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Derivatives Trading Forum: Regulatory Change
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Opening Remarks
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Hello everyone, and welcome to the Derivatives Trading Forum. Thank you for joining us today, and thanks to our sponsors, Tradeweb and Quantile.

This is the first in a series of events that will focus on derivatives trading from different perspectives. Today, we will explore how regulation is affecting the trading environment around the world.

In preparing these remarks, I was reminded of my time as a Commissioner at the Commodity Futures Trading Commission (CFTC) from 2009 to 2014, at the height of the Dodd-Frank rulemakings. During that time, I was acutely aware of the need to implement the rules appropriately and avoid disrupting the efficient cross-border trading of derivatives. This wasn't always easy, particularly when it came to defining the scope of the rules and aligning with other agencies and jurisdictions.

The Dodd-Frank Act is now more than a decade old, and we have learnt plenty of lessons from its implementation. We have seen just how important it is that regulations are implemented consistently and that there is a regular review process to ensure they remain appropriate. This is important as we continue to deal with regulatory change on multiple fronts, from the termination of LIBOR to the implementation of Basel III trading book rules.

In my remarks today, I will explore how regulation is affecting derivatives trading in three key areas: benchmark reform, trading venues and Basel III.

Benchmarks

I'll start with benchmarks.

It can't have escaped anyone's notice that LIBOR is now living on borrowed time. We have known since 2017 that its days were numbered, but on March 5, the UK Financial Conduct Authority (FCA) set out the timetable for the death of LIBOR. This confirmed that the majority of settings will cease publication or become non-representative immediately after the end of 2021. Five US dollar LIBOR settings will continue publication until mid-2023.

The implications of this are clear – all firms with exposure to LIBOR need to work out a plan to wean themselves off the benchmark as quickly as possible. What is perhaps less well understood is how and when liquidity in alternative rates will develop, so I'd like to spend a few minutes exploring this.

With trillions of dollars of exposure to LIBOR required to switch to other reference rates, market participants need to think carefully about what alternatives are available, how the market is evolving and how liquidity is developing.

The good news is that liquidity in some alternative risk-free rates has been growing – particularly in established rates like SONIA. According to analysis by ISDA and Clarus, 44.9% of total cleared sterling interest rate derivatives was linked to SONIA in March.

However, there's still some way to go. The percentage of cleared trading activity in SOFR was just 4.7% of total US dollar interest rate derivatives DV01 transacted in March.

So, with only eight months to go until the end of LIBOR, what needs to happen to improve liquidity in SOFR? What role might trading platforms play in ramping up liquidity in products referenced to alternative rates?

At this stage, many firms are still waiting for more liquidity before they trade, or are waiting for forward-looking term risk-free rates (RFRs) to emerge. But market participants need to take the leap and start trading in order to foster that liquidity. As trading increases, trading platforms – including swap execution facilities (SEFs), multilateral trading facilities and organized trading facilities – will play an important role in listing products referenced to alternative rates and improving price transparency.

Increased liquidity in RFR derivatives markets is also a necessary precursor to the development of any forward-looking RFR term rates. In fact, the US Alternative Reference Rates Committee said in March that current levels of liquidity in SOFR derivatives mean it will not be in a position to recommend a forward-looking SOFR term rate by its original mid-2021 target. Meanwhile, two term SONIA reference rates were launched in the UK in January, but authorities have said they expect the use of forward-looking benchmarks to be relatively limited.

RFRs are not the only rates available, of course. A number of other alternatives to US dollar LIBOR have also emerged, including some with a credit spread component meant to reflect the dynamics of bank lending markets.

I will also be interested to see whether regulators in the US and Europe introduce mandatory trading determinations for products referencing the RFRs, given the relatively low levels of liquidity in those markets.

This brings me to my next topic of trading venues.

Trading Venues

I talked earlier about my time at the CFTC during the period of Dodd-Frank rulemaking. One of the important lessons I learnt is the cost of regulatory-driven market fragmentation. All too often since the financial crisis, regulations with identical objectives have differed in substance, scope and timing across jurisdictions. This can quickly lead to inefficiencies, higher costs and increased risk.

