IQ In brief

ISDA's Regional Events in October covered a variety of key issues for derivatives markets, including LIBOR transition, sustainable finance, clearing equivalence and the digitisation of derivatives markets

ISDA Committed to Supporting Green Transition, Says O'Malia

Financial markets have a critical role to play in mobilising the estimated $110 trillion in capital that is needed to transition to a green economy and ISDA is committed to promoting legal certainty, standards and best practices to support the transition, ISDA chief executive Scott O'Malia has said.

"Reaching net zero is going to require every sector, every company and every individual to play its part. That's why ISDA is committed to supporting the transition across multiple fronts. You can count on us to continue this important work in the years and decades to come," said O'Malia during his opening remarks at the ISDA Regional Events in October.

ISDA has already published documentation templates to support the trading of emissions and certain types of environmental derivatives, and has developed a set of guidelines to promote the use of key performance indicators for sustainability-linked derivatives that are measurable, verifiable and transparent.

"We are slowly emerging from the COVID crisis and facing up to the challenge of the climate crisis. It's a time of both hope and anxiety"

Scott O'Malia, ISDA

A robust voluntary market for the trading of carbon credits will also be critical to the transition, and ISDA is participating in the work of the Taskforce on Scaling Voluntary Carbon Markets to help develop this market. The taskforce was established in 2020 and has made progress in establishing the necessary governance to promote transparent and robust standards for the verification of carbon credits.

"We believe it will be very difficult to achieve transformational change without a voluntary market, but we recognise the need for carbon credits to be very clearly and strictly defined. This will ensure the market scales safely and efficiently, without the risk of greenwashing," said O'Malia.

ISDA has developed a paper to address certain legal and documentation issues related to voluntary carbon credits, and is now working to support the development of robust documentation templates.

While climate change will dominate the financial sector for some time, there are other pressing issues facing derivatives markets, including the imminent cessation of most LIBOR settings at the end of 2021 and the move towards a fully digital trade lifecycle.

As well as paving the way towards greater automation and efficiency in the management of legal documents, ISDA is also exploring the fast-growing crypto-derivatives market. "We very much intend to stay in our lane here, so our focus will be on the legal, documentation and capital issues associated with crypto assets," said O'Malia.

"We are slowly emerging from the COVID crisis and facing up to the challenge of the climate crisis. It's a time of both hope and anxiety. But ISDA is committed to helping the industry meet these challenges head on, by developing mutualised solutions, legal documents and best practice standards, and by setting the foundations for a digital future," O'Malia said. IQ

Capital Treatment of Carbon Credits Critical, Says Litvack

Carbon trading markets will likely play an important role in helping countries meet their emissions-reduction targets, but appropriate capital treatment of carbon credits is essential to ensure this market can function efficiently, according to Eric Litvack, chairman of ISDA.

Speaking at the ISDA Regional Events, Litvack noted that banks will play an important role in the development and smooth functioning of both regulated emissions trading systems and voluntary carbon markets by acting as intermediaries – for instance, by selling forward contracts to utilities and industrial companies that need to reduce emissions in future and buying allowances at auctions.

"It's therefore critical the capital treatment of these instruments is appropriate and doesn't undermine the development of this market by unduly penalising banks that participate in it," he said.

However, a recent report by ISDA found that the Fundamental Review of the Trading Book (FRTB) would lead to excessively high capital requirements that are out of proportion with the risk they pose. Under the FRTB's standardised approach, carbon certificates would attract a 60% risk weight – twice that of crude oil. In contrast, ISDA's analysis of volatility during periods of stress suggests the risk weight should be 37%.

On October 27, the European Commission (EC) unveiled its revised Capital Requirements Regulation package, which will implement the final Basel III measures in the EU, including the FRTB. Significantly, the EC included a reduction in the risk weight for carbon credits from 60% to 40%. However, other key jurisdictions, including the US, have yet to reveal exactly how they will implement the FRTB framework.

"It's important to stress that we're not suggesting carbon certificates should get special treatment or that capital should be artificially low in an effort to encourage the transition to a green economy. We just want risk weights to accurately reflect the level of risk, so as to avoid embedding inappropriate incentives into the capital framework," said Litvack.

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>
> **Eric Litvack, ISDA**

Ultimately, inappropriately high capital levels could prompt banks to reduce activity or withdraw completely from the business, which could constrain the development of the carbon market and make it more difficult to meet emissions-reduction targets, Litvack added.

