AGM SPECIAL

AGM
Reports from the 37th Annual General Meeting

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COLLATERAL
Margin reaches $1.4 trillion at end-2022

IQ

ISDA® Quarterly

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* BETTER TOGETHER

The collective capabilities of ISDA's 1,000 members allow industry challenges to be overcome, delivering efficiencies and savings

A FOCUS ON CHICAGO

There were a couple of big themes running through ISDA's Annual General Meeting (AGM) in Chicago earlier this month. One was the regulatory and market responses to the series of stress events that have rocked markets since the dash for cash in March 2020. Others included the impact of the recent banking turmoil, the (mis)management of interest rate and liquidity risk and the role of social media in the collapse of Silicon Valley Bank, as well as the ongoing US debt ceiling discussions.

Over the two days of the AGM, delegates heard from leading regulators and industry leaders, including Commodity Futures Trading Commission chairman Rostin Behnam (who was interviewed on-stage by Bloomberg's Tracy Alloway and Joe Weisenthal in a live recording of the Odd Lots podcast), Securities and Exchange Commission chair Gary Gensler and US Treasury under secretary for domestic finance Nellie Liang.

This issue of **IQ** takes a lightening tour of some of the issues covered by this year's keynote speakers and panels, as well as providing information on some of the materials distributed at the AGM, from the 2022 Margin Survey to ISDA's latest animations on collateral management process efficiency and voluntary carbon markets. For more AGM content, watch ISDA's interviews with a number of policymakers and market participants who spoke on the panels here: bit.ly/437yTqI

We'd like to take this opportunity to sincerely thank all our delegates, speakers and sponsors for supporting the event – we simply couldn't run it without you. We very much hope to see all of you for the 38th AGM in Tokyo in April 2024.

Nick Sawyer
Global Head of Communications & Strategy
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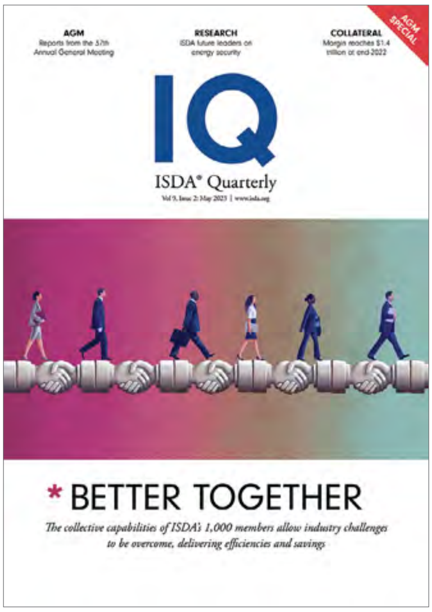

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Together We Get Better Results, O'Malia Tells ISDA AGM

The collective capabilities of ISDA's board of directors, staff and broad-based membership have enabled the association to successfully complete major initiatives like the transition from LIBOR and compliance with non-cleared margin regulations, and will remain critical as it seeks to make key processes more effective and efficient, according to ISDA chief executive Scott O'Malia.

Speaking at the start of the ISDA AGM on May 10, O'Malia said market participants recognise the value of ISDA's mission to foster safe and efficient derivatives markets to facilitate effective risk management. That's why ISDA passed the milestone of 1,000 members in September 2022, he said.

"Across ISDA's 1,000 members, nearly 13,000 practitioners regularly participate in our 94 working groups. Just think of the collective power of 13,000 people working together to address common industry challenges. Whether it's new regulations, changes in market practice or technological advances, that's an army of talent, deployed on a global scale," said O'Malia.

"As individuals and institutions, we can achieve a great deal. But when we work together in pursuit of a common goal, we can hit the ball right out of the park," he added. "It's our collective capabilities that have allowed us to achieve so much over the years. And it's why regulators keep coming back to us to help tackle the tough challenges."

"Let's be crystal clear that the voluntary carbon market will never reach its true potential if we don't take decisive action to eliminate greenwashing. Unless we act – and fast – this market could wither on the vine"

Scott O'Malia, ISDA

Tasked by the Financial Stability Board's Official Sector Steering Group to design a contractual solution to implement robust fallbacks for derivatives referenced to LIBOR, ISDA developed the ISDA 2020 IBOR Fallbacks Protocol, which now has more than 15,800 adherents. The protocol is expected to play a key role in minimising disruption when the last five US dollar LIBOR settings are retired at the end of June.

ISDA's work to develop and maintain the ISDA Standard Initial Margin Model, which is used by around 375 firms for the consistent calculation of initial margin requirements, has also won plaudits from regulators and market participants.

ISDA is now working on a variety of initiatives designed to make critical processes more effective and efficient through the development of mutualised digital solutions, O'Malia said.

ISDA's digital solutions include: ISDA Create, which is used by more than 300 firms to negotiate key documents online; Perun, ISDA's award-winning quantitative analysis platform that helps ensure consistent and accurate implementation of standardised capital models; the MyLibrary digital documentation platform that now hosts more than 85 flagship documents; and the Common Domain Model (CDM), a free-to-use data standard for financial products, trades and lifecycle events.

The CDM is already being used in the derivatives market in two key areas, O'Malia explained.

"As regulatory reporting rules are

revised to incorporate international data standards, we've used the CDM to transform requirements into code, paving the way towards more consistent and effective compliance. We've also applied the CDM to collateral management processes to improve levels of standardisation and automation and cut down on the potential for errors," he said.

Voluntary carbon market

Another key area of focus is the voluntary carbon market, which can help channel trillions of dollars of financing to the green projects and technologies that need investment. Given the importance of a robust legal and regulatory framework, ISDA has developed a series of whitepapers on the key legal issues associated with the market, followed in December by the 2022 ISDA Verified Carbon Credit Transactions Definitions.

"Buying carbon credits allows those companies that can't entirely eliminate their use of fossil fuels to offset their emissions while also boosting the flow of investment to sustainable infrastructure and technology. Efforts to scale this market have been underway for several years, and it's estimated that it could reach $1 trillion within 15 years," said O'Malia.

But O'Malia issued a strong warning on the need to prevent greenwashing, which threatens to erode the credibility of the market. One initiative that could help is the core carbon principles developed by the Integrity Council for the Voluntary Carbon Market, which establish standards that will help buyers identify those credits that have a permanent, additional and verifiable impact on emissions (see page 16).

"Let's be crystal clear that this market will never reach its true potential if we don't take decisive action to eliminate greenwashing. Unless we act – and fast – this market could wither on the vine. The development of the carbon credit definitions was a major milestone. Now we need to move quickly and decisively – alongside regulators – to stamp out greenwashing. Together, we can solve problems and get better results," said O'Malia. IQ

Watch ISDA's animation on the importance of the voluntary carbon market: bit.ly/3Oeib4L

ISDA EVOLVES IN LOCKSTEP WITH MARKETS, SAYS O'MALIA ON DAY 2

ISDA constantly advances its standards, documentation and definitions to make sure they are ready for the future of the derivatives market, ISDA chief executive Scott O'Malia told delegates during his welcoming remarks on the second day of the AGM.

"ISDA evolves in lockstep with the global markets we serve – that's why we're as relevant to our members today as we have always been," he said.

Following turmoil in the crypto-assets market last year with the collapse of FTX and several other entities, ISDA developed two whitepapers that explore fundamental questions relating to insolvency and the rights of investors, alongside standard documentation for the trading of digital asset derivatives. The ISDA Digital Asset Derivatives Definitions are intended to bring greater certainty to this asset class by creating a clear contractual framework that spells out the rights and obligations of both parties following a default.

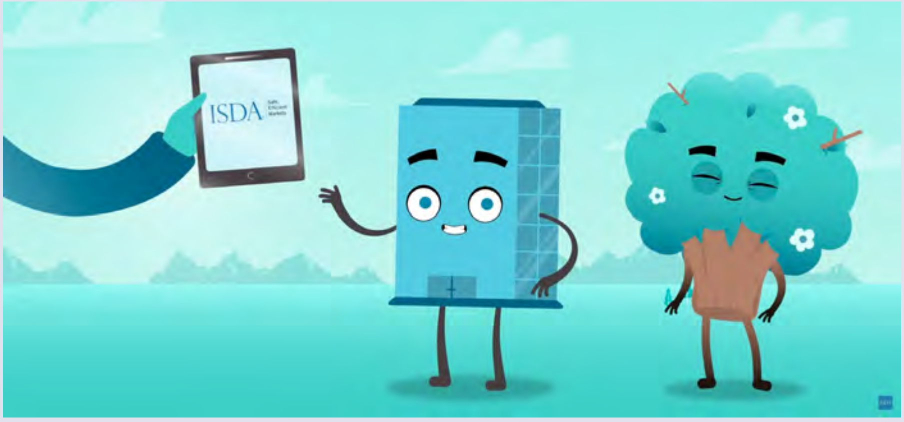
"The definitions are the first step in providing a clear and robust contractual framework for this asset class, and we're now working to expand coverage of our netting opinions to include these products. But we're not stopping there. We're also exploring what changes may be needed to allow certain types of digital assets to be used as collateral," said O'Malia.

ISDA is also responding to the growth of sustainable finance and the volatility in energy markets with the development of documentation for voluntary carbon credits, standardised terms and clauses for sustainability-linked derivatives and a new whitepaper from the ISDA Future Leaders in Derivatives programme that explores how the derivatives market can help to protect energy security while also facilitating the drive to net zero (see pages 22-23).

