ISDA® Safe, Efficient Markets

CFTC Market Risk Advisory Committee
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Counterparty Risk & Liquidity Risk

Good morning and thank you for inviting me to address this meeting of the Market Risk Advisory Committee (MRAC). I'm pleased to introduce the next section of our agenda, focusing on climate risk, market structure and benchmark reform.

It's almost three years to the day since the World Health Organization declared COVID-19 to be a global pandemic. The rapid escalation of the disease in March 2020 triggered the biggest shock to global markets since the 2008 financial crisis. Within weeks, asset prices plummeted around the world, liquid assets were sold off and risk appetite disintegrated. Illiquidity in US Treasury markets was a particular cause for concern.

As we now know, the liquidity shortfall in early 2020 was not an isolated episode. Since the pandemic struck, a similar pattern has been repeated in other markets, with an initial shock leading to market volatility and liquidity issues. It happened in early 2022, after the Russian invasion of Ukraine drove volatility in commodity markets, and again in September 2022, when UK gilt yields rose sharply, leading the Bank of England to intervene to calm the market.

In the early days of this committee, its focus was on addressing counterparty credit risk through clearing, capital and margin rules. The successful implementation of those rules has made the system safer and more robust, but it's clear that markets are now more susceptible to liquidity risk. Regulators and market participants must work together to identify and address the drivers of recent stress events so markets can better withstand future shocks.

I commend the MRAC for highlighting several critical issues. I'll briefly touch on several topics on today's agenda and how they might be vulnerable to counterparty or liquidity shocks.

I'll start with digital assets.

Digital Assets

We've heard today about the importance of an appropriate regulatory framework for this rapidly developing asset class. As the committee continues to study the market and consider this important issue, I do hope you will look carefully at counterparty risk exposure and what happens when a failure occurs.

Following the collapse of multiple crypto entities last year, it is critical that the legal fundamentals regarding bankruptcy and custody are fully considered. We need to ensure appropriate and clearly defined custodial and bankruptcy rules are in place and all participants are aware of their rights and the expected outcomes in a default scenario.

At ISDA, we have developed valuable resources to address these issues. In January, we published a whitepaper on navigating bankruptcy in digital asset markets, with a focus on close-out netting and collateral[1]. We will shortly publish a second paper that explores customer assets held with intermediaries and looks at how those holdings may be treated in an insolvency. In both cases, we can learn from traditional finance to ensure we protect the rights of customers in the digital assets market. I encourage the MRAC to consider these issues as lessons continue to be learned from recent turmoil in this market.

Climate Risk

Turning to climate risk, which will be the topic of the next session. Further work is required to build liquidity and manage counterparty risk in climate-related markets. We need to move quickly to create clarity on the legal framework, establish global product definitions, set high standards and develop consistent climate scenario data. Without these vital ingredients, we risk fractured, regional markets with insufficient liquidity. This will undermine the key objective of driving the trillions of dollars of investment in infrastructure that is needed to transition to a sustainable economy.

At ISDA, we have been working to develop standard definitions and templates that can be adapted to ensure climate products are consistently described and documented around the world. We published new definitions for verified carbon credits at the end of last year[2], and we are developing standardized terms and clauses for sustainability-linked derivatives[3]. I am also hopeful that the Integrity Council for the Voluntary Carbon Market will be successful in setting more selective global standards for carbon credits[4]. Failure to establish higher standards and best practices could lead to greenwashing, which will damage confidence and stifle liquidity in these markets.

It was the MRAC's climate subcommittee that published a landmark report in 2020 on managing climate risk in the US financial system[5]. The work to define appropriate risk management practices for different climate scenarios is complex and requires extensive collaboration between policymakers and market participants. ISDA has conducted a survey on climate risk scenario analysis for the trading book and we published our findings last year[6]. We're now developing further technical guidance that we aim to publish in the coming months. I hope the committee will continue to engage with the market on climate risk management as we work through this important topic.

