ISDA® Safe, Efficient Markets

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CEO Opening Remarks
Scott O'Malia
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Good morning ladies and gentlemen, and welcome to ISDA's annual general meeting here in Lisbon.

This is a landmark year for our organization. It marks the 30th anniversary of the ISDA Master Agreement, which formed the bedrock of the derivatives market we see before us today.

For over three decades, we have been the voice of that market. In my CEO update today, I want to highlight how ISDA is working to unlock value, making your business more successful, while at the same time contributing to the safety and efficiency of the derivatives market.

ISDA has taken the long view in working towards industry standards for the market. Looking back over the past 30 years, you come to realize the sheer scale of our work, including the Master Agreement, the Credit Support Annexes, the various legal opinions, the product definitions and now the ISDA SIMM. ISDA isn't just working towards a standard. Our work has become THE standard.

In this anniversary year, we should all congratulate ourselves on a job well done. However, there is more work to do, and ISDA is well positioned and up for the challenge. We will continue to provide a global forum for industry collaboration, and will carry on developing innovative market solutions that bring value to all market participants. We will argue on behalf of our membership on key policy issues. We will expand our suite of legal documentation. And we will work towards new solutions on market infrastructure and technology.

Each year, we move our AGM from Europe, to North America, to Asia, reflecting our global footprint and the global nature of the derivatives market.

The derivatives market works best when it is global. It gives derivatives users more choice, and better access to liquidity.

As a result of global regulatory reforms, our industry has undergone a period of intense and unprecedented change. Throughout that period, many predictions have been made about the future of this market. Not all of them have been positive.

Many believed that over-the-counter trading would wither on the vine, to be completely replaced by the futures market. Others felt that the advent of large-scale central clearing and electronic execution would kill off the non-cleared space, or that participants would one by one be squeezed out of the market by relentless cost pressures.

The reality has been quite different.

In fact, the overall market has remained robust. In the interest rate derivatives market, average daily notional volume reported to US trade repositories has grown from about $550 billion in 2014 to just under $640 billion last year. The first quarter of this year saw more than $780 billion in interest rate derivatives traded each day, reflecting the fact that these instruments continue to provide the best way for companies to hedge risk.

That's not to say the market hasn't changed. Clearing now plays a pivotal role in how derivatives are traded.

In the first quarter of this year, nearly 88% of average daily interest rate derivatives volume reported to US trade repositories was cleared. Overall, roughly three quarters of total interest rate derivatives notional outstanding globally is cleared, versus about 20% a decade ago.

Firms are now clearing more than they are mandated to clear – a shift driven by operational issues, netting efficiencies and the economic impact of margin and capital requirements for non-cleared trades.

So, there's no doubt the market has changed. And ISDA has adapted as well to ensure we continue to provide the solutions our members need.

We continue to be the voice of the global derivatives market, with offices in the major financial centers. Between our members and staff, we have unparalleled expertise. But it is the results and solutions we achieve that have drawn in a greater number of members than ever before.

By the end of last year, our membership had climbed to almost 900, a record for the Association.

At ISDA, we continue to invest in the future by expanding in strategically important areas. In the long term, we're working to exploit the potential of distributed ledger technology and smart contracts, as well as other emerging technologies. I'll return to that topic a little later.

Helping Members with the Margin Rules

In more immediate matters, we are still heavily involved in what has perhaps been one of the biggest and most important projects since the launch of the Master Agreement – the development of the ISDA SIMM.

The SIMM is a great example of what the industry can achieve when it comes together to meet a common challenge. This was a mammoth undertaking for ISDA and its members, requiring a huge commitment in time and effort. But this investment will provide enormous value to the industry as a whole by avoiding the need for each firm to develop and seek regulatory approval for its own initial margin model.

Despite the challenges, the ISDA SIMM was delivered on schedule, and was widely adopted by the first-phase banks for their September 1 implementation deadline last year. We're currently working with phase-two firms to prepare for initial margin requirements in September by sharing knowledge and experience from phase one.

ISDA's work in this area doesn't end there. We've established a broad governance structure for the ISDA SIMM, and model development and testing remains completely transparent to regulators. We recently added additional risk factors relating to cross-currency swaps, inflation swaptions and CDO tranches, ensuring those products won't be subject to punitive margin requirements. This investment by ISDA will continue to pay dividends to the entire industry for years to come.

