ISDA Safe, Efficient Markets

ISDA Washington Policy Conference 2017
ISDA Chairman's Remarks – Eric Litvack
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Good afternoon, everyone.

Welcome back to the afternoon session. We're going to pick straight up from where we left off before lunch, starting with our keynote address from CFTC Chairman Giancarlo. We're then going to look at one of the most immediate challenges that Scott highlighted in his opening remarks this morning – the issue of cross-border cooperation.

Before we start, though, I want to spend a few minutes putting all of this in context, and explain how it translates into ISDA's priorities going forward. We talked a lot this morning about the important and necessary changes that have been made to strengthen the financial system, but also about the need to review and strengthen the policy framework by removing unnecessary complexity and cost. We talked about specific, targeted fixes that would make the rules simpler and more efficient, without increasing systemic risk. And we talked about the importance of examining regulatory and capital requirements to ensure they are appropriate and support market liquidity and investment.

The fundamental question is: why is this so important? Why should policy-makers spend so much time reviewing these rules to check what's working well and what could be improved?

The simple answer is because derivatives play a critical role in helping firms reduce the uncertainty that comes from changing business and market conditions. Whether used by exporters to manage the exchange rate risk on overseas earnings, by manufacturers to lock in the cost of issuing debt to finance a new factory, by food producers to hedge crop and livestock prices, or by mortgage providers to manage interest rate risk on their loans, derivatives allow end users to closely offset the risks they face and create certainty and stability. That certainty means firms can invest in the future with more confidence, creating jobs and contributing to economic growth.

It's therefore important that these firms can access the derivatives market in a way that's as cost-effective and efficient as possible. Which is why the CFTC's Project KISS and the Treasury's review of financial market regulation are so important. I'm very much looking forward to hearing Chairman Giancarlo's remarks on how this important project is progressing. Later this afternoon, we'll also hear from a panel of end users about the issues they're facing, and the improvements they'd like to see.

To be clear: we are absolutely not asking for a repeal or a weakening of the regulatory framework. As Scott said this morning, a lot of work has gone into implementing Dodd-Frank, and the financial system is much safer than it was as a result. We do not want to undo that progress.

But we do think there is room for improvement. I don't think anyone can honestly say, hand on heart, that every single clause in the 800-or-so pages of Dodd-Frank, and every single one of the hundreds of rules subsequently rolled out, were bang on, 100% perfect first time round. We think there's scope to streamline and simplify certain requirements to remove needless complexity – complexity that imposes a hefty compliance burden on intermediaries and end users for little benefit. That risks deterring hedging, trading and investment. And it could put US firms at a competitive disadvantage globally.

There are currently many specific examples of complexity in the rules – from the compliance headaches caused by the lack of cross-border harmonisation, to the alphabet soup of data requirements and formats. Just take the example of the Volcker rule: a fairly straightforward concept in principle, which becomes a 70-page rule accompanied by 850 pages of explanatory text.

It should be possible to have a framework that is safe, efficient and appropriate – that ensures resiliency of the financial system *and* encourages economic growth, market liquidity and effective risk management.

The need for balance between resiliency, appropriateness and efficiency also feeds through to bank capital rules.

As we heard earlier, banks have significantly increased capital levels since the crisis – for example, common equity at the eight largest US banks has more than doubled over that period. In total, the largest global banks have raised more than $1.5 trillion in new capital. Banks, and the financial system as a whole, are undoubtedly more resilient now than they were in 2008.

But banks also need to be able to provide the financing and risk management services that are so vital to economic growth.

Asking banks to hold more capital will increase their resiliency to extreme market events. And it's clear that was necessary after the crisis. But keep on adding layer after layer of capital, and eventually you reach a tipping point – the moment when the cost of the capital allocated to a particular business is out of whack with the risks and returns of that activity. At that point, the business becomes uneconomic and difficult to run on a sustainable basis.

That means banks have to make some difficult decisions. The rational economic choice is to reallocate the capital elsewhere.

We're already seeing that to a certain extent, with some banks pulling back from specific activities. But further changes proposed by the Basel Committee could make that even more pronounced.

According to ISDA analysis, new market risk rules, known as the Basel Committee's Fundamental Review of the Trading Book, or FRTB, will result in market risk capital rising between 1.6 and 2.5 times current levels.

That's a big increase, and it will have the biggest impact on the areas critical to financing and hedging – bonds, equities, foreign exchange and commodities. If the amount of capital required for trading book activities is out of sync with the risks and returns, then banks may choose to focus less of their resources on market making, intermediation and lending. The logical conclusion is a reduction in the supply of these services – and that's not a good outcome for the economy.

Another example – the leverage ratio. The clearing of standardised derivatives was a key objective of the Dodd-Frank Act, and that's been a success: 89% of interest rate derivatives notional traded in the second quarter of this year was cleared.

But the leverage ratio requires banks to count segregated client initial margin towards their leverage ratio exposure. That collateral is meant to cover a client default, and cannot be touched by the bank. Including it in the leverage ratio increases the amount of capital needed to support client clearing activities. In effect, banks are being penalised for facilitating good risk management.