"The volatility in European energy markets following Russia's invasion of Ukraine has reminded us of the need for robust risk management to address price volatility. In both cleared and non-cleared markets, we need a risk-appropriate margining framework that ensures there is always sufficient collateral on hand," O'Malia added.

While these developments are important, ISDA continues to focus on promoting close-out netting as a means of reducing credit risk and helping countries develop a robust derivatives market. Clean netting opinions are in place for more than 80 jurisdictions, and netting regulations are now being drafted in Saudi Arabia. Once passed, this will mean close-out netting is recognised in all the Group-of-20 nations, O'Malia said.

"The passage of netting legislation might not make the headlines, but with every country that takes this important step, we improve the safety and efficiency of the market," he added.



Drivers of Recent Liquidity Stresses Must Be Carefully Considered, Says Litvack

Liquidity stress events have been occurring with increased frequency and the potential impact on financial stability means the drivers of these crises must be carefully analysed and addressed, says ISDA chairman Eric Litvack.

> "The widescale sourcing and posting of margin and balance sheet constraints on banks have at times created situations where central banks have had to act to prevent liquidity stresses from spiralling out of control"
>
> **Eric Litvack, ISDA**

Speaking to delegates at the ISDA AGM in Chicago on May 11, Litvack pointed to the succession of liquidity stresses that have occurred in recent years, including the March 2020 dash for cash, extreme volatility in commodity markets following the Russian invasion of Ukraine early last year and the rapid widening of gilt yields in September 2022.

These events had different catalysts, but they also had a lot in common, Litvack said – each time, a market shock was followed by a squeeze in liquidity and widespread selling of assets, jeopardising the functioning of core markets like US Treasuries and UK gilts.

While the introduction of mandatory central clearing, margining of non-cleared derivatives and higher bank capital requirements have helped to mitigate counterparty credit risk – an issue that was at the centre of the 2008 crisis – the financial system has become more susceptible to liquidity crunches following market shocks, said Litvack.

"We've pushed the tension points elsewhere, and that, in turn, requires careful consideration. The widescale sourcing and posting of margin and balance sheet constraints on banks have at times created situations where central banks have had to act to prevent liquidity stresses from spiralling out of control. Objectively, these occurrences have been more frequent in recent years, and that's a source of concern," he added.

Global regulators have begun a programme of work to understand and address potential vulnerabilities, focusing on leverage, liquidity and margin practices. For example, the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions published a report on margin practices in September 2022 that identified six areas for further work, including increasing transparency in cleared markets, enhancing the liquidity readiness of market participants, and evaluating the responsiveness of cleared and non-cleared initial margin models to market stress.

Following the report, ISDA has worked with regulators and market participants to review the methodology of the ISDA

▲ ISDA is working with market participants to increase efficiency and reduce operational risk in collateral management processes

Standard Initial Margin Model - the industry standard for the calculation of regulatory initial margin (IM) for non-cleared derivatives. While stressing that the model performed robustly during the various crises and IM remained relatively stable thanks to the model's intentionally conservative design, some adjustments have been made in response, Litvack said.

"Following this analysis, we reduced the thresholds at which firms need to report and remediate margin coverage shortfalls, and cut the time they have to address the deficit. We've also introduced a quarterly check to determine whether any recent market stress warrants a recalibration of the model outside of the usual annual cycle, enabling potential issues to be flagged more quickly. We'll continue to have close dialogue with regulators as the work on margin practices progresses, and will provide support wherever and however we can," Litvack said.

ISDA is also looking at the efficiency of collateral management processes, with the aim of ensuring collateral gets to where it's supposed to be quickly and efficiently. Current processes are not always fully automated and a lack of interoperability between systems means firms can struggle to manage the large increases in margin calls and settlement volumes that can occur during periods of heightened volatility, adding to the pressure on markets.

"The recent crises showed that collateral operations at some firms can get clogged up during periods of heightened volatility, because parts of the process still rely on manual intervention. That's not only inefficient and expensive – it's also a source and potential accelerator of risk during a crisis," Litvack explained.

To help resolve this issue, ISDA has been working with industry participants on several collateral management initiatives using the Common Domain Model (CDM), a free-to-use data standard for financial products, trades and lifecycle events that is available as code in multiple languages. For example, the CDM has been used to develop digital representations of key collateral specifications and operational provisions of ISDA's most widely used credit support documentation, and other use cases are also in development. The aim is to help counterparty onboarding, enhance interoperability and improve cash collateral calculations and payment processes, increasing efficiency and reducing operational risk.

"Of course, this won't stop liquidity crunches from happening, but taking friction out of the system by increasing data standardisation and automation could reduce the severity of each crisis. This won't happen on its own – it requires all of us to act by engaging in the working groups and ultimately adopting the industry standards and best practices. There are clear benefits from doing so – more efficiency, less risk, less resource and, ultimately, lower costs," said Litvack. IQ

Watch ISDA's animation on automating collateral management processes: bit.ly/41HWWeB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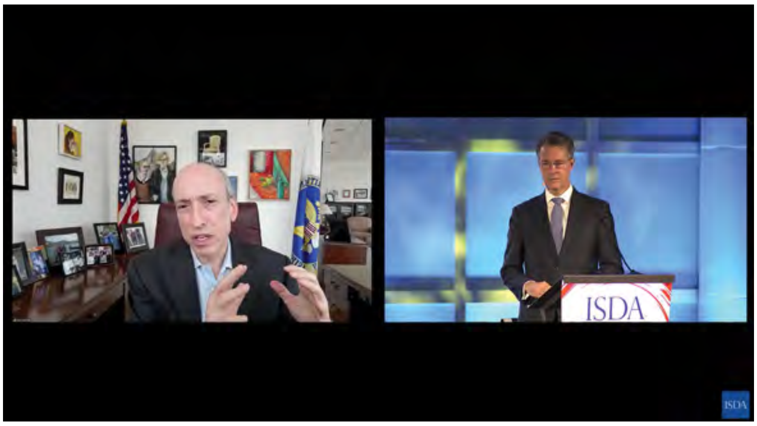
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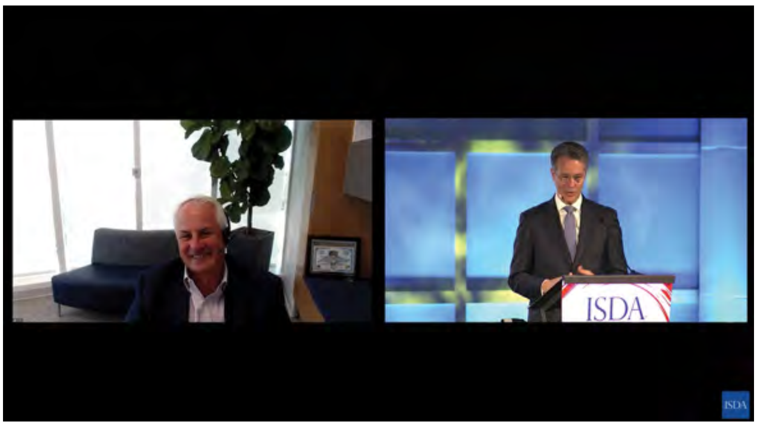
Odd Lots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US Default Would Make Roller Coaster Look Like Kiddie Ride, Says Gensler

A default by the US Treasury would have very significant and lasting effects on investors, issuers and markets that would be hard to predict, Gary Gensler, chair of the US Securities and Exchange Commission (SEC), has warned.

Speaking at the ISDA AGM on May 10, Gensler said that failure to resolve discussions on the US debt ceiling had already had an impact on the pricing and liquidity of short-dated Treasury bills, but any default would have serious consequences.

"In a word, it would make the Cyclone Roller Coaster at the 1933 Chicago World's Fair look like a kiddie ride," he said.

"While we at the SEC have no direct role in those discussions, the outcome is directly consequential to each part of our mission: protecting investors, facilitating capital formation, and maintaining fair, orderly and efficient markets," Gensler added.

Earlier in his remarks, Gensler described SEC efforts to improve the resiliency, efficiency and competitiveness of the US Treasury market in the wake of several recent stress events, including the March 2020 dash for cash. In September 2022, the SEC published a proposal that would require members of Treasury clearing houses to clear certain cash Treasuries and repos, as well as enhance customer access to clearing.

"By 2017, only 13% of Treasury cash transactions were fully centrally cleared. Interdealer brokers often are bringing just one side of the trade into central clearing when one of the counterparties is not also a member of the clearing house. Such reduced clearing increases system-wide risk. Thus, we proposed rules to broaden the scope of transactions in the Treasury markets required to be brought into central clearing," said Gensler.

> "In a word, it would make the Cyclone Roller Coaster at the 1933 Chicago World's Fair look like a kiddie ride"
>
> **Gary Gensler, SEC**

In keynote remarks the following day, Nellie Liang, under secretary for domestic finance at the US Treasury, also pointed to increased clearing of Treasury securities as an important step to increase the resilience of financial markets.

"Broader clearing has the potential to help make the secondary markets for Treasury securities more resilient by reducing counterparty risks and by increasing netting of repo positions, which could make it easier for institutions to expand capacity when demand for intermediation spikes," she said.

Ahead of the SEC proposal, ISDA conducted an industry survey to gather opinions on the implications of increased Treasury and repo clearing. The results revealed a wide variety of views on whether clearing would materially improve the resilience and efficiency of the US Treasury market. While most respondents were largely supportive of clearing, they did not back a broad clearing mandate, with concerns that it could result in some participants reducing their activity or withdrawing from the market due to increased costs.

