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CEO Opening Remarks – The Future of the Derivatives Market
Scott O'Malia
8:45am, April 25

Good morning, everyone. We are here to talk about the future of the derivatives market. But the future is hard to predict. Think about how all those classic sci-fi films of the past viewed the era we live in now. They never got it quite right, did they?

We're still waiting for the moon bases in 2001: A Space Odyssey, and the flying cars and hoverboards in Back to the Future II.

Perhaps science fiction writers can be forgiven for missing the mark. It's hard enough to make accurate predictions a few years ahead, never mind 30 or 40.

Just think about our industry. Who would have predicted Brexit five years ago, or the emergence of distributed ledger and cryptocurrencies? Who would have foreseen that artificial intelligence – the technology behind Skynet in the Terminator films – would be trialed as a trading tool?

So, at this year's AGM, I will refrain from predicting the future. Instead, I'll share the critical work ISDA is doing to transform the derivatives market and provide critical risk management tools that will lower costs and make the market more efficient.

In my remarks this morning, I'll cover three areas where ISDA is investing considerable time and effort. First is our effort to update our legal documentation. Here, our legacy is our strength as we develop solutions for Brexit, benchmark reform and the new initial margin regime.

Second is technology and how we are helping the market adapt to new automation and efficiency.

Third, I'll turn to another focus for our future – the development of new markets.

In the journey into the future, we are guided by you – our members. According to a survey we published yesterday, you – the market participants – are optimistic about the future of derivatives. Asked to rate the level of optimism on a scale of one to 10, with 10 being most optimistic, 65% opted for between seven and 10.

More than 80% think derivatives volumes will remain the same or increase over the next three to five years. And the same proportion think end-user activity will rise or remain unchanged over the same time frame.

So, we shouldn't look to the future with foreboding.

Nonetheless, big issues like benchmark reform, initial margin rules and the emergence of new technologies will bring transformative changes to derivatives markets. We don't know exactly what those changes will look like, but we can make sure we have the right foundations in place to prepare for possible future outcomes.

Those foundations are sound. Over the course of three decades, ISDA has been at the forefront of efforts to build up a solid base of industry standards, documentation and definitions that have formed the bedrock of the market. This has created a sturdy framework for trading derivatives globally, and brought legal certainty to our global market. This legacy is our strength.

But we also recognize that these documents and standards need to evolve with the market, and keep pace with regulatory evolution and technology.

Benchmarks

It's difficult to underplay the importance of getting benchmark reform right. It's not something any of us can ignore. Total outstanding notional IBOR exposure is estimated at over $370 trillion. ISDA's goal in this process is twofold – ensuring the viability of transactions, and the continued liquidity and safety of the market as a whole.

An important means to achieving that goal is our work to develop robust fallbacks for derivatives contracts that reference certain key IBORs. Once agreed, these fallbacks will be incorporated into ISDA's 2006 interest rate definitions. As amended, the definitions will stipulate the fallback rates that would apply if a key IBOR is permanently discontinued. This will cover new trades, but ISDA also expects to publish a protocol to incorporate the fallbacks into existing trades.

ISDA will shortly release a consultation on the proposed fallbacks, as well as the relevant credit spread methodology and term fixing adjustments for review and comment by the broader market. Your feedback is essential, so keep an eye open for this consultation.

The other key aspect of benchmark reform is the transition to alternative risk-free rates. This work is driven by concern about the robustness and viability of certain IBORs amid a lack of underlying transactions in the unsecured bank funding market.

As you can see from the slide, this work has been ongoing for some time, and significant progress has been made. Public-/private-sector working groups in a number of key jurisdictions have selected alternative risk-free rates, and are now working through the details of the transition.

To help raise awareness of the issue and support a smooth transition, ISDA and our partner associations published a benchmark transition roadmap earlier this year. We've also conducted a global survey of market participants to determine the issues they face and to identify possible solutions – we'll be publishing the results in the second quarter. As the transition efforts progress, we stand ready to make further changes to documentation and develop protocols as necessary.

With the significant changes that will be required as a result of benchmark reform, ISDA is also preparing a major new initiative to revise the 2006 definitions. Part of this is about making sure the definitions incorporate important developments like benchmark reform. But it's broader than that. We want to make sure the definitions are current and reflect market experience and feedback, and we want to deliver the final product in a technology enabled manner. I'll come back to technology later in my remarks.

It's important all of us are engaged on benchmark reform. On a scale of one to 10, 53% of respondents to a new ISDA poll rated the scale of the benchmark reform challenge at seven or higher. We encourage all of you to read the roadmap, take part in our working groups, and get familiar with the work of the public-/private-sector working groups.

Fortunately, we have several members of those groups on our first panel of the AGM on benchmarks – so stay tuned.

Brexit

I opened by talking about unpredictability. Well, there's nothing as unpredictable facing our markets as Brexit.

The implications for derivatives range from the treatment of third-country CCPs by European authorities to the effect on outstanding contacts. But, nearly two years on from the referendum, there are no definite answers to what the impact will be.

