ISDA Derivatives Trading Forum London
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Chairman's Remarks
Eric Litvack

Good afternoon, everyone.

As Scott mentioned this morning, this is the last of our Derivatives Trading Forum series, having already held events in New York, Hong Kong, Tokyo and Sydney.

If you take a look at the agendas of each of these events, they tell an interesting story. While there are some common global themes across all five locations, there are also a lot of unique local market issues, which means each agenda has been different. In the US, we focused almost exclusively on the potential impact of proposed US Treasury market reforms. In Hong Kong, we explored regulatory and market structure changes affecting access to China's derivatives market. And in Tokyo, we looked at the impact of a weak yen and the future of euroyen TIBOR.

This focus on local content is not altogether surprising. Each market has its own preoccupations and priorities, its own specificities and its own currency. But this increased local focus is also a sign of a larger trend we've seen playing out in derivatives markets in recent times: the slow slide towards increased fragmentation.

Derivatives markets have always been global, enabling companies to raise capital and manage risk in the most cost-effective and efficient way. It's therefore important that the regulatory framework reflects that global dimension. This point was recognized by the Group-of-20 (G-20) nations when developing their post-crisis derivatives reforms, noting that national authorities should implement global standards in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage.

Targeting rules to suit the characteristics of domestic markets is completely understandable, and we should never expect to get to a point of complete consistency across borders. And for good reason – markets have many commonalities but are not homogenous. There's also been an increased willingness by some regulators to consider the competitiveness of their local financial markets when setting rules. I very much welcome the sentiment behind that, as it's an acknowledgement that vibrant financial markets are a valuable economic and strategic attribute – bustling, busy, liquid markets allow firms to raise money, to grow, to hire and to invest, which contributes to economic growth and development.

But diverge too far from global standards, and it creates challenges for globally active firms to manage risk consistently, coherently and efficiently. If there's a lack of coordination in the adoption of global standards and each jurisdiction takes its own path, the rules become more complex and costly, and it becomes much more difficult for financial institutions to accompany and service their clients across borders.

Take the capital framework as an example. Global standards are developed and agreed by the Basel Committee on Banking Supervision, which comprises 45 central banks and supervisors, representing 28 different jurisdictions. If there are any rules that you'd expect to be consistent across borders, it's those governing capital requirements, because they reflect a consensus across those 28 countries.

Yet, as we've seen with national proposals for adopting the final Basel III framework, that consistency is eroded at the local level. The rules will apply for some Japanese banks from March 2024, EU proposals are currently due to come into effect from the start of 2025, and US regulators have proposed to begin implementation six months later.

That creates problems. A staggered, uncoordinated rollout would result in significant complexity for internationally active banks as they would need to comply with different rule sets at different times.

Given this, we welcome the recent decision by the UK Prudential Regulation Authority to push its implementation date back by six months, bringing it in line with the US. Proposed EU legislation also allows for changes to be made to the EU start date to match with other jurisdictions – so we hope further harmonization of timelines is forthcoming.

In addition to considerations of timing, the various legislative proposals diverge in their approaches. For example, US prudential regulators have opted to replace the advanced approaches with a new expanded risk-based approach – a methodology that no longer provides banks with the option to use internal models for credit risk, counterparty credit risk and operational risk.

This deviates from the Basel Committee and the approach taken by many other jurisdictions, which have retained the option for sophisticated banks to use internal models for credit risk and counterparty credit risk.

As we've done in the past with other draft rules, ISDA will run a quantitative impact study to analyze exactly how the US proposals will affect capital requirements, but our message remains the same: we strongly believe the framework should be consistent, risk sensitive and appropriate. Fragmentation and disproportionate increases in capital could force banks to retreat from certain trading and intermediary businesses, creating capacity constraints and raising financing and hedging costs for end users.

In other areas, instances of miscalibration at the Basel level have prompted individual regulators to take their own approaches to resolve the issues. A good example is the diverse treatment of credit valuation adjustment and the standardized approach for counterparty credit risk, caused by jurisdictions applying their own fixes.

The very fact this diversity exists suggests there's something wrong with the standard itself. Once the dust settles on implementation, we think the Basel Committee should take the opportunity to review and address specific areas of miscalibration at the global level. This will encourage greater consistency and reduce some of the distortions we see across borders.

