ISDA Annual Europe Conference

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Opening Remarks

Scott O'Malia, ISDA Chief Executive

Good morning, everyone.

You'll have to excuse me if I move around the stage a bit this morning, or stomp my feet while I'm speaking. I need to hit at least 10,000 steps before the end of the day. Those of you who use fitness trackers will know that it can get quite addictive. I'm constantly checking my steps and thinking up new ways to increase my total for the day.

This all started a few months ago, when ISDA signed up to the Virgin Pulse Global Challenge, an annual competition in which teams of employees look to improve their health by increasing their steps over a three-month period. ISDA's staff split into 12 teams from all geographies and competed to see who could get the most steps.

To be honest, I was a bit apprehensive about what I could realistically contribute. It's not always easy to fit in a long walk or a fast run on days when my diary is backed up with meetings and travel. But that's the beauty of the steps challenge – you work as a team. On days when I was tied up, others in my team were working to keep the steps up. While I might not have achieved a particularly high total on my own, together we were able to achieve so much more.

To me, that's a great analogy for what we do at ISDA. Derivatives market participants face many of the same challenges, but it would be ineffective and inefficient for everyone to tackle those challenges on their own. By joining forces as an industry and stepping together, not only can we achieve more, but we can do it more effectively.

In my remarks this morning, I'll describe three areas where ISDA has worked in concert with our members to develop globally consistent industry solutions to common challenges – margin, capital and benchmarks. I will give an update on some long-term initiatives in these three areas, and I will also tell you about some exciting new initiatives we're now working on.

Margin

The implementation of initial margin (IM) requirements for non-cleared derivatives has been a major area of focus for ISDA for some time, and for good reason. Did you know that it can take up to 18 months to complete all of the necessary steps to prepare for the regulatory IM requirements?

ISDA has identified eight distinct steps to this process, from identifying in-scope entities and making disclosures to counterparties, to establishing custodial relationships and negotiating IM documentation. Each of these steps will require time, resources and careful attention to detail.

Given the scale and operational complexity of the IM requirements, we are grateful that regulators have taken action to reduce the compliance burden for smaller, non-systemically important firms. This followed extensive analysis and advocacy by ISDA and its members on the implications of the original phase-in timetable.

In March, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions stated that counterparty exposures below a €50 million IM exchange threshold are not required to meet documentation, custodial or operational requirements. They followed up in July by splitting the phase-five September 2020 implementation deadline into two, giving the smallest in-scope firms an extra year to comply.

This regulatory relief is undoubtedly helpful and will reduce the potential for a compliance bottleneck in September 2020. The original phase-in would have seen the threshold for inclusion fall from €750 billion to €8 billion in non-cleared derivatives aggregate average notional in September 2020, bringing more than 9,000 counterparty relationships into scope at once. New documentation would have needed to be negotiated with every counterparty – a significant operational lift and a big stretch on industry resources.

Following the July statement, the threshold will now be set at €50 billion for September 2020 and €8 billion for September 2021. Our analysis shows about one-third of the counterparty relationships originally in scope for phase five will still have to meet the September 2020 deadline, but the remainder will now have until September 2021 to comply.

Of those 3,600 counterparty relationships that are still in-scope from September 2020, roughly 28% are likely to breach the €50 million IM exchange threshold within the first two years of their regulatory IM obligation, assuming they are using the ISDA Standard Initial Margin Model (ISDA SIMM). Of the 5,400 relationships in-scope for phase six in September 2021, 15% may breach the IM exchange threshold.

That's a big improvement on what we had before. But there are still a lot of relationships that need to be documented, and it will be a significant challenge for the industry to get it all done.

To help with the compliance effort, ISDA has developed a number of industry solutions that can be used to implement the requirements as efficiently and consistently as possible. That includes standard ISDA IM documentation, the ISDA SIMM and ISDA Create, an online platform that allows users to negotiate and execute IM documentation with multiple counterparties simultaneously.

Earlier this month, we announced a new custody function for initial margin on ISDA Create, which will enable users to complete all documentation required for regulatory IM on a single platform. We're looking to further develop this service and add other ISDA and non-ISDA documentation. The aim is to create a comprehensive electronic documentation negotiation system, enabling users to capture and store important structured legal data for all their documents.

We also recently launched version 2.2 of the ISDA SIMM methodology, which includes several updates and enhancements. This new methodology is fully transparent – it's available on our website – and can be used by the entire industry.

But our work doesn't stop there. We recently launched an ambitious new initiative to further improve collateral and other post-trade processes, with possible options including greater standardization and automation.

This might include improving the speed of collateral transfer settlement and confirmations, reducing the number of settlement failures, and addressing the mobility of collateral. More broadly, we're looking at the entire post-trade process, from trade confirmation and affirmation to payment and settlement processing.

This is now a big priority for ISDA and will involve not only buy- and sell-side firms, but administrators, custodians and technology and infrastructure providers. We believe this project will help reduce operational risk, improve counterparty risk management and lower costs.

We launched three surveys over the summer to gather industry feedback on key priorities – one on collateral management, one on legal documentation and one on post-trade services and processes. The results of those surveys will be available shortly, together with recommendations for further action – so watch this space.

Capital

Let's turn now to another area where ISDA has constantly moved in step with the industry – regulatory capital. Ensuring we have a capital framework that is consistent, appropriate and risk sensitive has long been part of ISDA's core mission.

Did you know that Basel I, published in 1988 was just 25 pages in length? Fast-forward to Basel II and it had grown to 347 pages. And, as of January 2019, the Basel III framework had reached more than 1,800 pages, and may increase further as the regulations evolve.

The first Basel III consultation paper was issued in 2009, when the financial crisis was still fresh in the memory. Basel III has been a constantly evolving framework since then, and we have worked with our members along the way to provide detailed, aggregated and anonymized data to regulators to show the impact of various requirements on the industry.

