International Swaps and Derivatives Association
30th Annual General Meeting
Montreal April 21-April 23, 2015

Chairman's Remarks
Eric Litvack
9.00am April 23, 2015

Good morning everyone, welcome back. I hope you all enjoyed last night's entertainment at Arsenal Art Contemporain. I see a lot of tired faces out there, so it looks like you did. Hopefully, the art has inspired you, and you're feeling enthused and invigorated for the day ahead.

We have a schedule today that will quickly feed that enthusiasm and inspiration. Later this morning, we'll hear from Timothy Massad, chairman of the Commodity Futures Trading Commission (CFTC). Chairman Massad assumed his role last June, and moved quickly to introduce a series of measures intended to reduce the burdens on hedging by end users – steps that we entirely support and applaud. I'm sure he'll give us some very useful insights into the priorities for the CFTC in the year ahead.

After that, we'll take a detailed look at some of key initiatives that ISDA is working on – the development of the ISDA SIMM model as part of the OTC margin requirements implementation project, to name just one.

Before we do that, though, I want to take a step back and take a broader view.

As most of you will know by now, I took over the reins as ISDA chairman at the start this year. Coming hot-on-the-heels of the appointment of Scott as chief executive last year, it seemed like a natural time to pause and take stock. To look closely at ISDA, its mission statement and the work it does, and the extent to which that has evolved in response to changing market conditions. And above all, to ensure ISDA is properly positioned to execute on its mission.

Clearly, the changes in market conditions have been significant. All OTC derivatives trades are now required to be reported to trade repositories in the US, Europe and several other jurisdictions. Regulations in the US also require standardised derivatives to clear through central counterparties and to trade on electronic trading venues where appropriate, and other countries either have or will soon follow suit.

According to US swap repository data, 76.5% of average daily interest rate derivatives notional volume was cleared in 2014, and 52.4% was traded on a swap execution facility. It's a similar story in the credit derivatives market: 74.7% of CDS index average daily notional volume was cleared last year, with 62.5% traded on a SEF.

But that's only part of the story. Other regulations are still to be rolled out. Non-cleared derivatives will soon be subject to a new initial and variation margin regime. And capital and liquidity requirements are being phased in, which will cause – and indeed, in causing – banks to reassess business models and look closely at their resources and how to best use them.

So, what is ISDA's role in this changing world? To put it bluntly, what has ISDA done for its member firms? And what can it do going forward?

The answer is: plenty.

I mentioned the OTC margin requirements project earlier. Let's start with that. New rules will require the majority of derivatives users to post initial and variation margin on their non-cleared derivatives transactions. Despite the vast increase in clearing volumes over the past couple of years, the non-cleared market will continue to be large. Adding up the currently non-clearable products in the interest rate space alone – swaptions, cross-currency swaps, options – and the total comes to some $90 trillion.

These types of instruments play an important part in the risk management strategies of corporates, insurance companies, pension funds, sovereigns and others. For instance, swaptions can help pension funds to protect funding ratios against a decline in interest rates and protect mortgage banks from convexity risk in their portfolios. Utility companies use inflation swaps to match the structure of their liabilities with their inflation-linked revenues. Non-financial companies can issue debt in foreign currencies to access new investors and tap into cheaper funding, then use a cross-currency swap to eliminate interest rate and currency mismatches.

In fact, end-user activity accounted for 65% of total OTC derivatives turnover in 2013, according to BIS triennial data. And in a new ISDA survey that we released this morning, 90% of end-user respondents said derivatives were either important or very important to their risk management strategies.

The new margin requirements will be a seminal change. For most of the firms subject to the new requirements, it will be the first time they've had to post initial margin on their non-cleared derivatives trades. For some non-bank users, it will also be the first time they've had to post variation margin. The impact on funding will be significant, particularly for those institutions with directional portfolios – for instance, pension funds and asset managers. Firms will need to find sufficient amounts of high-quality collateral to meet margin requirements, and for some that may well prove challenging.

Aside from that, though, the rules pose a huge operational challenge for all derivatives users. Firms will need to revise their collateral documentation so that it complies with the relevant regulatory requirements – and these may differ in each of the jurisdictions in which individual firms are active.

Institutions will also need to implement technology to calculate margin in as close to real time as possible, set up systems and processes to govern the exchange and settlement of collateral, and establish segregated custodial accounts.

The workload is immense. And meeting the requirements will be challenging, even with the revised implementation date recently announced by regulators.

ISDA is playing a leading role in helping the derivatives industry to prepare for this challenge. Through the ISDA OTC margin requirements implementation initiative, we've been working to make the requisite changes to collateral documentation, and we're playing a key role in developing standard business and technology practices for each of the steps involved in posting collateral.

