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Chairman's Remarks
Eric Litvack
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Good morning, everyone. Welcome back to day two of the AGM. We covered a lot of ground yesterday. We heard a variety of opinions on how the derivatives markets will evolve in response to regulatory and market-structure changes, as well as where the challenges and opportunities lie. I hope you found the sessions valuable and thought provoking.

After all that hard thinking, I also hope you took the opportunity to visit the impressive Meiji Kinenkan last night. It's always good to be back in Tokyo – it really is a beautiful and vibrant city. ISDA holds an annual regional conference in Tokyo each October, but this is actually the first time we've held the AGM here since 2003.

That's a long time, and it goes without saying that a lot has happened in those 13 years. Let me take you back to 2003 for a minute, and remind you of the events that were topical during the time of that AGM.

The invasion of Iraq had begun in March, and a statue of Saddam Hussein in Baghdad was famously toppled on April 9, the opening day of the 2003 AGM.

SARS was sweeping through Asia, infecting thousands of people from China to Toronto. Concorde made its last commercial flight, Apple launched the iTunes store, and Arnold Schwarzenegger was elected governor of California.

In the world of sport, a young Swiss tennis player called Roger Federer was set to rack up his first Grand Slam win at Wimbledon.

And in finance, the US Federal Reserve decided to cut interest rates by a quarter of a percentage point to 1% – then the lowest level in 45 years. Little did we know that, 13 years on, 1% would be considered normal.

A look at the ISDA AGM agenda for 2003 shows the focus was on Basel II implementation issues, the continued fallout from the collapse of Enron, and opportunities for new products and markets.

Panelists included representatives from Lehman Brothers, a pre-BAML Merrill Lynch and Bank of America, and ABN Amro. SwapClear had launched its clearing service for interest rate swaps four years earlier, but it was still very much early days – and clearing received only passing references at the AGM.

Fast forward to 2016, and so much has changed in the worlds of politics, sport and finance.

Focusing on derivatives, several of the firms that participated in the 2003 AGM either no longer exist or no longer exist in the same form. Others are rethinking their business mix, constrained by capital and compliance costs.

There's now less talk about new products and expanding into new markets, and more focus on how to achieve efficiencies and cost savings through standardization and technology.

These days, the word 'complexity' tends to be used more in the context of collateralization, funding and valuation adjustments, rather than product development.

More fundamentally, there's a lot of uncertainty. Given the sheer scale of the changes in regulation and market structure, it's easy to understand why.

Now, more than two thirds of interest rate derivatives are cleared through central counterparties (CCPs). As recently as 2008, that figure was more like 20%. More than 50% of interest rate swaps reported to US swap data repositories are now traded on a swap execution facility (SEF). Back in 2003, the concept of a SEF didn't even exist.

Most derivatives transactions are now reported to a trade repository, giving regulators access to much more information than they had 13 years ago. And while all the talk in 2003 was about Basel II implementation, a new package of capital, liquidity and leverage reforms is being phased-in in the guise of Basel III – and there's more on the way.

ISDA believes many of these changes are beneficial, and help ensure the derivatives market is safer and more efficient.

But that's not to say those changes haven't come with challenges. Among the most significant is a lack of consistency in the shape and timing of derivatives reforms in individual jurisdictions.

This not only increases costs and complexity for derivatives users, but it contradicts a specific Group-of-20 (G-20) commitment to implement derivatives reforms consistently on a global basis.

Unfortunately, evidence shows the resulting fragmentation is already occurring in some markets. For example, ISDA research shows European dealers are now typically choosing to trade euro interest rate swaps with other European counterparties where possible – a change that coincided with the introduction of the US SEF regime.

This kind of split in liquidity pools is not a good thing: it reduces choice for end users, increases costs and could make it more challenging to unwind large positions in volatile markets.

Cross-border issues are also having an effect on clearing. Specifically, slow progress in the cross-border recognition of clearing houses restricts the choice of clearing venues for counterparties, exacerbating the fragmentation of liquidity.

Recent progress has been made by US and European authorities to pave the way for substituted compliance and equivalence determinations for US and European Union clearing houses. This is very welcome, but more needs to be done. For example, several CCPs in Asia-Pacific have received recognition from the European Securities and Markets Authority (ESMA), including the Australian Securities Exchange (ASX), Japan Securities Clearing Corporation (JSCC), OTC Clearing Hong Kong and Singapore Exchange (SGX). But a number of others haven't.

The impact could be significant: any product cleared through a non-recognized CCP by a European bank or its affiliates will be subject to eye-watering capital requirements once European capital regulations are enforced, potentially discouraging European firms from participating in those markets.

This issue of cross-border recognition is likely to become more prominent as new clearing mandates are introduced in Australia, Europe, Hong Kong and Singapore over the next 12 to 18 months.

I'd like to flag another issue: reporting. In theory, this should have been the G-20 commitment that was easiest to implement. Indeed, a large majority of the Financial Stability Board (FSB) member states have implemented mandatory derivatives reporting rules. The problem is these rules differ within and across jurisdictions, which has hampered the ability of regulators to obtain a complete picture of global risk exposures.

