ISDA Safe, Efficient Markets

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Opening Remarks
Scott O'Malia, ISDA Chief Executive

Good morning, and welcome to ISDA's 34th Annual General Meeting here in Hong Kong.

It's a great venue for the AGM, isn't it? A modern, vibrant, global financial center, a hub for derivatives trading, and the gateway to China, with all its growth potential.

It seems a long, long way from Williamston, the small town in Michigan where I grew up. Living in a town of just 3,000 people, the world seemed a very big place. New York was 700 miles away, and Hong Kong might as well have been on another planet.

Things were very different back then, of course. It was an analogue age, and the world felt much less accessible than the uber-connected one of today. My own kids can't imagine having only four TV stations, let alone communicating with distant friends and relatives by mail and the occasional phone call.

We've obviously advanced light years since I was growing up. But, working at ISDA, you really do realize just how connected the world has become. I'm not just talking about smart phones, email and Skype. ISDA's seven offices support a truly global market, and our operations extend to every corner of the world where derivatives are traded. I'm only half joking when I say 71% of the earth's surface is covered by water, but ISDA covers the rest.

That the derivatives market is global is no accident. This market developed to facilitate the transfer of capital from where it is to where it needs to be. It enables global companies to cost-effectively raise financing and manage their exposures. This is critical in generating sustainable economic growth.

This might seem obvious to all of us sitting here, but it cannot be taken for granted. Wherever you look, from the impact of Brexit to challenging trade negotiations, there are powerful forces pushing in the other direction. We must continue to passionately make the case for global derivatives markets, and to prevent fragmentation along national and regional lines.

In my remarks today, I will explain why global markets are an important part of Asia's growth story. I'll talk about some of the global challenges we all face, and the global solutions being developed in response. And I'll talk about the steps we need to take to avoid fragmentation of global markets.

Asia growth

I mentioned the growth potential of China at the start of my remarks, but this extends to much of Asia. According to research by Standard Chartered, China will become the world's largest economy by 2020. By 2030, seven of the top 10 economies are predicted to be emerging markets, with India and Indonesia joining China in the top five.

While long-term GDP growth between now and 2030 is forecast at below 2% in the US, the euro area and Japan, it is expected to reach 5.6% in China, 7.6% in India and 4.3% in Asia excluding China, India and Japan.

As China and other Asian markets grow, the need for infrastructure investment will also increase. China's Belt and Road Initiative is an important example of this, and involves an ambitious program of investment and infrastructure development stretching from the Artic to the southern most tip of Asia.

Overall, it's estimated by the Asian Development Bank that developing Asia will need to invest $1.7 trillion per year in infrastructure until 2030 to maintain its growth momentum.

In many cases, local markets are too small to support this level of financing. Instead, companies, governments and others will likely have to turn to global markets to ensure they can access the financing they need at the best available price. The ability to borrow outside the domestic market, and to hedge that risk efficiently, is critical for global growth.

When we are asked to make the case for global markets, I can think of no better response than this – global markets unlock the potential for sustainable economic growth.

The ability to hedge the FX and interest rate risk arising from this financing is an important part of the story. Given this, it's no surprise that derivatives markets in Asia have continued to develop. According to the latest triennial survey from the BIS, interest rate derivatives and FX average daily turnover in Asia grew at a faster rate than the global average between 2007 and 2016.

As a result, Hong Kong and Singapore have bolstered their positions as regional trading hubs. The BIS reports they had a combined share of interest rate derivatives turnover of 5.5% in 2016, and a combined share of FX turnover of 14.6%.

According to a new survey of Asia's derivatives market that we published yesterday, most participants expect this will continue to increase over the next three to five years.

Nonetheless, three key elements are necessary in order to ensure this potential growth is on firm foundations: a strong legal infrastructure; adoption of global standards and solutions; and harmonization and cooperation between regulators and rule sets.

When it come to a strong legal infrastructure, I can think of no more important element that close-out netting. This is the single most effective tool for reducing credit risk between counterparties, and is critical to establish certainty and encourage participation in local markets. Nonetheless, it is still unclear whether close-out netting is enforceable in several key jurisdictions in the region.

I'll return to this issue in more detail tomorrow.

Global solutions

Another key factor is adoption of global standards and solutions, which brings me to the second part of my remarks.

Whether in Hong Kong, Beijing, London or New York, we face many of the same challenges. We could all adopt our own unique solutions to those challenges, but that's a waste of time, money and resources and ultimately contributes to fragmentation. Global challenges need consistent, global solutions – and that's where ISDA plays a part.

Take benchmark reform as an example. With an estimated $370 trillion notional in exposure to key interbank offered rates, this is an issue that affects us all.

ISDA has been working on this on multiple fronts, but has played a leading role in an industry effort to develop robust, consistent fallback language for derivatives contracts. The aim is to enable contracts referencing LIBOR and other IBORs to survive a sudden discontinuation of the underlying benchmark with the minimum possible disruption.

Last year, we consulted on technical adjustments that would apply to the fallback rate in the event an IBOR is permanently discontinued. I'm pleased to say that a clear market consensus was reached on the preferred approaches for those benchmarks covered by the consultation.

Equally importantly, market participants expressed a preference for the same consistent approach to be applied to other IBORs – a view that will be validated in a new consultation on spread and term adjustments for US dollar LIBOR, HIBOR and CDOR.

We're continuing to work hard on this issue. As well as the consultations on the technical adjustments, we are about to undertake another consultation on pre-cessation triggers for derivatives. We're also working to develop the final parameters and mechanics for the fallbacks, and we plan to have new fallback language in place for certain IBORs by the end of this year.

