ISDA Annual General Meeting
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Chairman Remarks
Eric Litvack, ISDA Chairman

Good morning, everyone.

It's great to be back in Chicago again, a city that is truly steeped in financial history. It's here that the Chicago Board of Trade introduced the first standardized futures contracts in 1865, a big step on the path to the development of modern derivatives markets. It's also here that the Chicago Butter and Egg Board, a forerunner of CME Group, was founded in 1898, reinforcing Chicago as a focal point for the trading and risk management of commodities.

So, it seems very apt that Chicago is the location of this year's Annual General Meeting (AGM). But, as the students of history and assiduous participants at our AGM will know, the story of derivatives and risk management didn't start here. From Mesopotamia in the second millennium BC, to ancient Greece and Rome, to Renaissance Italy, 17th century Amsterdam and 18th century London and Paris, forms of derivatives have existed for centuries, enabling people to reduce uncertainty and transfer the risk associated with trade and commerce.

The 19th century Chicago exchanges took those rudimentary risk mitigation tools and codified them, just as subsequent generations have developed them further. It is the job of all of us to act as the latest custodians of this market, to help advance it where we can, and then to pass a safer, more efficient iteration onto the next generation. I've said in previous speeches that we stand on the shoulders of those who came before us. If those who come next can say the same about us, then we would have fulfilled our responsibilities.

We take this duty very seriously at ISDA. Fostering safe and efficient markets has been our watchword since inception – an effort that started nearly 40 years ago with the launch of the ISDA Master Agreement. That work continues to this day. Recent examples include development of robust contractual fallbacks for derivatives linked to LIBOR, launch of the ISDA Standard Initial Margin Model (ISDA SIMM) to enable consistent initial margin calculations, and our rapid response last year to help firms understand and manage the implications of the Russia sanctions. Each of these represent solutions that ensured derivatives markets continued to function effectively.

We're proud of these achievements. But, in a constantly changing world, there are new challenges that must be addressed to maintain resilience. Most recently, attention has focused on issues that led to the collapse of Silicon Valley Bank and Signature Bank, as well as the acquisition of Credit Suisse by UBS.

Regulators and market participants are also looking closely at the recent spate of liquidity crises in key markets. Starting with the March 2020 dash for cash, we've subsequently seen extreme volatility in commodity markets following the Russian invasion of Ukraine early last year and a rapid blowout in gilt yields in September 2022, which forced the Bank of England to intervene to restore order.

These liquidity crises all had different triggers and trajectories, but they also had a lot in common: each time, an initial acute market shock was followed by a liquidity squeeze and widespread selling of assets, risking disruption to the functioning of essential markets like US Treasuries and UK gilts. The potential for contagion and the impact on financial stability means this is something that has to be analyzed, understood and addressed.

Happily, the financial system as a whole is more robust than it was 15 years ago. Mandatory central clearing, margining of non-cleared derivatives and higher capital requirements have helped to mitigate counterparty credit risk – an issue that was at the center of the 2008 crisis.

But while dialing up the needle on these vulnerabilities has reduced contagion as a result of counterparty credit risk, it's meant the system has become more susceptible to liquidity crunches in the event of market shocks. We've pushed the tension points elsewhere, and that, in turn, requires careful consideration.

The widescale sourcing and posting of margin and balance sheet constraints on banks have at times created situations where central banks have had to act to prevent liquidity stresses from spiraling out of control. Objectively, these occurrences have been more frequent in recent years, and that's a source of concern.

As we heard yesterday, regulators are developing a program of work to address this issue while maintaining the hard-won advances in systemic resilience achieved with the 2008 reforms. It's an incredibly difficult balance to get right, and many policy options are on the table. One that has gained traction with regulators is increased clearing of cash US Treasuries and repos.

In September last year, the US Securities and Exchange Commission (SEC) proposed rule amendments that would require Treasury clearing houses to direct their members to clear certain Treasury securities transactions.

Ahead of that proposal, ISDA conducted an industry survey to gather opinion on the implications of increased Treasury and repo clearing. The results revealed a wide variety of views on whether clearing would materially improve the resilience and efficiency of the US Treasury market. While most respondents were largely supportive of clearing, they did not back broad clearing mandates, with strong concerns expressed that this could result in some participants reducing their activity or withdrawing from the market altogether.

The lack of consensus suggests further research on the costs and benefits of increased clearing in the US Treasury market is necessary to help clarify what it is we're trying to achieve. Given the pivotal role that US Treasuries play in the financial system, including as collateral for derivatives markets, it's essential that the scale and timing of this proposal is very carefully considered and calibrated. We look forward to engaging further with the SEC as the proposal is developed, as well as with affected market participants and infrastructure providers.

Among other policy options, regulators are also looking closely at margin practices and have identified six areas of further work, including increasing transparency in cleared markets, enhancing the liquidity readiness of market participants and evaluating the responsiveness of cleared and non-cleared initial margin models to market stress.

For non-cleared derivatives, the ISDA SIMM performed robustly during the recent crises, and initial margin remained relatively stable, thanks to the model's intentionally conservative design. Nonetheless, we've taken quick action to review the methodology, working closely with global regulators and ISDA SIMM users to ensure continued resilience and effectiveness.

