IQ In brief

The third day of the ISDA Annual General Meeting on May 12 featured panels on the new normal for derivatives markets, the development of local rules to implement Basel III, the digitisation of derivatives documentation and alignment between derivatives and securities financing transaction markets

Resilience of Markets Critical to Pandemic Response, says O'Malia

Regulatory reforms implemented after the last crisis played a critical role in ensuring the resilience of financial markets during the pandemic, and enabled banks to play a key part in helping the various central bank measures flow through to the real economy, according to Scott O'Malia, ISDA's chief executive.

The rapid escalation of the coronavirus crisis in March 2020 caused markets to tumble and liquidity to deteriorate amid a dash for cash, prompting central banks to pump trillions of dollars into the financial system. Despite extreme volatility, markets remained open and infrastructure continued to function, enabling firms to continue to access financing and manage their exposures, said O'Malia in opening remarks on the third day of the ISDA Annual General Meeting.

"There's absolutely no doubt in my mind that the resilience of the financial system and the ability of banks to support their clients through this period of stress was made possible because of regulatory reforms over the past decade. Bank capital and liquidity positions have been drastically strengthened because of Basel III, while counterparty credit risk is much, much lower due to mandatory clearing and the margining of non-cleared derivatives exposures," said O'Malia.

Nonetheless, there are lessons that can be learned to ensure markets remain resilient in the future, he said. In particular, trading book capital requirements were shown to be highly procyclical. According to analysis of 20 banks compiled by ISDA, the Global Financial Markets Association and the Institute of International Finance, credit valuation adjustment risk-weighted assets (RWAs) increased by more than 45% in the first quarter of 2020, while counterparty credit risk and market risk RWAs rose by 20% and 22%, respectively.

Amid concern rising RWAs would impede the ability of banks to extend credit and provide intermediation services, regulators provided temporary relief to smooth the procyclical impact of the capital rules. "But it's a reminder of the importance of an appropriate, risk-sensitive and non-procyclical capital framework," said O'Malia.

The pandemic also highlighted stresses that can emerge when liquidity is impaired, making it important to avoid barriers that might limit the ability of firms to trade with a wide range of counterparties, he added.

"Unfortunately, the lack of equivalence between EU and UK trading venues has made it much more difficult for entities in those jurisdictions to trade with each other," O'Malia said.

Following the end of the Brexit transition period on December 31, 2020, EU entities trading derivatives subject to the EU derivatives trading obligation (DTO) are required to execute those transactions on an EU or EU-recognised trading venue, while UK firms must trade derivatives subject to the UK DTO on a UK or UK-recognised venue. Without equivalence, in-scope trades between EU and UK counterparties can only take place on US swap execution facilities (SEFs), which are recognised by both jurisdictions.

Those firms that can't or don't want to use SEFs can only trade with counterparties on their local venues, resulting in split liquidity and less choice.

"This is not ideal for anyone, including EU banks that want to maintain client business on UK venues. We continue to believe that trading venue equivalence is the only way to comprehensively solve this issue. Given EU and UK trading venue rules are virtually identical, we can't see any technical or legal reason why equivalence isn't possible, so we continue to urge regulators to take action," said O'Malia.

IQ In brief

Buffer Framework Under Review, Says EC's Berger

The capital and liquidity buffer framework is being reviewed in Europe after banks showed reluctance to draw down their reserves during the coronavirus crisis, a senior European regulator has confirmed.

"The pandemic has shown that most banks in most jurisdictions have been reluctant to draw down on their capital and liquidity buffers to increase the provision of credit to the economy, even when they were actually encouraged by the regulators to do so. The concerns around buffer usability in periods of crisis have prompted us to take a closer look at why the buffers did not work as intended," said Nathalie Berger, deputy director of banking regulation and supervision at the European Commission (EC).

Speaking on the capital panel on the final day of the ISDA Annual General Meeting, Berger said analysis of the buffer framework is ongoing and there will be further communication in the coming months on the findings, as well as possible policy measures to address any issues.

Preliminary studies have already provided evidence that could inform policy action, she said. Specifically, the reluctance to draw down on buffers during times of stress was partly caused by financial markets pressure and concerns over a possible rise in funding costs if buffers shrink.

"Even with clear communication from the regulators, banks are concerned that regulators might require them, once the crisis is over, to replenish their regulatory capital ratios in too short a period. Being unable to do so could trigger other breaches and restrictions on dividend distributions," she said.