"Of course, when considering next steps, potential costs of expanded central clearing, such as higher costs in normal times and increased concentration of risks at a clearing house, also will be considered," Liang said. IQ

Read the results of the ISDA survey on US Treasury clearing here: bit.ly/3mYDhsC

Obvious Risks Have Been Ignored, Warns CME's Duffy

A widespread failure to respond to the risks associated with the Russian invasion of Ukraine and rising interest rates in the US suggests the market has been "carefree of risk", CME Group's chairman and chief executive Terry Duffy has warned.

Speaking during a fireside chat with ISDA chief executive Scott O'Malia at the ISDA AGM on May 10, Duffy expressed surprise that markets didn't react sooner to the build-up of Russian troops on the Ukraine border in early 2022 or the US Federal Reserve's signals that it would raise interest rates in response to soaring inflation.

"The Fed was saying that we have a real problem with inflation but still the market didn't believe it and the market didn't react until after the fact, which I found really amazing. I couldn't believe people didn't understand the risks associated with these different events. People are just not paying attention to risk – it's right in front of them and they're still not looking at it," said Duffy.

Asked about recent turmoil in crypto-asset markets, Duffy acknowledged his initial reticence to list crypto products at CME Group and said it was important to make sure appropriate guardrails were in place before moving forward. The exchange now lists a range of products, including futures and options on Bitcoin and Ether.

"I was reluctant at first to list crypto because I wanted to make certain that we had the right tools in place – the right procedures, protocols and technology. Once we did that, I wanted to make sure I could put in margins we thought were responsible. When exchanges list these products, they need to make sure people are aware of what they're participating in," said Duffy.

In the long term, Duffy expects the crypto market to survive. "We have to eliminate some friction to make markets more efficient," he said. IQ

CFTC Duty-bound to Protect Crypto Investors, Says Chairman Behnam

The same regulatory framework that applies to traditional financial assets in the US should apply to crypto assets and the Commodity Futures Trading Commission (CFTC) has a duty to protect investors in those assets, according to the agency's chairman, Rostin Behnam.

Speaking during a live recording of Bloomberg's Odd Lots podcast at the start of the ISDA AGM on May 10, Behnam said that while there is a lively debate about how the crypto market should be regulated following the collapse of several crypto entities in 2022, "we have to use the same playbook that we've used in the past as we think about policy that we construct for crypto".

"We've all read or heard about or know individuals who were hurt by last year's turmoil in the crypto market. It is a largely unregulated market, notwithstanding some state-level requirements, and I do think my responsibility within the context and mission of the CFTC is to protect investors," said Behnam.

▲ From left: Joe Weisenthal, Tracy Alloway and Rostin Behnam

Although the CFTC doesn't have legal authority to regulate cash crypto markets, the existence of listed futures contracts means it does have a "very vested interest in the protection, monitoring and surveillance of the underlying cash market, which remains largely unregulated", Behnam added.

"I will continue advocating, and I do always fall back to that home base position as chair of this agency that I have to focus on protecting US customers, and as long as this market exists, and potentially grows, ebbs and flows in terms of size and market cap, we need to do whatever we can to protect those investors," he explained.

Asked about the implications of the recent cyber attack on ION Markets, which delayed publication of the CFTC's Commitments of Traders Report in February, Behnam acknowledged the severity of the incident. While the CFTC has no legal authority to register, police or supervise third-party technology providers, there is an active conversation over possible changes to the supervisory structure for vendors, he said.

One option would be to maintain the status quo, in which the CFTC would only be able to issue advisory guidance and best practices, or a new regulated structure could be implemented, with the CFTC given authority to register and regulate vendors. A third possible solution would allow the CFTC to supervise only those vendors that provide regulated services to regulated entities within its oversight. All three options have been proposed to Congress, and each has its own benefits and risks, Behnam said.

"I do think this is something that we have to think about because, in the context of cyber risk, regardless of the size of the registered entity, this is a single-point-of-failure issue. As we saw with ION, which really was not a huge provider of back-office services to US entities, this had a pretty significant impact on our ability to do our job – most notably, to issue the Commitments of Traders Report. This is a serious risk and something that I think demands a new policy conversation," said Behnam.

The podcast interview also explored the development of the voluntary carbon market and the threat posed by greenwashing. The CFTC has an interest in the underlying market and, while there are limits to its jurisdiction, questions relating to the integrity of carbon registries and offsets are relevant, said Behnam. The CFTC is closely following private-sector initiatives in this area, he added, including the Integrity Council for the Voluntary Carbon Markets, which recently published its core carbon principles to set a global benchmark for high-integrity carbon credits (see page 16).

"We're not an environmental regulator and there are limitations to what we can and cannot do, but there are a number of private-sector, market-driven initiatives to create standards and best practices around the voluntary carbon market. We are thinking about what role we can play in ensuring the underlying market has integrity and credibility, because the price dislocation that might occur between the underlying cash market and the derivatives market is very important to us," said Behnam. IQ

Listen to the Odd Lots podcast episode with Rostin Behnam, recorded at the ISDA AGM: bit.ly/3MvyyY2

Regulators to Relook at Liquidity Risk Following Bank Failures

Banks and regulators must consider how liquidity and interest rate risk management practices and regulation need to change in the wake of recent bank turmoil, which involved withdrawals of customer deposits at an unprecedented pace fuelled by social media and aided by technology.

In keynote remarks to the ISDA AGM on May 11, Nellie Liang, under secretary for domestic finance at the US Treasury, pointed to the failure of Silicon Valley Bank (SVB), which occurred when uninsured depositors withdrew tens of billions of dollars in a single day after concerns about the financial health of SVB spread on social media.

"Going forward, banks and regulators will review how liquidity risk and interest rate risk management and regulation may need to adjust given the effects of changes in technology and social media on deposits – their sensitivity to interest rates and their stability in stress," said Liang.

In an April 28 review of the collapse of SVB, the Board of Governors of the Federal Reserve System identified a number of issues that contributed to its failure, including weaknesses in interest rate and liquidity risk management, shortcomings in regulatory supervision, and a relaxation of the rules for small- and mid-sized US banks.

When news emerged on March 8 that SVB had restructured its balance sheet to cover losses on its securities portfolio due to rising interest rates and a lack of hedging, depositors withdrew $40 billion on March 9 alone, prompting the California Department of Financial Protection and Innovation to close SVB the following day and appoint the Federal Deposit Insurance Corporation as receiver.

"SVB was closed after it was unable to raise capital to cover interest rate risk losses on default-free government securities, and its depositors, nearly all uninsured and highly concentrated, ran at extraordinary speed," said Liang.

In a letter accompanying the SVB report, Michael Barr, the Fed's vice chair for supervision, suggested several possible policy options, including revisiting the rules for banks with $100 billion or more in assets, relooking at how it supervises and regulates a bank's management of interest rate and liquidity risk, and rethinking the approach to stress testing. He also acknowledged the role of social media, which enabled depositors to instantly spread concerns about a bank run, as well as technology, which allowed customers to make immediate withdrawals.

> "Going forward, banks and regulators will review how liquidity risk and interest rate risk management and regulation may need to adjust given the effects of changes in technology and social media on deposits"
>
> **Nellie Liang, US Treasury**

Speaking during another session at the AGM, Costas Stephanou, head of financial stability analysis at the Financial Stability Board, said global policymakers will be looking into the role played by social media, as part of a broader report on the drivers of the recent banking turmoil.

"It is early days in terms of coming up with concrete results, but it's very clear that social media may have played a role in the speed and type of runs. So, the first thing we are trying to do is to establish the facts," he said. IQ

Central Bank Deposit Accounts critical for CCP Resiliency, Says LSEG's Schwimmer

In response to increased instances of prolonged market volatility, London Stock Exchange Group (LSEG) is looking at ways to reduce potential risks to customer funds and enhance financial stability, including the possibility of holding cash in central bank deposit accounts, according to LSEG chief executive David Schwimmer.

"Access to central bank deposit accounts can help ensure that clearing houses have a safe harbour to place collateral, particularly during periods of financial market volatility. We have access to central bank deposit accounts in eight countries, but not in some where the need is greatest," said Schwimmer, speaking during keynote remarks on May 11.

Speaking on the benefits to financial stability, Schwimmer added: "More open access in those countries could allow central counterparties (CCPs) to securely hold cash without being forced to further invest, easing liquidity requirements of CCPs in stressed market conditions."

Schwimmer also urged increased use of optimisation tools to enable greater efficiencies across cleared and non-cleared portfolios. "Existing market compression services, such as post-trade risk reduction, significantly reduce systemic risk by streamlining the overall risk for each institution's portfolio across the market," he said.

Following its acquisition of Acadia and Quantile, LSEG is focusing on bringing greater efficiencies to the non-cleared derivatives market. "Uncleared derivatives are relied upon by governments, investment managers, corporations and virtually every sector. From helping pension funds meet their obligations to retirees and enabling banks to lend and support economic growth, uncleared derivatives play a vital role in risk management that cannot be filled by clearable instruments," said Schwimmer. IQ

Collaboration Needed to Address System Vulnerabilities, Say Policymakers

▲ From left: Costas Stephanou, Kristin Johnson, ISDA's Steven Kennedy, Sarah Breeden and Klaus Löber

In developing an appropriate and effective response to recent market shocks and liquidity shortfalls, policymakers will need market participants to respond constructively to proposals and provide as much data and evidence as possible, according to speakers at the ISDA AGM.

