ISDA Safe, Efficient Markets

ISDA Annual General Meeting

May 11, 2022

Opening Remarks

Scott O'Malia, Chief Executive Officer

Good morning, and welcome to the ISDA Annual General Meeting (AGM) here in Madrid. It's hard to believe it's been three years since we were last able to hold this in-person event. It's fantastic to be back and to have the opportunity to meet face to face once again.

A lot has changed since our 2019 AGM in Hong Kong. None of us could have predicted how the past three years would play out – a deadly virus, new variants, repeated lockdowns and the rollout of mass vaccination programs, all of which turned our professional and private lives upside down. In a word, chaos.

There have been big upheavals in the financial world too. Inflation is rising, markets have been volatile, and interest rates are on the way up, weighing heavily on economic growth. Sanctions on Russia have also had an impact on interest rate, FX, credit, commodity and equity derivatives markets, which ISDA has been helping to address. Added to all that, we've had to navigate one of the biggest challenges financial markets have ever faced – the shift away from LIBOR.

Throughout this time of change, ISDA has remained true to its core mission – to maintain order and efficiency in rapidly changing markets.

Over the past three years, we avoided chaos during the LIBOR transition by introducing robust fallbacks. We helped firms meet phase five of the initial margin rules for non-cleared derivatives. And we evolved our interest rate derivatives definitions to reflect market changes – as well as publishing them in digital form for the very first time.

Today, we are looking ahead to the significant role derivatives will play in the fast-moving crypto assets market and in the transition to a more sustainable economy. As you'll hear throughout this AGM, we are taking a firm grip on both issues and intend to bring order and efficiency through the development of definitions and robust contractual standards.

Whatever you think about crypto, there can be no denying its potential to completely reshape financial markets. With rising demand from institutional investors and a rapidly growing derivatives market, we've welcomed native crypto firms to our membership in recent months. Their contribution to our working groups will be important as we hammer out standards for crypto derivatives – this can only be achieved with traditional and decentralized finance working together.

At the same time, there is an urgency to the climate crisis that cannot be ignored. Around the world, commitments have been made to reduce emissions to net zero, and this can't be achieved without trillions of dollars in new investment. Derivatives will bring financial stability, but tough issues like the potential for greenwashing must be tackled to ensure companies can support the transition to a sustainable economy with integrity and transparency.

Just as we avoided chaos during the LIBOR transition and initial margin implementation, I'll set out how we are bringing order and clarity to crypto and environmental, social and governance (ESG) derivatives markets. I'll explain why standards and a risk-appropriate capital framework are so important for both crypto and ESG. There is a tremendous amount of work to be done here, and we need your involvement to make it a success.

Documentation

Our foray into the worlds of crypto and ESG is a new direction for ISDA, but it's underpinned by work that has been done in the past to set the legal foundations for robust derivatives markets.

This year marks the 35th anniversary of the launch of the ISDA Master Agreement. This document was vital in creating order in the early derivatives markets of the 1980s, replacing the tangled web of bespoke agreements. It has provided a robust foundation that can be used across a variety of products, including crypto and ESG.

As a reminder of the lasting importance of the ISDA Master Agreement, we've made it the subject of our latest whiteboard animation.

We haven't allowed the Master Agreement to gather dust. Instead, we have continued to evolve this document and add others to keep pace with market changes. For example, we recently published new provisions allowing firms to document derivatives and securities financing transactions under a single ISDA Master Agreement – a change that will enable firms active in both markets to benefit from increased netting efficiencies.

Of course, the evolution of technology means today's derivatives market is almost unrecognizable from what it was in 1987, and our documentation has adapted to reflect this.

The ISDA Master Agreement is now available on ISDA's electronic library, alongside our flagship interest rate and FX product definitions. We've also added it to ISDA Create, our online document negotiation platform. This solution serves as the ideal platform for our members – especially crypto members – that want to document their counterparty relationships in digital form.

Today, I'm pleased to announce that ISDA Create will be available through S&P Global's Counterparty Manager platform, enabling users to easily access a full digital history of their on-platform contractual relationships.

Throughout the chaos of the past three years, ISDA staff and members have worked hard to bring order and certainty. Our work to digitize documentation and take on major industry challenges like LIBOR reform have positioned us well for the next task of bringing crypto and ESG derivatives under the ISDA documentation framework.

Crypto

Thinking about crypto, I'm reminded of my tenure as a commissioner at the Commodity Futures Trading Commission (CFTC), where I focused on the role technology would play in shaping financial markets. We spent a lot of time thinking about high-frequency trading (HFT). Regulators were aware of Bitcoin back then, but it was generally considered to be something akin to hocus pocus.

Fast-forward to 2022, and we hear little of HFT, but crypto has evolved from a fringe retail product to a sophisticated financial market with an estimated value of $3 trillion. Increased demand from institutional players has driven the development of the crypto derivatives market, starting with exchange-traded products and extending to over-the-counter (OTC) instruments.