ISDA has also played a key role in the wider implementation of the non-cleared margin rules. We published a whole new suite of credit support documents to help firms comply with September's first-phase rollout and the introduction of variation margin requirements from March 1.

The latter deadline was particularly difficult, as it applied to thousands of financial institutions in a single, big bang implementation. That created an unprecedented repapering challenge in a tight time frame, involving more than 150,000 CSAs.

ISDA tracked industry progress and updated regulators on a weekly basis. As March 1 approached, it became clear the deadline wouldn't be met, which would have resulted in many firms being locked out of the market and unable to hedge.

Fortunately, regulators across the globe – helped by ISDA's data – recognized the market wasn't ready, and provided additional time for firms to finish making the changes to their CSAs. The industry remains committed to completing the necessary work and is making good headway. We will continue to update regulators on the progress.

Reviewing the Regulatory Framework

As I've already said, the market is evolving, and ISDA has evolved with it to ensure we continue to unlock value for our members. Along with clearing and margining requirements, the industry has made tremendous progress in meeting the other post-crisis regulatory reforms.

Nonetheless, we think the regulatory framework can be made to work better. This can be done in three ways – by reducing complexity and removing unnecessary cost and compliance burdens; achieving cross-border harmonization of capital and market rules; and conducting cumulative impact studies to assess the impact of current and forthcoming rules.

I'll quickly outline each of those in more detail.

First**,** there are many examples of complexity and duplication in the rules that result in higher costs for derivatives users and ultimately discourage trading, investment and hedging.

In Europe, for instance, both parties to a transaction are required to independently report each new derivatives trade. This differs from the approach taken by other regulators. Crucially, dual reporting results in significant compliance costs for end users – we estimate more than €2 billion in aggregate. Despite the cost, the dual reporting requirement doesn't actually improve the quality of data that is reported, with both pairing and matching rates at low levels.

The European Commission has recently proposed some helpful changes to the reporting framework, but those changes – in our view – don't appear to deal with the dual reporting issue to the extent that is required.

In the US, the different rule sets for swaps and security based swaps issued by the CFTC and SEC has also led to inconsistencies, duplication and complexity. An example of this is regulatory reporting, where the rules diverge on required data fields and the format of submission. Swap dealer registration requirements and compliance regimes also look likely to differ, requiring firms to develop two similar but different systems and processes in order to comply with both sets of rules.

The Volcker rule, too, has created massive complexity – in part due to the fact that five regulatory agencies are jointly responsible for it. This was actually highlighted as an issue by former Fed governor Tarullo in his final address before resigning.

Coming in at approximately 70 pages when issued, it was accompanied by about 850 pages of explanatory notes, which highlights the extreme complexity of this rule. Rube Goldberg himself would be proud of it.

Making sense of it and collecting the required metrics has created a massive compliance burden for banks of all sizes, regardless of the extent of their trading activities.

There are many other examples of duplication, inconsistency and complexity that are overly cumbersome and costly without having any obvious benefit from a systemic-risk perspective.

ISDA has consistently flagged these issues, and has looked to provide value through our fact-based advocacy and by proposing solutions aimed at simplifying operational complexity – for instance, through our work to promote common identifiers and taxonomies.

Fortunately, both Europe and the US are reviewing their rules with an eye to making refinements where necessary. We welcome initiatives like the EMIR Review, the CFTC's Project KISS and the US Treasury's current review of regulation. We agree that it makes sense to ensure the costs of complying with new regulations do not outweigh the benefits.

A critical part of these reviews will be the cross-border impact of the rules – the second of the three fixes required. As I mentioned earlier, the derivatives market works best when it is global.

But if cooperation between regulators fails, we may see markets fragment, turning that liquidity pool into liquidity puddles. That means less choice for end users, less efficiency, and potentially higher costs.

Unfortunately, that fragmentation has already started to emerge. ISDA studies have shown a dramatic reduction in the participation of US counterparties in the European interdealer market for euro interest rate swaps since US SEF rules were introduced.