"We want to get views not just on whether the direction of travel is correct, but on how else we can do things. So, it's not just about shooting down proposals – it's about offering alternatives to how things can be fixed, perhaps in a more efficient or effective way. To do that, arguments are good, data is even better and evidence is the best," said Costas Stephanou, head of financial stability analysis at the Financial Stability Board (FSB).

Speaking during a panel discussion at the start of the AGM on May 10, Stephanou and others discussed the common themes of the recent series of market shocks that include the dash for cash in March 2020, the energy market volatility following Russia's invasion of Ukraine and the UK gilt market crisis in September 2022.

In response, international standard-setting bodies including the FSB have embarked on a programme of work to address concerns that the growth of non-bank financial intermediation (NBFI) could amplify shocks and threaten financial stability. Possible policy measures include monitoring leverage, improving margin practices and ensuring a stable liquidity supply during stress events.

"We care about NBFI because it has grown quite a bit in the past 10 years," said Stephanou. "The March 2020 market turmoil was the start of a very ambitious NBFI work programme for us, based on the lessons from that turmoil and subsequent events. Its aim is to enhance resilience, and the ultimate objective is to ensure a stable provision of financing to the economy and reduce the need for central bank interventions."

While each of the market stress events was driven by a unique external shock – such as the official declaration of a pandemic, the Russian invasion or a UK government fiscal announcement – similar trends occurred in each instance, with sharp price movements, increased margin requirements and liquidity mismatches.

A lack of resilience to these stresses meant market behaviours amplified the initial shocks, allowing them to cascade more broadly and create risks to financial stability, resulting in a need for central bank intervention, said Sarah Breeden, executive director, financial stability strategy and risk and a member of the Financial Policy Committee at the Bank of England. There is now a clear need to understand how markets behave under stress and to build greater private-sector resilience, she said.

"The heterogeneity of folk participating in financial markets is really wide, and what we found in the UK case was that it was a tiny part of the market – liability-driven investment pooled funds – that provided the snowball that then caused the avalanche that led to the need to intervene. So we need better disclosure, better transparency, better stress testing and us all working together to think in advance of stress about how markets might behave," said Breeden.

Policymakers are already well advanced in exploring possible improvements to margining practices. Six workstreams are underway, including increasing transparency in centrally cleared markets, enhancing the liquidity readiness of market participants and evaluating the responsiveness of centrally cleared and non-cleared initial margin models to market stresses.

While it remains to be seen what policy measures could result from the review of margining practices, Klaus Löber, chair of the CCP Supervisory Committee of the European Securities and Markets Authority, suggested a review of the incentives for market participants to use central clearing may be needed.

"Despite the significant number of major stress events we have been seeing in short succession, the system has held. We are in a situation that is to some extent evidence of our efforts over the past 15 years. It may be necessary perhaps to revisit some of the basic assumptions we had following the global financial crisis, and perhaps also to try to better understand whether the incentives we set for central clearing are still adequately calibrated or whether we need to look further," said Löber. IQ

Watch ISDA chief executive Scott O'Malia interview Kristin Johnson in the ISDA AGM Studio: bit.ly/42FLPV4

Watch ISDA global head of public policy Steven Kennedy interview Costas Stephanou: bit.ly/3M34yCO

Further Liquidity Stresses to be Expected, Say Market Participants

Market participants should be prepared for further liquidity stress events in the future as lessons are learned from shocks such as the dash for cash in March 2020 and the energy market volatility following the Russian invasion of Ukraine in 2022, according to panellists at the ISDA AGM.

"Something is going to happen – the trigger may be different, but it will happen, so preparedness is key. If there are inconsistencies or low-hanging fruit in terms of updating rule sets, especially around liquidity, I think now is the time to do it," said Laide Majiyagbe, head of financing and liquidity at Bank of New York Mellon, speaking during a panel on May 10.

Her view was shared by Emmanuel Ramambason, financial markets global head of resources management and analytics at Standard Chartered, who said there would "undoubtedly" be more stress events in the future.

"We need to go back and stress the different rules around liquidity buffers that have been put in place. If we put them all together and look at what the outcome is, we will see collectively that there are unintended consequences. There should be a common-sense-driven approach that can definitely help us for the next crisis and bring down the level of self-induced stress," said Ramambason.

Reflecting on the stress events of recent years, a distinction was drawn between those shocks that could not have been predicted, such as the escalation of the pandemic in 2020 or the invasion of Ukraine in 2022, and those that had been clearly signposted, such as the rise in interest rates that contributed to several bank failures.

"The rise in interest rates was very well telegraphed, so I have trouble believing that financial participants, intermediaries or regulators were surprised. When you have something like interest rate risk, institutions need to step up and do their own stress tests. There could have been a lot more focus on preparing for a big regime change than there was," said Darcy Bradbury, managing director at the DE Shaw Group.

One of the common themes of recent liquidity shocks has been a spike in margin requirements that drove widespread selling of liquid assets to raise cash to meet margin calls, further accentuating market disruption. In response, policymakers have set in motion a wide-ranging review of margining practices in both cleared and non-cleared markets.

"What you're generally striving for is a set of models that will notice when conditions change and react to those changes, but in a proportionate way and in a way that is somewhat predictable and hopefully transparent to your users, so they know what's going to happen. Where the review can help is in giving a sense of what best practice looks like in this space and coming up with recommendations to effectively raise the bar on minimum standards," said David Horner, chief risk officer at LCH. IQ

Effective Digitisation of Documentation Requires a Cultural Shift

Achieving effective digitisation of derivatives documentation requires a cultural change within companies and a recognition that a meaningful return on investment (ROI) may not be achieved immediately, according to speakers on a panel at the ISDA AGM on May 10.

"Everyone can agree that the notions of digitisation, efficiency and automation sound great, but there are some really big mountains to overcome and that's going to require taking people on a cultural journey of change because it's going to get harder before it gets easier. We need to accept there may be no ROI in the first year, but commit to a multi-year strategy," said Tuvia Borok, global head of policy and documentation, global banking and markets at Goldman Sachs.

In a recent whitepaper that explored the efficiencies and savings that can be gleaned from using ISDA Create to digitally negotiate key derivatives documents such as account control agreements, it was shown that the platform could yield time savings of up to 70% when compared with manual negotiation.

"I think we've all bought into the fact that technology will make things easier – the conversation needs to move to how do you realise the benefits. That's partly change, partly process and partly appreciating that technology isn't magic – you don't just plug it in and it all works. You have to talk to your people, work out what your process is and where the technology fits in that process, and make sure it's well designed for users," said Shilpa Bhandarkar, chief executive of CreateiQ at Linklaters. IQ


▲ Shilpa Bhandarkar and Tuvia Borok

Watch ISDA general counsel Katherine Tew Darras interview Tuvia Borok and Shilpa Bhandarkar in the ISDA AGM Studio: bit.ly/3WjnqlW

Read *ISDA Create – Unlocking Efficiencies and Savings: Digitized Legal Documentation Negotiation*: bit.ly/3MF3mXM

Regional Bank Deposit Outflows Could Persist, Says Panellist

The outflow of deposits from US regional banks could continue as customers look for higher returns on their money, contributing to further challenges for the sector, a speaker at the ISDA AGM has warned.

"Many, many more average Americans, if you will, have woken up to the fact that they're earning very little or next to nothing in their savings accounts at banks and you can earn greater than 5% on a T-Bill, which is safe – well, we'll see if it defaults or not, but generally it's safe. What that means is, given how quickly people can move money, I think those outflows will continue steadily and that has implications for lending and a lot of different things," said Thomas Pluta, president of Tradeweb Markets. "I hope I'm wrong, but I do think those pressures will continue."

Silicon Valley Bank (SVB) closed on March 10, after a run on the bank that saw more than $40 billion in deposits withdrawn on March 9 and expectations that a further $100 billion would be pulled from the bank the following day – an outflow that represented approximately 85% of its deposit base. This was followed by the failure of New York-based Signature Bank a few days later and San Francisco-headquartered First Republic Bank in May.

"No question, when the year started, I think everyone had their plans laid out. The dynamic I think was how aggressive was the Fed going to be, how aggressive were other central banks going to be, and where would that put the likelihood of recession and tapering inflation down. We were not predicting the kind of March that we saw," said Dave Olsen, president and chief investment officer at Chicago-based Jump Trading Group, speaking on an AGM panel on May 11.

"It was a good test of systems resiliency and we've got two or three other really big moments left to play out this year, some sooner than others perhaps – I'm referring, of course, to the debt ceiling. So, I think staying nimble and really understanding liquidity, available capital and procyclicality of margin terms really jump to the top of the page so far in 2023," Olsen added.

> "One thing that was eye-opening to me this year was just how poorly managed and regulated these regional banks are"
>
> **Don Wilson, DRW**

A review of the collapse of SVB published by the Board of Governors of the Federal Reserve System on April 28 identified a number of failings, including weaknesses in risk management and shortcomings in regulation and supervision. For example, the Fed found that SVB failed to assess and manage the interest rate risk in its securities portfolio and removed interest rate hedges amid a focus on short-term profits.

"One thing that was eye-opening to me this year was just how poorly managed and regulated these regional banks are. This idea of having securities that you can just put in a held-to-maturity bucket so you don't mark them to market is completely contrary to the way modern financial markets work. So, it's that antiquated risk management approach that has led to these macro problems and this heightened volatility," said Don Wilson, founder and chief executive of trading firm DRW.

The answer, added Wilson, is marking assets to market and exchanging collateral in as close to real time as possible.

"If all assets are marked to market in real time and collateral moves in real time, it's not that it's going to cause volatility to go away, but it's going to reduce the number of massive bursts of volatility that we see," he said.

