoiding a significant increase in capital requirements for EU banks.

Consolidated tape

The EC will also intensify its work on the review of the Markets in Financial Instruments Regulation this year, with the aim of assessing how market infrastructure works in different asset classes. While McGuinness said the framework does not necessarily need a complete overhaul, she added that creating a consolidated tape to gather all core transaction data together will make markets fairer and more efficient.

"This consolidated tape will be a reliable data source for all transactions executed anywhere within the EU on a single screen for equities, bonds and certain highly standardised derivatives. It will help build the capital markets union and foster the democratisation of capital markets by giving smaller investors the same level of market intelligence on where the best price can be obtained that currently is available only to the big players," she said.

McGuinness also briefly explored the importance of benchmark reform, recognising the urgency to transition from LIBOR as most settings are due to cease publication or become non-representative at the end of this year. She said switching LIBOR off was unthinkable when it was first announced by the Bank of England in 2017, and praised ISDA's work with the industry to develop robust contractual fallbacks to move the transition forward.

"Indeed, it is through ISDA's work on developing a solution that standardised derivatives products can carry on life without LIBOR. The approach of standardised fallback provisions has been so successful that it is now helping market participants to plan ahead for the end of LIBOR for non-ISDA products and even cash products," said McGuinness. IQ

TONA Liquidity Set to Rise, Says Panel

Liquidity in TONA, Japan's risk-free rate (RFR), remains limited, but a series of milestones later this year could help to drive up liquidity, according to speakers on the second day of the ISDA Annual General Meeting.

According to analysis by ISDA and Clarus, just 2.4% of yen-denominated cleared over-the-counter and exchange-traded interest rate derivatives DV01 was linked to TONA in March, but this proportion could rise as the date set by the UK Financial Conduct Authority for most LIBOR settings to either cease or become non-representative draws closer.

"Ultimately, we expect liquidity in RFRs will steadily increase as we approach the end-2021 deadline. Transition milestones set by the official sector and various RFR working groups will also likely help. For example, the Cross-industry Committee on Japanese Yen Interest Rate Benchmarks has recommended that new swaps linked to yen LIBOR with a maturity after the end of 2021 should stop by September 30," said Scott O'Malia, ISDA's chief executive, in his opening remarks for day two.

Other upcoming milestones include a 'TONA first' target for quoting yen interest rate swaps by the end of July and a shift of cleared yen LIBOR derivatives exposures to TONA compounded in arrears at the end of this year. These will also likely contribute to a pick-up in TONA liquidity, said speakers on a panel focusing on benchmark reform in Japan.

"Going forward, if the market can make another important derivatives milestone – TONA first in the bid/offer quoting practice in the interbank swap market by the end of July – then I believe the Japanese yen swap market will be able to get the traction to shift from Japanese yen LIBOR swaps into TONA overnight index swaps quickly," said Atsuya Watanabe, director in markets and securities services at Citigroup Global Markets Japan.

But while the country's big banks are largely ready for a shift to TONA, many corporate clients have expressed a preference for TORF, the forward-looking RFR term rate based on TONA that began full publication on April 26.

This could be problematic, argued Shinichiro Itozaki, senior manager in the global markets engineering division at Mitsubishi UFJ Morgan Stanley Securities. "Remember that the essential problem with LIBOR was the inherent fragility of the inverted pyramid, where a sheer volume of financial contracts referenced financial benchmarks that were based on tiny markets. We shouldn't repeat the inverted pyramid problem with a new benchmark," he said, noting that use of TORF should be limited.

Other panellists welcomed the fact that market participants have a choice of rates to replace yen LIBOR and can opt for whichever best suits their purpose. However, Citi's Watanabe stressed there would need to be sufficient liquidity in TONA for this multi-rate approach to be effective.

"The multi-rate framework is good in the sense of giving multiple choices to the benchmark users in the market. On the other hand, the framework may not be desirable without a clear shift from Japanese yen LIBOR into compounded TONA as a central liquidity source in the derivatives market, because liquidity fragmentation could create cost and liquidity issues for the end users of derivatives, as well as benchmark users in the cash market," he said. IQ

Hybrid Working the Way Forward, says JP Morgan's Pinto

JP Morgan is looking at a shift to a hybrid model of working in future, and is creating algorithms designed to ensure the optimal mix of staff is in the office at the same time to enable interaction.

Talking about how working practices will likely change as a result of the pandemic, Daniel Pinto, co-president and chief operating officer at JP Morgan Chase and chief executive of the corporate and investment bank at JP Morgan, said it is unlikely the bank will return to the status quo of everyone being in the office full time.

"We will bring more people back, but I think the scenario where everyone goes 100% back to work in the office is a very low probability, and the scenario where the bulk of the employees work from home is also a very unlikely scenario," he said in a keynote interview with ISDA chief executive Scott O'Malia on the second day of the ISDA Annual General Meeting.

Instead, a hybrid model of working will likely emerge, with employees split between working from home and in the office. "But not where everyone shows up on Tuesday, Wednesday and Thursday and no one is in the office on Monday and Friday. We have to be very organised, and it has to be well designed for the needs of each component of the business," he added.

To enable this, the bank's artificial intelligence lab is working to create algorithms to help determine the optimal rotation of employees, based on the constraints of each business, to maximise interaction and encourage collaboration, Pinto explained. "If you were to go to working from home for a long period of time, I think you will really destroy the culture of the company. You are going to kill innovation, you are going to really kill the good that comes from personal interaction on a day-to-day basis." IQ

IQ In brief

Policy-makers Cautious on Climate Disclosures

Financial markets will play a major role in the transition to a low-carbon economy in the coming years, but policy-makers must tread carefully when it comes to setting prescriptive disclosure requirements to ensure they do not stifle innovation, senior officials have warned.

