ISDA Europe Regional Conference
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CEO Opening Remarks - Scott O'Malia

Good morning, everyone.

The more observant among you may well have noticed that one of the images in our opening sequence was Lord's Cricket Ground. Now, Lord's is close to where I live. And for the past couple of years, I've watched as huge crowds have trudged to the ground for big games, some dressed in their colorful red and gold ties or blazers, and wondered what all the fuss is about.

So, this year, I decided to find out. I've been to two Twenty 20 game at Lord's. I had a great time, but I have to admit – I was baffled by much of what was going on. You play ***on*** a wicket, bowl ***over*** or ***around*** the wicket and you try to ***take*** a wicket. For a beginner to the game, it's all very confusing.

So I thought I throw myself in the deep end and play a game. A couple of weeks ago, we held our first Twenty 20 charity cricket match against FIA at a local cricket club.

The good news is, we raised a few thousand pounds for the charity Futures for Kids. And, as an added bonus, the game of cricket now makes much more sense to me. The bad news is, we lost.

Congratulations to FIA – it was a great game. But we have our eye on the rematch in 2019. We want another shot at winning the trade association Twenty 20 title.

As it happens, 2020 is the focus of my remarks this morning. This may come as a disappointment to some of you, but I don't mean cricket. Instead, I want to focus on the changes facing the derivatives market, and the fact that many of those changes will reach a critical point in 2020.

Just think about what 2020 means for the derivatives market. The final phase of the initial margin requirements for non-cleared derivatives will be rolled out in September of that year. The transition period for the EU Benchmarks Regulation is due to have expired, and industry efforts to adopt risk-free rates as an alternative to interbank offered rates will be at a crucial juncture. And then there's Brexit – which either would have occurred, or will be about to occur following the end of a transition period.

Margin, benchmarks, Brexit. These are all enormous challenges facing our market. Even if we tackle them one by one, they would tax the resources of market participants to the limit. Together, they will put an enormous strain in the ability of firms to comply.

2020 might feel like a long time away, but I assure you it's not. Early preparation will be critical, as will industry coordination and cooperation – and ISDA has been working hard to develop solutions to help.

I’m going to touch upon each of those issues in my remarks today.

First, I’ll describe some of the work ISDA is doing in the margin space, and the importance of preparing early for the 2020 phase-in. Second, I’ll update you on the global effort to reform benchmarks – particularly ISDA’s work to develop fallbacks. Finally, I’ll touch upon Brexit, and the issues we think need to be resolved.

Initial margin

I’ll start with margin. The requirement to post initial margin on non-cleared derivatives trades has been implemented in stages since 2016, but September 2020 will see the threshold for compliance plunge from €750 billion to just €8 billion.

This change will exponentially increase the number of entities subject to the rules, many of which will be smaller banks and buy-side firms that pose little or no systemic risk. According to ISDA estimates, over 1,000 new firms will come into scope of the rules from September 2020. This works out at more than 9,000 trading relationships between in-scope counterparties that will be affected.

Many of the newly in-scope firms will be familiar with posting variation margin, but initial margin is a very different concept that will require systems and processes to be adapted or built from scratch. New documentation will need to be negotiated and agreed with every counterparty. Third-party custodial relationships will need to be set up. Initial margin calculation methodologies will need to be implemented and tested. And all of this comes at a time when everyone is doing the same thing.

Despite the cost of this compliance initiative, new ISDA analysis shows the vast majority of these firms will post little or no initial margin, because the size of their derivatives exposures fall below the €50 million initial margin exchange threshold.

Without a change to the €8 billion level, these smaller companies face a significant compliance burden without actually posing enough of a systemic risk to require margin to be posted.

The pressure on resources across the industry will also be severe, potentially leading to disruption in the non-cleared derivatives market.

It may not seem like it looking around this room today, but there are only so many lawyers available to negotiate the documentation. Unless firms start their implementation efforts now, there is a real risk of a compliance bottleneck come 2020.

ISDA has been working to raise awareness of the issue, and to develop solutions to help firms with implementation.