Following this analysis, we reduced the thresholds at which firms need to report and remediate margin coverage shortfalls, and cut the time they have to address the deficit. We've also introduced a quarterly check to determine whether any recent market stress warrants a recalibration of the model outside of the usual annual cycle, enabling potential issues to be flagged more quickly.

We'll continue to have close dialogue with regulators as the work on margin practices progresses, and will provide support wherever and however we can.

As well as ensuring margin models are transparent and resilient, and firms have resources to meet elevated margin calls during periods of stress, it's also critical that the collateral gets to where it's supposed to be quickly and efficiently.

Unfortunately, that's not always the case, and the recent crises showed that collateral operations at some firms can get clogged up during periods of heightened volatility, because parts of the process still rely on manual intervention.

That's not only inefficient and expensive – it's also a source and potential accelerator of risk during a crisis.

Addressing this inefficiency is a big focus for ISDA – and it's also the subject of our latest animation.

As the animation says, ISDA is working on a number of initiatives in this space. For example, we've used the Common Domain Model to develop digital representations of key collateral specifications and operational provisions of ISDA's most widely used credit support documentation, and other uses cases are also in development.

Together, this can – among other things – help counterparty onboarding, enhance interoperability and improve cash collateral calculations and payment processes, increasing efficiency and reducing operational risk.

Of course, this won't stop liquidity crunches from happening, but taking friction out of the system by increasing data standardization and automation could reduce the severity of each crisis.

This won't happen on its own – it requires all of us to act by engaging in the working groups and ultimately adopting the industry standards and best practices. There are clear benefits from doing so – more efficiency, less risk, less resource and, ultimately, lower costs. I very much hope you'll all play your part by contributing to the effort to make collateral management safer and more efficient.

Another way of reducing the impact of market stresses is to further increase the use of post-trade risk reduction. Using portfolio compression and rebalancing to shrink risk exposures lowers counterparty credit risk and operational risk, but also lessens the potential for large margin calls, easing liquidity strains in the event of a market shock.

Unfortunately, take-up has been hampered by the fact that new trades resulting from post-trade risk reduction exercises could be subject to the clearing obligation. We've long advocated for a change on this point, and we welcome the fact that the UK is amending its rules to allow an exemption. We would urge the EU to also include an exemption in the forthcoming revision of the European Market Infrastructure Regulation – something that will further strengthen the resilience of Europe's derivatives market.

I'd like to highlight one more ISDA initiative to help markets function more efficiently – capital benchmarking. We've continued to enhance our benchmarking offering, which helps banks and regulators achieve consistent and accurate implementation of standardized approach capital models.

Users can now conduct their own analysis directly through Perun, a web-based analysis tool developed by ISDA, giving banks the ability to check their implementation against an industry benchmark and identify the reasons for any variation. I'm pleased to report that some regulators have also now hooked up to Perun, enabling them to closely monitor implementation in their jurisdictions whenever they want.

For the 71 banks around the globe that have participated in ISDA's benchmarking initiative, being able to check that they have interpreted and implemented the standardized approach in line with their peers has proved to be a valuable resource. But it's worth pausing for a moment to remember why this focus on the standardized approach is necessary.

According to a recent survey by ISDA, use of internal models is set to fall dramatically under the Fundamental Review of the Trading Book (FRTB). Based on responses, internal model coverage of bank trading desks is set to fall from an average of 86% currently to just 31% under the FRTB. Banks cited high costs and complexities associated with the P&L attribution test, the risk-factor eligibility test and the non-modellable risk factor framework as the reason for their decision.

Which begs the question: is this a good thing? The new standardized approaches are much more risk sensitive than earlier versions, which is certainly welcome. But widescale use of a more uniform model could lead to herd behavior and drive concentrations – everybody potentially buying and selling the same assets at the same time because everyone has identical information from a common capital model. Given recent examples of liquidity stresses and one-way selling in key markets, we should think very carefully about whether this is the result we want to achieve. Maintaining risk sensitivity and appropriateness in the capital framework is critical.

I'd like to finish by echoing what Scott said in his remarks yesterday – that we achieve better results when we work collectively. That requires everyone to pull together to act in the best interests of this market – to take what we have inherited from the previous generation and to pass a safer and more efficient market onto the next. I'd therefore like to thank all of you who participate in our working groups and contribute to that important mission. It's all of you working together that makes ISDA so effective.

I'd also like to thank my colleagues on the ISDA board. The structure of the board has changed markedly in recent years, and there's now much greater representation from the buy side and infrastructure providers, as well as improved gender diversification. This composition is much more reflective of the markets we serve and enables us to make better, more inclusive decisions. Thank you for everything you do.

Finally, I'd like to thank the ISDA staff for driving forward ISDA's initiatives so effectively. We consistently survey working group members to assess views on performance, and I'm pleased to say the average score has increased in each of the past three years. Thank you for your boundless energy, your professionalism and your commitment.

I started these remarks by looking back at Chicago's important role in evolving the derivatives market and the fact that this is one link in a long chain of derivatives development. A part of that story I didn't mention was the emergence of rice futures in Japan in the 17th and 18th centuries, which led to one of the earliest futures trading bourses at the Dojima Rice Exchange in 1730. It therefore seems entirely fitting that next year's AGM will be held in Tokyo. I hope to see all of you there, where we'll further our work to ensure a better functioning, robust and more efficient derivatives market.

Thank you.