Elsewhere, ISDA is working to bring efficiency to FRTB implementation efforts, including through benchmarking of standardised approaches (SA) – an initiative that has so far involved more than 60 banks and 16 regulators globally. Benchmarking enables banks to implement the more complex standardised models under the FRTB accurately and consistently by enabling the identification of any variations and providing analysis on the reasons for the discrepancies.

"These standardised approaches will play a much more prominent role in the calculation of capital going forward, so it's important to avoid divergences in how banks interpret the requirements. That's why the ISDA SA Benchmarking initiative has been so successful – it makes it much easier for banks to achieve the consistency in implementation that regulators would like," said Litvack. IQ

Read ISDA's analysis on the capital treatment of carbon credits here: bit.ly/3beI5lx
Find out more about ISDA's SA Benchmarking initiative here: bit.ly/3jDkLRK

Act Now on US Dollar LIBOR, Says New York Fed's Wuerffel

Firms should act now to reduce their use of US dollar LIBOR, ahead of a year-end supervisory deadline to halt new US dollar LIBOR trades, says Nate Wuerffel, senior vice president in the markets group at the Federal Reserve Bank of New York.

In keynote remarks to the 2021 ISDA North America Conference on October 27, Wuerffel warned that liquidity in US dollar LIBOR would likely drop in the run-up to December 31. While five US dollar LIBOR settings will continue to be published until mid-2023, various regulators, including the US Federal Reserve Board, have specified that firms should stop entering into new US dollar LIBOR contracts from the end of 2021, except in limited circumstances.

Last month, US prudential regulators clarified that a new contract would include an agreement that creates additional LIBOR exposure for a supervised institution or extends the term of an existing LIBOR trade.

"Most market intermediaries have some connection with a bank, and market participants therefore should broadly expect that the guidance will impact them either directly or indirectly. In other words, all market participants should feel a sense of urgency around the deadline," Wuerffel said.

> "Delaying your transition from US dollar LIBOR could risk financial, operational, and reputational consequences to your firm"
>
> **Nate Wuerffel, Federal Reserve Bank of New York**

However, firms should not wait until December to wind back their LIBOR use and adopt alternative rates. Some banks have established internal dates to slow their use of US dollar LIBOR in the lead-up to end-2021, potentially resulting in a decline in liquidity, while year-end code freezes may make it difficult to implement significant process changes in December, explained Wuerffel.

"Delaying your transition from US dollar LIBOR could risk financial, operational, and reputational consequences to your firm, and result in you not being well positioned at year-end to meet the supervisory deadline. For those firms still entering new US dollar LIBOR contracts, my strong recommendation is this: act now to prepare for the end of LIBOR. Do not wait until December to move to alternative rates," he said.

Trading activity in alternative reference rates has been increasing in recent months, with SOFR volumes seeing strong growth following the introduction of a 'SOFR First' initiative, which changed the quoting convention for linear swaps in the interdealer market from US dollar LIBOR to SOFR on July 26. SOFR First has since been extended to interdealer cross-currency swaps on September 21 and will cover non-linear derivatives from November 8.

"The SOFR First initiative certainly helped the US swap market move," said Sonali Theisen, managing director, head of fixed income, currencies and commodities e-trading and market structure at Bank of America, speaking on a panel at the North America Conference. "All in all, I think the swaps market is in pretty good shape and making very good progress towards adopting SOFR as the duration benchmark."

According to data from ISDA and Clarus, trading activity in derivatives linked to SOFR reached 15.2% of total cleared US dollar interest rate derivatives DV01 in September versus 7.4% in July. Speaking on the same panel, Thomas Pluta, global head of linear rates trading and co-head of North America rates trading at JP Morgan, said that figure understates the current market share of SOFR as it includes compressions as firms unwind their LIBOR portfolios, instead estimating the volume of new business in interest rate swaps at 70/30 in favour of SOFR. "Our swaps traders would rather quote SOFR than LIBOR because our liquidity in the interdealer market is in SOFR," he said.

Other panellists agreed the picture was rapidly changing for SOFR. "The volumes are moving in the right direction, which is a very good thing. I think more important than that is the liquidity," said Jack Hattem, managing director in global fixed income at BlackRock, noting that liquidity in LIBOR and SOFR swaps is now equivalent on most days. "I think that's a really big step, and SOFR First had a lot to do with that," he added.

The final phase of the SOFR First initiative will capture certain futures and other exchange-traded products on a currently unspecified date. However, panellists expressed some concern about the extent to which market makers in the Eurodollar futures market will make the switch in line with the time frame set by the US Commodity Futures Trading Commission's Market Risk Advisory Committee, the architect of SOFR First.