More than 10 years since the Group of 20 nations agreed their landmark derivatives reforms, we must still be on the lookout for fragmentation. I'd like to touch on two particular areas of interest in this respect – the SEF rules, and the European trading obligation.

In the US, the Securities and Exchange Commission (SEC) is expected to move forward this year with the implementation of rules for trading security-based swaps on SEFs under Title VII of the Dodd-Frank Act. It is doing so many years after the CFTC finalized and implemented its own SEF trading rules. ISDA has always made the case for alignment between the two rule sets. We look forward to working with the SEC and market participants to implement these rules effectively without risking market fragmentation.

In Europe, we have seen in recent months just how quickly a lack of equivalence can cause liquidity to fragment.

When the Brexit transition period ended on December 31, there was no equivalence in place between EU and UK trading venues. This has meant that EU entities trading derivatives subject to the EU derivatives trading obligation (DTO) have had to execute those transactions on EU-recognized venues, while UK firms must trade derivatives subject to the UK DTO on UK venues.

The only venues where in-scope trades between EU and UK counterparties can take place are SEFs, which are recognized by both jurisdictions. Analysis of SEF trading volumes so far in 2021 shows they have already captured a large chunk of euro- and sterling-denominated interest rate derivatives trading.

Meanwhile, EU and UK firms that cannot trade on SEFs have only been able to trade with counterparties on their respective local venues, leading to fragmented liquidity, reduced choice and a greater potential impact on pricing.

While the FCA has taken action to enable UK firms, in certain circumstances, to trade with EU clients subject to the EU DTO on EU venues, this has not been reciprocated. EU banks are therefore unable to transact with clients and other banks that continue to trade on UK venues.

As EU and UK trading venue rules are almost identical, there seems no reason why equivalence should not be possible. We will continue to advocate for trading venue equivalence as the only viable way to resolve this problem and reduce market fragmentation.

The trading venue rules are not our only concern. Fragmentation of clearing in the wake of Brexit could also negatively affect liquidity in European derivatives markets. While a temporary equivalence determination has been helpful, it lasts only until mid-2022 and European firms have been urged to reduce their exposure to UK central counterparties.

Should the temporary equivalence expire, mass relocation of legacy portfolios could lead to significant market disruption. Market fragmentation would drive supervisory fragmentation, complicating the Capital Markets Union and the international role of the euro. It could also diminish the role of European banks internationally, leading to less competition and higher prices for end users.

Basel III

When it comes to regulations that are still to be implemented, the final parts of Basel III are high on the agenda. While a one-year delay was granted due to the impact of the coronavirus pandemic, the Fundamental Review of the Trading Book (FRTB) and revised credit valuation adjustment (CVA) capital rules are due for implementation at the start of 2023. Countries around the world will issue rules this year that will transpose these global standards into law.

One of the hallmarks of the trading book capital rules will be the scaling back of the use of internal models to calculate capital requirements. In the new CVA framework, the option to use internal models is removed altogether, while all firms will need to calculate market risk capital under the standardized approach as part of the FRTB, irrespective of whether they also have approval to use internal models.

The net result will be far greater use of standardized approaches in the future. Basel III standardized approaches are more risk-sensitive than previous iterations to make sure they can be used as credible alternatives to internal models. Nonetheless, this will represent a step change for banks. It will alter the way they measure risk, and this will inevitably impact their trading decisions.

ISDA is committed to consistent and accurate implementation of the rules, and has developed a benchmarking initiative that enables banks to rigorously test their implementation of the new standardized approaches. So far, 58 banks have participated in the exercise, using our unit test and hypothetical portfolio exercise to compare their capital calculations with an industry standard and address any variations in a timely way.

Conclusion

I have talked in these remarks about three major areas where regulation is affecting the trading of derivatives, and the proactive steps ISDA is taking to address common challenges and support effective implementation of new rules.

I am looking forward to hearing the perspective of market participants and policy-makers on these issues during the course of today’s event.

For our first keynote address of the day, I am very pleased to welcome SEC Commissioner Hester Peirce, who I know shares our commitment to safe and efficient derivatives markets. Commissioner Peirce has a distinguished track record on Capitol Hill and was sworn in at the SEC in January 2018. Over the past three years, she has taken the lead in moving the regulatory regime for security-based swaps through to completion in a collaborative and constructive way.