Greater regulatory cooperation and harmonization is not an impossible dream. Progress on developing a global framework for margin and capital shows it can be done.

New non-cleared margin rules, for instance, were developed and agreed at a global level by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) before being implemented by national regulators. That's a process we very much support.

But challenges have emerged here too. While the various national implementations are largely consistent – particularly in terms of phase in and thresholds – differences do still exist.

For instance, final rules from US prudential regulators and the Commodity Futures Trading Commission (CFTC) require variation margin to be settled the day after execution of the trade. This approach is more or less mirrored in European rules, albeit with some attempt to mitigate the impact on cross-border trades. In comparison, Japanese rules only require variation margin to be exchanged as soon as practically possible.

These differences matter, and the tighter time frame set by US and European regulators will make it practically difficult for US and European firms to trade across time zones with Asian counterparties.

Another challenge involves the tight timeline for implementation. There are now just five months before the rules begin to phase in, and a lot needs to be wrapped up before then. Firms will need to revise thousands of their legal documents to comply with the rules in each jurisdiction, implement and test technology to calculate margin, and ensure those models receive the necessary regulatory approvals.

That work couldn't progress to completion until final rules were published by national authorities – and this has come fairly late in the day. US regulators published their final rules at the end of last year, and Europe and Japan followed in March. This has created a last-minute dash to the finish line.

More broadly, there are significant concerns about the overall impact of capital reforms. ISDA believes capital requirements should be globally consistent, coherent and proportionate to the risk of a given activity.

As a result, we're concerned about the regulatory shift away from internal models – the latest example of which is the Basel Committee's decision to restrict the use of internal models for credit risk-weighted assets, and to eliminate their use completely for the calculation of credit valuation adjustment (CVA) capital.

We believe internal models are much more sensitive to risk, and better align with how banks actually manage their business.

The use of non-risk-based measures could mean the required capital for a particular asset doesn't adequately reflect its risk. Reducing the sensitivity to risk incentivizes poor decision-making. A bank might choose to stop investing in low-risk assets where capital costs are relatively high. Or, vice versa, it might opt to invest in higher-risk assets that appear attractive from a capital standpoint.

Overall, a non-risk-based capital framework is likely to lead to a rise in total capital requirements across the bank – essentially because standardized models tend to be more conservative.

The G-20 has made clear its support for refinements to the Basel III reforms to ensure coherence and effectiveness, but stressed in a recent communique that changes should be made without further significantly increasing overall capital requirements across the banking sector.

As it stands, an overall impact study hasn't been conducted on the full set of capital, liquidity and leverage rules, but studies of individual elements of the framework that haven't yet been implemented present some cause for concern.

As we heard in the final panel yesterday afternoon, the Basel Committee's own estimates on the impact of the final Fundamental Review of the Trading Book (FRTB) suggest a weighted mean increase of approximately 40% in total market risk capital requirements, on top of the increases that occurred as a result of Basel 2.5.

That estimate was based on a recalibration of quantitative-impact-study (QIS) data from an earlier version of the rules. However, ISDA has led a separate, industry QIS on the final FRTB framework, based on data from 21 banks. The results show a similar increase in market risk capital to Basel estimates – up 50%. But this assumes all banks will receive internal model approval for all desks, which is unlikely. If all banks fail the internal model tests, market risk capital would increase by 2.4 times. ISDA believes the end result will be somewhere in between.

Our FRTB panel this afternoon will give more information on these results.

Analysis conducted last year by ISDA also indicates significant costs related to the net stable funding ratio. Based on projections from a sample of 12 banks, the rule would result in an estimated €0.75 trillion of additional required stable funding, at an estimated annual cost of up to €15 billion.

The failure of the leverage ratio to recognize the risk-mitigating effect of segregated client cash collateral could also increase the amount of capital needed to support client clearing services. The end result is that the economics of client clearing would make it extremely difficult for clearing members to provide this service, which runs counter to the objective set by the G-20 to encourage central clearing.

ISDA has been drawing attention to this issue for some time, and the Basel Committee last week reopened the leverage ratio for consultation. As part of that consultation, the Basel Committee said it would collect data to study the impact of the leverage ratio on client clearing, with a view to potentially recognizing the exposure-reducing effect of initial margin posted by the client.

We welcome that development – although it's disappointing the consultation won't consider the recognition of initial margin more broadly. We'll work with members to provide the necessary data for this consultation. Clearing has become a huge part of the derivatives market, so it's incredibly important we get this measure right.

Raising these issues does not mean the industry is pushing back against regulatory change or is trying to maintain the status quo circa 2003. On the contrary, we recognize that the markets are always evolving, and that we as an industry need to adapt as well.