In response to the events at SVB, Signature Bank and First Republic, Tradeweb's Pluta said he expected to see more hedging of interest rate risk from US regional banks.

"I think we can expect to see an uptick in hedging through interest rate swaps of these held-to-maturity portfolios from some of these regionals – we're having some of those conversations. So, I do think we'll see some better risk management practices going forward and hopefully we'll work our way through this," he said. IQ

▲ From left: Thomas Pluta, Sonali Das Theisen, Dave Olsen, Don Wilson and Jack Hattem

Changes to Term SOFR Make Rate Sustainable, Says Bowman

Recent refinements by the Alternative Reference Rates Committee (ARRC) to its term SOFR scope-of-use recommendations should help dealers manage their risks and ensure term SOFR can continue to be used sustainably in the business loan market, according to David Bowman, senior associate director at the Board of Governors of the Federal Reserve System.

The ARRC announced on April 21 that it had updated its best practice recommendations to recognise the ability of dealers to enter into term SOFR-SOFR basis swaps with any non-dealer participant including hedge funds and asset managers, even if the non-dealer firm does not have a term SOFR cash exposure.

The committee had previously recommended that term SOFR derivatives should only be used by end users hedging cash products that reference term SOFR and specifically stated that term SOFR should not be used in the interdealer market. As a result, dealers offering term SOFR hedges have largely warehoused the one-way risk exposure, raising concerns that they may eventually hit risk limits, pushing the cost of term SOFR hedges to prohibitively high levels.

The update to the best practice recommendations is intended to give dealers an additional means of offsetting the risk accumulated by offering term SOFR hedges to end users.

"We don't think [term SOFR-SOFR basis swaps are] going to be wildly used. It's sort of like the spread between one- and three-month LIBOR – it's not something that gets traded a lot. But it is a market that can help dealers manage their risk better, and so we think it's going to help and make term SOFR sustainable as a tool in the business loan market," said Bowman, speaking on a LIBOR transition AGM panel on May 10.

Despite refining the best practice recommendations to allow term SOFR-SOFR basis swaps, Bowman stressed that the prohibition on interdealer trading of term SOFR would continue.

"There are some things you cannot do, and I hope you are never going to be able to do. One is, under the ARRC recommendations, there is no interdealer trading of term SOFR," he said.

Speaking on the same panel, Tom Wipf, vice chairman at Morgan Stanley and chair of the ARRC, said the recommendations are based on a fundamental principle: to avoid a similar situation to what the market experienced with LIBOR.

"We always try to stick to a few first principles, which is, number one, don't reintroduce any of the vulnerabilities that we saw in LIBOR and ensure there's a robust set of transactions under any rate that we decide to use, and that was part of how we thought about this," said Wipf. IQ

Basel III NPR Expected by Mid-year, Says Fed Official

US regulators expect to issue a long-awaited notice of proposed rulemaking (NPR) for the Basel III trading book rules before the end of the second quarter, according to a senior official at the Board of Governors of the Federal Reserve System.

"The next step is to release the NPR – hopefully, the second quarter of this year is where we end up. We will then begin doing discovery reviews of how banks are preparing to implement this, and we will conduct hypothetical portfolio exercises. With that, the next step would be to get a final rule out and then we can begin going through the approval processes that are necessary in order to go live with the expected date of January 2025," said David Lynch, assistant director, programme direction section, supervision and regulation at the Federal Reserve Board.

Speaking during a panel discussion at the ISDA AGM on May 11, Lynch acknowledged the potential for regional variations in the interpretation of the Basel standards and said there is an ongoing dialogue between supervisors around the world to ensure the rules are as consistent as possible.

"The idea of the Basel capital rules is that they establish the global minimums. When each country tries to implement them, a lot of times they find there are gaps," said Lynch.

Market participants have raised concerns about potential distortions that would be created by major variations in how the rules are implemented. For example, an exemption from the credit valuation adjustment (CVA) risk capital charge for non-financial entities in the EU has not been replicated in other jurisdictions.

"As large global institutions, we're used to dealing with slight differences across the globe, but we are a little concerned by the CVA exemption in Europe. I know for European banks that's welcome, but this is capital against sovereign, corporate and pension funds, and it's hard to argue that we shouldn't have capital against some of those exposures. We've seen volatility there and we've seen losses," said Debbie Toennies, managing director and head of regulatory affairs for the Corporate and Investment Bank at JP Morgan.

Jacques Vigner, chief strategic oversight officer for global markets at BNP Paribas, voiced his concern about the economic impact of the rules and the lack of harmonisation. "When regulators try to translate Basel III into their own legislation, everyone wants to fix some shortcomings and there are many of them," he said. IQ

Watch ISDA's head of capital Panayiotis Dionysopoulos interview Debbie Toennies and Jacques Vigner in the ISDA AGM Studio: bit.ly/45iGR20

AGM Panel Debates Active Accounts

A proposal for active accounts under the latest iteration of the European Market Infrastructure Regulation, known as EMIR 3, could result in increased costs for European firms, particularly if quantitative thresholds are applied, according to Daniel Maguire, chief executive of LCH Group and head of post trade at London Stock Exchange Group.

"I've not spoken to a single client – dealer, buy side, clearing broker – that wants active accounts. And if they do have active accounts, nobody wants quantitative – they want qualitative," said Maguire, speaking on an exchange and clearing panel at the AGM on May 11. "There are a lot of factors at play here, but the fundamental issue is, if we have this forced artificial fragmentation, the cost for EU firms will be pretty prohibitive. So, I think that's the challenge – the political versus the economic reality of the situation."

Speaking on the same panel, Erik Tim Müller, chief executive of Eurex Clearing, said the active accounts proposal, which would require EU firms to clear a yet-to-be determined proportion of certain euro- and zloty-denominated derivatives at an EU clearing house, was intended as a compromise and is less draconian than an earlier policy, which would have required certain systemically important central counterparties (CCPs) to be established in the EU in order to clear euro-denominated derivatives for EU entities.

Nonetheless, he called for several modifications to the proposal, including exemptions for EU banks that act as market makers and those that service US clients. "There are many banks, especially European banks, that say I need to continue to do market making on both venues. So, that's an obvious one that should be included in [the] level-one [text]. They also say I want to be able to continue to service US clients, so if a US client prefers to go to [LCH], a European bank should be able to take it to [LCH]. No doubt, these exemptions I think are legitimate and should find their way in level one," said Müller.

Müller also proposed that thresholds should be included in the level-one text, arguing that the current proposal – waiting for the European Securities and Markets Authority (ESMA) to subsequently determine threshold levels – would take too long.

"On the thresholds, the current legislation foresees that this is done in a second step by ESMA and that I just think takes too long, provides uncertainty to the market for a period of well over 18 months from now, maybe two years, and then we go into the temporary exemption running out in June 2025. So, this is, in my view, where it can be improved. Even if it's a low threshold, just include it in level one," he said.

LCH's Maguire acknowledged that the "temperature has come down a bit" in the euro clearing debate, but argued that an active accounts requirement would ultimately negatively impact European firms.

"The outcome from our standpoint is not brilliant but from an EU customer standpoint, EU dealers, EU real-money accounts, pension funds and the like, they will have restricted access to the global liquidity pools and the global markets," he said. "I guess the bottom line is, if you want the rest of the world to use your currency, you kind of need to live with the rest of the world." IQ

Carbon Principles Will Create Certainty, Says ICVCM Board Member

The core carbon principles and assessment framework developed by the Integrity Council for the Voluntary Carbon Market (ICVCM) will create a global benchmark for high-quality carbon credits that will pave the way towards greater certainty in the voluntary carbon market, according to a market representative on the ICVCM governing board.

"We're hopeful that the principles and assessment framework will give a lot more certainty to operators and buyers in the voluntary carbon market that they'll be able to identify what 'good' looks like. I think going forward, there will be a lot of innovation here, because you'll have companies that will only buy or trade credits aligned with the principles," said Jeff Swartz, vice president, low carbon strategy, regulatory affairs and partnerships at BP Trading & Shipping.

Speaking on a panel at the ISDA AGM on May 11, Swartz said the voluntary carbon market would be "critical" for hard-to-abate sectors that face a long journey to decarbonise, but integrity has to be front and centre. The ICVCM launched its 10 core carbon principles in March, focusing on governance, emissions impact and sustainable development.

"The purpose was to develop a global benchmark for what would constitute a high-quality carbon credit. We didn't have that in the past – as buyers or sellers or traders in the market, you had to do your own interpretation. There was no single authority to help you identify what looks good in carbon credits and what doesn't," said Swartz.

The ICVCM has said the initial assessment phase will launch around mid-year, following publication of its criteria for assessing different categories of carbon credits. While the initiative is led by an independent governing board, regulators are closely monitoring the development of the market.

"As these markets are growing, we're not looking at them that differently than we do any derivatives product, which is to ask whether they reflect the underlying cash market and serve as a price discovery and risk mitigation tool for end users. Our focus is on ensuring that there's market integrity, that there's liquidity and that those contracts can play the part they're supposed to play in the broader ecosystem," said Summer Mersinger, commissioner at the US Commodity Futures Trading Commission. IQ

Watch ISDA chief executive Scott O'Malia interview Summer Mersinger in the ISDA AGM Studio: bit.ly/3MO24d4

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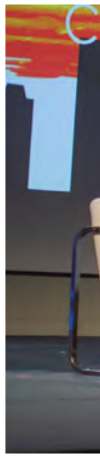


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* Collateral Cushion

As the final phase of initial margin requirements was implemented in September 2022, ISDA's annual survey shows the amount of margin collected by 32 leading derivatives market participants rose to $1.4 trillion at the end of 2022

At the end of 2022, 32 leading derivatives market participants had collected $1.4 trillion of initial margin (IM) and variation margin (VM) for their non-cleared derivatives exposures, versus $1.3 trillion the previous year, according to the ISDA Margin Survey, which was published at the start of the ISDA AGM on May 9.

