ISDA Safe, Efficient Markets

ISDA Regional Events 2021

Chairman Remarks
Eric Litvack, Chairman, ISDA

Hello everyone.

It's great to be able to hold these regional events again after a COVID-induced pause last year. ISDA is a global organization, and I've always valued the opportunity to attend the events in each location and meet firsthand with the people who matter most – you, our members, who contribute so much to ISDA's work and mission, as well as the regulators that oversee these vital markets.

Unfortunately, the realities of COVID mean I have to speak to you virtually, but I very much hope that the cautious relaxation of restrictions we're seeing in many countries is able to continue, and that I can address you in person next year.

As some countries start to return to some form of normality, it's only natural to look back and consider what happened, how we fared and what lessons can be learned. It should come as no surprise, then, that several recent reports have emerged analyzing the performance of financial markets during the crisis.

Obviously, none of this can be considered independently of the massive public-sector support to the economy, without which the outcomes would have been much more severe. But a common thread running through these reports is the resilience of the financial system during the extreme stress of the pandemic. This is largely attributed to regulatory reforms put in place after the last crisis, which meant financial markets were able to continue to function and play a vital role in supporting the economy, acting in many cases as the relay of public support measures.

As an example, a recent report by the Basel Committee concludes that the higher levels of capital and liquidity as a result of Basel III helped banks weather the shock of the pandemic. That enabled them to continue to extend financing, facilitate access to capital and provide risk management services to clients.

We at ISDA agree. The Basel reforms, along with other changes to the regulatory framework, like clearing and margining of derivatives, undoubtedly meant the financial system was better prepared to deal with the crisis – **as our latest animation explains.**

As the animation states, while financial markets and institutions played a key role in supporting the economy, it's important we look closely for any lessons to ensure markets remain resilient in the future – particularly as new challenges, like climate change, really start to bite.

The Basel report, for instance, identifies several areas of the capital framework that may warrant further consideration, including the usability of capital and liquidity buffers, procyclicality in parts of the framework and the impact of the leverage ratio – specifically, whether the leverage ratio acted as a non-risk-sensitive binding constraint on bank intermediation activity during the crisis.

These are in line with issues identified by ISDA, the Institute of International Finance and the Financial Services Forum in an analysis we published earlier this year on the role of financial markets during the pandemic, so we welcome the Basel Committee's willingness to monitor these issues going forward.

While examining the impact of some current measures, regulators are also preparing to introduce new ones. Over the coming days, weeks and months, individual jurisdictions will publish draft rules to implement the final Basel III measures, which include the Fundamental Review of the Trading Book (FRTB).

As market participants absorb these rules and prepare for the January 2023 start date, ISDA's priority will be to help bring as much efficiency as possible to bank implementation efforts. In the rest of my remarks, I'd like to focus on some of the important work that ISDA is doing, both in terms of practical solutions to facilitate implementation and in terms of thought leadership and advocacy to ensure the framework is appropriately adapted and fit for purpose.

A key prong of this work is ISDA's Standardized Approach (SA) Benchmarking initiative.

This has been developed by ISDA's in-house analytics team to help ensure banks can implement the new, more complex standardized models within Basel III accurately and consistently, and in the most efficient way possible. Through this initiative, we're able to work with member firms to drill down and analyze the reasons for any variation by individual institutions, enabling them to quickly spot and rectify any errors in their application.

So far, more than 60 banks have participated in ISDA's benchmarking exercise, and 16 regulators have used the data to monitor implementation in their jurisdictions to ensure consistency. Having started with an initial focus on the FRTB, we've now extended the program to cover the standardized approach to counterparty credit risk and the revised credit valuation adjustment framework as well.

These standardized 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.

The FRTB standardized approach is more risk-sensitive than its predecessor, which is very welcome given its elevated role in setting capital requirements. But that extra risk sensitivity doesn't mean standardized approaches can and should replace sophisticated internal models entirely.

