ISDA® | Safe, Efficient Markets

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Chairman's Remarks: ISDA Asia Regional Conferences

Stephen O'Connor, ISDA Chairman

Thank you Bob, and good morning everybody.

There is a lot going on in our markets today!

I've only been around for five years or so on the Board, but I can't imagine that there has been a busier time for ISDA, a fact I confirmed recently when talking with a few former ISDA Chairmen.

And if we are busy, you are busy, not just at your firms, but also helping ISDA through working on various committees and we really appreciate all of the work that you as members are doing in support of our efforts.

Maybe one day you'll get back to your day jobs — remember those?

There is so much going on that I can't cover every issue that I would like to in this opening address, so I am going to pick a few: cross-border issues, initial margin for uncleared swaps, trade compression and benchmarks.

Yes, clearing, capital, other elements of the G20 commitments, legal and documentation, risk management all deserve their time in the sun, and they will get that — some on panels later today.

Let's start with cross-border issues, or extraterritoriality.

We talked a lot about ET during our conference here last year.

Well, it continues to pose major challenges for market participants.

The agita over the October 2nd deadline for compliance with the US SEF rules is a case in point. "Broker-dealers urge CFTC to delay reforms" said a headline in the Financial Times. Another was: "US rules 'endanger' derivatives reforms." The take from the Wall Street Journal was: "Swaps Rules Worry Industry."

As the FT noted in its story: "The immediate concerns range from technical difficulties broker-dealers face in meeting the requirements to regulatory worries about the extra-territorial reach of incoming US rules, which…a CFTC commissioner…labeled 'regulatory imperialism'."

Regulatory imperialism…. I must admit: it has an interesting ring.

So what is ISDA doing about issues related to ET?

On one level, we are working very hard on a day-to-day basis to resolve in the best way possible the many logistical and operational and legal problems arising from implementation of the new regulations.

We're asking for regulatory clarifications and extensions and no action letters so that market participants across jurisdictions have the ability to address problem areas.

On a broader level, we're also working with global policymakers to outline a coherent and consistent approach on cross-border issues.

In late summer, ISDA issued a document that outlines principles for inter-jurisdictional recognition of derivatives regulation through a principles-based substituted compliance methodology.

The document incorporates views expressed by international regulators and market participants.

We believe these principles can help achieve the widely shared goal of a harmonized international regulatory framework.

We also believe that within this framework, IOSCO has an important role to play.

I've shared our thinking with IOSCO and we very much welcome the creation on the IOSCO Cross Border Taskforce.

Moving on to discuss the new margin requirements…

As you know in September, BCBS and IOSCO issued their latest margin requirements for non-cleared swaps.

While we fully support the goals of the initiative and many of the specific rules, including mandatory variation margin for swaps, there are a number of elements in the new rules that we remain quite concerned about.

Here are three issues related to the margin requirements. First:

The rules should allow certain ordinarily clearable swaps to be withheld from clearing in specific situations where such transactions are clearly identifiable hedges to non-clearable transactions.

The mandatory initial margin requirements should recognize the risk-reducing benefits of clearable swaps that offset the risk of non-clearable swaps.

The mandatory clearing of transactions that offset non-clearable risks will result in significantly higher systemic risk than if this narrow exception were made.

There is no economic case that justifies the clearing of such hedge transactions.

The approach we advocate will reduce risk in the system.

Moving on to the second major issue related to the margin requirements:

Pro-cyclicality. As currently proposed, the size of initial margin requirements increase as volatility increases.

As markets move towards the bottom of the next cycle, incremental IM calls resulting from increased volatility could further stress both institutions and markets.

This could add pressure to any sell-off as less-liquid assets are sold to raise liquidity for margin needs and could even directly cause defaults as demand for new liquidity to meet margin calls exceeds capacity at institutions.

The third major issue related to the margin requirements:

While we support the relief given to IM for currency swaps, we are quite concerned that the mandatory IM regime on other non-cleared swaps could harm risk-hedging that is important for many economic sectors.

This includes the housing market, which relies on interest rate options, as well as pensions and insurance companies, which depend on inflation swaps.

There are many other examples as well.

I will now touch upon some further thoughts on initial margin….

We believe that a further economic analysis should be conducted to isolate the incremental costs and benefits of mandatory IM.

Such analysis should cover not only the direct costs and benefits of IM but also the costs and implications of behavioral change, namely a reduction in the use of non-cleared or the use of imperfect hedges in cleared OTC or listed derivative markets.

In addition, while we recognize that the current approach to margin requirements is, and should be, "gross" by counterparty, consideration should be given to a net risk approach.