"Further analysis of buffer usability is being conducted now at all levels by national regulators and international regulatory bodies. The Basel Committee will review the effectiveness of the buffer framework as part of its longer-term evaluation of Basel III." IQ

Consistent Deviation from Basel III Could be Best Option

Consistent implementation of the outstanding components of the Basel III framework is critical and any deviations from the global standards should be harmonised across jurisdictions, speakers on the capital panel on the third day of the ISDA Annual General Meeting warned.

The final round of Basel III reforms, including the Fundamental Review of the Trading Book (FRTB) and the revised credit valuation adjustment framework, is due for global implementation in January 2023 and major jurisdictions are expected to issue draft rules this year. While further changes to the global standards are unlikely, jurisdictions could make coordinated changes in areas where there are concerns over the calibration.

"Such issues are not specificities – they are just issues to be considered in the Basel calibration. I am not so sure there will be appetite to work on those issues at the Basel level, so it is left to the specific jurisdictions to deviate and they will probably not have much choice, but we hope those key jurisdictions at least would deviate in sync," said Véronique Ormezzano, head of group prudential affairs at BNP Paribas.

Analysis of how the new capital requirements would have behaved during the COVID-19 pandemic has shown that while parts of the framework should be less procyclical than current standards, concerns remain over excessive conservatism. These findings have prompted calls for coordinated modification of the Basel rules in certain targeted areas.

"Frankly, I would ask the question, maybe a little bit provocative, but when the key jurisdictions adopt the same standards, deviating in the same way from the Basel standards, are these jurisdictions deviating or is it not the Basel Committee that is deviating from prudent regulatory choices by being excessively conservative?" said Ormezzano.

With less than two years until the implementation deadline, market participants are awaiting draft legislative proposals from key jurisdictions. In Europe, FRTB reporting requirements for the standardised approach will come into effect in September and a draft of the third Capital Requirements Regulation will transpose the remaining elements of the capital standards.

In the US, the timing of the publication of the notice of proposed rulemaking (NPR) on the Basel standards is not yet known, but it is likely to be delayed as the Biden administration has yet to nominate a comptroller of the currency – one of the prudential agencies that would legislate on Basel III. The delay has given rise to concerns that the timeline for implementation will be very tight.

"Given this is the entirety of the Basel III revision NPR, which will be quite extensive, I expect the new comptroller will want to take the time to fully understand these rules before they are put into effect. As the regulators jurisdictionally are looking at this across the globe, we very much hope and understand that they are in regular discussion about any revisions they are making to keep them as consistent as possible in implementation," said Debbie Toennies, global head of regulatory affairs for the corporate and investment bank at JP Morgan. IQ

IQ In brief

Derivatives Markets on Path to 'New Normal'

The derivatives market has begun the journey towards a 'new normal' and will be ready to respond to forthcoming challenges, having proved its resilience during the coronavirus pandemic, according to a group of senior regulators speaking on a panel during the final day of the ISDA Annual General Meeting.

"I hope the new normal continues to rely on the derivatives market for price formation and risk management purposes," said Brian Quintenz, commissioner at the US Commodity Futures Trading Commission (CFTC).

Quintenz said the smooth functioning of markets should not depend on normal economic conditions. "What we want is for derivatives and financial markets to operate normally in response to the economic environment that exists. We don't want financial markets to either pause or exacerbate whatever those financial or economic conditions are," he said.

Panellists suggested the new normal is likely to be defined by responding to the growth of environmental, social and governance investing, completing the final parts of the regulatory reforms, including the last two phases of initial margin requirements for non-cleared derivatives trades, and ensuring operational resilience as remote working continues.

"The 'normal' part of the new normal will be the continued reliance on technology; the 'new' part will be profoundly influenced by the existential challenge of our times, which is climate change. We have to be prepared for more volatile pricing and for historical correlations to break down due to unexpected weather events," said Wee Ling Phua, executive director in the markets policy and infrastructure department at the Monetary Authority of Singapore (MAS).

"On the flipside, there are opportunities. The real world will need risk management tools to manage the risks, and derivatives can play a huge part. I think we should really use derivatives markets as a force for good to help us all transition to a more sustainable future," Phua added.

Reflecting on the lessons learned from the pandemic, regulators echoed observations made by ISDA chief executive Scott O'Malia in his opening remarks – that the regulatory reforms of the past decade played a critical role in ensuring the resilience of financial markets during the coronavirus crisis.

When the pandemic escalated in March 2020, entire businesses had to switch to remote working at a time of very high market volatility. While trading volumes spiked and some markets announced temporary closures, derivatives market infrastructure remained generally robust and central counterparties (CCPs) continued to function. Regulators credit the Basel capital and liquidity reforms, as well as central clearing, non-cleared margin requirements, electronic trading and trade reporting, for this overall resilience.