The $1.4 trillion total comprises $325.7 billion of IM and $1.1 trillion of VM, which compares to $304.1 billion of IM and $1.0 trillion of VM at the end of 2021. The 32 market participants that responded to the survey include all 20 of the firms subject to the first phase of regulatory IM requirements in September 2016 (phase-one firms), five of the six phase-two firms and seven of the eight phase-three entities.

IM and VM collected by the 20 phase-one firms, which represent the largest derivatives dealers, totalled $1.3 trillion at the end of 2022, a 5.6% increase versus year-end 2021. That encompasses $307.2 billion of IM (a 7.4% rise from $286.0 billion collected at the end of 2021) and $983.7 billion of VM (a 5.0% rise from $936.5 billion collected at the end of 2021).

"All six phases of the margin rules for non-cleared derivatives have now been implemented, with the final phase successfully rolled out in September 2022. This means more entities than ever before are subject to margin obligations, which significantly helps to mitigate counterparty credit risk. The corollary is that large amounts of cash and high-quality liquid assets need to be sourced as collateral, which can have knock-on impacts on liquidity. It also means internal processes for managing large numbers of margin calls must be highly efficient," says Scott O'Malia, chief executive of ISDA.

Of the $307.2 billion of IM collected by phase-one firms, $231.0 billion was required under global margin regulations. This represents an increase of 13.5% compared to $203.5 billion of regulatory IM collected at year-end 2021 (see Chart 1). The amount of regulatory IM continues to grow as more firms have become subject to the IM rules. The final implementation date, for phase-six firms, occurred on September 1, 2022.

Meanwhile, $76.2 billion of IM collected by phase-one firms was independent amount (IA) received from counterparties not currently in scope and/or for transactions not covered by the margin rules, including legacy transactions. This represents a 7.6% decrease from the $82.5 billion of IA collected at year-end 2021. The drop in discretionary IM reflects the rise in the number of firms subject to regulatory margin requirements.

Of the $983.7 billion of VM collected by phase-one firms, $695.4 billion was required under global margin regulations. This represents a 31.7% increase compared to $527.9 billion of regulatory VM collected at year-end 2021 (see Chart 2).

CHART 1: REGULATORY IM AND IA RECEIVED BY PHASE-ONE FIRMS (US$ BILLIONS)

"More entities than ever before are subject to margin obligations, which significantly helps to mitigate counterparty credit risk"

Scott O'Malia, ISDA

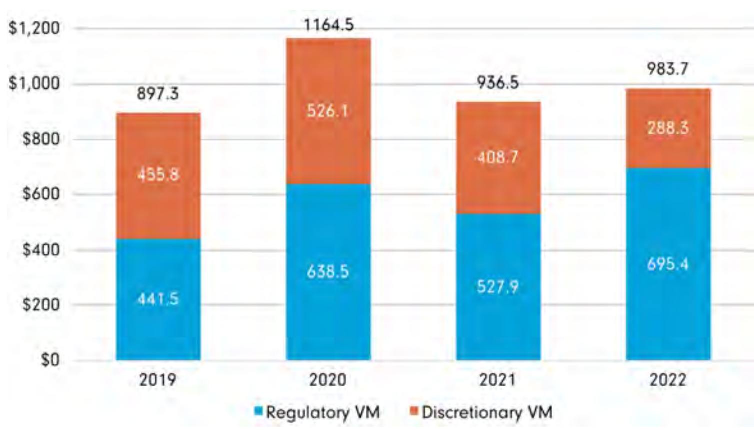
In contrast, $288.3 billion of VM collected by phase-one firms was discretionary and was received from counterparties and/or transactions not covered by the margin rules, including legacy transactions. This represents a fall of 29.5% ($120.4 billion) compared to $408.7 billion of discretionary VM collected at year-end 2021. The decline in discretionary VM is likely due to fewer legacy transactions covered by discretionary VM and more new transactions in scope of regulatory VM.

The 12 other firms that participated in the survey (five phase-two and seven phase-three entities) collected $18.6 billion of IM at the end of 2022, including $17.4 billion of regulatory IM and $1.2 billion of IA. These 12 firms also collected $101.7 billion of VM, including $79.3 billion of regulatory VM and $22.4 billion of discretionary VM.

The survey also reports the amount of IM posted by all market participants to major central counterparties (CCPs). Total IM posted for cleared interest rate derivatives (IRD) and single-name and index credit default swaps (CDS) reached $384.4 billion at the end of 2022, an 18.8% increase compared to $323.4 billion at the end of 2021.

Of this, $314.3 billion was posted for cleared IRD transactions and $70.1 billion was posted for cleared CDS transactions. Open interest in IRD products across five major CCPs totalled $425.8 trillion at year-end 2022, while open interest in CDS products at four major CCPs was $2.9 trillion at year-end 2022.

CHART 2: REGULATORY AND DISCRETIONARY VM RECEIVED BY PHASE-ONE FIRMS (US$ BILLIONS)



Read the ISDA Margin Survey Year-end 2022 in full: bit.ly/41SAi3x

SURVEY METHODOLOGY AND PARTICIPANTS

The ISDA Margin Survey assesses the amount and type of collateral posted for non-cleared and cleared derivatives transactions.

For non-cleared derivatives, ISDA surveyed 20 firms with the largest derivatives exposures. These firms were subject to the first phase of regulatory initial margin (IM) requirements for non-cleared derivatives in the US, Canada and Japan from September 2016, and in Europe from February 2017 (known as phase-one firms).

ISDA also surveyed phase-two and phase-three firms that were subject to the IM requirements from September 2017 and September 2018, respectively. Responses were received from five of the six phase-two entities and seven of the eight phase-three firms subject to the margin rules.

Phase-four, phase-five and phase-six firms became subject to the IM regulations in September 2019, September 2021 and September 2022, respectively. These firms were not directly included in this survey, but IM and VM received from and posted to these entities was captured in margin data reported by the survey participants.

For cleared derivatives, the survey uses publicly available margin data from two US central counterparties (CCPs) (CME and ICE Clear Credit), four European CCPs (Eurex Clearing, ICE Clear Europe, LCH Ltd and LCH SA) and two Asian CCPs (Japan Securities Clearing Corporation (JSCC) and OTC Clearing Hong Kong Limited (OTC Clear)). The collected data only reflects IM for interest rate derivatives and credit default swaps.

* Forging Ahead

The derivatives market can help to protect global energy security while facilitating the transition to net-zero emissions, according to a new whitepaper from the ISDA Future Leaders in Derivatives programme

Climate change may be humanity's greatest threat. Rapidly increasing greenhouse gas emissions have led to rising sea levels, recurring heatwaves and melting glaciers, all of which have contributed to an increasingly dismal economic and environmental outlook. Between 2030 and 2050, the World Health Organization forecasts there will be an additional 250,000 deaths per year as a direct consequence of climate change. Between 2016 and 2018, climate-related disasters were reported to have cost the global economy $650 billion.

In an effort to mitigate and ultimately offset these effects, governments and organisations across the globe have committed to implementing solutions to halve greenhouse gas emissions within the next decade and eliminate net emissions by 2050. Specifically, the EU and US have committed to reaching carbon neutrality – or net-zero emissions – by 2050; China has committed to become carbon neutral before 2060, and other countries participating in the 2015 Paris Agreement have made similar commitments. More recently, decisions made at the 2022 United Nations Climate Conference reiterated the commitment to achieving carbon neutrality within previously proposed timeframes. As a result of these initiatives, a number of new solutions to reduce or eliminate carbon emissions have developed, in addition to new markets to finance these solutions.

One particular area of focus has been the intersection between the net-zero transition and global energy security. The energy sector produces around three quarters of global greenhouse gas emissions, making it a primary contributor to the climate crisis. In order to ensure long-term energy security while achieving global net-zero targets, public and private investments in renewable energy and green technology must triple by 2050. However, recent volatility in energy markets, exacerbated by geopolitical conflict, has negatively impacted green investment. Innovation in financial and risk management solutions will be vital to safeguarding energy security and facilitating the transition to a net-zero economy.

In a new whitepaper, the ISDA Future Leaders in Derivatives (IFLD) programme aims to build on existing literature on the topic of decarbonisation and provide insight into how the derivatives market can protect energy security while facilitating the transition to net zero.

The paper provides insight into the current state of the market and the challenges resulting from extreme price volatility in energy markets, most notably for corporates in the energy sector participating in cleared derivatives markets.

Price volatility

Extreme volatility in energy prices has eased over the past year, primarily due to a combination of unseasonably warm winter weather, significantly reduced energy demand and increased reliance on emergency energy reserves. However, there are still fundamental concerns regarding continued reliance on fossil fuels and supply chain concentration. Recent geopolitical events, such as the war in Ukraine and its impact on European energy markets, highlight these vulnerabilities and the need for immediate action to strengthen market resilience against further disruption.

Policymakers' efforts to address these and related energy security concerns have traditionally focused on the underlying causes of energy market volatility by ensuring the availability of conventional energy resources and improving existing power generation infrastructure. However, recent spikes in volatility have instead been met with direct intervention in secondary markets – including emergency trading closures and price caps – with unintended adverse consequences.