A vital part of that effort is the development of a standard model for calculating initial margin. Margin regulations allow firms to choose between using a standard table or an internal model to calculate initial margin. But the standard table leads to punitive margin amounts, so most participants will prefer the internal model method where possible. But if everyone develops their own models, no one will be able to agree on the initial margin amounts that need to be exchanged. That would, obviously, hamper quick and efficient trading and hedging.

The ISDA Standard Initial Margin Model, or ISDA SIMM, is an advanced-method standard model that everyone will be able to use for their margin calculations, allowing them greater efficiency in margin usage while reducing the potential for disputes. It's an effort that has required a huge amount of resource and money, and has entailed detailed conversations with multiple industry participants and regulators. Frankly, I don't think any organisation other than ISDA could have taken this on. And its development is going to be crucial to the safe and efficient running of the non-cleared OTC derivatives market going forward. It's a great example of how we can envision the future and make it happen.

Let's take another issue: the recast European Union Markets in Financial Instruments Directive, or MIFID 2.

As you know from yesterday's excellent panel, the revised MIFID II/MIFIR legislation requires liquid instruments to be subject to strict pre- and post-trade transparency regimes, as well as potentially being subject to an obligation to trade on regulated venues.

Pre-trade transparency will mean disclosing bid and offer prices before a trade takes place. Post-trade transparency will involve publishing extra information – including price and volume – within minutes of a transaction being executed. This requires a delicate balance between transparency and liquidity.

Appropriate calibration is the key to getting this balance right. The crucial issue here is what is defined as a liquid instrument. Apply that definition too broadly, and it could actually reduce market liquidity and lead to higher costs. Market-makers will be reluctant to facilitate client orders in less liquid markets, as other participants could use the information against them before they have an opportunity to hedge their risk. The result would be fewer dealers willing to participate in those markets, and wider spreads from those that stay.

Unfortunately, the European Securities and Markets Authority (ESMA) has proposed in its rule-making consultation paper a very low bar in defining what is liquid. Most interest rate derivatives instrument classes, for instance, would be deemed liquid if they trade just once or twice a day, together with a relatively low average daily notional threshold. In our view, an instrument that trades just once or twice a day is not liquid.

As part of our response to the consultation, ISDA ran analysis on a three-month series of data, using a higher threshold of 15 trades a day with a higher average daily notional threshold than what was used by ESMA.

The results of the ISDA analysis were, I have to say, very interesting. Importantly, the change in thresholds didn't drastically lower the coverage ratio for some instruments, but it did reduce the number of liquid classes. For fixed-to-floating swaps, for example, the number of liquid classes fell from 247 under the ESMA approach to just 27. However, the coverage ratio didn't fall anywhere near as much – overall notional captured fell from 97% to a still healthy 72%.

In other cases, the impact was more significant, but these were precisely the instruments that tend to be much less liquid – swaptions, for instance, where the ESMA analysis had classed all Australian dollar, euro, US dollar, sterling and yen swaptions, regardless of tenor, as liquid. I think that anyone who has looked closely at the issue can assure you: 50-year euro swaptions are not liquid.

In short, the ISDA analysis highlighted that these liquidity determinations need to be based on evidence – and the evidence suggests many derivatives instrument sub-classes are simply not sufficiently liquid. That doesn't mean ESMA's methodology needs to be scrapped. In some cases, simply raising the thresholds creates a sensible balance between the policy objective of greater transparency and the need to ensure liquidity providers can offer pricing support in less liquid markets, and so enable end users to hedge their economic risks. We look forward to continued constructive engagement with ESMA.

I mention this because ISDA's number-crunching was a central plank of the response. And it was only possible because of its in-house research capabilities and the ability to respond quickly – the consultation period was less than three months. It's another great example of how ISDA's breadth and depth makes it happen.

Research has also played a part in how ISDA has responded to another key issue: cross-border harmonisation.

Over the past few years, individual regulators have implemented new derivatives rules with too little regard to how they will interact with those in other jurisdictions. That has exposed globally active firms to duplicate and potentially contradictory rules, and it's causing markets to fragment along geographic lines.

ISDA research has shown this is happening already. Following the implementation of US SEF rules in October 2013, European derivatives users increasingly began concentrating their trading of euro interest rate swaps with other European dealers. By August last year, more than 95% of euro IRS transactions were traded between European entities, up from approximately 75% before the SEF rules came into force.

The last quarter of 2014 saw a slight reversal of that trend, reflecting a general decline in activity in the European interdealer market for euro interest rate swaps. But the largest liquidity pool for this instrument remains European-based – creating access problems for US firms obliged by US law to trade on SEFs.

