ISDA Safe, Efficient Markets

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Chairman's Remarks – Eric Litvack

It's been a couple of years since I last came to Hong Kong. But every time I do, I'm struck by how quickly the place changes. Restaurants I went to last time are no longer there. Whole buildings have sprung up that weren't there before. The harbor is just that little bit narrower than the last time. The whole place is busy, bustling and dynamic – and fascinating for it.

This pace of change is not unique to Hong Kong, of course. In virtually every aspect of our lives, we've been assailed by forces of change that are entirely unprecedented. I could pick any number of examples, but let's think about technology.

We've gone from the first commercially available mobile phone from Motorola to being able to download movies on our smartphones in just over three decades. Thirty years ago, the prospect of owning a cell phone was out of reach for most people. Now, there are an estimated 5 billion mobile subscribers, with more than half of those here in Asia-Pacific.

Think about the way we listen to music.

Believe it or not, this year marks the 40th anniversary of the Sony Walkman. Now, the concept of listening to just one album or one painstakingly compiled mix tape seems quaint and primitive, with literally millions of songs available to stream to our mobile devices at the click of a few buttons.

And guess what. The pace of change isn't going to slow down any time soon. In fact, the world will change in ways we can't possibly imagine in the coming decades. Just look at demographic data.

You all know the headline numbers: the world's population has grown from about 4.4 billion in 1980 to 7.6 billion in 2017, and is predicted to reach 8.6 billion in 2030 and 9.8 billion in 2050.

But look deeper into those numbers, and consider how they will drive change.

Importantly, a large part of this growth is down to higher life expectancy. According to the UN, the number of people aged 60 or above is expected to more than double by 2050, while the number of people aged 80 or over is expected to triple. In 2030, the UN predicts that people aged above 60 will outnumber children under the age of 10 for the first time in human history. By 2050, this older demographic will outnumber people aged between 10 and 24.

This will have a profound impact on just about everything. It will have implications on the way we live, on the use of technological assistance in our daily lives, on interconnectivity and, by extension, on privacy. It will have consequences for the economy, for wealth creation and for wealth preservation.

These are tectonic shifts, which will have an impact on investment and retirement planning. By extension, they will have implications for risk management as we think about the future of the derivatives industry, and will likely act as a further catalyst to automation and new technologies.

So, what does it mean for ISDA? We'll need to be agile, and respond quickly to changes in the requirements and practices of derivatives markets. Our role as the source for industry standards, an advocate for effective risk management and a proponent for safe and efficient market infrastructure will become even more critical as markets rapidly evolve.

The good news is that you, our members, think we're doing a good job on this at the moment.

According to our most recent member survey, you rated the association as effective in executing our strategic goals, with scores of more than four out of five in all areas. That represents an average score increase of 33% versus our last member survey in 2014.

But this survey was never about patting ourselves on the back. The most important motivation was to get your thoughts on how markets will change in the coming three to five years, and to hear what you think ISDA should focus on.

Here's a collection of some of the most frequently used words in those responses. For me, three main themes jump out. Benchmark reform – words like LIBOR, IBOR, benchmark and transition. Automation – words like standardization, technology and smart contracts. And initial margin – so, words like regulatory, margin and collateral.

I'll briefly talk about each of those issues, and outline some of the areas of focus.

I'll start with initial margin. The key date here is September 2020. That's when the compliance threshold for initial margin requirements falls from €750 billion to just €8 billion in aggregate average notional amount of non-cleared derivatives.

At that point, more than 1,100 entities will come into scope of the rules, representing over 9,500 trading relationships. To put that in context, over the three years of phased implementation so far, just 34 firms have come into scope.

That means the scale of the compliance effort will be many times greater than anything we've seen so far. So much so, there was a very real risk of a compliance logjam that could have resulted in many small firms being locked out of the non-cleared derivatives market, at least temporarily.

Fortunately, the Basel Committee and IOSCO last month published a statement highlighting that counterparty relationships that fall below the IM exchange threshold aren't obliged to meet documentation, custodial or operational requirements.

On the face of it, this is helpful. As it stood, new documentation would have needed to be negotiated with every counterparty and two custodial accounts would need to be set up for each relationship.

That would have been a massive legal and operational lift – and, for the most part, entirely unnecessary. ISDA data shows most of these phase-five relationships would not actually be required to exchange initial margin, because their actual exposures fall below the €50 million IM exchange threshold.