Block Rules

[1] www.isda.org/a/mIxgE/Navigating-Bankruptcy-in-Digital-Asset-Markets-Netting-and-Collateral-Enforceability.pdf
[2] www.isda.org/2022/12/13/isda-launches-standard-definitions-for-the-voluntary-carbon-market/
[3] www.isda.org/2022/11/21/the-way-forward-for-sustainability-linked-derivatives/
[4] https://icvcm.org/the-core-carbon-principles/
[5] www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf
[6] www.isda.org/a/e55gE/Climate-Risk-Scenario-Analysis-for-the-Trading-Book.pdf

Turning to the market structure component of today's agenda, I want to reiterate ISDA's commitment to the regulatory reforms that have improved transparency in the derivatives market. The implementation of these rules has made the financial system and our markets safer and more resilient.

It is within this context that I express concerns about changes to the Commodity Futures Trading Commission's (CFTC) block rules that are due to take effect in early December. Based on data from 2020, we estimate these changes would raise the threshold for block trades by as much as 100% or, in some cases, 200% from their 2013 levels. Under the revised thresholds, made-available-to-trade swaps that are currently traded bilaterally as blocks will have to be executed on swap execution facilities with a request for quotes to three parties. Critically, the uncapped notional amounts of these trades will have to be publicly disseminated in real time.

These increased thresholds will have a big impact on market liquidity, exposing dealers to 'winner's curse', whereby others will know they are looking to hedge in large size. Liquidity providers will need to account for this, leading to widening bid/offer spreads, increased transaction costs and delays in executing hedges.

The key to determining appropriate block sizes is the level of liquidity and risk sensitivity of a particular asset class. These measures naturally evolve over time and can change in different market conditions. We would urge the CFTC to consult further on how the revised block thresholds could affect liquidity before they come into force.

Treasury Markets

Finally, I'll touch on the US Treasury market, the beating heart that keeps liquidity flowing through the global financial system. A number of ideas have been discussed to enhance liquidity and resilience in this market. Inefficiencies in the US Treasury market could adversely affect collateral for derivatives, so ISDA members would like to see an outcome that increases liquidity in this critical market.

I'll highlight two ideas that have been discussed. Firstly, changes to the supplementary leverage ratio and the surcharge for global systemically important banks would allow regulated banks to transact in the US Treasury market in a more balance-sheet efficient and cost-effective manner. Changes to these requirements are, of course, a matter for prudential regulators, so I won't go into further detail here.

The second is the Securities and Exchange's (SEC) proposed rules that would require clearing of certain US Treasury securities transactions.

Prior to the SEC's proposal, ISDA carried out a survey on Treasury clearing to help inform the discussion. This highlighted a wide variety of views on whether increased clearing of US Treasuries and repos would materially improve the resilience and efficiency of the market. Most respondents were broadly supportive of clearing, but there was little support for a clearing mandate, with suggestions this could lead participants to reduce their activity or withdraw from the market.

The SEC has also proposed that clearing agencies offering clearing of US Treasuries should take steps to facilitate access to client clearing. We support these client-based provisions, but it is important that clearing agencies consult with the market before making any changes to client clearing models. This will allow market participants to fully understand and prepare to manage the risks, costs and benefits of clearing under those models.

LIBOR Transition

Before wrapping up, I'd like to emphasize that the end of US dollar LIBOR is fast approaching – the last five settings will cease publication, or potentially become non-representative, on June 30.

Great progress has been made in the transition to alternative reference rates, but as we enter the final phase of this multi-year process, we mustn't lose momentum. Firms should continue to proactively move away from LIBOR and use the tools that are available for legacy transactions. For non-cleared derivatives, the 2020 ISDA IBOR Fallbacks Protocol remains open for adherence. Voluntary transition prior to the deadline is still the best-case scenario, but derivatives and other contracts that continue to reference US dollar LIBOR must at least have fallbacks, like those in the protocol, to provide clarity and certainty.

It's an honor to provide input on the important and wide-ranging topics on the MRAC's agenda. As that agenda continues to evolve, I encourage you to keep in mind the need to address both counterparty risk and liquidity risk.

Thank you.