**ISDA Europe Regional Conference**
**September 26, 2018**
**Chairman's Remarks – Eric Litvack**

Good morning.

The timing of this conference means that, in recent days and weeks, you will have seen and heard a great deal of retrospective analysis on the financial crisis. Ten years ago, the markets were in a very uncertain place. Lehman had just gone under, triggering a shockwave that turned what had until then been a gradually building credit crisis into a full-blown financial panic.

Within a short period of time, banks around the world were facing existential crises. Many had to be publicly rescued, and credit and trade flows contracted violently, leading to a crushing recession in the real economy.

Anyone who lived through that time has images of it seared in their minds. I recall spending the Sunday before Lehman on the phone with the ISDA board sorting through issues relating to the Fannie Mae and Freddie Mac conservatorship, all the while listening with half an ear to reports of the weekend meeting at the New York Fed to try and cobble together some sort of rescue package.

By dinner time, I had to go and explain to my then eight- and 10-year-old children what a bank collapse meant. Of course, I was wrong: it was actually much worse. At times over the next few weeks, it felt like the entire financial system was close to the precipice.

Thinking back, it really doesn't seem that long ago. But a lot has happened between then and now. In the UK, for instance, we've seen three prime ministers, three general elections and four referendums over that period – the most recent of which, of course, was over Brexit.

A lot has happened in financial markets too, driven by a determination to make the system more resilient. Most banking crises are rooted in depressingly similar fragilities: mismatched liabilities in currencies and maturities, unstable sources of funding, and long-term assets of uncertain quality backed by insufficient capital.

Today, banks are much better capitalized than they were before the crisis. The largest global banks have added about €1.5 trillion of Tier 1 capital to their balance sheets since 2009, and further measures finalized by the Basel Committee last December will result in an estimated €85.7 billion in additional capital. More than €400 billion in additional Tier 1 and Tier 2 bail-in-able capital has also been raised since 2011, creating an extra buffer that can be used to absorb losses during market stress.

Bank liquidity profiles have significantly improved since the crisis, shifting to more stable sources of financing and avoiding mismatches. And, in the event a bank fails, formal processes for recovery and resolution are now in place – which wasn't the case in 2008.

The derivatives market has also undergone fundamental change, in line with commitments made by the G-20 nations in 2009. Around three-quarters of total interest rate derivatives notional outstanding is now cleared, mitigating counterparty credit risk.

Margin requirements are being rolled out, significantly reducing the risk of losses that could follow the collapse of a counterparty. And regulators have much more visibility on risk exposures following the introduction of reporting requirements.

Ten years on from Lehman, the financial system is more robust, more resilient and more transparent.

But, 10 years on, there is now an opportunity to look at the regulatory framework and, with the benefit of time, experience and evidence, consider whether the rules are doing what they were meant to do. Just as importantly, are they doing it in the best possible way?

That doesn't mean reversing the important changes that have taken place, like clearing, reporting, margin and capital rules. But it does mean improving the rules where possible and making the framework more effective and more efficient.

Part of that means eliminating duplication and unnecessary complexity, which adds to compliance costs without any compensating benefit in systemic risk reduction. The regulatory reporting framework is an obvious example.

There is a clear advantage in having greater consistency in data fields, reporting formats and identifier standards across jurisdictions. The current jumble of data requirements and formats not only creates a needless burden for derivatives users; it also muddies the water for regulators and means they are unable to get a clear picture of exposures on a global basis. That cannot be what was intended, and we support the efforts of CPMI-IOSCO to push for greater consistency and coordination in this area.

We also need to ensure the rules are targeted appropriately and meet the stated policy objective of mitigating systemic risk. That means using data to assess whether existing calibrations and metrics are suitable and proportionate, and target systemically meaningful risks and entities.

When it comes to the margin rules for non-cleared derivatives, for example, the threshold for compliance plunges in September 2020 from €750 billion in aggregate average notional amount to just €8 billion. According to ISDA analysis, this will capture more than 1,000 smaller entities, which will need to put new documentation in place, enter into custodial arrangements and adopt initial margin models.