"The problem with the Eurodollar market is that it's not the banks that are the primary liquidity providers – there are still locals in the pit. The pit is now virtual but there are locals that make markets in futures and options, there are buy-side firms that make markets, there are high-frequency trading firms that make markets, so it's a question of to what degree are they going to be held accountable by their regulators," said Pluta.

That may result in sustained Eurodollar futures volumes beyond the end of 2021, he added. "What I'm worried about is, to the extent that market is different and they may have a different set of objectives, you could have more Eurodollar volumes than we'd like to see going forward. So, I think that remains an open question," said Pluta.

IQ In brief

Effective Regulation Critical for UK Finance, Says HM Treasury

The UK government is seeking to set openness, innovation, sustainability and competitiveness at the core of its financial services sector as it reviews the regulatory framework following Brexit, according to Richard Knox, co-director of the financial services group at HM Treasury.

"The UK already has one of the world's most robust regulatory regimes, and our plan is not to weaken but to strengthen that regime, because we believe that high-quality regulation must be central to a successful global financial centre," said Knox, speaking during a keynote address at the 2021 ISDA Europe Conference on October 21.

"The government will tailor the financial services regulatory ecosystem to reflect the UK's new position outside the EU, ensuring it supports and promotes the interests of UK markets and maintains high regulatory standards in the face of new and evolving risks," said Knox.

On July 1, the Treasury published a consultation on the UK Wholesale Markets Review (WMR), seeking to determine how the UK's wholesale capital markets regime should be reformed. The consultation covers multiple asset classes, including equities, commodities, fixed income and derivatives, as well as key market facilities and processes such as trading venues, systematic internalisers, market data and reporting.

"The WMR is not intended to significantly overhaul the current regime. Instead, it seeks to deliver a rulebook that is fair, outcomes-based and supports competitiveness, whilst ensuring the UK maintains the highest regulatory standards," said Knox.

ISDA submitted its response to the WMR consultation on September 24, in which it welcomed the opportunity to tailor the revised Markets in Financial Instruments Directive (MIFID II) to the UK market but proposed several changes, including recalibrating transparency requirements for derivatives markets.

Speaking during a panel discussion at the conference, Tom Duggan, deputy director of securities and markets at HM Treasury, recognised the opportunity afforded by the WMR to improve the derivatives transparency rules.

"Obviously, we want to see transparency to improve price formation and best execution, but, in some areas, this clearly has not worked effectively. In particular, things like pre-trade transparency do not apply very well to many instruments. We see very high burdens, complex waivers and complex calculations that go into this, with little benefit for price formation or best execution, so I think that's an area that's ripe for reform," said Duggan.

Matthew Coupe, global head of cross-asset market structure at Barclays, welcomed the UK's willingness to work with the derivatives market to improve transparency. The biggest problem is that existing rules fail to properly identify the economics of derivatives trades, he explained.

"Data quality is also a big challenge, because you're trying to shoehorn data elements to identify things or to actually show prices on things that don't necessarily make sense and we end up with a huge hotchpotch of data out there, so we need to work through that," said Coupe. IQ

Work Together with Urgency on LIBOR Transition, HKMA Warns

As the end of 2021 approaches, all market participants must work to facilitate a smooth transition away from LIBOR in the Asia-Pacific region and not rely on the continuation of US dollar LIBOR, a senior official at the Hong Kong Monetary Authority (HKMA) has warned.

"With a clear and certain timetable for LIBOR cessation, we should all work together with a sense of urgency. Although certain US dollar LIBOR settings will continue to be published until end-June 2023, this 18-month extension is intended to allow time for more legacy US dollar LIBOR contracts to mature. And this won't alter the fact that LIBOR will come to an end," said Edmond Lau, deputy chief executive of the HKMA.

Speaking at the 2021 ISDA Asia-Pacific Conference on October 19, Lau urged all entities to step up their transition efforts, including corporates as well as banks and buy-side firms. The HKMA, he said, has been very focused on raising awareness of LIBOR transition.

"Over the past decades, LIBOR has been so widely used and deeply ingrained in our global economy that the pricing and return of a broad range of financial products were referencing to this critical benchmark. To help us tackle this complex exercise and further expedite our transition progress, collaborative efforts would be key," said Lau.

Lau highlighted the increased trading of interest rate derivatives linked to risk-free rates like SOFR in recent months, noting these rates will "no doubt have further room to grow". In Hong Kong, a multi-rate approach will see the continued publication of HIBOR and HONIA, and the HKMA is taking steps to promote the development of the HONIA-linked market, said Lau.