"We were in a much better starting point with this crisis than we were in the financial crisis of 2008-2009, when we had a sectoral approach to supervision and a lot of blind spots across the board. As a result of the reforms, we now have a holistic approach, which is mutually reinforcing. We have increased requirements for CCPs, but they are complemented and supported by higher capital and liquidity requirements for banks," said Klaus Löber, chair of the CCP supervisory committee at the European Securities and Markets Authority.

The CFTC's Quintenz agreed that the regulatory reforms had ensured financial institutions were well prepared for the coronavirus crisis. "The lay of the land of the financial reforms really contributed to the derivatives market's resiliency and its ability to operate normally in response to the economic conditions, which saw businesses, supply chains and entire economies to some extent shutting down, which dramatically increased unpredictability and risk," he said.

Unlike the previous crisis, there are few big policy changes that need to be made in response to the past 14 months, said Benoit de Juvigny, secretary general at France's Autorité des marchés financiers. However, while regulators announced a one-year delay to implementation of phases five and six of the initial margin requirements for non-cleared derivatives during the coronavirus crisis, he stressed these rules must be rolled out in full.

"We have to stick to what is already decided – for instance, the postponement to September 2021 and September 2022 of the margin requirements on the non-centrally cleared derivatives. We have to stick to this rule and put it into force exactly at these deadlines," he said.

IQ In brief

Reforms to MMFs Necessary, Says Bailey

The 'dash for cash' in March 2020 exposed serious vulnerabilities in money market funds (MMFs) that threaten financial stability, and reforms are necessary to improve their resilience, says Andrew Bailey, governor of the Bank of England.

Speaking in a keynote address on day three of ISDA's Annual General Meeting, Bailey explained that the scramble for cash as the coronavirus pandemic worsened resulted in a surge in outflows from MMFs, totalling about £25 billion for sterling funds over eight days from March 12. With MMFs unable to sell sufficient assets in an illiquid market to meet investor demand for cash, money market rates rose sharply, affecting the cost and availability of credit to the broader economy.

Regulations allowing MMFs to impose gates to halt outflows once certain liquidity thresholds are met exacerbated the situation by causing investors to rush to pull cash out of other funds, Bailey explained. The resulting threat this posed to financial stability led to the Bank of England and other central banks "turning on the fire hoses at full blast" to pump liquidity into the financial system.

"It is clear from experience that money market funds as currently structured may often be perceived as cash-like, but cannot make good on this expectation in a sufficiently wide range of market conditions, and so can contribute to stress in short-term funding markets. The objective must be to improve the resilience and functioning of MMFs to protect the stability of the financial system," Bailey said.

Any reforms should be based on three high-level changes, Bailey said: removing adverse incentives introduced by liquidity thresholds that allow the use of gates and redemption fees; clarifying the distinction between cash-like funds and investment funds; and explicitly defining what is meant by 'cash-like'.

"Money-market funds are a cash management instrument, so it may seem odd that the meaning of cash-like as a term has not been well defined. The resultant ambiguity may have seemed convenient as a means to stretch the boundary of the definition to allow less liquid instruments in, but when a stress event like the dash for cash happens, the flaw is badly exposed and financial stability is in jeopardy," he said.

Clarity on the definition of cash-like would help eliminate uncertainty and avoid mismatches between an instrument's liquidity and its use. Funds that don't meet the definition could then be clearly identified, said Bailey. "We may end up with some MMFs becoming more cash-like and some less cash-like, but we need to avoid the muddy middle."

Acknowledging that no single reform will solve the issue, Bailey set out three broad approaches that could be taken – limiting asset holdings to government instruments, introducing notice periods rather than allowing funds to promise cash on demand, or alternatively introducing a combination of potential measures.

The Financial Stability Board is currently looking at this issue, and a consultation on potential reforms will be published shortly, Bailey said.

"The dash for cash provided an unwelcome reminder that the post-financial crisis did not finish the job and left a dangerous gap in our exposure to the risk of financial instability. We must finish the task this time," he said. IQ

Opportunities for SFT Alignment Exist

Efforts to achieve closer alignment between derivatives and securities financing transactions (SFTs) could bring significant efficiencies for financial institutions, but it will be important to retain the unique characteristics of each market in any common documentation, said speakers on the third day of the ISDA Annual General Meeting.

"Fundamentally, financial services provision is under more and more constraints, whether that's balance sheet or capital, and clients of the financial services industry also see a very fragmented structure in the way in which they are investing," said Duncan Rodgers, managing director and head of ALM strategy at UBS, talking on a panel on derivatives and SFTs. "Ultimately, you can see the need for convergence between markets that have similar risk functions and similar risks."