It's not absolutely clear how the BCBS-IOSCO statement will be applied by national regulators. But even in the best-case scenario, it doesn't eliminate the compliance challenge. For example, these smaller firms will need to continually calculate IM and monitor threshold levels, which means IM calculation systems will need to be implemented and tested.

Faced with this ongoing burden, some phase-five entities may be tempted to reduce their derivatives exposure well below the threshold level, limiting their ability to effectively hedge. In a world of rapidly shifting risks, that would clearly be a sub-optimal outcome.

We maintain the most appropriate solution is to make the €8 billion phase-five compliance threshold more risk-sensitive, so that non-systemically important entities are taken out of scope of the rules entirely. This will not only reduce the costly compliance burden on smaller firms, but would be more aligned with the policy objective of reducing systemic risk.

This issue of risk appropriateness and risk sensitivity is an important one for ISDA, and it comes up a lot in what we do. Whether it's margin, liquidity and capital, or trading, clearing and reporting, we believe it's essential that regulatory requirements reflect the risk posed by a given activity.

If requirements are too onerous and not aligned with risk, then firms would either need to swallow higher costs, increase prices to maintain their return on equity, or pull out of the business altogether. That reduces the available avenues for end users to access cost-efficient financing and to manage risk.

That has real consequences. A wide variety of financial and non-financial firms use derivatives for a reason: they help them run their business more efficiently and more effectively.

To quote CFTC chairman Giancarlo from the most recent issue of our member magazine, IQ:

"The use of commodity futures, swaps and other derivatives is one of the reasons citizens find plenty of food at stable prices in grocery stores, affordable energy to warm homes and drive cars, and steady rates to pay home mortgages and invest retirement savings."

Simply put, a safe, efficient derivatives market is a critical component of sound and sustainable economic growth.

Let's turn now to another key issue raised in our member survey: benchmarks.

A year ago, ISDA and other trade associations ran a major survey of market participants to gauge the state of readiness for benchmark reform.

The report threw up some interesting findings, but it also highlighted a lack of awareness in many quarters, and a limited understanding or acceptance of the risks posed by a cessation of LIBOR and other IBORs.

Coming just six months after FCA CEO Andrew Bailey's speech in which he said the regulator would not compel or persuade panel banks to submit to LIBOR after the end of 2021, much of the market seemed still to be in denial.

A year later, and many market participants seem to have moved quickly through the stages of anger, bargaining and depression, and have arrived at some level of acceptance. Although some of you, admittedly, are still working your way through the depression stage.

The various public-/private-sector risk-free rate working groups have focused on outreach, and knowledge of the issues appears to be much greater than it was. In the US and UK, we've seen the emergence of futures products and clearing services for swaps linked to the new risk-free rates, and the first cash bonds linked to SOFR and SONIA have been issued.

In Asia-Pacific, regulators in Australia, Hong Kong, Singapore and elsewhere have worked to review the robustness of existing domestic benchmarks and identify reliable fallbacks.

We are today in a much better place than we were 12 months ago. But that's not to downplay the scale of the task or the work that needs to be done.

With exposure to LIBOR and other IBORs estimated at $370 trillion across derivatives, bonds, loans and mortgages, this is arguably the most challenging and complex task the industry has ever faced. It will require laser-like focus and all-out effort from every single part of the industry. And we don't have the luxury of time.

In the case of LIBOR, we cannot predict the end game. LIBOR might cease to exist in 2022 as successive panel banks pull out; it might not.

Given this uncertainty, it might be tempting to hold back and wait to see what happens. Well, I'm afraid that sitting on your hands isn't a sound strategy here. You need to be informed, you need to have assessed your sensitivities to changes in benchmarks, and you need to have identified and addressed the fallbacks in your current contracts and investments.

You certainly don't want to be the last person standing, when liquidity in LIBOR and LIBOR-referencing contracts has significantly declined. Given the scale of the exposure and the systemic implications, that's irresponsible risk management.

The best strategy for benchmark reform is to start preparing now, and that includes new issuance and new contracts based on the alternative RFRs. Start executing a strategy for legacy trades. Review and strengthen contractual fallback language, leveraging on ISDA's extensive work in this space.

Of course, some RFRs are still relatively illiquid – particularly those, like SOFR, that are new. That's to be expected at this stage of development. But we all have a responsibility to put our collective shoulder to this wheel. The only way for liquidity to develop is for people to trade these new rates.

In our benchmark trading panel this morning, we'll take a closer look at how these RFRs are being traded, how people are managing basis risk, and the opportunities that currently exist. We've made progress, but we have more to do – and we all have a part to play.