"To facilitate the adoption and usage of HONIA, we are planning to issue HONIA-indexed floating rate notes (FRNs) under the government bond programme later this year. We hope the proposed FRN issuance could encourage the private sector to consider issuing similar products in the future and provide further impetus for the development of other HONIA-linked instruments in Hong Kong," said Lau. IQ

EC Considering Industry Feedback on Euro Clearing Relocation

The European Commission (EC) is considering the feedback it has received during a period of industry outreach on the opportunities and challenges of transferring derivatives clearing from UK central counterparties (CCPs) to EU CCPs following Brexit, a senior EC official has said.

"Being excessively exposed to a critical third-country entity is not a desirable situation in terms of potential consequences for EU financial stability," said Ugo Bassi, director of financial markets in the EC's directorate-general for financial stability, financial services and capital markets union, speaking at the 2021 ISDA Europe Conference on October 21.

"We reached out to a broad range of market participants with the aim of exploring possible solutions and avenues for a voluntary market-driven move out of UK CCPs. The feedback we generally received from these exchanges is varied. We received overall lots of information, and a lot of data, which we are now digesting and assessing very carefully," said Bassi.

In September 2020, ahead of the end of the Brexit transition period, the EC granted temporary equivalence for UK CCPs. This equivalence decision is due to expire on June 30, 2022, and the EC has urged European market participants to use this time to reduce their exposure to UK CCPs.

Data presented during a panel discussion at the conference by Kirston Winters, chief risk officer at post-trade company OSTTRA, showed that clearing of euro swaps on UK CCPs had fallen earlier this year and risen on EU CCPs, with the UK share on a trade count basis dropping below 90% during the first quarter and the EU share rising above 10%. Clearing on EU CCPs had fallen back to 6%-7% during the third quarter, Winters said.

On September 16, ISDA and eight other trade associations wrote to Mairead McGuiness, European commissioner for financial services, financial stability and capital markets union, requesting that the EC grant an extension to the equivalence decision or issue a non-time-limited equivalence determination.

Speaking during the panel, market participants raised concerns about the possible disruption that could be caused by allowing the equivalence to expire. This could lead to increased risks and rising costs for European market participants, as well as driving fragmentation in derivatives clearing.

"A forced relocation is likely to be very costly, especially for European market participants, and it might increase the overall risk in the system, not to mention the impact on the global level playing field," said Erik Floor, senior regulatory adviser at ABN AMRO Clearing Bank.

Forcing the migration of clearing from the UK to Europe could also diminish the liquidity that is available to European market participants, added Nafisa Yusuf, vice president of market structure for Europe, the Middle East and Africa at BlackRock.

"What we could find is that for certain products that are cleared at UK CCPs today, our European clients would have to access those products at a European CCP and therefore would be accessing a smaller liquidity pool compared to our other clients that are not bound by this derecognition. Having some clients accessing a smaller liquidity pool than others could hinder our ability to achieve best execution," said Yusuf.

Panellists discussed possible solutions, including a so-called actively managed account structure, which might involve the EC requiring EU firms to have an account with an EU CCP or EU-recognised CCP that they use to clear some part of their portfolio.

"We actively recommend to clients to open accounts on multiple CCPs, just for risk management purposes. However, if this were to be mandated by the EU, that's probably going a step too far. First of all, it will come at a cost for European market participants – a cost that will not have to be borne by non-EU market participants – and will put them at a competitive disadvantage," said Floor. IQ

Digitisation Addresses Patchwork Documentation, Says Panel

The digitisation of derivatives documentation is a valuable opportunity to reduce inefficiencies and streamline internal processes, according to panellists at the 2021 ISDA North America Conference on October 27.

"Over the years with the inception of Dodd-Frank and other regulations, many of you have experienced having to sign up to different types of ISDA protocols and bilateral amendments for a range of issues. It's a patchwork and it's hard to capture all of those different nuances and contractual requirements," said Wendy Yun, managing director and associate general counsel at Goldman Sachs Asset Management.

The 2021 ISDA Interest Rate Derivatives Definitions and the MyLibrary digital documentation platform enable users to revise documents electronically, drastically reducing the inefficiencies of manually piecing together documentation for every trade.

"Streamlining the client experience and making it as fast as possible from onboarding to first trade massively speeds up this process and enables us to get away from the email exchange of documents," said Mary Ann Dickson, managing director, global head of agreements and documentation at Bank of America Securities. IQ

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