We recently published guidance on the steps firms will need to take in order to comply with regulatory initial margin requirements. As you can see, there’s a lot that needs to get done. Some of these steps will require a lead time of 18 months or so, so it’s absolutely vital that firms start thinking about this now.

To help firms with their compliance efforts, ISDA has developed a variety of industry solutions. Two years ago, we published the ISDA Standard Initial Margin Model, or SIMM, which established a common methodology for margin calculations, reducing the potential for disputes.

Last month, we published version 2.1, which includes updates based on a full recalibration and industry back-testing of the methodology. The ISDA SIMM has become the industry standard for initial margin calculation, and so newly in-scope counterparties will have the ability to apply a methodology that is well tested and approved for use.

On top of this, we're working to automate the process of negotiating collateral documents through our new ISDA Create – IM service. This will enable firms to create, negotiate and execute derivatives documents completely online, and with multiple counterparties simultaneously. This will make the negotiation process much more efficient and less time consuming.

A beta version of the online tool will be launched in the next few days, so look out for that. We'll also be talking more about this initiative later on today. Please also take an opportunity to visit the ISDA Create stand and ask for a demonstration.

Benchmarks

I'd now like to turn to the issue of benchmark reform.

This is another huge task for the industry. In fact, I can't think of any other event past or present that even comes close in terms of scale and impact.

From derivatives, to loans, to mortgages, to deposits – LIBOR and other key IBORs saturate financial markets, with total exposure estimated at more than $370 trillion. The adoption of risk-free rates as alternatives to the IBORs will therefore be felt by virtually everyone.

The reliability and viability of the IBORs has been in doubt for some time. That's because there's been a sharp decline in unsecured interbank funding markets, which underpin the IBORs.

Work to prepare for adoption of alternative risk-free rates has been under way for several years, led by various public-/private-sector working groups. But the market is acting under a tight schedule. In the case of LIBOR, the UK FCA has declared that it won't compel or persuade panel banks to make submissions after the end of 2021.

Considering the scale of the task, it is simply not possible to leave this until the last minute. 2020 will therefore be a crunch year – even more so because the transition period for compliance with the EU Benchmarks Regulation is due to expire at the end of 2019.

Given EONIA is not expected to meet the requirements of the EU Benchmarks Regulation, the market will likely be adapting to a new rate from the start of 2020. The ECB recently announced that it will publish a new euro short-term rate called ESTER, which it expects to be available by October 2019. Given the short window between October and end-2019, it means as much preparation as possible will need to be completed beforehand.

ISDA has been working to raise awareness about the issue, and support the industry as it prepares to adopt alternative risk-free rates.

In June, we published a survey and report on benchmark reform, which includes an implementation checklist for market participants. If you haven't read that paper, I'd encourage you to do so.

There has been some progress since that report was published. In the US and UK, we've seen the emergence of futures products and clearing services for swaps linked to the new rates. Cash bonds linked to SOFR and SONIA have been issued. And several of the public-/private-sector working groups are looking at the development of forward-looking term rates. These are all critical developments that will help build liquidity in the alternative risk-free rates and encourage adoption.

But it's vital that everyone engages with this now. Develop an IBOR transition program, allocate budget and resources, assess your firm's exposure to the IBORs. Don't get left behind.

Aside from the adoption of alternative risk-free rates, ISDA is leading an initiative to implement robust fallbacks for derivatives contracts referenced to certain IBORs.

Having robust fallbacks is critical for the stability of the financial system. If an IBOR permanently ceases to exist, it is vital that market participants have certainty that their existing IBOR contracts will fall back to a robust and clearly defined reference rate. Following consultation with the industry, regulators and the FSB, it was determined that the fallbacks will be the risk-free rates identified by the relevant public-/private sector working groups as an alternative to the IBORs.

However, if a fallback rate takes effect, it's important that it occurs with the minimum amount of disruption. We launched a consultation in July that sets out some potential options for adjustments that would be made to reflect the differences between IBORs and overnight risk-free rates. They're listed on the screen behind me. I won't explain each of the options, but I would strongly encourage you to read the consultation – it is available on our website – and respond by the October 12 deadline.

