ISDA Safe, Efficient Markets

ISDA Derivatives Trading Forum
Chairman Remarks
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Good morning, everyone.

What would you do if you were stuck in the same place, and the same scenario played out every day, regardless of your attempts to change the outcome? It's the dilemma faced by Bill Murray's character, Phil Connors, in the iconic film Groundhog Day. Phil is trapped in a time loop and has to relive the same day over and over.

I mention this because several market-based financial stress events in recent years have followed a similar pattern that, at times, have had Groundhog Day vibes. The March 2020 dash for cash, the February 2022 energy market turmoil and the September 2022 liability-driven investment (LDI) crisis in the UK were the result of very different exogenous shocks, but they all had similar characteristics. Each time, acute market stress was followed by sharp increases in margin requirements or redemptions, causing firms to sell assets to raise cash. This led to a spiral of further price moves, margin calls and the forced sale of assets, causing broader disruption across markets – to the extent that central banks had to step in to restore order.

Given heightened geopolitical uncertainty and the continued growth and importance of market-based finance alongside the traditional banking system, further liquidity shocks in the wake of market volatility certainly aren't out of the question. So, like Phil Connors, it's important to analyze and understand what's going on and decide what changes might be necessary to mitigate the potential for future, similar shocks – in other words, break out of the time loop.

Regulators and market participants are currently doing exactly that. The Financial Stability Board (FSB) is coordinating a significant work program to enhance resilience and liquidity preparedness, as well as review the data supervisors use to spot risks in private markets. In this process, it's important to recognize the broad diversity of the non-bank space, and to be very clear about exactly what problem we're trying to fix, what steps should be taken, and who or what those measures should target – as well as fully understand whether there are any potential knock-on implications.

In doing that, it's helpful to consider the broader backdrop of regulatory reforms since 2008. There's little doubt that our markets have changed almost beyond recognition over the past 15 years. Mandatory central clearing, margining of non-cleared derivatives and higher bank capital requirements have been implemented across the globe, going a long way to mitigating counterparty credit risk – an issue that was at the center of the 2008 financial crisis.

But in responding to one problem, another has emerged – a bit like a game of whack-a-mole. While mandatory margin requirements have helped to provide protection against counterparty

credit risk, the system has, in turn, become more prone to liquidity crunches during periods of stress. At the same time, higher capital requirements have meant bank balance sheets are much more constrained, limiting their intermediation and risk-buffering capacity in certain circumstances.

Regulators have been working to square the circle – to make the market more resilient to liquidity stresses, without compromising on the post-crisis initiatives to mitigate counterparty credit risk. A focus of those efforts has been to shore up perceived vulnerabilities in non-bank financial intermediation (NBFI), amid regulatory concerns about the growth of this sector, which has come to represent about 50% of global financial assets, and the increasingly important role it now plays in providing finance to the real economy.

International policymakers are working on a variety of initiatives intended to increase NBFI resilience, focusing on margin practices, transparency and leverage. Earlier this year, for example, the FSB published a set of policy recommendations to enhance the liquidity preparedness of non-banks for margin calls, in which it called for improved liquidity risk management practices, liquidity stress testing, resilient operational processes and the maintenance of sufficient levels of cash and readily available assets to meet margin calls.

Many of these recommendations are sensible on the face of it, but they're not without complexity. For one thing, the NBFI sector is not a single, homogenous group – something the FSB acknowledges. The acronym masks an amalgam of participants, from money market funds, insurers and pension funds to hedge funds, family offices and private equity and credit firms, each with different trading and investment strategies. Any policy response therefore needs to be proportionate to the size, business model and risk profile of the various market participants. In other words, we need to be very clear about the purpose of each new regulation and who it is aimed at, and weigh the costs and complexity of implementation versus the potential systemic risk posed by each user type.

The practicalities of sourcing sufficient eligible collateral in stress also aren't straightforward. Many NBFI entities, such as pension funds and asset managers, tend not to hold large cash buffers as they need to invest for the benefit of their clients, but clearing houses require variation margin to be posted in cash for very sound risk management reasons. Dealer counterparties also tend to prefer cash variation margin for non-cleared derivatives due to capital and liquidity costs associated with holding non-cash collateral, as well as the complexity of valuing trades that have the option to post different types of assets.

According to the latest ISDA margin survey, cash accounted for 76% of regulatory variation margin received by the leading market participants for their non-cleared derivatives exposures at the end of 2023.

Market participants could look to negotiate their credit support agreements to allow flexibility in the type of assets that can be delivered for non-cleared variation margin to avoid being reliant on cash. But this comes at a cost and is subject to bank balance sheet constraints – banks don't have infinite capacity to accept non-cash collateral.

A common option is to use the repo market to quickly transform assets into cash to meet margin calls. But this runs into similar issues – capacity constraints at banks due to capital reforms, potentially curtailing their ability to participate in this market as intermediaries. Balance sheet pressures will likely be most acute precisely when participants have the most need for collateral transformation – during a stress event.

Regulators in the US think that central clearing is part of the answer for one of the most heavily traded and widely held assets in the world. The Securities and Exchange Commission finalized regulations last December that include a requirement to clear certain Treasury repos from June 30, 2026 – a step proponents think will help reduce settlement risk, enhance liquidity and increase balance sheet capacity.