Despite the cost and effort of complying, most of the derivatives exposures of these newly in-scope entities are so small that, despite having to assume the significant operational cost of complying with the margin framework, they will actually exchange little or no initial margin due to the €50 million minimum transfer amount.

Our analysis suggests that a recalibration of the September 2020 threshold to a higher level than €8 billion could exclude a significant number of smaller, non-systemically important entities without a meaningful reduction of the amount of margin posted.

Any such adjustment to the calibration would need to be coordinated globally so that the framework continues to work efficiently on a cross-border basis.

The framework for margin rules has been a rare area in which post-crisis derivatives rules have been highly coordinated. Elsewhere, cross-border harmonization has been less fruitful. While there have been several important successes in agreeing substituted compliance and equivalence, the determinations have, for the most part, been based on granular, rule-by-rule comparisons that take time and can ultimately result in frustration and added complexity.

Derivatives markets are global, which gives companies the ability to efficiently and cost-effectively manage their exposures. For this to function effectively, we need a robust cross-border framework that recognizes overseas rules that are comparable in outcomes, without requiring the rules to be identical, so long as they avoid a competitive distortion.

This was recognized by the G-20 back in 2009, which stressed that the reforms should be implemented in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage.

At ISDA, we believe the answer is for regulators to take a risk-based approach to equivalence or substituted compliance. In other words, regulators should focus comparability assessments primarily on those rules that relate to risk – for example, capital and margin requirements, clearing mandates and regulatory reporting.

In contrast, greater deference should be given where possible to rules that don't address risk, such as trading, public reporting and business conduct. These reflect local market characteristics and trading practices, and so are better left within the remit of local regulators.

Increasingly, regulators are cognizant of these issues. Earlier this month, CFTC chairman Giancarlo announced his intention to relook at the CFTC's cross-border framework to ensure it is calibrated to address systemic risk and allows regulatory deference for overseas rules that achieve comparable outcomes.

This is on top of other CFTC initiatives like Swaps Regulation Version 2.0, which are aimed at improving the US regulatory framework, removing inefficiencies and supporting economic growth.

The EU is also in the process of reviewing the European Market Infrastructure Regulation in order to eliminate disproportionate costs and burdens on smaller counterparties. A key aim is to simplify the rules without compromising the objective of mitigating systemic risk.

We have engaged, and will continue to engage, with regulators on all of these initiatives to provide industry feedback, recommendations and analysis. It's important we continue to move forward with this process and finalize specific, targeted fixes to make the rules simpler and less operationally burdensome. We must also implement the necessary changes to ensure the rules work effectively on a cross-border basis.

Coordination, cooperation and alignment are vital when it comes to the global capital framework as well. A lack of harmonization on the core components of the capital rules would create significant hurdles for internationally active firms, reducing the efficiency of markets and increasing compliance costs.

Fortunately, capital standards benefit from significant alignment because the requirements are agreed at the global level through the Basel Committee. The final Basel measures were published last December, and represent a hard-won consensus between global regulators on issues such as the level of an output floor.

But as attention turns to the transposition of the global framework to national rules, there are inevitably questions about whether national rules will be consistent, both in terms of timing and substance. As well as being consistent, the rules also need to be appropriate and risk sensitive.

This is a particular issue for the Fundamental Review of the Trading Book, or FRTB. Earlier this year, the Basel Committee announced a delay in implementation until January 2022, and published a new consultation on certain technical elements. This includes the P&L attribution test, the treatment of non-modellable risk factors and the calibration of the sensitivity based approach.

The Basel consultation tackles some important issues – the requirements as they stood would have had a negative impact on banks' trading book activities and their ability to make markets and provide hedging solutions to end users.

ISDA has highlighted several areas where we think further work is required to ensure the rules are appropriate and risk sensitive, particularly with regards to non-modellable risk factors. The latest industry impact analysis shows that FRTB capital for trading desks using the internal models approach would be over three times higher than under current rules, largely because of the non-modellable risk-factor requirements.

This would discourage banks from using internal models and reduce liquidity in those products hardest hit by the rules. I'll come back to the importance of risk sensitivity in a moment.

We've proposed a number of simple modifications to the non-modellable risk factor framework, including a widening of permitted data sources to determine whether a risk factor is modellable. We believe these changes will result in better capital alignment with underlying risks, and will reduce the volatility of IMA capital.