The third notable theme in the member responses is standardization and automation.

Looking through the written comments in our member survey, it's clear that you see increased use of technology as one of the big trends over the next three to five years. Greater automation is seen as essential to meeting increasingly complex regulatory requirements, particularly those relating to collateral, improving efficiencies and reducing costs.

Many financial institutions are well advanced in exploring new automated solutions for certain resource-intensive businesses, often involving technologies like cloud, artificial intelligence or, in some cases, distributed ledgers. Some banks are even putting in place comprehensive change programs to overhaul legacy systems and infrastructure across their firms.

They are doing this for a reason. Current infrastructure is a bit like a wind-up wristwatch. It tells the time, but it relies on a series of complex gears and mechanisms. You need manual intervention to keep it going, and even the best-kept watch will almost certainly be fractionally slower or faster than your customer's. You might want your watch to do other things, but there's limited scope and capacity for extra functionality.

Likewise, derivatives market processes are complex, with lots of moving parts. Over time, each firm has developed its own systems and procedures, and its own way of representing events and product data. This means firms rarely have the same information in the same format at the same time, requiring constant crosschecking between counterparties.

New regulations have added extra requirements and additional steps, and have introduced new entities that have to be looped into the process – trading venues, data repositories and clearing houses. So far, this has been bolted onto inefficient legacy infrastructure, but we're dangerously close to reaching capacity of what is possible.

Automation of certain processes within this structure will help to an extent. Certainly, there are some practices in the collateral space that are crying out for technology solutions. But automation on its own will only get you so far. If each bank and each platform uses its own bespoke standards and conventions, then you'll never eliminate the need for translation and reconciliation. You'll never have a scalable solution that can operate seamlessly across all businesses, firms and platforms.

That's why those of us on the ISDA board are so excited about the ISDA Common Domain Model. By providing a set of standard representations for events and processes that occur through the lifecycle of a derivatives trade, the ISDA CDM will provide a common blueprint that everyone can follow. This really has the potential to be transformational in creating efficiencies and helping to realize the full potential of new technologies.

Now, many of us work for large financial institutions with big, complex legacy infrastructure. We all know that change isn't easy. It's expensive, and it can be difficult to quantify the benefits. It's often all too easy to stick with the status quo.

But it's getting to the point where we can't continue patching up the current complex system and finding workarounds as we add new functionality. We need a sustainable infrastructure that sets the foundation for derivatives trading in the 21st century.

The development of the ISDA CDM goes hand in hand with other ISDA initiatives to bring standardization and automation to the derivatives industry. ISDA Create is one, where we're bringing the negotiation and execution of initial margin documentation online.

More broadly, ISDA is also working to standardize its documentation to enable digitization and electronic processing, and to facilitate the capture of structured legal data. This includes a review of the 2006 interest rate definitions and work to standardize the schedule to the ISDA Master Agreement.

This standardization is an important precursor to the development of smart contracts, which could drive further efficiencies and reduce the need for manual intervention. You'll hear more about that in our legal panel later today.

I started my remarks this morning by talking about change. The world has altered in so many ways over the past 20 years or so. So has our industry. Derivatives markets are completely different from how they were when many of us started our careers.

But buckle up, because you ain't seen nothing yet. Technological change will accelerate, with profound impacts on how we live and work. The bonds of trust and cooperation that have held sway in international relations are shifting. Climate-related change will further challenge our assumptions of normality. The next 20 years will see changes that we can't even begin to imagine.

I'm confident, though, that there will be one constant – the need for standards, best practice and documentation. You can be sure that ISDA will continue to meet that need, and ensure we have a derivatives market fit for tomorrow.

I'd like to finish by thanking you all on behalf of the ISDA board for all of your support. Without your participation on the working groups, your feedback and your ideas, ISDA would not be anywhere near as effective as it is.

I'd like to thank you for attending the AGM. And I'd like to thank all our sponsors and exhibitors. Without your support, it wouldn't be possible to hold an event like this.

I'd also like to take this opportunity to thank the ISDA staff for their work in bringing the industry together and reaching consensus on so many important industry issues. It's not always the easiest thing to achieve, and so I'd ask you all to join me in thanking the ISDA staff for their drive, enthusiasm and patience.

Finally, a thank you to my colleagues on the board for the time they give to ISDA and the contributions they make. The board is made up of people from different parts of the market and different geographies, but they all have one thing in common: a commitment to ensuring safe and efficient derivatives markets. Thank you for all you do.

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