ISDA Annual General Meeting
May 11, 2021

Opening Remarks
Eric Litvack, Chairman, ISDA

Hello everyone. Welcome to day two of ISDA's virtual AGM.

Usually during this slot, I'd start off talking a bit about our host city – whether it's the vibrancy of Hong Kong, the beaches of Miami or the history and culture of Lisbon – and the pleasure of meeting up with friends old and new. This year, for most of us, it's our own bedroom, dining room or kitchen, while social events are a remote memory.

It's yet another reminder of the monumental changes that have occurred over the past 12 months. The pandemic has fundamentally changed how we do things – where we work, the *way* we work, how we communicate and how we interact with others.

In many cases, the virus has accelerated changes that were emerging anyway. Work from anywhere had been slowly gaining a foothold in our industry, but the pandemic has swept away internal restrictions and firewalls that hampered use of technologies like Zoom and WebEx.

It's also acted as a further catalyst to automation in derivatives markets. Having people working away from the office and in isolation has, by necessity, forced us to relook at how we negotiate, trade and process derivatives. Scott talked yesterday about some of the initiatives ISDA has been working on in this space, including the extension of ISDA Create, the rollout of regulatory reporting pilots using the Common Domain Model and the forthcoming launch of the first fully electronic ISDA definitions. While many of these initiatives were in train before the pandemic hit, it has made them even more relevant and important.

But while the pandemic has accelerated some positive changes like use of technology, it has also exacerbated some negative ones. Most worryingly, it has widened the gap between the haves and have nots and worsened social inequality. That goes for countries as well as individuals.

The financial market turmoil in March and April 2020 is a case in point. Many emerging markets are heavily reliant on US dollars in various ways, but a global shortage of dollars during the height of the COVID crisis left these countries unable to replenish foreign exchange reserves and service outstanding dollar debt, putting real pressure on their economies.

Central banks responded to the crisis by flooding the market with liquidity and improving access to US dollars, including through the setting up of swap lines. That action undoubtedly helped calm market volatility and bring some semblance of normality. However, those swap lines were mostly with developed countries, meaning the dollar shortage for many emerging markets remained acute.

The International Monetary Fund ultimately extended its emergency financing facilities, which helped loosen the dollar squeeze in these territories. But ensuring adequate and ongoing support for emerging markets is something that needs to be reviewed and strengthened as we think about lessons learned from this crisis.

For our part, ISDA continues to focus on helping emerging markets build the foundations for effective risk management and hedging. Working with local authorities to develop appropriate netting legislation is fundamental to that, and the past 12 months has seen successes in Costa Rica, Croatia, Ghana, Nigeria and Ukraine, among others.

As well as mitigating credit risk and increasing credit capacity, having a legally effective netting regime in place encourages greater participation by both foreign and domestic banks, increasing liquidity and competition.

ISDA's Model Netting Act provides a useful template for authorities as they develop their own legislation, and ISDA is now working to build a model regulatory framework too. This will provide guidance that reflects best practices in managing derivatives markets across the globe, which emerging market regulators can use to establish their own framework.

On its own, this won't solve the challenges that emerging markets face. But the development of vibrant local capital markets and the ability to manage exposures *is* part of the answer. Being able to hedge risk on a cost-effective basis shouldn't just be the preserve of rich countries – everyone should be able to access safe and efficient markets.

Social impact is also an important element in climate transition, and the two need to go hand in hand – there is, after all, a reason why there's an S in ESG. As we transition to a green economy, it's important we do so in a way that doesn't leave segments of the population behind.

That's not going to be easy – meeting ambitious targets for net-zero carbon emissions will entail a seismic shift in the way we live our lives. Nonetheless, financial markets can help manage that shift by channeling trillions of dollars of investment to new sustainability initiatives and infrastructure, creating new jobs and new opportunities.

Derivatives will play an important role here by enabling issuers and investors to manage the risks associated with this shift. 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 optimize risk, which creates certainty and stability. That certainty gives firms the confidence to borrow, lend, invest, expand and hire.

I'd like to pause here for a moment and play our latest whiteboard animation on the role that derivatives will play in the transition to a low-carbon economy.

