Interest Rate Swap Futures: Finally the Right Time

A History Lesson

After three decades of increasing use of OTC derivatives for sophisticated, customized and even generic forms of risk transfer (call it “swap-ification” of risk), the frameworks being implemented via Title VII and Basel III are compelling participants to migrate to more generic products for trading and hedging.

Market participants have begun turning to futures as capital-efficient, low-cost alternatives for generic risk transfer. Hence the new era of “future-ization.”

In the interest rate markets, competing swap futures recently began trading. While past initiatives for interest rate swap (IRS) futures have been unsuccessful, we think it will be a different story this time.

Many solid capital market offerings have not been successful due to poor timing or the lack of sufficient impetus for participants to adopt them. For example, Blackbird, a technology start-up, launched an electronic swap trading platform in 1999. The innovative trading platform leveraged technology in the IRS markets and could be considered similar to a present-day alternative trading system (ATS) or swap execution facility (SEF). Unfortunately, the timing was off: there was no compelling need or regulatory impetus driving dealers or participants to trade on the platform.

CME launched the original interest rate swap futures contract more than 10 years ago, but it never gained traction. While the product has obvious merits (as a cleared hedging alternative to mitigate counterparty risk), it has yet to attract sufficient volume or liquidity or use on a widespread basis. This can be attributed to a variety of factors at the time of launch. Cost (clearing cost and initial margin) was comparatively high relative to a swap. The future contract’s structure, which called for cash settlement and did not offer the same convexity as a swap, did not appeal to participants. Furthermore, existing market convention at the time, the use of CSAs to mitigate counterparty risk, was viewed as sufficient.

In the end, the swap futures contract failed to generate discernible volume and liquidity because there was no compelling reason for participants to trade the contract. To the contrary, IRS liquidity concentrated in the inter-dealer market, combined with the relatively low cost of trading swaps in terms of capital, margin and execution cost, proved superior.

There were compelling reasons to turn to the OTC markets to transfer risk. The swap markets offered a highly liquid market for participants to transfer risk, both in customizable and generic terms. The depth and liquidity of the IRS market, created by customized end user hedging, made it the more attractive market for generic risk transfer.

Back to Today

Title VII of the DFA changed the rules and market structures for the OTC derivative markets. Basel III similarly altered the quantity of capital needed and its associated cost for banks and financial firms. The cost structure for OTC derivative transactions has changed dramatically, in addition to changes in methods of execution and post-trade requirements. These factors will affect market participants (both directly and indirectly) through their reliance on bank dealer liquidity as their trading counterparty.
Transaction costs as measured by capital and margin are now directly related to the degree of customization offered by the product used. As depicted below, highly customized swaps that are not clearable will be most expensive and subject to CVA Var under Basel III, and will likely require 10-day Var calculations for initial margin (IM). Standard swaps that are required to be cleared will carry a 2% capital risk weight with 5-day Var IM and FCM imposed clearing costs. Futures will have significantly lower IM requirements, clearing and capital cost. This cost structure is no accident: it provides incentives for the use of generic and standardized products that can be centrally cleared and easily managed in a stressed or default scenario.

Accordingly, the introduction of new generic futures contracts, deliverable swap futures from CME and quarterly cash settled contracts from Eris, are likely to have cost-driven reasons for broad use. Both offer capital efficiency through favorable treatment, 2-day Var margining (at present, with 1-day Var likely in the future) versus 5-day Var margining for cleared swaps or Eris’ flex-futures. Participants have a choice between cash settlement (Eris IMM contracts) or swap delivery (CME contracts).

We do not see either contract replacing the swap market. Yet, both offer attractive, capital-efficient alternatives for generic risk transfer at a time when participants, particularly banks, face significantly higher capital and funding costs.

Factors making these instruments compelling alternatives to cleared benchmark swaps include: favorable capital treatment (for both the end user and clearing FCM); lower IM requirements; increased netting and margin offset with other listed products; and lower clearing cost. In addition, differences in execution requirements (key SEF/DCM final rules and core principals are still pending), including lower block trading thresholds, may result in greater flexibility for futures execution relative to swaps.
Futures contracts also offer operational benefits relative to cleared swaps. These include ease of termination, no need for compression and the ability to use existing infrastructure and technology. The use of futures may allow some participants to avoid some, or all, of the new swap market regulation. These advantages are augmented by participant’s familiarity and comfort level trading futures contracts electronically.

Working against these contracts is the cost of rolling a hedge forward and the lack of current trading volume and liquidity.

**Expected Evolution of the IRS Markets**

As the swap markets become more electronic, we expect both swaps and swap futures to trade side-by-side.

The evolution toward futurization is the result of cost differences of trading products with similar risk profiles. Regulation has created economic incentives to transfer generic risk through generic products. Using a customized product, such as a swap, to take a directional view on rates or swap spreads will no longer be the most cost-efficient way to express that view. While many see this as the futurization of the swaps markets, it is actually the reversal of the swap-ification of generic risk transfer.

Who will trade these products?

- Dealers trying to balance their cleared swap risk positions at CCPs, particularly as alternatives to cleared swaps for non-cleared end-user transactions
- Participants seeking an interest rate or swap spread position that do not want or need the customization of a swap, nor the need for unwinding and/or compression
- Participants seeking to maximize nettable offsetting risk with other futures products
- Participants that actively trade the markets (HFTs, arbitrage players, etc.)
- Firms wishing to operate under a single regulatory framework
- Smaller firms frozen out of FCM clearing access

Why now? As the clearing mandate phases-in (and subsequently the trading mandate), the costs involved will become tangible and begin to accrue. Firms will adopt strategies that minimize the all-in cost of a transaction over its expected lifecycle. This will include execution-related cost as well as funding. We expect firms to reevaluate the criteria used in their hedging programs and to more closely consider the costs and benefits between acceptable basis risk and the “perfect” hedge.

When will volume grow? Likely over the same phase-in period.

As seen in the chart below, current volume in the 5 Year Deliverable Swap Futures contract is rather modest, although not that different from the early days of the Treasury Bond contract, which averaged just over 200 contracts per day in late 1977/early 1978.
The realistic potential trading volume for IRS swap futures is significant. Recent daily activity in the benchmark 5-year IRS averaged around US$10-15 billion notional reported to DTCC (spot starting 5-year IRS contracts only). It is plausible, if not likely, that a significant percentage of this generic risk transfer could easily migrate from swaps to futures (in addition to volume from futures traders, speculators, and other ISDA and non-ISDA participants). These are conservative estimates but illustrate baseline market potential.

So while swap futures in the past have not gained traction, the market environment today is ripe. There is clear impetus for firms to adopt risk-equivalent, low-cost alternatives to cleared swaps. The economic incentives hold true for banks, swap dealers, speculators and end users alike. The evolution will continue as risk transfer migrates to the most efficient and lowest-cost products. In many cases these are likely to be swap futures contracts.

The rules of the game have changed. In response, participants will change the way they play.

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