That hasn't stopped the industry thinking about the possible outcomes, and preparing for some of the eventualities. The least desirable outcome would be a so-called hard Brexit, where there is no agreement between the EU and UK.

Considering these outcomes has colored our response. For example, ISDA is currently working on French and Irish law Master Agreements for those counterparties that want to continue trading under an EU member state law post-Brexit. That might be because they want to retain the automatic recognition of EU member state court judgements across the EU 27, or because they want to keep certain benefits of EU legislation. Both documents are out for consultation, and will be published at the end of the second quarter.

To be clear, this doesn't mean the English law Master Agreement will not be valid. There will be good reasons to continue using the English law Master Agreement or to use an EU-law-governed agreement post-Brexit. This is about providing options to the industry and being ready for all eventualities.

Another issue that's got a fair amount of airtime is the treatment of existing trades between EU and UK counterparties, and whether they will continue without interruption post-Brexit. It's important to stress here that existing derivatives contracts between UK and EU counterparties will not suddenly become void after Brexit. Firms will continue to be able to make payments, transfer collateral and settle existing contracts, whatever the outcome.

However, carrying out certain lifecycle events on those trades, such as novations and portfolio compression, may become more difficult. We are fighting for an agreement that protects all existing contracts. The simplest way to deal with it is to include language in the withdrawal agreement that allows counterparties to continue to manage their contracts as before.

It's clear that market participants are thinking hard about these issues: 44% of our survey respondents rate the challenge of Brexit as seven or higher, on a scale of one to 10.

Initial Margin

As I've shown so far, ISDA is committed to developing solutions to help participants solve common industry problems. One of the biggest tasks faced by the market in recent years has been the introduction of new margin rules for non-cleared derivatives.

This task is about to get even more challenging as the threshold for compliance drops, especially when a wider universe of smaller firms – literally hundreds of counterparties will come into scope in September 2019 and 2020.

The compliance burden is significant. Initial margin documentation will have to be negotiated. Custodial relationships will need to be set up. Margin calculation systems and processes will need to be put in place.

The 20 largest dealers managed to get this done when they came into scope in September 2016. But we can't underestimate the challenges for smaller firms without the same resources – particularly when so many entities will come into scope at the same time. It will be the biggest IM implementation hurdle we've faced so far.

We've just published a fact sheet on the necessary preparations for this implementation. It includes a list of steps that counterparties will have to take if they're going to be ready for day one. As you can see, there is a lot to think about, and a lot of work to be done, so firms should get going as soon as possible.

According to the ISDA survey, almost 50% of respondents believe that preparations for the next stages of the IM rollout are already behind schedule. That's a worrying statistic.

Implementation is not helped by the fact that many of these processes are still manual and resource intensive.

Can you believe that a large chunk of collateral in the market is exchanged and confirmed via fax machines and wet signatures? In a world where I can buy a can of soda with a thumb print on my smartphone and autonomous cars are being tested on city streets, there's no reason why we can't develop a modern, automated method for exchanging collateral.

ISDA has focused on developing industry solutions to help firms comply with the rules. Two years ago, we published the ISDA Standard Initial Margin Model, which for the first time established a common methodology for margin calculation, reducing the potential for disputes.

We're now working on a number of other initiatives to optimize and automate the collateral process. For example, we're introducing a standard taxonomy of CSA terms, and a standard for margin call issuance and response. We are also drafting next-generation initial margin documentation to support the September 2019 and 2020 rollouts.

What's more, we're looking to automate and digitize the documentation process. We've partnered with Linklaters to design an online IM documentation negotiation tool, which is scheduled for rollout in early 2019.

Called ISDA Create – IM, it will provide a more efficient way to negotiate individual contracts on a mass scale. Firms will be able to select the provisions they want simply by clicking on a screen. Once they've specified their election choices, the documents can be sent out to multiple counterparties at the same time. The system automatically matches these against the elections made by other firms, flagging up areas of difference.

This will make the whole negotiation process much more efficient and less time consuming. Once the negotiations are finished, the document can be confirmed electronically, and added to the participant's existing legal archive.

Critically, this data is stored digitally, and can be used to inform strategic decision-making and risk management across the firm.

The next-generation IM documentation will be the first documents to be supported on ISDA Create, ISDA's new digital documentation platform.

This is a great example of ISDA building on existing standards and documentation to bring modernity to the market. Addressing the challenges of the future doesn't mean reinventing the wheel. We can use the legacy of the past three decades to provide solutions for the next three, and beyond.

Technology

Collateral isn't the only area where we're looking to bring greater automation. We want to radically change the whole market, and prepare it for the future.

There is wide recognition that modernization is needed. According to our survey, 50% of respondents believe that new technologies will bring cost savings right across the firm.

We are very excited to be close to launching the first digital version of the ISDA Common Domain Model. This is a hugely ambitious project that tackles the very foundations of our infrastructure. Its intention is to create a standard blueprint for events and actions that occur throughout the lifecycle of a trade. It will essentially set out the very fabric of the market – it will support how derivatives are traded and managed across the lifecycle, describing how each step in the process is represented. This will bring order and commonality to the execution and post-trade management of derivatives transactions, which is currently a complex and costly mess.