In the meantime, ISDA will work with regulators to smooth out the rough edges of the various national proposals to ensure we have a framework that is risk appropriate and as globally consistent as possible. That will allow banks to continue providing essential market liquidity and lending to support economic growth and development.

I'd now like to turn to another area where we are seeing fragmentation in regulatory approaches and market practices: sustainability and environmental, social and governance issues.

This is a quintessentially global problem that requires a joined-up global response. Yet, while governments around the world have signed up to global commitments on carbon reduction, the policies to achieve this are very much driven at the local level.

To some extent, this is unavoidable – countries are at different stages of development, with different infrastructures and different levels of reliance on particular energy sources. But the approaches we've seen across jurisdictions so far are fundamentally different in some cases.

For example, the EU has led primarily with a regulatory and compliance approach, while the US has focused more on investment and incentives. This is a natural result of cultural and political biases in both systems, but the different approaches have consequences: one leads to resources being diverted towards compliance with complex frameworks; the other encourages investment but with fewer controls on direction and outcomes. Greater convergence – and a better balance of carrot and stick – would enable more efficient global capital allocation to manage climate risks and energy transition.

You might legitimately ask what is ISDA's role in this matter? What do derivatives have to do with sustainability? Well, everyone has a role to play in preparing the future. At ISDA, we are focusing on specific segments – for example, the voluntary carbon market. This market is intended to allow companies unable to immediately transition fully from fossil fuels to buy credits to offset their emissions. This in turn channels capital to those projects that generate credits by reducing or removing greenhouse gases from the atmosphere.

Our work in this space has focused on developing common legal standards and documentation. We published two whitepapers in 2021 and 2022 that explored the key legal issues associated with the voluntary carbon market and recommended steps to achieve greater legal certainty, which included the creation of standard documentation.

We followed that last December with the launch of the 2022 ISDA Verified Carbon Credit Transactions Definitions, which bring greater consistency to the trading of carbon credits. Having a single contractual framework that can be used for any carbon standard or registry will allow firms to trade carbon credits more easily and on a global basis – in turn, enhancing liquidity.

Establishing standard legal documentation is an important foundation for any market to develop and grow at scale, but it's by no means the only factor. To build confidence in this market, we also need a robust framework to eliminate the risk of greenwashing, which threatens to impede the growth and impact of this market.

Efforts are underway to address this. The Integrity Council for the Voluntary Carbon Market (ICVCM) has developed a set of core carbon principles that establish global standards for firms to identify high-quality credits. These principles should help buyers to distinguish credits that have a permanent, additional and verifiable impact on emissions.

With legal standards and measures like the ICVCM's core carbon principles in place, we now have the basis of a single global framework that can avoid fragmentation in this market.

I'd like to finish with a positive example of where rules are starting to become more consistent after a concerted global regulatory and industry effort – regulatory reporting.

Trade reporting has been widely implemented since being identified by the G-20 as a key part of the post-crisis derivatives reforms, but each country initially developed its own rules. This has led to a lack of consistency in what is required to be reported, when it is to be reported, and the format in which the information is submitted, putting an unnecessary burden on firms and causing discrepancies and duplications in the reported data.

Fortunately, global standard setters have responded by developing a globally harmonized set of data standards. These include unique transaction identifiers, unique product identifiers and critical data elements, which specify a common definition and format for the reporting of trade information.

It's an important step, and regulators around the world are now in the process of updating their reporting rules to incorporate the standards. The US Commodity Futures Trading Commission was the first to make the change last December, and other jurisdictions will soon follow suit, including the EU in April next year.

Of course, this won't eliminate all differences between jurisdictions, and firms will still need to interpret and implement each rule set, which can lead to discrepancies in what each institution is reporting. ISDA's Digital Regulatory Reporting initiative can help here by enabling firms to use a single common industry interpretation of each rule set as open-access code, ensuring regulators receive data that is more consistent and accurate.

We'll be discussing this in more detail during the final panel of the day, so please do stay for that.

Regulatory reporting is a good example of where greater coordination and cooperation on a global basis can benefit both market participants and regulators, but there are many parts of the derivatives markets where we're seeing the opposite – a shift to increased fragmentation. Yes, there will always be a need for local rules that meet the specific circumstances of a particular market. But we believe convergence in areas where global standards make sense – for instance, in capital requirements and sustainability – will reduce complexity and avoid unnecessary fragmentation. That will lead to safer, more robust, more cost-effective and more efficient markets.

Thank you.