But by making reasoned critiques of proposed regulation, backed by evidence, and by presenting practical solutions, ISDA is trying to ensure the changes can occur in a way that does not disrupt markets. Far from resisting change, ISDA has played an integral role in getting down to the nuts and bolts and making sure the requirements can actually be implemented safely and efficiently.

Take clearing as an example. Mandatory clearing cannot just be switched on overnight by flicking a switch. It required substantial effort to develop the necessary documentation.

That includes the ISDA/FIA Client Cleared OTC Addendum, as well as tools to allow firms to represent to their counterparties whether they are subject to the clearing obligation. It also required work to ensure firms have the necessary ISDA clearing legal opinions to enable them to run their businesses efficiently. That work is ongoing – and providing that legal, documentation and infrastructure work is an area in which ISDA excels.

ISDA has also commented extensively on clearing-related issues – from how best to roll out the various clearing obligations, to drawing attention to the problems created by the frontloading requirement in Europe.

And we've continually stressed the need for harmonized rule sets and a workable equivalence and substituted compliance regime to reduce the potential for liquidity fragmentation.

ISDA is now very much involved in the debate on CCP resilience, recovery and resolution. With more clearing mandates set to come into effect, it's vital these systemically important institutions have the necessary protections in place – and ISDA has been vocal in expressing its view and the view of its members through a variety of principles papers and letters.

In short, ISDA has delved into the weeds, tackled the complex issues that need to be resolved, and developed practical solutions to ensure the rules can be implemented in an efficient way.

Similar work is under way right across the board. In reporting, ISDA has launched a so-called Symbology initiative to develop a standard derivatives product identifier mechanism for reporting and data reference purposes.

This initiative will incorporate recommendations on data standards from the Committee on Payments and Market Infrastructures (CPMI) and IOSCO, and we will advocate for these global standards to be incorporated by national regulators.

In trading, ISDA recently published a paper that highlights areas of similarity between the US SEF rules and Europe's revised Markets in Financial Instruments Directive (MIFID II) regime in order to help facilitate substituted compliance determinations.

In addition, ISDA has highlighted the fact that certain elements of MIFID II can only be implemented once other requirements, such as data collection, are up and running. Recognizing this, we proposed a transition plan that takes account of these dependencies to ensure MIFID II can be implemented smoothly and without market disruption.

In the capital space, ISDA has leveraged its in-house technical expertise, and the deep knowledge of its membership, to lead industry impact studies, spot practical implementation challenges, and propose specific, technical modifications to models.

And in the margining space, ISDA has led industry efforts to prepare for implementation. We're modifying collateral documentation to incorporate new regulatory requirements, establishing the means to implement those changes efficiently, developing the ISDA SIMM initial margin model, and creating a robust dispute resolution process.

I haven't touched upon the extensive and vital work ISDA does on legal documentation. When regulators determined that they needed a contractual solution to facilitate cross-border bank resolution, they came to ISDA to do the technical legal drafting.

This work resulted in the 2014 and 2015 Resolution Stay Protocols. This is now being expanded via a buy- and sell-side industry group to develop a Jurisdictional Modular Protocol. That will allow market participants to comply with new regulations that require the inclusion of temporary stays in contracts.

Since we last held an AGM in Tokyo, our industry has undergone unprecedented change. We now have to operate in a tough new regulatory environment, market structures are evolving, balance sheets are more constrained, and compliance costs have soared. The changes are still under way, and it's not entirely certain what the end state will look like.

It’s easy to feel gloomy as a result. But there are also reasons to be optimistic. We live in an uncertain world, and companies will always look for ways to reduce the impact of this uncertainty on their business. Ultimately, derivatives continue to provide the most efficient and effective tool for those companies to manage their risk.

Yes, some banks have pulled back from certain businesses. But other new entrants are stepping in – from niche trading firms, to infrastructures and technology providers. There are opportunities for those firms that can adapt and seize them. This industry has a track record of evolving to meet customer needs and market conditions. There’s no reason why this won’t continue to be the case in future.

What’s ISDA’s role in all this? A look at the 2003 AGM agenda highlights the areas ISDA was working on: the 2003 Credit Derivatives Definitions, the 2002 Master Agreement, and Financial products Markup Language (FpML), to name just three.

Over the past 13 years, ISDA has adapted to reflect changing markets and to meet the evolving needs of our members. We may be doing different things in different ways, but we’re meeting the same fundamental need: working on behalf of the industry to develop market-standard documentation, best practice and infrastructure.

When we next meet at a Tokyo AGM – hopefully sooner than another 13 years – the market will undoubtedly have changed even more. But ISDA will continue to steer a path, making sure the market is able to function safely and efficiently.

I just want to finish by thanking you on behalf of the Board of Directors for coming to the AGM. ISDA is only able to provide leadership in this market because of the technical expertise of its members. Thanks to all of you who participate on our various working groups, and my thanks to those who sit on the board for the long hours they selflessly contribute. Finally, on behalf of all the membership, please join me in thanking the ISDA staff who make it all possible.

I hope you enjoy the rest of the conference.

Thank you.