This is one issue where a consistent global solution is paramount, but there are others.

Initial margin requirements pose another sizeable challenge for the industry. The final phase of implementation in September 2020 will sweep a large number of new entities into scope as the threshold falls to $8 billion. Many will be smaller firms that may lack the resources to independently develop and maintain the necessary systems, as well as the bandwidth to bilaterally negotiate new IM documentation with all of their counterparties.

Again, ISDA has developed global solutions that ensure consistency in how firms apply the rules. To mitigate the potential for disputes over margin calculations, we released the ISDA SIMM in 2016. Use of a single model helps with operational use, model approval, legal documentation, economical running costs, transparency and infrastructure development by users, regulators, vendors and middleware providers.

More recently, as the IM regulatory framework extends to smaller entities, we developed ISDA Create - IM, a powerful digital platform that automates the negotiation and execution of IM documents.

Sticking with technology, financial institutions across the globe are thinking about how they can harness the potential of new technologies to drive efficiencies and reduce costs.

However, the derivatives market has developed over time in a bespoke and bilateral way, without standard conventions for how trade events and processes are represented. Each firm has developed its own unique representations over time. The lack of firm foundations has limited the ability to apply automated solutions across the industry in a scalable way.

In response, ISDA has developed the Common Domain Model, a digital blueprint for how derivatives are traded and managed across the trade lifecycle. Last month, we launched the full version of the ISDA CDM for interest rate and credit derivatives. Even more importantly, we opened access to entire market free of charge.

Creating a standard representation for events and products that can be used by all participants, infrastructures, platforms and regulators will enable firms to develop automated solutions that can be interoperable and scalable in a way that has never been done before.

We think the ISDA CDM is a game changer for the derivatives market, and we encourage you to download the CDM and think about how it can be deployed.

Fragmentation

I'll now turn to the issue of market fragmentation.

Huge progress has been made in meeting the G-20 derivatives reforms. There has been significant headway in clearing, reporting, capital, margin for non-cleared derivatives and trade execution. As I described a moment ago, the industry has also worked together to develop global solutions to ensure certain requirements can be met as consistently as possible.

In short, the industry has done its part. It has delivered.

Unfortunately, the rules have often differed in scope, substance and timing when implemented in different markets. This has led to inefficiencies, complexity and higher costs for derivatives users, and contributes to market fragmentation. Ultimately, it increases risk for market participants and financial markets.

There are numerous examples of regulatory discrepancies, overlap and timing issues in all areas of regulatory reform, and further differences could emerge. For instance, the finalization of the Fundamental Review of the Trading Book earlier this year means attention will now turn to implementation by national authorities. There are already signs that not all jurisdictions will be able to meet the Basel Committee's target implementation date of January 2022.

Cross-border harmonization is an issue that is very important for ISDA, and we've long highlighted the importance of global consistency.

That's not to say all rules need to be identical in every jurisdiction. We recognize there may be legitimate reasons to deviate in certain areas to suit local market characteristics and the pace of development. But there are cases where divergences only create unnecessary compliance costs for end users and fragmentation in markets.

Reporting is a case in point. There's no reason why firms should be required to report varying data forms and formats in different markets. That not only creates additional expense, but it impacts the ability of regulators to monitor risk on a global basis.

In order to resolve this, we need to make the process for substituted compliance and equivalence determinations more efficient. Regulatory tools already exist to provide for substituted compliance, but the decisions in practice have been slow to arrive and are often made on a granular, rule-by-rule basis.

As an alternative, we have proposed a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes in foreign jurisdictions. We think this approach strikes an appropriate balance by focusing on risk and its cross-border implications.

We also believe that international standard-setting bodies should establish a process that would enable national regulators to implement equivalence and substituted compliance determinations in a predictable, consistent and timely manner.

Rather than attempting the impossible task of aligning each and every regulatory requirement across jurisdictions, this approach would allow substituted compliance determinations to be based on broad outcomes. It would reduce the chances of lengthy negotiations that could ultimately lead to reduced liquidity and fragmentation.

Ten years on from the G-20 commitments, it's time this issue was resolved. That's why we welcome the focus on this issue by the Japanese presidency of the G-20. The industry has done its bit to implement the regulatory reform agenda. We now need to work with regulators to ensure the market is able to function efficiently on a global basis, and can continue to support economic growth.

With regards to Brexit – in whatever form or whenever it occurs – ISDA will do its part to identify the issues and mitigate the impact. Whether it is updating FAQs or legal documents, or advocating against market fragmentation in clearing or trade execution, we will make sure policy-makers have the facts, and market participants have the best solutions to navigate the future state.

Conclusion

In my remarks this morning, I have touched on the important role of global markets, and I've explained why global challenges need consistent global solutions.

Ten years on from the G-20 commitments, we are at an important crossroads. Our market is in a far better place this it was in 2009. It is safer, more transparent and more resilient. We have much to be proud of – and, with strong growth predicted in markets like China and India, we have much to look forward to as well.

But addressing fragmentation is the critical next step. Unless this is tackled, it will hinder the further development and progress of financial markets. Ultimately, it will impact the potential for economic growth.

The time to act is now.

I'd like to finish by thanking all of our sponsors, exhibitors and delegates for joining us this week in Hong Kong. In particular, I'd like to say a big thank you to LCH for hosting such a great event last night.

I hope you find the AGM useful and informative, and have a chance to meet with colleagues and friends, old and new.

Thank you.