This would mean that IM would be imposed on the net risk of an institution.

ISDA is working to develop tools and infrastructure that will result in a systemic loss outcome that will be driven by the "net" risk of a defaulting entity.

This is a significant effort and will take some time but as we move forward in the process we will advocate for a "net" approach to margin to reflect the loss outcome.

We are also working on a standard industry margin model, or SIMM, to help reduce disputes that would arise in a world where market participants build their own IM calculation engines. More on that later.

These are some of the issues related to the margin requirements that we are working on.

Turning to portfolio compression.

We think that portfolio compression has a very important and continuing role to play in our markets.

Portfolio compression, as you know, enables early termination of economically redundant derivatives trades without changing the net position of each participant.

It does so by terminating existing trades that offset from a risk perspective, resulting in portfolio with a smaller number of trades with substantially the same risk.

Portfolio compression improves derivatives risk management and reduces operational risk.

Over the past few years, the industry has reduced interest rate notionals by 165 trillion US Dollars.

We've reduced CDS notionals by 86 trillion US Dollars.

This is an outstanding accomplishment…some $250 trillion in notionals reduced.

But there is more to be done here.

There continues to be a significant opportunity to compress portfolios and reduce notionals.

That's why ISDA is forming a global Compression Task Force.

Its aim will be to achieve maximum sustained compression across all relevant asset classes, including risky and riskless, for cleared and uncleared trades.

The group will comprise market participants, clearing houses and compression firms.

It will focus on four key elements:

1. Developing, compiling and educating on best practices for compression;

2. Coordinating compression "big bang" events that will significantly reduce notionals though global concerted efforts;

3. Developing tools to embed and automate compression in our activities so that it becomes a regular and essential feature of the derivatives business; and

4. Reporting on progress achieved and highlighting future areas of focus.

And we are very encouraged by the buy-in of our member firms to this Compression Task Force initiative.

It is not inconceivable that the reduction in notional we see via compression from this point forward could be in the multiple hundreds of trillions of dollars.

Let me now say a few words with regards to our on-going work on industry benchmarks, in particular, ISDAFIX.

ISDAFIX is the method for setting benchmarks for Par Swap rates — essential in applications such as the exercise of swaptions.

Our focus here is to ensure alignment of ISDAFIX practices with evolving best practices in the setting of benchmark rates.

This means basing the rates on live executable prices whenever possible.

Toward that end, we currently have in place a two-phase process for moving to an alternative, market-based ISDAFIX rate setting.

The first phase consists of a series of interim steps to strengthen the process by which the ISDAFIX interest rate benchmark is determined and calculated.

Work is underway on an ISDAFIX Code of Conduct, which addresses internal governance, systems and controls so as to maintain the highest standards and professional reputation for ISDAFIX and contributing banks.

The second phase of process includes moving from the current bank submission based model to an automated model that utilizes live prices from execution venues or multilateral trading facilities (MTFs).

MTFs or SEFs in US increasingly represent liquid and stable markets for interest rate swaps that provide a viable source for reference rates such as ISDAFIX.

Moving to a rate-setting process based on MTFs reflects an evolution in best practices for this important rate-setting process.

It would enable rates to be sourced directly from electronic trading venues, rather than relying on rate submissions from contributing dealers. Transparency and auditability are also improved.

The target for transition to a MTF submission based approach is first quarter of next year for euro swaps, with the US dollar and sterling swaps following later in 2014.

In addition to our work to improve the ISDAFIX process, we are also assisting with benchmark reforms on a broader level.

As you may know, the Financial Stability Board established an official Sector Steering Group on benchmarks. The Steering Group coordinates and maintains the consistency of reviews of existing interest rate benchmarks.

The Steering Group also guides the work of the Market Participants Group which is examining the adoption of additional reference rates and potential transition issues.

I was very happy to accept an invitation from Martin Wheatley to serve as Vice-Chairman of the MPG.

Darrell Duffie of Stanford is the chair.

So let me briefly sum up the current agenda for ISDA.

First, we continue to work for safe, efficient markets…

And we know that achieving our goal requires a globally consistent regulatory framework that encourages and ensures appropriate risk management activity by firms around the world.

Second, we continue to look to provide essential support and services to our members to help them cope with the tidal wave of change that is transforming our industry.

This includes such initiatives as developing a standard industry margin model and driving compression of notionals.

Third, we also continue to engage on a broader level with global policymaker and market participants on major issues shaping the financial markets.

And we need your help on all of these initiatives — so thank you in advance — the future is coming into focus, but we still have a lot to do!

Thank you.