Futurization Comes to Europe

By David Wigan

Several exchanges are preparing to launch an array of swap futures in the coming months aimed at participants in the European swaps markets. With mandatory clearing requirements set to take effect later this year, the exchanges believe swap futures may appeal as a more capital-efficient alternative.

Eurex led the way in September, launching a range of euro-denominated futures similar to the delivery swap futures introduced in the U.S. by CME Group just over two years ago. More recently Eurex signed an agreement with Global Markets Exchange Group to license its design for a "constant maturity" interest rate swap futures contract, and said it plans to offer access to the GMEX product through its trading platform.

In December Intercontinental Exchange jumped into the ring, announcing an agreement with Eris Exchange to license its methodology for swap futures. Eris has created a market for swap futures in the U.S., and the partnership will bring the Eris model to Europe via ICE's infrastructure.

CME is also targeting the European market. It has introduced a euro-denominated version of its deliverable swap future on its U.S. platform and officials have indicated that the exchange is exploring the possibility of listing swap futures on CME Europe, its London-based subsidiary, sometime in 2015. Last but not least, the London Stock Exchange reportedly has begun talks with a group of banks about launching a European swap future. No details have been disclosed by LSE, but industry observers speculate that LSE aims to leverage the large amount of interest rate swaps outstanding at its subsidiary LCH.Clearnet.

Why Swap Futures?

Why the sudden interest in swap futures? The key attractions of swap futures are lower capital requirements and reduced margins.

Under the Basel III capital standards that are now coming into force around the world, banks are confronting increased capital requirements for their OTC derivatives, arising from higher risk weightings on trading activities, a new credit valuation adjustment charge and more stringent measures for measuring default and credit migration risk.

Regulations also call for higher initial margins for OTC products compared to exchange-traded futures. Margin requirements for swaps are based on the amount of risk over a time period of five days for cleared swaps and 10 days for uncleared swaps. In contrast, the time horizon for measuring the risk of swap futures is just two days.

Another key attraction is standardization. Like other futures contracts, the new swap futures offer the operational efficiencies of a standard contract design. Two contracts that offset each other can be netted out through clearing, and the processing of trades is greatly simplified.

There is no standard approach to contract design, however, and the market will be faced with a diverse array of competing products with significantly different characteristics.

Details of European Contracts

The deliverable swap futures contracts offered by Eurex have physical settlement, meaning that when these contracts expire, the positions settle into the underlying interest rate swaps. In other words, an asset manager that goes into the expiration with a long position in Eurex 10-year Euro Swap contracts at expiration will receive a 10-year interest rate swap. Eurex offers contracts with maturities of 2, 5, 10, and 30 years, with physical delivery into a plain vanilla euro denominated interest swap with the corresponding maturity.

The GMEX interest rate swap futures contract is constructed in a very different way. The contract does not have a fixed expiration; instead the contract is revalued daily so that the maturity remains constant. "We are offering annual maturities from two to 30 years, and the maturities are sticky so a 10-year today is 10-year tomorrow," said Hirander Misra, the company's founder and chief executive officer. "The way you can hedge is through weighted contracts in different maturities."

Under the terms of the agreement announced in December, trades in the GMEX contract will be arranged on GMEX's trading platform, which is regulated in the U.K., and then executed at Eurex, with clearing taking place at Eurex Clearing. In effect, this means that Eurex members will have access to two types of interest rate swap futures—deliverable and constant maturity.

ICE is planning to offer two sets of swap futures based on the Eris methodology. One set will target the credit default swap market; ICE said it will list swap futures based on benchmark CDS indices in both the U.S. and Europe. These new contracts will supersede a previous effort by ICE to create a CDS swap futures contract that failed to gain traction. This time around, the contracts are designed to offer clients "the regulatory certainty of futures without compromising traditional OTC characteristics," ICE said. These include the inclusion of "price alignment interest," an adjustment to the value of the futures contracts that mimics the cash flows on traditional OTC swaps.

The other set will target the interest rate market. ICE Futures Europe will list interest rate swap futures based on two contract designs developed by Eris—standards and flexes. Standards have quarterly expirations based on the standard calendar used in the interest rate futures market; the flexes allow users to customize the maturity to any date out to 30 years. The ICE contracts will be denominated in euros and pounds sterling, complementing the existing Eris dollar-denominated contracts that trade on Eris' own platform and clear at CME.

Modest Success in the U.S.

Despite the perceived benefits of swap futures over traditional swaps, the actual demand is far from certain. The Euro Swap contracts launched by Eurex in September have no open interest, an ominous sign given the exchange's large customer base in Europe. Even in the U.S., where the Eris and CME contracts have been live for more than two years, the contracts have achieved only modest success so far.

During the quarterly rolls, volume in CME's deliverable swap futures has reached as high as 61,000 contracts traded in a single day, but normally the daily volume is below 10,000 per day, and volume at Eris has been about half that. On the other hand, both exchanges report that open interest has been rising steadily, an indication that customers are increasing the number of contracts being held in their accounts. Open interest at year-end was approximately 125,000 at CME and 140,000 at Eris.

Portfolio Margining

In Europe, one of the keys to success will be portfolio margining–the ability for clients to reduce margin requirements via offsets from related instruments. In credit, ICE is the dominant player in the clearing of OTC credit default swaps and it will be able to offer netting of margin requirements for users of its forthcoming credit swap futures.

In the rates market, the situation is more complex and each of the major contenders offers a different margin netting opportunity. Eurex is the dominant player in fixed income futures thanks to its bund, bobl and schatz contracts. ICE is the dominant player in the short-term interest rate futures thanks to its acquisition of Liffe and that exchange's STIRS complex. LSE has no share of the market for interest rate futures, but the SwapClear service offered by its subsidiary LCH.Clearnet is the dominant clearinghouse for interest rate swaps.

Recognizing the potential benefits of offering margin netting across all three sets of products, Eurex is working to improve the competitiveness of its clearing service for interest rate swaps as well as the ease of trading STIRS on its platform. Eurex has updated its trading system with significant short-term interest rate functionality, including packs and bundles as well as strips, butterflies and condors as bespoke strategies.

"Investors trading our Euro fixed income futures, OTC cleared swaps and new interest rate futures will be allocated one margin bucket, so the efficiencies are pretty clear," said Stuart Heath, executive director and head of the Eurex representative office in the U.K. "Clearly market participants need to evaluate where it would be cheaper on a trade by trade basis, and it depends on their positions, but end-users probably stand to benefit considerably."

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