But this is a huge, transformative change that will come with costs and significant operational challenges – from the development and negotiation of legal documentation to the testing and implementation of client clearing models. Given the vital role the US Treasury repo market plays in short-term global dollar financing, it's important to ensure these issues are carefully considered and sufficient time is given for implementation so there isn't a negative impact on market liquidity or funding.

Given the various pinch points, it seems likely that central banks may have to continue to play some kind of role in backstopping market liquidity during acute stress events. The Bank of England has already taken steps in this direction and is working on a lending facility for certain NBFIs that would kick in during periods of stress. The facility will initially target specific participants – insurance companies, pension funds and LDI funds – and will allow those entities to access central bank lending backed by gilts. You'll note a common precondition: these are all entities already subject to significant supervisory oversight. The Bank of England has said it will consider eventually expanding the facility to other users and other assets – the question is what and when, and under what conditions, and also whether other central banks will follow suit.

These are incredibly complex issues, with lots of moving parts. It's clear we need to understand the drivers of the recent liquidity shocks and minimize the potential for similar disruption during future stresses. But the policy responses need to be carefully calibrated to reflect the diversity of the NBFI sector, recognize the important role that banks play in intermediation and the balance sheet constraints they face, and strike a balance between resilience and market efficiency. At a time when competitiveness and economic growth loom large on political agendas, we need to avoid any blunt, one-size-fits-all approaches that could undermine market liquidity and resiliency.

ISDA has submitted responses to the various regulatory consultations on margin practices and we'll continue to engage with policymakers as they refine their final recommendations. In some areas, however, we're already acting to make positive changes to the margin process.

Initial margin calculation is one such area. Along with liquidity preparedness, regulators have been looking at the responsiveness of cleared and non-cleared initial margin models to market stress. For non-cleared derivatives, we've taken quick action to review the methodology of the ISDA Standard Initial Margin Model (ISDA SIMM), and we're working together with market

participants and global regulators to move to semiannual calibration from 2025. This is an important change and will ensure that the ISDA SIMM remains risk appropriate and is updated in a predictable and efficient manner.

Another area is the automation and standardization of collateral management processes. Being able to meet elevated margin calls during periods of stress is obviously important, but it's also imperative that the collateral gets to where it needs to be quickly and with the minimum of friction. That proved to be a problem during the recent crises, when collateral operations at some firms gummed up under stress because of a continued reliance on manual intervention and a lack of interoperability.

In response, ISDA has worked with members to publish suggested operational practices and leverage the Common Domain Model (CDM) to digitize key documents, represent eligible collateral terms and automate cash collateral calculations and payment processes, with other use cases in development.

This won't prevent liquidity shocks from occurring, but it could reduce frictions and improve interoperability within the collateral management ecosystem, which could limit the severity of the crisis and help to stabilize markets in a stress scenario.

We recently launched a new CDM Collateral Start-up Guide, so I'd encourage all of you to download a copy from the ISDA website to see what's needed to get started. There are clear benefits from doing so – more efficiency, less risk and, ultimately, lower costs.

Going back to our Groundhog Day analogy, Phil does do something that matters in the end. He eventually uses his intimate knowledge of the day, gained by watching the same events happen again and again, to make important changes that break him out of the recurring loop. Sometimes, with enough work, you can make a happier ending.

Before I finish, I'd like to briefly touch on the global bank capital framework. These standards are set by the Basel Committee on Banking Supervision and reflect the views of 45 central banks in 28 different jurisdictions. This process of agreeing standards at the global level is important, because consistency in capital rules matters. If each jurisdiction develops its own rules, it creates challenges for globally active firms to manage risk consistently and efficiently. It also makes it much more difficult for banks to service their international clients, reducing competition and choice.

It's inevitable that some level of divergence will occur as national regulators adapt the standards to suit the nuances of their own banking systems. But, having started with a common song sheet for trading book capital requirements, we appear to be heading toward a cacophony of different tunes, with substantial differences emerging in both timing and substance. In the case of the US, we still have no idea what the final rules look like and when – or if – the new framework will actually be implemented.

Individual regulators, including the EU and UK, have shown a willingness to adjust timelines to harmonize start dates, which is very welcome. The differences in substance, however, are more problematic.

We believe the Basel Committee has a responsibility to address this at the earliest opportunity. Where divergences are most rife – for example, in the rules for credit valuation adjustment and the standardized approach to counterparty credit risk, incentives for market risk internal models and the treatment of client clearing – it suggests there's something wrong with the original calibration. Rather than leaving national regulators to apply their own fixes, we believe the Basel Committee should make any necessary changes at the global level to ensure the standards are appropriate, risk sensitive and, as far as possible, consistent across borders.

If not, it will not only make it more difficult for global banks to operate internationally – we could arrive at a complex and challenging situation in which some national regulators decide to impose extra capital requirements on their banks for exposures to other banks in those jurisdictions perceived as being less strict in their implementation of the Basel standards.

We'll never have identical rules in each jurisdiction, but, for the good of the global financial system and the companies that rely on it, we need to get closer to that common song book. Substantive divergences across jurisdictions undermine the credibility of the global framework. That is, of course, a different movie, and it doesn't end well.

I'd like to finish by thanking all of you for coming today. ISDA is a global association and our members – whether in the US, Europe or Asia Pacific – play a valuable role in helping ISDA achieve its mission of fostering safe and efficient markets. These events are a terrific opportunity for us to listen to and engage with members, and I look forward to speaking with many of you over the course of the day.

Thank you.