ISDA published a whitepaper last October that identified opportunities for closer collaboration between derivatives and SFTs, and set out a proposal for how the ISDA Master Agreement could be expanded to cover SFTs in order to create potential netting benefits.

While recognising the advantages, Paul Tagliareni, executive director at Morgan Stanley, noted that SFTs have their own unique lifecycle events that would need to be preserved, while differences in regulatory, capital and accounting treatment would also need to be considered.

"If we're able to put together a construct that works from a legal perspective with the cadence of all the individual lifecycle events, I do think there's an opportunity going forward," he said. "It's just really important that, as an industry, we are very measured and prudent about how we think about harmonising these respective products together in one cohesive document."

An ISDA working group is currently looking at these issues, with the aim of identifying differences that need to be retained versus those where there is a potential for harmonisation. IQ

IQ In brief

EU Credibility at Stake on Basel III, Says EBA Chair

The EU must implement Basel III in full and without materially deviating from Basel standards or it will undermine the global framework and weaken the effectiveness of the Basel process, European Banking Authority (EBA) chairperson José Manuel Campa has said.

Speaking in the final keynote address of the ISDA Annual General Meeting, Campa said that by increasing the risk sensitivity of standardised approaches and limiting the use of internal models where there has been excess variability, Basel III strikes the right balance between maintaining a risk-based framework and restoring trust in global standards.

"This is an area where the credibility of the EU, but also the Basel Committee, is at stake and we consider it of utmost importance that the EU continues to be perceived as a key player in the setting of financial regulations. Keeping our goal to preserve a global level playing field and to avoid regulatory fragmentation should be a key principle as we approach the final implementation of the reform," said Campa.

The coronavirus crisis has highlighted the importance of a high-quality regulatory framework and a robust banking sector, adding to the expectation of the full, timely and consistent implementation of the Basel III framework, Campa noted. "While we recognise that the COVID-19 pandemic has required the need for exceptional measures, the structural nature of the Basel III reforms will still be needed," he said.

Campa also refuted any suggestion that the costs of transitioning to the new framework could damage the economic recovery from the pandemic. "I do not share this point of view. I would, in particular, highlight that the new framework will be completed only in 2028 in line with the Basel calendar – hence, its implementation entails a limited impact on any COVID-19 supporting measure."

The EBA updated its analysis of the quantitative impact of implementing the Basel reforms in December 2020, and found that tier-one minimum required capital would increase by 18.5% under Basel III, down from the previous estimate of 24.1%, which was based on June 2018 data. The total common equity tier-one capital shortfall of the sample of 99 banks was estimated at €30.2 billion, down from €74.6 billion in the previous analysis.

"This shows a significant reduction, signalling the efforts that banks are already taking to comply with the Basel III rules in the future. The new set of standards is meant to address the drawbacks of the previous framework and does not impact all banks with the same magnitude. Hence, the level of increase in capital is commensurate to the flaws that are addressed, and will be negligible, or even negative, for some EU banks," said Campa. IQ

Digitisation Must Begin With Common Standards

Standardisation of data and processes is a pre-requisite for achieving higher levels of digitisation in derivatives markets, according to participants in a panel discussion sponsored by the Depository Trust & Clearing Corporation on the final day of the ISDA Annual General Meeting.

Reflecting on the development of the Common Domain Model (CDM) as a standard industry terminology for derivatives trade events and processes, Angus Moir, senior manager in the Bank of England's data collection transformation team, recognised the benefit that common data standards can bring for market participants, regulators and central banks.

"Those benefits include much greater flexibility and speed in our ability to change our collections and get new information and data, and the pandemic really highlighted the need for us to change and respond quite quickly to new risks and problems that could come up in the financial sector," said Moir.

In February, the Bank of England set out its approach to delivering improvements in data collection over the next decade, with the aim of getting the information it needs to fulfil its mission at the lowest possible cost to the industry. The central bank plans to achieve this by defining and adopting common data standards, modernising reporting instructions and adopting a more streamlined, efficient approach to data collection.

"It has been well documented that there have been a lot of problems with the quality and consistency of data, particularly for transaction reporting. If we can get the raw ingredients – the very start of this process – standardised and described consistently, then that makes everything further downstream more consistent and standardised," said Moir.

Panellists also discussed the impact of ISDA's key digitisation initiatives, including the CDM, ISDA Create and the ISDA Clause Library. Douglas Donahue, partner at Linklaters, explained that standardisation efforts are essential to ensure industry processes and concepts are consistently described.

"We have developed a standard ISDA language to allow us to efficiently and effectively communicate and process extremely complex subject matter without having to describe and analyse every nuance of every concept during every conversation," said Donahue. IQ

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