We look forward to seeing the final FRTB rules in the coming months.

However, this timing creates some questions on how the rules will be implemented at the local level. The European Commission first proposed its revised capital rules back in November 2016 – more than a year before the Basel reforms were finalized and before the FRTB consultation.

Given the fact the final FRTB rules probably won't emerge until the end of the year, new legislation will be required at the EU level to incorporate these changes. With the parliament elections next year, and a new commission to install, there's a lot to do by the January 2022 start date.

In the US, on the other hand, it's not entirely clear how and when the FRTB will be implemented. In a report published last year, the US Treasury recommended that the FRTB should be delayed until it is appropriately calibrated. However, speaking at the ISDA annual general meeting earlier this year, an official from the Federal Reserve suggested the US will draft FRTB rules once changes are complete at the Basel level. A lot therefore depends on the changes that are made and the impact of those revised rules.

Elsewhere, the EU, the CFTC and the US Treasury have proposed diverging from Basel leverage rules with respect to client clearing. The EU package recognizes the exposure-reducing effect of client initial margin, and the CFTC and US Treasury have recommended taking a similar approach. This will make a big difference to the economic viability of client clearing businesses.

However, the Basel Committee at this stage has only agreed to monitor the impact of the leverage ratio on client clearing for two years. We remain confident this issue will be addressed at the Basel level, and we stand ready to support the Basel Committee in the review process.

On all these issues, our view at ISDA is very clear: we believe the capital framework should be appropriate, risk sensitive and – as far as possible – consistent. We think the Basel Committee should consider adjustments to rules or calibrations at a global level wherever widespread concerns result in the risk of divergence and hard data supports the case for recalibration.

I've mentioned risk sensitivity a couple of times, so I'd like to spend a moment or two explaining why this is so important.

Close alignment between risk and capital ensures the riskiest assets attract the highest capital requirements. If that relationship breaks down and the rules are insensitive to risk, then incentives start to change. Simply put, if the level of capital required for a certain asset or business is greater than what is justified by the risks, and the returns aren't enough to offset the cost of capital, then banks will allocate the capital elsewhere. They will stop trading those assets or pull out of that business.

This is already starting to happen – for instance, in client clearing, where a number of clearing members have pulled back from offering the service. Think about the other areas I've mentioned today, like bank trading activities. Liquidity provision helps markets function efficiently. They ensure companies can access products that transfer risk and reduce the uncertainty that comes with changing business and market conditions. We need banks to act as intermediaries, and to provide the financing and risk management services that are so intrinsic to economic growth.

It's therefore vital that the level of capital allocated to these activities reflects the risks they pose. Go too far beyond what is appropriate and the business becomes uneconomic and, eventually, unsustainable. That reduces the available avenues for firms to access cost-efficient financing and to manage risk.

Ten years ago, the collapse of Lehman revealed real weaknesses in the financial system. Banks were found to have insufficient capital or liquidity to withstand a severe market shock. The bilateral nature of the derivatives market meant there was a network of interlinking trading relationships, which contributed to contagion. A lack of reporting meant there was uncertainty over who had what exposures, which undermined confidence and the willingness to extend credit.

Ten years on, those weaknesses have been addressed. That is not to say that we will not see other crises – and other opportunities to explain to our children the sins of their elders.

Continued high levels of public- and private-sector debt in developed economies continue to pose a strain, and aging populations will only add to that burden. Many emerging economies remain exposed to currency mismatches and trade imbalances. Worryingly, while global economies remain massively interdependent, the common bonds that allowed global authorities to coordinate their actions 10 years ago are weaker today.

Risks remain ever-present, and that means safe, efficient derivatives markets for risk hedging are more important than ever. That remains the heart of ISDA's mission.

There are still plenty of challenges in front of us – some, like Brexit and benchmark reform will be discussed during the course of today's conference. But the banking system and derivatives markets are today far more resilient than before the crisis.

However, it's also important that we balance that resiliency with the need for accessibility and efficiency. By getting that balance right, we will have a market that continues to be both safe and efficient.

Thank you.