Speaking on a panel on the second day of the ISDA Annual General Meeting, US and European regulators and central bankers addressed the question of how much granularity and standardisation should be required in the climate risk disclosures made by financial institutions and corporates.

Julie Ansidei, head of strategy and sustainable finance and secretary to the executive committee at France's Autorité des marchés financiers, said progress has been made in climate reporting, but there is a long way to go before markets and supervisors have the kind of information they need.

"We do need to further clarify what we expect in terms of climate reporting and further standardise the kind of information we're expecting from companies. One is around how they define their risks, but also how they relate those risks to their strategy and their objectives – that connection needs to be demonstrated," Ansidei explained.

The EU has moved ahead of other jurisdictions to put in place regulations to support the transition to a sustainable economy and increase transparency by requiring clearer reporting on sustainability. But some panellists argued that regulators should not be too prescriptive in their approach.

"We can't prescribe what is going to be material for every company or industry, certainly not across all jurisdictions, and I think with some of these efforts to standardise climate disclosure – while I understand the rationale – I'm concerned we're forcing uniformity and comparability that doesn't actually exist," said Hester Peirce, commissioner at the US Securities and Exchange Commission.

While the idea of distilling climate risk down to a set of comparable metrics might be appealing, the numbers may not be meaningful and could lead to capital being directed to where regulators think it should go rather than where the innovation will actually develop, she added.

"I understand the seriousness of the problems we're trying to solve, but the solutions really do lie in the markets, and we have to give them the freedom to figure out what those solutions are, not to prescribe it by developing a very precise set of metrics," said Peirce. IQ

Prepare for Phases Five and Six, Say Speakers

The phase five and six rollouts of the initial margin requirements in September 2021 and 2022 will capture different types of firms compared to earlier phases, which is creating some additional complexity in the compliance process, according to speakers on the second day of the ISDA Annual General Meeting.

Following a one-year delay due to the coronavirus pandemic, phase-five implementation will take effect on September 1, 2021 for firms with an average aggregated notional amount of non-cleared derivatives greater than €50 billion, with the threshold falling to €8 billion in September 2022. According to analysis by ISDA in 2018, this will capture approximately 314 entities this year and a further 775 in 2022.

Speaking on a margin panel sponsored by SmartStream, Wayne Forsythe, global head of collateral operations at State Street Bank & Trust, said the different types of in-scope firms resulted in new challenges that hadn't emerged in the earlier phases.

"What this means is that you have a different set of complexities that have to be taken into account. In many cases, you have a wide array and use of sub-advisors, meaning that you don't have a concentrated single pool of managed assets. And you could have a variety of underlying documentation," he said.

Speaking on the same panel, Tara McCloskey, managing director, global operations, at MetLife, said several unexpected challenges have emerged with the custody onboarding process, which will take time to resolve.

"It's one thing making sure that you complete all the documentation for a custodian that you've chosen," she said. "The other big piece is making sure you complete the KYC for the custodian where your counterparty is posting. I think that is a huge lift that a lot of us didn't understand what the requirements are."

Given these and other operational and documentation challenges, and the timelines set by custodians for onboarding, firms should not leave their preparations until the last minute.

"It's not an infinite amount of resources that we have, so the timelines are key with this. We're very focused right now on completion of those firms that we've signed on for phase five. I believe, in most cases, we seem to be very well down the path of that. But, again, even looking ahead to phase six, the nuances we discussed earlier means it's a completely different game. So, time is our friend at this point, but the clock will be ticking and we're trying to get ahead of that as best we can by looking ahead to the next year," said State Street's Forsythe. IQ

IQ In brief

At the AGM Today

8:00 AM **EDT**	Virtual Networking
8:15 AM **EDT**	Opening Remarks *Scott O'Malia*, Chief Executive Officer, ISDA
8:25 AM **EDT**	The New Normal Governments, central banks and regulators took decisive and critical action in response to the economic and financial turmoil caused by the coronavirus outbreak in March and April 2020. What have regulators and policy-makers learned from that period? To what extent did the post-crisis financial reforms help ensure resiliency of banks and the financial system as a whole? Are further policy responses necessary?
9:15 AM **EDT**	Capital – Harmonisation or Deviation? Having been given an additional year to prepare for the final Basel standards because of the coronavirus outbreak, the US, EU and others are working to finalise national rules. What approach will legislators and regulators take in order to balance financial stability and economic development, and to what extent will local rules be consistent with the final Basel framework? What impact will the rules have on banks in those jurisdictions?
10:00 AM **EDT**	Keynote Address *Andrew Bailey*, Governor, Bank of England
10:20 AM **EDT**	Break and Virtual Networking
10:40 AM **EDT**	Keynote Address *José Manuel Campa*, EBA Chairperson, European Banking Authority (EBA)
11:05 AM **EDT**	Digitising Derivatives The coronavirus pandemic and the shift to remote working has highlighted challenges associated with the existing infrastructure and the reliance on paper documents. Market participants are increasingly looking to technology to provide the answer. According to a recent ISDA survey, 96.6% of respondents said they supported an ISDA objective to develop standards and digital formats for documentation and other services in order to support automation. What steps have been taken, and what else needs to happen to further digitise the derivatives market? **Panel Sponsored by DTCC**
11:50 AM **EDT**	Break and Virtual Networking
12:00 PM **EDT**	Derivatives and SFTs Financial institutions are searching for ways to overcome squeezed margins by improving efficiency and reducing costs. Greater alignment and standardisation between derivatives and securities financing transaction markets could help achieve that – but what would this entail?
12:45 PM **EDT**	Virtual Networking
1:45 PM **EDT**	End of ISDA AGM

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