To its credit, the Basel Committee has always given careful consideration to our data and analysis, and has taken action where it has been shown that certain parts of the framework could be improved.

For example, the final version of the Fundamental Review of the Trading Book (FRTB) contains a number of revisions and enhancements that ensure the rules are closer to the Basel Committee's original objectives – to develop a comprehensive, coherent and risk-sensitive framework for market risk. We will continue to provide detailed analysis on how these changes impact capital levels.

We are also working hard in other areas – for instance, the credit valuation adjustment (CVA) capital rules, where our analysis shows targeted amendments are still necessary.

But we're not stopping there. Following publication of the final Basel III framework, we will monitor how these rules are applied in each jurisdiction. We are also focusing on specific implementation solutions.

For example, most banks will have to implement the standardized approach for calculating capital under the FRTB, even if they also intend to use internal models. The question is how to ensure each firm implements the regulations and develops its standardized model as efficiently as possible and in a way that is consistent and comparable with others.

ISDA has been working with a number of banks active in the UK on an initiative to support accurate, efficient and consistent implementation of the FRTB's standardized approach (SA). This will help banks to ensure they are meeting best practices in their implementations.

The next step will be to expand this service further, possibly to other geographies. This is new territory for ISDA, and we are enthused by the opportunity to add value for our members in such a critical area.

The project bears many similarities with the work we have done on the ISDA SIMM. There, we developed a single model for calculating margin that ensures consistency and transparency, and cuts down on the potential for disputes. ISDA conducts quarterly monitoring to analyze performance, and runs annual calibration, back-testing and benchmarking exercises to ensure regulatory compliance.

Because firms don't each have to develop and maintain their own models, running costs are significantly reduced. We think our work on the FRTB-SA will bring similar efficiencies to bank implementations.

As national regulators finalize their capital rules and banks ramp up implementation efforts, ISDA will continue to identify opportunities to bring the industry together to develop effective, consistent solutions.

Benchmarks

It's difficult to talk in any detail about industry challenges without mentioning benchmark reform. ISDA has been actively working on this front for several years, and I'm pleased to say we are now reaching a big milestone in our work on fallbacks to the key interbank offered rates (IBORs).

Did you know that the 20 panel banks that contribute to LIBOR across different currencies have only committed to ensuring the sustainability of the benchmark for another 834 days? That equates to about 20,000 hours, or 1.2 million minutes.

That might seem like a lot of time. It really isn't given the scale of the challenge – and that clock won't stop ticking.

With more than $370 trillion in exposure to IBORs across the financial sector, this is not an issue that any single firm can tackle by itself. As with margin and capital, we need to work together to come up with industry solutions to the shared challenges we face.

Led by the public- and private-sector working groups in the US, EU and elsewhere, the industry has come together to coordinate adoption of the alternative risk-free rates that will replace LIBOR and other IBORs, and to create a clear pathway for transition. ISDA has played an active role in these groups, and has worked to raise awareness of the issues.

As policy-makers have noted, the transition is now picking up pace. Trading volumes in the risk-free rates are increasing, although there is still a way to go. Meanwhile, ISDA has led the work to develop robust contractual fallbacks for derivatives contracts. On this front, I'm pleased to say that the end is now almost in sight.

Fallbacks have often been compared to a seatbelt or parachute. Just as it would be reckless to drive a car without wearing a seatbelt, or to jump from a cliff without a parachute, having robust, consistent fallbacks should be a no-brainer when the days of LIBOR and other IBORs are clearly numbered.

Many of you will know that ISDA carried out a detailed consultation last year to determine the adjustment methodology that should apply to risk-free rates if and when fallbacks apply. In July, we published the results of our second consultation, which covered several other benchmarks, including US dollar LIBOR. Both consultations revealed a strong industry consensus on the preferred methodology for the adjustments.

These adjustments may be technical, but they are critically important. They aim to mitigate the inherent structural differences that exist between the IBORs and the risk-free rates that will replace them in a fallback scenario. This includes the fact that the IBORs are available in multiple tenors, but the risk-free rates are overnight. The IBORs also incorporate a bank credit risk premium and a variety of other factors, while the risk-free rates do not.

Publication of the adjustments will provide certainty and transparency to the market, and will help to ensure the contracts function as closely as possible to the counterparties' original intentions after a fallback kicks in.

We recently selected Bloomberg as an independent third-party vendor to calculate and publish those adjustments. Our current focus in this process is an additional market-wide consultation to further fine-tune the parameters and mechanics for the adjustments. Step by step, we are developing a sound infrastructure to support the new fallback framework.

Our aim is to finalize the amendments to the ISDA definitions and develop a protocol for legacy contracts by the end of 2019. By mid-2020, the new fallbacks will be up and running. This represents a big step forward to reduce the systemic threat of a permanent IBOR discontinuation. It's a step we are taking together with the industry, and one of which we can be very proud.

Conclusion

So let's see: I've been speaking for nearly 15 minutes; how many steps have I clocked up? Not so many. It just goes to show there is a difference between the physical steps we take with our legs and the metaphorical steps we take with each other. In the latter case, we've come a long way in a relatively short amount of time.

In my remarks this morning, I have brought you up to speed on some of the biggest projects we at ISDA are focusing on in three critical areas – both new initiatives and work that has been ongoing for some time.

I talked earlier about the importance of not working in isolation. Whether clocking up steps as part of a team or working to tackle complex, technical challenges that impact the derivatives market, the same principle applies. Together, we can achieve more.

On margin, capital and benchmarks – as in everything else – you can count on ISDA to move in step with the industry. That way, we make sure that, together, we are able to solve the problems that are too big and too complex for any single institution to tackle on its own.

Thank you.