That has made it more difficult for clearing members to provide this service, prompting some to scale back or withdraw. This a concern Chairman Giancarlo has flagged repeatedly. The end result is less clearing access for end users, which is surely contrary to the objectives of Dodd-Frank.

National regulators and policy-makers are taking note of these challenges, and have begun to address them. As part of its review of financial regulations, the US Treasury has proposed delaying domestic implementation of the Basel FRTB until the rules can be appropriately calibrated and assessed. It has also recommended recognising the exposure-reducing effect of initial margin for cleared derivatives in the supplementary leverage ratio.

The US Treasury and CFTC aren't the only ones to suggest changes to the calibrations. The European Commission has proposed a 65% scalar on FRTB capital requirements during a three-year phase-in, and has made a similar proposal to the US Treasury on the leverage ratio.

We think it's important for the calibration and implementation timeline of these measures to be globally consistent as far as possible to prevent fragmentation and an unlevel playing field. The Basel Committee is monitoring various aspects of the rules, and continues to engage with the industry – which we welcome. We hope the committee will consider adjustments to rules or calibrations wherever widespread concerns result in the risk of global regulatory divergence. Any adjustments should also be made with an eye on economic growth by ensuring the rules are proportionate and sensitive to risk.

ISDA has been working to draw attention to the potential impact of these changes through a number of quantitative impact studies. This fact-based approach has helped clarify potential implementation issues.

We've also been working on solutions for the industry to help tackle some of the future compliance challenges. For example, we're leading an industry effort to agree a common interpretation of FRTB requirements on the modelling of risk factors – work that could ultimately result in a data pooling solution that will not only help firms with implementation, but will also help create more consistency and more transparency.

Creating solutions, and driving standardisation, is what ISDA does best. That began more than 30 years ago with the publication of the ISDA Master Agreement – a landmark document that provided a standard template for derivatives trades, and set the market on a steep trajectory of growth. We're now looking to ensure the foundations are in place for the next 30 years.

One of consequences of the regulatory changes that have occurred in recent years is the addition of new steps and processes into the trading of derivatives. Electronic trading, clearing, reporting, margining – all of these steps have either been added, become more prevalent, or subject to specific requirements. They're all now in place, and they're working. The system is more resilient because of that.

But in implementing these measures under tight deadlines, firms haven't necessarily had the time to think through how everything can best work together. The end result is a process that is often complex and reliant on manual intervention and reconciliation.

We need to differentiate here between complexity in the rules and complexity in the process. The former – the lack of cross-border harmonisation, for example – can only be resolved by targeted improvements to the rules.

The complexity in process, on the other hand, can be resolved through standardisation and automation. And we think new technologies including distributed ledger and smart contracts may present an opportunity to unlock value and make the process simpler and more efficient.

For that to happen, though, these new technologies need to be compatible across different platforms and different firms. That requires standards – both on the operational and legal sides.

That's where ISDA comes in. We're currently working on an initiative to identify key industry processes, and to translate them into concise, standard machine-readable code that will sit within a central hub, a kind of industry encyclopaedia that we call a common domain model. The idea is that everyone could tap into this resource and use those common representations within their technologies to aid interoperability.

This is a huge and ambitious project for ISDA, and, if we are successful, it will help to drive efficiencies and greater automation in this market.

I want to finish by touching on another important initiative for ISDA: benchmarks. As I'm sure you all know, public-private sector initiatives have been under way for some time in the US, UK, Japan and Switzerland to identify new risk-free rates that could be used as an alternative to certain key IBOR rates. The rates have now been selected in those jurisdictions, and attention is turning to how to transition to the new rates over time without disrupting markets.

The issue has recently achieved prominence following news that the UK FCA will not compel or persuade banks to make LIBOR submissions after the end of 2021.

Of course, the fact the FCA will no longer compel banks to submit doesn't mean LIBOR will suddenly disappear after 2021. But there's now a certain sense of urgency, and some understandable concern about what will happen to new and existing trades that reference LIBOR.

The important thing to point out is that the relevant public-private sector working groups have already started to develop transition plans, and are committed to ensuring these plans work for all market participants, including end users.

Simultaneously, ISDA is working on a separate initiative to identify robust fallback rates, and to ensure these fallbacks are written into derivatives documentation so they would apply if one of the key IBORs permanently ceases to exist.

Ultimately, ISDA would make changes to the ISDA definitions to specify the fallbacks. It's possible we would also publish a protocol to help participants include fallbacks in their legacy contracts.

These are all good examples of what ISDA does – work to develop standards and solutions to ensure the market is safe and efficient. Much has been accomplished, but there is plenty still to do, and we look to the future with confidence and ambition.

Safety and efficiency is paramount in our markets. We have to get this right. That goes for the regulatory framework and capital requirements, as well as new technologies and benchmarks. The ability of end users to access financing, investment and risk management services all depend on it.

Thank you for your kind attention, and I hope you enjoy the rest of the conference.

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