Rather than implementing ad hoc trading suspensions and other market interventions, policymakers should instead focus on putting in place transparent and consistent volatility controls to promote orderly market functioning. Many securities and derivatives exchanges have already implemented high-frequency market monitoring functions (often referred to as circuit breakers) that temporarily halt trading in the event of extreme price moves to prevent errant trades and irrational price moves. Research indicates circuit breakers have been effective in reducing volatility during times of market stress.

In addition, the extreme market volatility due to recent global events led to significant challenges for corporates in the energy sector that participate in cleared derivatives markets. In volatile markets, these corporates face greater difficulties in securing favourable future energy prices (required for their core business activities) and they incur higher margin requirements as a result. To address some of these challenges, the European Securities and Markets Authority recently introduced target measures to ease liquidity pressures, including the temporary expansion of the scope of eligible collateral to uncollateralised guarantees for corporates participating as clearing members, and to public guarantees for all participating members.

Although these and other market monitoring and control functions could be adjusted to operate over longer periods to allow market participants sufficient time to assess risks during periods of high volatility, such measures are not sufficient to address market disruption in the medium and long term.

Energy solutions

Energy shortages resulting from the COVID-19 pandemic and recent geopolitical conflict led to an increased reliance on coal, among other non-renewable energy sources. As a primary source of greenhouse gas emissions, coal is a particularly damaging form of non-renewable energy. Increased reliance on climate-harming energy resources directly contradicts net-zero targets. It is critical for policymakers and market participants to ensure that energy security is preserved in a manner that aligns with net-zero objectives. The measures taken so far to respond to volatility and collateral challenges are a helpful starting point but, in order to be sustainable, they must be complemented by investment in green technology and a transition to renewable energy sources.

Investment from the public sector is expected to have the greatest impact on the development of green technologies and the transition away from fossil fuels in the medium and long term. In the US, the 2022 Inflation Reduction Act will invest around $369 billion in energy security and climate change programmes over the next 10 years. The 2022 Inflation Reduction Act aims to lower energy costs, increase cleaner energy production and reduce carbon emissions by roughly 40% by 2030. The EU is looking to implement similar measures through its Green Deal Industrial Plan, in which it will relax the EU's state aid rules for investment in green technology.

However, large-scale investment from the private sector is also necessary to fund the transition to net zero. The voluntary carbon credit market has the potential to generate significant private investment in green projects in the medium term, and the derivatives market can facilitate the scaling of that market.

ABOUT THE IFLD

The ISDA Future Leaders in Derivatives (IFLD) programme aims to make a positive impact on the future of the derivatives market by identifying a diverse group of emerging leaders across the industry. The programme has four core objectives: to create an active forum for networking and discussion of industry topics and future industry trends; to increase the demographic, cultural and professional diversity of senior leaders within the financial services sector; to support emerging leaders in developing soft skills and technical expertise; and to develop and produce content on issues of strategic importance to ISDA and its members. For more information on the IFLD programme, contact IFLD@isda.org or visit: bit.ly/43eOpBa

Recommendations

The paper makes a series of medium-term and long-term recommendations, including: scale existing voluntary carbon credit markets; further standardise emissions products; create the necessary legal framework to establish a unified global market; and update derivatives products to reflect rapidly evolving needs as renewable energy grows in adoption and importance to global energy security.

As the world faces the reality of the climate crisis, it is clear the transition to a net-zero economy is vital to ensure the long-term sustainability of the planet. The commitment of governments and multilateral organisations across the globe to reduce greenhouse gas emissions is encouraging, but the private sector will also play a central role.

The IFLD invited emerging leaders across a diverse range of functions, business lines and geographies within the derivatives market to engage with the group during the development of the paper. Participants in the 2022-2023 IFLD cohort have expertise in environmental, social, and governance, energy (renewables and non-renewables) and the related financial markets from leading multinational financial institutions, market infrastructure platforms, and legal and compliance firms.

Engaging expertise across jurisdictions, the IFLD has identified ways in which strategic use of derivatives can be a fundamental risk management tool and can support innovative financing solutions that will encourage greater investment in green technologies and the global economy's transition from carbon. If implemented in collaboration with industry, regulators, governments, multilateral organisations and other key stakeholders, these recommendations can help to safeguard energy security and create a sustainable future for generations to come. IQ

Read the IFLD paper, *Energy Security and the Road to Net Zero: the Role of the Derivatives Market,* in full: bit.ly/41ZHZF9

MISSION STATEMENT

ISDA fosters safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products

STRATEGY STATEMENT

ISDA achieves its mission by representing all market participants globally, promoting high standards of commercial conduct that enhance market integrity, and leading industry action on derivatives issues.

THE PREEMINENT VOICE OF THE GLOBAL DERIVATIVES MARKETPLACE

Representing the industry through public policy engagement, education and communication

AN ADVOCATE FOR EFFECTIVE RISK AND CAPITAL MANAGEMENT

Enhancing counterparty and market risk practices and ensuring a prudent and consistent regulatory capital and margin framework

THE SOURCE FOR GLOBAL INDUSTRY STANDARDS IN DOCUMENTATION

Developing standardized documentation globally to promote legal certainty and maximize risk reduction

A STRONG PROPONENT FOR A SAFE, EFFICIENT MARKET INFRASTRUCTURE FOR DERIVATIVES TRADING, CLEARING AND REPORTING

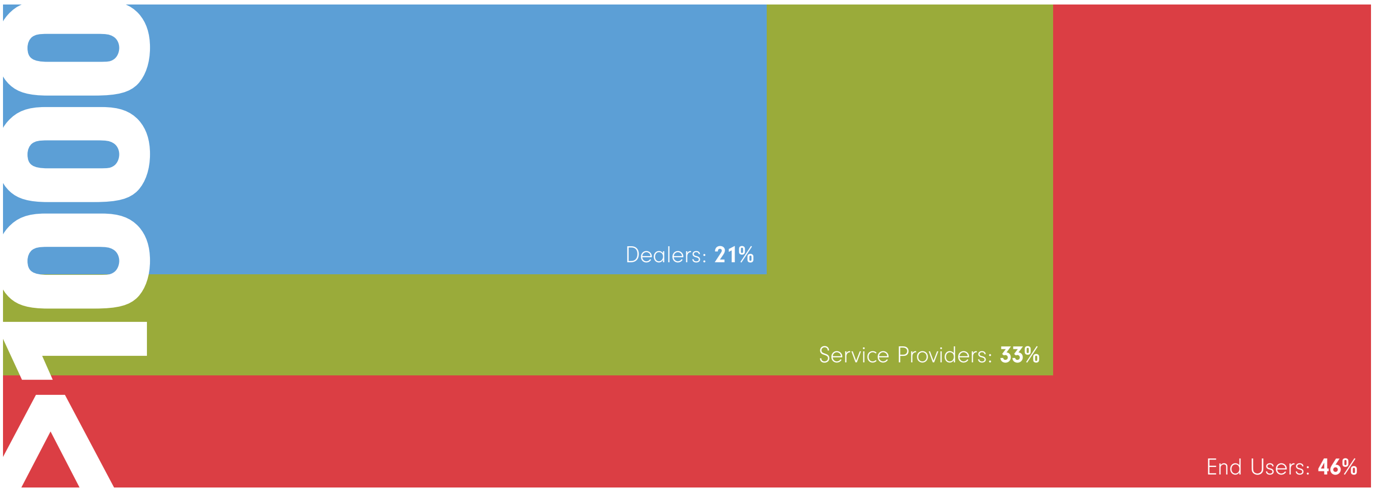
Advancing practices related to trading, clearing, reporting and processing of transactions in order to enhance the safety, liquidity and transparency of global derivatives markets

www.isda.org

MEMBERSHIP INFORMATION

ISDA has over 1,000 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.

MEMBERSHIP BREAKDOWN



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Banks	31%
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Asset Managers	9%
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Energy/Commodities Firms	7%
Diversified Financials	5%
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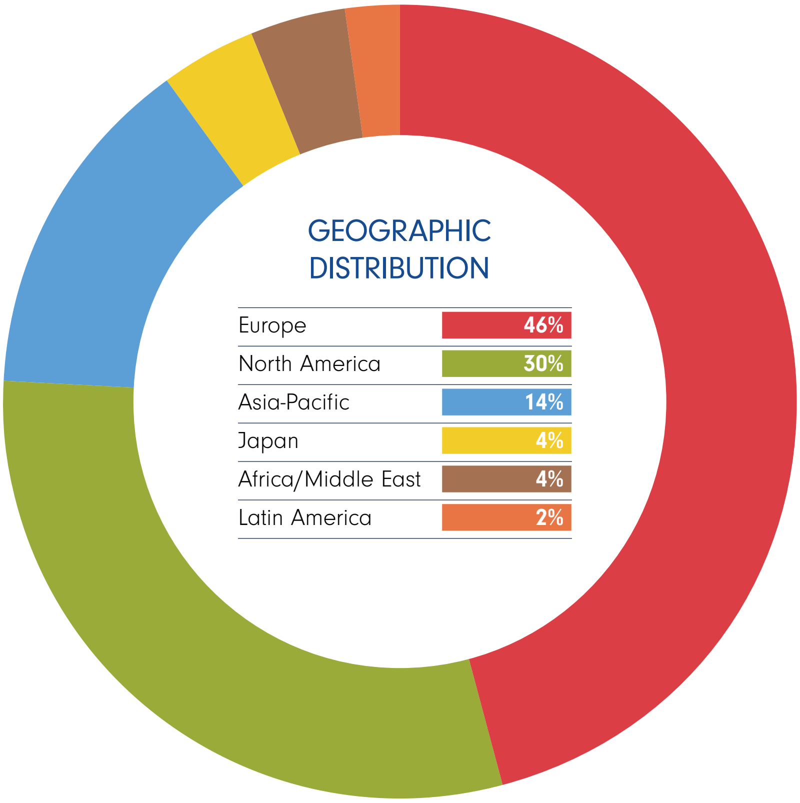
Other	9%