At first glance, the CDM can be a tricky thing to get your head around. When I think about it, I'm reminded of the animal trees I studied in high school biology. Every animal is different, but at some level they share basic characteristics.

Take cats, for instance. They're not all the same. Some of them can happily sit on your knee while you watch TV. Others might make you want to run a mile. But they all have fur, they all have tails, they all have claws. They belong on the same 'tree'. Putting them in the same family group helps biologists classify the natural world.

This is what the CDM will do for derivatives. Interest rate options, FX options, equity options – on the face of it, they're all distinct, but they all have common features. For example, the payout mechanism is pretty much the same for each of those products – payout occurs after a strike is breached.

The CDM essentially breaks down each event that occurs through the lifecycle of a trade into standardized, reusable modules. These modules are then spelled out for each event. Firms and fintech providers can then take that common code, and apply it consistently across all infrastructures to describe events and processes in the same way.

Think about the London underground map. It's a common representation of how the system works, where it interacts and what the stations are called. Once you have that in digital form, you can create all kinds of cool services.

When I moved to London with my family three years ago, we had an important ally in the Citymapper app. We used that app to find out the best route from one location to another. It told us where to change trains and which routes were faster. But imagine what a different experience it would have been if the standard London underground map didn't exist, and each service provider used its own unique representation of how the system worked. We'd still be able to get around, but it'd be a lot more confusing.

Outside on our FpML stand, you can see what we have achieved so far. We've now modelled the core products in interest rates and credit, and the most important lifecycle events. The first full digital version of the CDM will be published next month. From that point, we'll be working with market participants, fintech companies, infrastructures and others on proofs of concepts. We'll essentially be throwing it out to the market for the next phase of development work. We hope all of you will get involved, work on proofs of concept and help make the CDM effective.

We’ve got two panels on technology tomorrow, so make sure you listen into them. The first will look at the potential for new technologies like distributed ledger, cloud and artificial intelligence. The second, tomorrow afternoon, will feature some of the institutions that might use the CDM, and explore how the industry can go about adopting it.

New Markets

I’ve talked about documentation and technology. But there’s another aspect of our future we can’t ignore, and that’s geographical.

Different jurisdictions are moving at a different pace, but we believe hedging and risk optimization bring an important benefit to economies. The certainty that derivatives provide give firms the confidence to borrow, lend and invest.

It’s therefore incumbent upon us to provide whatever support we can to ensure these markets are built on firm foundations.

Part of that means continuing to advocate for cross-border harmonization and globally consistent regulatory standards. Our markets work best when they are global, and when participants can access as wide a liquidity pool as possible. I’ll have more to say on this topic later today.

Another major part of our effort is securing legal certainty for trading. Everyone here knows how much we care about effective close-out netting. It’s an area we have worked tirelessly on for decades. It is a bedrock of sound risk management, reducing costs for all participants. The treatment of non-netting jurisdictions under the new margin requirements for non-cleared derivatives provides an additional incentive.

We’ve worked with authorities across the globe to explain the benefits of netting and to support efforts to create effective close-out netting regimes. Nowhere is this more important than China. China’s economy is absolutely central to global growth, and it is vital that domestic and overseas firms can access a safe and liquid onshore derivatives market. The legal certainty that netting brings would further enhance this market.

We’re making progress here. Last August, a letter from China’s banking regulator was made public that expressed support for close-out netting. That was great news for market participants. While the statement does not eliminate uncertainties about whether close-out netting would be enforceable in a Chinese court, public support for close-out netting by the Chinese banking regulator marks a big step forward.

Earlier this month, we also received good news from Chile, where netting regulations have been produced, and are under review. Likewise, Saudi Arabia has enacted enabling provisions with regulations to come. In Argentina, Morocco and Serbia, provisions that would provide effective netting are currently awaiting approval by the respective authorities in each country.

Netting certainty doesn't happen fast. It's a long process, and it spends a lot of time rumbling away quietly in the background. But it's hard to overstate its importance. You can be sure this will continue to be a major area of focus for ISDA.

Conclusion

In these remarks, I've talked about the future, and about the preparations we are making. I've touched on what ISDA is doing to update industry standards and to make sure we have a market fit for the future.

Over the past decade, the market has adopted many new regulations, new practices and new standards. ISDA has been your partner each step of the way. We've helped the industry overcome obstacles and implement market and capital reforms. We will continue to walk beside you on the road ahead.

The industry is on the cusp of major changes. There is so much work to do in so many areas. But let's not forget that the future holds promise too. The derivatives market is safer and stronger now than it has ever been. There is confidence that overall derivatives volumes will continue to increase in the years ahead, and that liquidity will remain robust, as our survey has shown. I believe we have a lot to look forward to, and you can be sure that ISDA will be there with you to build a better market.

All that's left for me to say is thank you for coming. Thanks also to our sponsors and exhibitors that help make our AGMs so special. I hope you enjoy the next two days in Miami. The agenda certainly has something for everyone – in-depth panel discussions, fireside chats and keynote speeches. I hope you all get a chance to link up with old colleagues and friends, and make a few new ones too.

Thank you.