As Europe prepares to roll out MIFID II, it's vital that a substituted compliance decision is made quickly, based on broad outcomes, in order to prevent further fragmentation. In fact, ISDA research published last year shows the SEF and MIFID II rules are broadly similar in outcomes. Our aim is to unlock the value of new trading platforms and processes for market participants by promoting global consistency and harmonization.

Nonetheless, the substituted compliance process would be helped through amendments to the SEF rules to promote trading on SEFs, improve market liquidity and bring the requirements more in line with the approach in other markets. We are optimistic about the CFTC's new reform agenda, which includes bringing more flexibility to SEF trading. You should not miss Acting Chairman Chris Giancarlo's speech tomorrow morning.

The need for outcomes-based substituted compliance and equivalence isn't limited to trading, of course – it's important across the board. Take clearing. There's been lots of noise recently about the possibility of Europe introducing a location requirement for euro-denominated derivatives. This could have massive implications for efficient cross-border flows. Breaking up netting sets by requiring certain currencies to be cleared in specific locations reduces the potential for risk-exposure offsets, which increases costs, risk and operational complexity for derivatives users.

Understanding the cost and impact of any rule individually and in combination with others is the third remedy to ensure the regulatory framework works better.

We have long supported moves to make sure the industry is adequately capitalized, and great progress has been made in that direction. Since the crisis, banks have been required to bolster capital levels significantly, as well as increase their stock of high-quality liquid assets. For example, the average common equity Tier 1 ratio of large EU banks increased by more than 40% between 2012 and 2015, according to the EBA.

While increases were necessary in the wake of the financial crisis, it's important that further capital measures are appropriate, in line with risk, and do not undermine economic growth.

However, ISDA analysis has shown further measures currently being considered by the Basel Committee will ultimately result in higher capital requirements for banks.

Our analysis shows the Fundamental Review of the Trading Book could result in an increase of market risk capital of between 1.5 and 2.4 times compared to current levels. The exact impact will depend on the extent banks can use internal models. But the model eligibility test within the

FRTB is currently unclear and complex. A requirement to prove that sufficient data exists in order to model risk factors will also be complex to implement.

ISDA is working on an initiative to set the ground work for a data pooling solution to help banks meet the risk factor modellability requirements – another example of unlocking value for the industry. There is nothing to be gained by everyone trying to find their own solution to this problem. Only cooperation and consensus can achieve the desired result.

Elsewhere, the leverage ratio is having an impact on the ability of firms to offer client clearing services. ISDA studies have shown the failure to recognize the exposure-reducing benefit of client initial margin significantly increases leverage ratio exposure for bank client clearing businesses. This could make it more expensive for smaller clients to access clearing, contrary to the intentions of the G-20.

There is currently significant uncertainty about the Basel III reforms. At ISDA, we believe there should be four specific outcomes from the negotiations this year.

We believe the capital framework should:

1. Not cause a significant increase in capital levels, as directed by the G-20.
2. Be appropriate, risk sensitive and consistent. To that end, regulators should conduct a comprehensive impact study before all the rules take effect to understand the effect that current and forthcoming rules will have on the derivatives ecosystem as a whole.
3. Be harmonized on a cross-border basis to avoid global inconsistency.
4. Be simplified to reduce operational complexity.

A Smart Future

I've talked about the past and the present. Now, I'd like to talk about the future. To meet the multitude of new regulatory requirements, the industry has implemented numerous tactical solutions to comply with the rules. The focus has been on meeting deadlines, rather than creating consistency or efficiency. Now is the time for the industry to take a thorough look at the system and determine what works, what doesn't, and how we can unlock value through efficiency. We need to be bold.

One area where improvements can be made is in trade processing and market infrastructure. The industry has spent the past several years with its head down, meeting regulatory deadline after regulatory deadline. An immense amount of plumbing has had to be built to connect up the new additions to the derivatives landscape – execution platforms, trade repositories and clearing houses.

Operating to such tight deadlines has left little time for participants to step back and look at the big picture.

As a result, we are left with processes and infrastructures that are costly to maintain, far too complicated and increasingly unfit for purpose. But capital rules and tighter margins require the adoption of innovative and less complex structures that increase efficiency and cut costs.