Worryingly, there are indications that this could in fact occur as a result of demanding and hard-to-meet requirements placed on internal models under the FRTB. A European Central Bank survey conducted last year found that nearly two thirds of banks that currently use the internal models approach may stop in favor of the new standardized approach under the FRTB.

I raised this point recently at the ISDA Annual General Meeting, and I'm raising it again because it's important. Switching from a diverse array of advanced, risk-sensitive models to uniform use of a homogenous standardized model will inevitably have knock-on effects, and we should be mindful of the associated risks.

For example, if all banks use the same model, they will have the same view on what assets and businesses look most attractive, which could lead to herd behavior – everyone chasing the same assets in good times and ditching them in bad.

Now, there's a debate to be had about the 'right' mix of internal models and standardized approaches. Clearly, the last financial crisis exposed shortcomings in and an over-reliance on certain internal models. But pushing the needle too far in the other direction will have consequences as well, and we should be clear-eyed about what they are before we leap in.

In addition to this important focus on implementation, ISDA is also working on a number of other fronts to ensure the incentives baked into the framework are appropriate and don't unnecessarily inhibit banks from participating in key markets and supporting the economy. Here, I'd like to highlight two particular examples of this work.

The first is the treatment of carbon certificates in the FRTB, a topic on which ISDA published a thought-leadership paper in July.

Carbon trading markets are seen by many policy-makers as a vital tool to meet tough emissions-reduction targets. Regulated emissions trading systems have been established in several jurisdictions, and – as Scott outlined this morning – work is under way to develop a framework for a scalable voluntary carbon market.

With growing political momentum across the globe towards net-zero emissions over the next few decades, trading in carbon certificates is certain to grow further as a market-based solution to facilitate the reduction of emissions in an economically efficient way.

Banks will play an instrumental role in the development and smooth functioning of this market by acting as counterparties to buyers and sellers of carbon certificates. It's therefore critical the capital treatment of these instruments is appropriate and doesn't undermine the development of this market by unduly penalizing banks that participate in it.

Unfortunately, the analysis by ISDA shows the FRTB would lead to excessively high capital requirements that are out of proportion with the risk they pose.

For example, under the current framework, carbon certificates have been allocated a risk weight that is twice that of crude oil. Our analysis of the volatility of carbon certificates during stressed periods suggests the current risk weight is as much as 60% higher than it ought to be.

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.

If capital levels are inappropriately high, the economically rational response is to reduce activity or withdraw completely from the business – which, in this case, could constrain the development of the carbon market and make it more difficult to meet emissions-reduction targets.

The second example of ISDA's work on the FRTB framework is the capital treatment of equity investments in funds. Funds are an important and cost-effective means for groups of investors to get access to a diversified portfolio of managed assets, and are a popular underlying asset for structured products and derivatives.

Unfortunately, the FRTB approach to funds is very complex and burdensome to implement. The only viable option for many banks may be to use the least computationally intensive method, which is also the most punitive from a capital perspective. This could severely undermine banks' ability to engage in this market, in turn depriving investors of an important and cost-effective means of investing. ISDA continues to engage with members and supervisors on solutions to ensure more flexibility is introduced into the framework.

As domestic regulators work to develop, consult on and implement the FRTB, there is a chance to improve the framework to ensure it is appropriate and risk sensitive and doesn't create incentives that lead to perverse outcomes. Given the importance of all of these issues, we would urge regulators to take that opportunity.

On behalf of ISDA members, I'd like to thank the ISDA staff, and notably the capital, analytics and advocacy teams, for the important work I've highlighted today, which are just a couple of examples among many where ISDA is hard at work to prepare the derivatives industry for the future.

I'd also like to thank all of you on behalf of the ISDA Board for attending today, and for your continued support that makes ISDA's important work possible, particularly over the past 18 challenging months. We still have many challenges ahead of us, and I very much hope we'll have the opportunity to meet in person next year, whether in Australia, Hong Kong, London, New York or Tokyo.

Thank you.