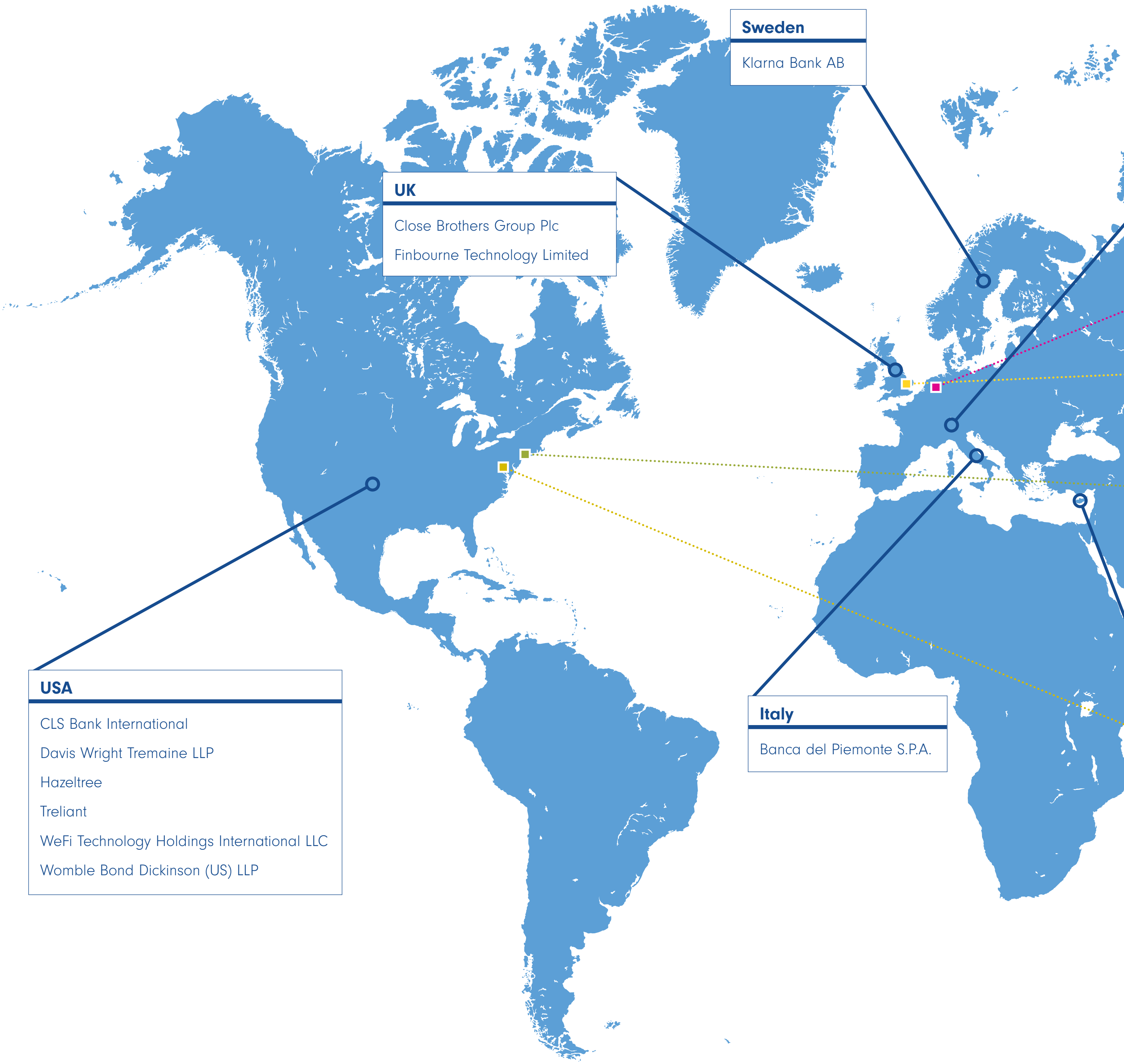
GEOGRAPHIC DISTRIBUTION

Europe	46%
North America	30%
Asia-Pacific	14%
Japan	4%
Africa/Middle East	4%
Latin America	2%

Additional information regarding ISDA's member types and benefits, as well as a complete ISDA membership list, is available on the ISDA Membership Portal: https://membership.isda.org/

NEW ISDA MEMBERS

A big welcome to all new members that joined ISDA in the first quarter of 2023. We look forward to working with you in the future



For additional information on joining ISDA, please visit the ISDA Membership

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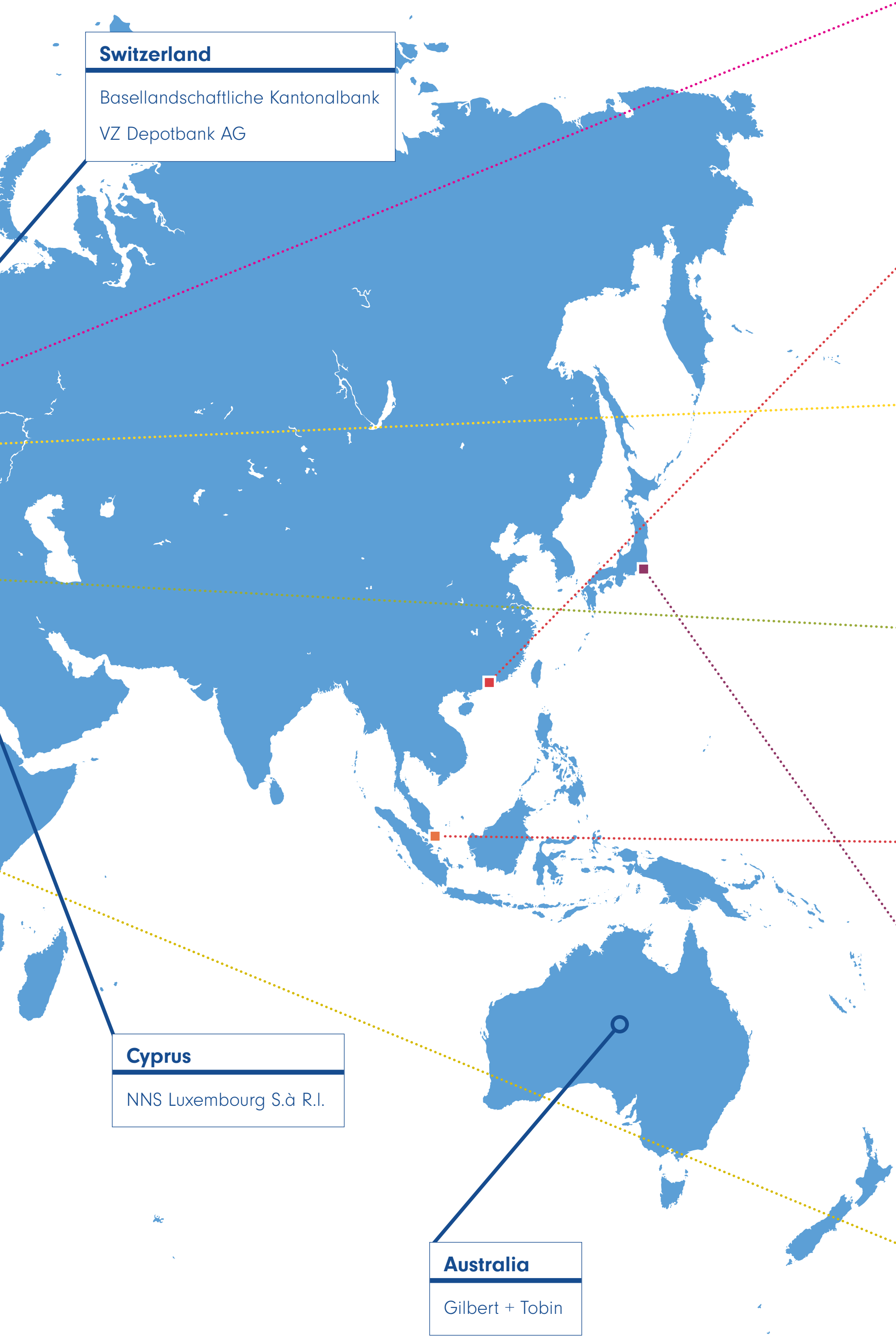

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2023 ISDA Derivatives Forums

The ISDA Derivatives Forums will provide attendees with cutting-edge intelligence and analysis on key industry topics, as well as exclusive insights from senior regulators and market participants. These in-person events will feature high-level keynote speakers, coverage of critical topics including liquidity risk, sustainable finance and digitisation, and valuable networking opportunities

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Visit **isda.org** for dates, locations and agendas

If you have an idea for a topic you would like to sponsor or if you see an event you would like to sponsor, please contact Rob Saunders: +44 (0) 20 3808 9727 | rsaunders@isda.org

*

"As individuals and institutions, we can achieve a great deal. But when we work together in pursuit of a common goal, we can hit the ball right out of the park. It's our collective capabilities that have allowed us to achieve so much over the years"

Scott O'Malia, ISDA