As things stand, there are two fundamental challenges that have created inefficiency in the system

First, there is a need for constant reconciliation between counterparties throughout the lifecycle of the trade. Existing workflows are bilateral in nature and do not scale up easily. Clearing and exchange-trading offer the opportunity to implement more standard processes, but firms have been forced to take tactical action to meet the regulatory requirements.

The second challenge is that the current system was not built on a consistent data or process hierarchy. As a result, the industry lacks common standards and requires very specific and nuanced solutions for each step in the process. Firms have developed their own data systems due to the lack of a common standard, forcing them to constantly reconcile their trades at each step of the process. This is compounded by the fact that regulations have driven different reporting, transaction and confirmation requirements in the various jurisdictions.

Today, the trading network is populated by brokers, clearing houses, trade repositories, compression cycles and execution venues – the picture looks pretty complicated. Everyone has to constantly talk to everyone else to reconcile developments in the trade lifecycle. With so many messages flying around – as you can see on this slide – everything slowly gets clogged up and harder to manage.

The one standard element to all of this is the legal framework – work ISDA has led for the past 30 years. If we're going to upgrade the system, we need to adapt our legal framework to the digital environment by future-proofing our documentation – or future-proofing our legal framework.

We recognize the challenges facing the industry, and are ready to contribute to finding a solution to this extremely complicated and inefficient system.

Ultimately, the solution will be built on three standard models. First, we have must have data standards that consistently represent the economic terms of the trade, including a globally consistent product definition. Next, we need process standardization to consistently represent both external and internal trade events. Finally, we can develop smart contracts. These will provide an automated legal framework for financial instruments based on a standardized data and processing hierarchy.

With a single, trusted, automated record, there's no need for constant chatter between all parties. There is much less need for manual input during the trade's lifecycle, meaning back-office resources can be diverted to different tasks. Trade processing becomes smoother, simpler, more accurate, and less costly. This standardized model provides enhanced transparency, risk management and trade processing efficiency.

In September last year, ISDA published a white paper setting out the improvements in data, documentation and process that will need to be made. Consistent data standards, such as product and trade identifiers, are fundamental to market efficiency and need to be natively embedded in the underlying market. Commonality here will ensure that innovators and market participants use the same reference points across the trade lifecycle.

ISDA has already set out the key principles that should govern the design of a global product identifier, and we have begun work to define appropriate product taxonomies. We are also working with regulators to develop a suitable trade identifier framework.

The industry can springboard off robust and familiar legal architecture to reduce development time and investment costs for smart contracts. Existing Financial product Mark-up Language templates can be extended to include business logic that creates a self-executing transaction. ISDA has already demonstrated a proof of concept of this, and is working to expand the capabilities of this system.

Over time, a simplified, re-ordered workflow could create more efficiency over the lifecycle of a trade, and encourage the use of standard terminology. It would provide a transparent view of how a market works to aid regulatory oversight and rule-making. Once agreed, processes can be encoded as common domain models that accurately reflect how the market works and aid interoperability.

This vision isn't a top down, single platform for all users. On the contrary, we believe market innovators will bring new competitive solutions that will be enhanced by a consistent data and process representation. ISDA wants to work with technology providers, process innovators and lawyers to explore these new opportunities and create an environment where innovation and competition bring cost-effective solutions.

When ISDA offered the first Master Agreement, it was licensed to the market, allowing everyone to build off this common legal foundation. That is what we are offering today.

ISDA will be on hand to do what it has always done – bring the industry together, find consensus and hammer out solutions. I believe we can play just as vital a role in the development of smart contracts, enabling the market to keep growing over the next 30 years.

I hope I have given you a clear vision of our successes in the past and the opportunities for the future. ISDA is constantly working to unlock the value in these markets and improve systems – whether legal systems or trade flows – to ensure these markets work safely and efficiently.

Before I close, I want to thank our sponsors and our exhibitors for joining us. I also want to thank the ISDA staff for the most innovative and interactive AGM, as well as a really broad set of issues and panelists.

Lastly, I want to thank you all for joining us here this week. This AGM will give you chance to reconnect with friends and colleagues, and get involved in all the latest issues affecting our industry. I hope you enjoy the event, and I hope you enjoy your time in this incredible city.

Thank you.