We need your views on this. The success of the fallback implementation ultimately depends on broad market input on these issues.

As well as working on fallbacks for certain IBORs, we also published a new Benchmarks Supplement last week. This was published in response to the EU Benchmarks Regulation, which requires counterparties to set out the actions they would take if a referenced benchmark is materially changed, ceases to be provided or is prohibited from use. Unlike the IBOR fallbacks work, the ISDA Benchmarks Supplement covers derivatives that reference interest rate, FX, equity and commodity benchmarks.

Together, benchmarks and the broader phase-in of initial margin requirements will require a monumental effort from the industry. But at least the implications of the two changes are largely understood. With Brexit, it's not yet clear what the rules will be, nor whether the UK and EU will agree a withdrawal agreement and transition period before March 29, 2019.

Brexit

There's obviously a lot we don't know about Brexit. But, unless some alternative arrangement on its status is agreed, the UK will become a third country under EU law at the point it leaves the EU.

It will be a very unusual third country, though. The minute it leaves the EU, the UK's regulatory framework will be absolutely identical to the EU's.

Depending on the terms of the withdrawal, the UK might opt to seek equivalence determinations from the EU. This will be a real acid test for the cross-border framework. Given the fact the rules between the two will be the same, anything other than a quick equivalence determination would be a massive setback for cross-border harmonization – not just for the UK, but to all third countries trying to access the EU.

Even a short delay between the UK becoming a third country and being deemed equivalent by the EU could cause disruption. For example, EU 27 counterparties would be unable to act as clearing members at UK CCPs at the point the UK becomes a third country, and neither they nor their clients would be able to clear products subject to the EU clearing mandate until UK CCPs are recognized by the EU.

There may also be challenges in servicing existing derivatives contracts between EU and UK counterparties. While the contracts themselves will remain legally valid, it may not be possible in many cases for counterparties to perform important lifecycle events such as the exercise of options, the rolling of open positions, portfolio compression and material amendments. These occur regularly and are vital to the efficient functioning of the derivatives market.

Firms need to be authorized in the UK and EU to conduct these activities, but may no longer have the necessary permissions in the other jurisdiction after Brexit. Without remedy, the only way these legacy contracts could continue as before would be to transfer them to a locally authorized entity.

A transfer of this scale has never before been attempted, and is operationally unlikely without regulatory and legislative support from the EU and UK.

At ISDA, we're working to identify the possible impacts of these Brexit-related challenges on the derivatives market, and to recommend solutions. We've shared a paper with regulators in the EU that explains the challenges associated with transferring large numbers of contracts, and we've drafted language for the continuity of existing derivatives contracts for inclusion in a withdrawal agreement. We are also developing a Brexit paper that identifies the cliff-edge effects of a hard Brexit. In addition, we have launched French and Irish law Master Agreements to provide options for those institutions that would prefer to continue trading under an EU member-state law with EU court jurisdiction clauses once the UK leaves the EU.

We think many of the potential challenges should be addressed through the withdrawal agreement, or through legislative or regulatory action by the UK and the EU. However, we would also urge European regulators to put backstop arrangements in place – for example, a temporary permissions and recognition regime, similar to what UK authorities have said they will implement. This will enable firms in the EU 27 and UK to carry on doing business until a permanent authorization or equivalence determination is achieved, minimizing disruption to global markets in a hard Brexit scenario.

Conclusion

I'd like to finish by taking you back to cricket. After my game of Twenty 20 cricket earlier this month, one thing became clear to me. You've got to get a good start. You can't spend the too much time blocking. You need to get runs on the scoreboard. Before you know it, you're out of time and you haven't done nearly enough.

The same goes for the three issues I've discussed today. As I've shown, 2020 will be a pivotal year for the derivatives markets. Early action, industry coordination and mutualized solutions will be critical to avoid disruption. Throughout it all, you can count on ISDA to develop those industry solutions. Together, we'll work to ensure derivatives markets remain safe and efficient.