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So, what needs to happen to further spur the development of ESG-related financing, investment and risk management products? According to a survey of ISDA members at the end of last year, one of the key factors is establishing a consensus on ESG standards and metrics.

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 standardization in documentation, market practices and operational processes.

ISDA documentation can already be used to reference and trade ESG assets, and we're now expanding our suite of templates to include renewable energy certificates. As this market grows, we'll work with members to identify other areas where standard terms, documents and definitions are necessary.

I'd like to finish my remarks by looking at how derivatives markets weathered the COVID crisis. Analysis conducted by ISDA and others has studied the sudden deterioration in liquidity during the worst of the crisis, caused by a dash for cash by end users and reduced risk appetite among banks.

Central banks acted quickly to stabilize the situation – but even during the worst of the disruption, the review of the data showed that derivatives markets continued to function.

Investors had to trade in smaller size, but they were still able to transact and hedge. Key infrastructures, including clearing houses and trading venues, operated largely without issue. Banks continued to support their customers and played a key role in channeling the transmission of central bank interventions to the real economy.

In the first real test since the financial crisis, derivatives markets held up extremely well.

To a large extent, this can be attributed to the regulatory reforms of the past decade. Derivatives markets are now more transparent and resilient following the introduction of mandatory clearing, trading and reporting. Banks are better capitalized due to revisions in the Basel framework, and non-cleared derivatives are now backed by high-quality collateral following the rollout of new margining requirements.

There are some final reforms still to come this year, though. September will see the fifth phase of the initial margin requirements – and we've got a panel later today that will explore the implications of that in depth.

We'll also see national regulators develop rules to implement the final Basel measures, including the Fundamental Review of the Trading Book (FRTB) and the revised credit valuation adjustment (CVA) capital rules. This is a critical last piece of the capital jigsaw, so it's important it fits well with everything else and doesn't create incentives that skew the picture.

As an example, a European Central Bank survey conducted last year found that 40% of banks that currently use the internal models approach intend to ditch it in favor of the new standardized approach under the FRTB, with another 20% undecided.

There are various reasons for that – for example, the introduction of a complex P&L attribution test and the rules on non-modellable risk factors. But I personally find that statistic shocking: it means nearly two thirds of banks that currently use sophisticated risk models may stop in favor of using a blunter, less risk-sensitive tool instead.

Let's just remind ourselves why the Basel Committee on Banking Supervision adopted a risk-based capital framework in the first place. It was to encourage banks to invest in sophisticated, cutting-edge risk management systems. By doing so, banks would be allowed to hold levels of capital more reflective of the risks they face – subject, of course, to the models being reviewed and approved by regulators.

Some of those models were shown to be lacking during the financial crisis, but it doesn't necessarily follow that risk-sensitivity as a concept is flawed. It cannot be a good idea to temper incentives for banks to invest in the best possible risk models.

The new FRTB standardized approach is much more risk sensitive than the standardized approach previously used for market risk capital, which is an important and welcome development. But standardized approaches are, by definition, a one-size-fits-all tool that can be used by everyone.

This has several implications. If all banks are subject to the same standardized models, they'll have the same view on what assets and businesses to target, leading to herd behavior. Creating a disconnect between risk and capital can also have undesirable consequences – for example, banks retreating from certain businesses or geographies because the capital required is out of whack with risk and return.

I've had occasion to say this at previous ISDA events: as national regulators develop their rules, it's important to ensure the overall framework is risk-sensitive, appropriate and coherent. A key driver, especially in the wake of the COVID crisis, should be to avoid any unnecessarily detrimental impact on market liquidity, and ensure banks can continue to lend to the real economy and provide crucial risk management services.

Before I end, I would just like to take a moment to thank all of you for your continued support during what has been an extraordinary year. Despite everything going on, you and your firms have been as active as ever, enabling us to produce a huge body of advocacy letters, consultation responses, documentation, protocols and mutualized solutions. Thank you for all your efforts.

I hope you find the rest of the AGM useful. And I hope the next time I speak to you at an AGM, it will be on stage, in person, in Madrid next year – and maybe we'll even be able to raise a glass or two together.

Thank you.