Regulators have acknowledged this problem, and are working to resolve the issue – and we heard the thoughts of some leading regulators about this issue on Scott's panel yesterday. Let's be clear: it's not an easy problem to resolve. But more needs to be done. Regulators have to find a way to cooperate, coordinate and defer to other regimes, rather than getting bogged down in considering each other's regulations on a rule-by-rule basis.

This is a vital issue for ISDA's members – and ISDA can help with the solution, both through further research and through the development of common standards.

Data is a good example of how common standards could drive more efficient solutions. Most jurisdictions now require mandatory reporting of derivatives trade data. But the irony is that regulators are unable to make sense of that information because of a lack of consistency in reporting rules. An absence of specific guidance on what needs to be reported – and how – has also meant data is submitted in a variety of formats, even within the same jurisdiction, making the aggregation of that information all but impossible. IOSCO has identified this as a priority mission.

Again, ISDA has been helping. We've led industry efforts to develop common taxonomies, a common reporting format in FpML, and common identifiers for trades and products. It's important this is resolved as a matter of urgency – and ISDA stands ready to do its bit by developing the standards as necessary. Greater transparency to supervisors was one of the key promises of the post-crisis reforms, and ISDA wants to see it happen.

Let me turn now to capital. ISDA has long played a key role in coordinating and leading the industry's response to new capital requirements. A current and extraordinarily important area of focus is the Basel Committee's Fundamental Review of the Trading Book. We'll have a specialist panel later this morning discussing initiatives in this space, so I won't dwell on it. But ISDA's work to foster a close working relationship with the Basel Committee's Trading Book Group has meant the industry has been able to put its views across in an open and constructive way, and led to a fruitful dialogue.

Many of the issues for the industry centre on extremely technical modelling questions – an area in which ISDA excels. But there are broader areas of focus too. For one thing, it's important that implementation timetables are realistic – something that is particularly relevant to the Fundamental Review of the Trading Book. The new rules are meant to be finalised by the end of this year, but certain elements have not yet been fully tested. ISDA believes the deadline should be extended to allow another quantitative impact study that incorporates all elements of the new framework. Otherwise, there is a real risk that this vast overhaul of trading book rules will be based on incomplete data and simplified assumptions with real-world impacts on capital-allocation decisions.

We also believe capital rules should be globally consistent, coherent and risk-sensitive. The latter is an important point. There is an increasingly strong tendency to decry risk-weighting in the elusive pursuit of simplicity and comparability. But abandoning risk-based measures would not be an appropriate outcome. Capital charges that are insensitive to risk can create perverse incentives by encouraging firms to make business and investment decisions that are weighted more to returns and less to risk. These are all issues at the centre of ISDA's research and advocacy efforts.

Looking beyond those topics into more traditional ISDA territory: documentation. This continues to be a key part of ISDA's work. Whether it is revisions to the credit derivatives definitions, the development of disclosure templates for counterparty categorisation under EMIR or Dodd-Frank, or changes to the Credit Support Annex to facilitate initial and variation margin exchange, ISDA plays – and will continue to play – a vital role in derivatives markets evolution.

This is recognised by regulators too. Look at the 2014 Resolution Stay Protocol. When regulators decided that contractual stays should provide a short-term fix to a risk that cross-border derivatives trades would not be captured by existing and forthcoming domestic resolution regimes, they asked ISDA to do the heavy lifting and provide that solution. ISDA made it happen. The 18 largest dealers signed up to a voluntary protocol opting into a temporary stay on close outs in order to facilitate the cross-border resolution process.

Another critical topic is netting. This is the lifeblood of the derivatives business. Without the extremely valuable netting opinions that ISDA commissions, the derivatives business would become largely uneconomic in its current form.

This is just a small selection of the work ISDA is doing. The fact is, ISDA is unparalleled in dealing with difficult problems. And in getting things done.

Yes, everyone needs to adapt to the new environment – and we have been adapting. And ISDA remains a vital part of that evolution. It was instrumental in putting the processes in place for the derivatives market to develop 30 years ago. And in its 30th year, it continues to play a vital role in ensuring OTC derivatives markets – both cleared and non-cleared – are safer and more efficient.

In closing, I'd like to take this opportunity to express a vote of thanks to ISDA's staff, who work tirelessly on our behalf. It's not always an easy job, and it can be particularly difficult in the face of the often ill-informed criticisms that are regularly levelled at derivatives and derivatives users. And on behalf of the Board of Directors, I'd like to express our thanks to you our members for your continued support and participation.

All of you, the staff, the members, we are ISDA. And together, we make it happen.

Thank you for your support, thank you for your attention and enjoy the rest of the conference.