Far from being a dark art, we recognize that distributed ledger technology has the potential to reshape both retail and wholesale financial services in ways I couldn't have imagined in my CFTC days.

At ISDA, we are maintaining a laser focus on the areas where we have the deepest experience – standard contractual terms and risk-appropriate capital.

Just like any other asset class, crypto derivatives require precise and consistent terms and standards that reflect their unique features. Equally, the risk profile needs to be properly understood so capital requirements can be appropriately calibrated.

Last year, we convened the ISDA Digital Assets Legal Group and moved quickly to develop a whitepaper that explored the features of crypto assets such as forks and airdrops that would need to be addressed in any standard definitions. By combining the knowledge of our crypto members with the standards that have been developed for traditional finance, we will be successful in drafting robust and consistent definitions.

Just as the ISDA Master Agreement brought order to the chaos of the nascent derivatives market 35 years ago, we believe standards will bring the same clarity and consistency to OTC crypto derivatives. We are moving fast towards a contractual framework to include cash-settled forwards and options referencing Bitcoin and Ether, which we want to launch later this year.

As we develop consensus among our members, we will build on this work and add new products. But if you're expecting a definitional booklet for crypto derivatives to add to your bookshelf, you're going to be disappointed. In keeping with our digital strategy, we intend to publish a fully digital contractual framework, which can be integrated with blockchain technology.

Of course, our focus extends beyond contractual standards. The demand for crypto exposure from institutional investors has prompted interest from banks to bring their deep experience in intermediation and risk management to this market. But to respond to client demand, banks need to be sure they will not be hit with unduly punitive capital requirements. The accounting treatment also needs to be fit for purpose.

ISDA has just published a whitepaper that explores the changes needed to the accounting framework for digital assets. We've also raised concerns that the very conservative capital treatment of crypto assets set out by the Basel Committee on Banking Supervision would make it difficult for banks to participate in this market in a meaningful way. For example, the proposed 1,250% risk weight for certain crypto assets is designed to ensure banks hold capital at least equal in value to their exposures.

We think this is excessive. Capital standards that more appropriately reflect the risk of crypto assets would enable banks to respond to client demand – in turn, broadening market participation and liquidity.

ESG

I'll now turn to our work on sustainable finance.

The climate crisis is clearly the greatest challenge of our times. The scale of the problem calls on all of us – governments, companies and individuals – to play our part in the transition to a more sustainable economy. But with a problem of this size, it can be overwhelming to try to make a positive and lasting impact.

As in the crypto world, ISDA is working to bring order to this massive policy challenge by developing robust legal and contractual standards and advocating for risk-appropriate capital treatment for the growing ESG derivatives market.

Our objective is straightforward. We want everyone to have confidence in the resilience and credibility of ESG products, including sustainability-linked derivatives and voluntary carbon credits.

To this end, we have participated actively in the development of a climate taxonomy here in the EU. And we have developed several whitepapers to support the development of standards for sustainability-linked derivatives – the latest of these will be published tomorrow by our Future Leaders.

We all need to be clear about the cost of continuing to emit carbon and the need to take decisive action. The development of a voluntary carbon market is going to be critical to the success and speed of the green transition, because it will allow businesses to compensate for those emissions they can't reduce organically, as well as fund innovative carbon-reducing technology.

Just like other asset classes, robust legal foundations will be critical for the trading of carbon credits. ISDA has explored the key legal and regulatory issues that must be addressed in any contractual terms so the market can achieve its full potential.

While we think carbon markets have a vital role to play, the forthcoming Fundamental Review of the Trading Book (FRTB) would assign disproportionately high capital requirements to carbon trading. ISDA has published two reports that explore this issue, analyzing historical data from several carbon trading markets to show that the risk weight should be set at around 37%, rather than the 60% assigned by the FRTB.

We have shared this fact-based analysis with policymakers around the world, and we welcome the European Commission's proposal to reduce the risk weight to 40% as part of the third Capital Requirements Regulation. We urge other legislators to take a consistent approach when transposing Basel III to ensure banks can continue to play a constructive role in the transition to a sustainable economy.

Conclusion

I started these remarks by reflecting on how ISDA has remained true to its core mission by maintaining order and certainty through the chaos of the past three years.

As we face up to the challenges of climate and crypto, I am proud that ISDA is now taking the lead in promoting standards and best practices in these markets, as well as advocating for risk-appropriate capital. This is what we have always done to deepen liquidity, manage risk and promote market resilience.

I invite you to engage in these issues and other relevant topics we are actively focusing on. Together, we can make real progress in bringing greater order to both crypto and environmental markets.

I'd like to thank all of our sponsors, speakers and delegates for supporting the AGM. Like me, I know you've been eager to get back to this kind of interactive event, and I'm really looking forward to catching up with you over the coming days.

Thank you.