Futurisation of swaps under new trading rules

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Financial innovation is the creation of new financial products, sometimes inspired by the launch of new regulatory mandates. Regulations are often perceived as working against a free market, yet markets continue to expand under their weight. If regulators set reasonable rules and apply them uniformly, markets will adjust. Dodd–Frank Wall Street Reform and Consumer Protection Act (‘Dodd-Frank’) and European Market Infrastructure Regulation (EMIR) each represent a major paradigm shift for derivatives trading, both over-the-counter (OTC) swaps and exchange-traded futures, each regulated differently. The change marks a major shift for the US$600 trillion global swaps market while the futures market remains virtually unaltered. This article addresses a recent phenomenon, the movement of some traditionally swap transactions to futures exchanges as swap futures. Swap futures introduce a unique variable into financial markets. They take the flexibility of OTC transactions and drop them into futures exchanges. This ‘trade migration’ has become known as ‘futurisation’.

This article examines the pros and cons of swaps migrating to futures exchanges as swap futures and discusses why futurisation is unlikely to occur on a mass scale, with the possible exception of some energy and interest rate trades. We examine futurisation from the viewpoint of four key market interests to show the risk of mass migration is minimal. We conclude that an amount of trade migration to futures exchanges is good for financial markets and signifies economic progress and innovation.

The debate

Intense interest in futurisation rose in early 2013, prompting the CFTC to convene a meeting in late January to...
discuss the topic with market participants representing various interests. Opinions were mixed as the conferees debated the utility of levelling the regulatory playing field between traditional futures and swaps cleared under the new Dodd-Frank regime. The meeting closed with no mandate or plan of action to level the playing field as it was agreed that futurisation has some benefits and some drawbacks. One side of the debate suggests futurization signals the decline of traditional swaps trading. The other believes this concern is unfounded.

**Futures and swaps**

Hedging offers protection against price movements. Two key hedging instruments used by market participants are futures and swaps, both regulated differently. A future is a standardised contract traded on an exchange by two parties for the purchase and sale of a standardised commodity, equity or financial instrument for an agreed price. Delivery and payment occur on a specified date in the future. The futures exchange acts as intermediary to minimise the risk of default by either party by standardising margin requirements and contract settlement terms. Futures customers may also execute privately negotiated ‘block trades’ on exchanges. Block trades are allowed for specified products and subject to minimum size requirements which vary according to product, transaction type and the time of execution. Block trades may be executed by parties looking to hedge a specific risk through the exchange at a fair and reasonable price. Global futures exchanges and their governing rules are well-established.

Swaps are privately negotiated OTC transactions, bilateral contracts executed by two parties (‘counterparties’) to hedge financial exposure. In a swap, the parties exchange cash flows at agreed intervals based on changes in the value of an underlying asset or instrument. Historically, swaps were not heavily regulated nor were they subject to third-party clearing or transparency rules. This allowed banks to charge larger spreads for swap transactions. Given the bilateral nature of swaps, they are more easily tailored to hedge exposure where futures trades are subject to lot sizes and tenors available in the designated contract market.

Swaps serve a key function in global economic markets providing market participants protection against risks unique to a counterparty, whether those risks lie in exposure to equities, commodities, fixed income, credit or other product types; swaps are better suited to manage those risks. Dodd-Frank seeks to regulate swap markets by creating clearing and margining mechanisms similar to the futures exchanges market, requiring that swaps be cleared through clearinghouses.

**Regulatory arbitrage**

As new rules for swaps clearing, margining and reporting are implemented, market participants will exploit differences in the regulations governing swaps and futures by choosing the most beneficial regulatory scheme for each trade. This exploitation, which utilises substantive variations in different regulatory schemes, is known as ‘regulatory arbitrage’. Regulatory arbitrage between swaps and futures may be beneficial to a party but its benefits may abate following a transition period where product trading stabilises after new regulations are fully implemented. Regulatory arbitrage is a natural component of financial innovation compelled by regulatory mandate. Regulatory arbitrage is difficult to prevent but market participants alarmed by futurisation can relax knowing that, as regulations are finalised and swap markets settle under the new trading infrastructure, the benefit of hedging a specific exposure under the appropriate regulatory scheme will become apparent.

**ICE, CME and the energy sector**

Intercontinental Exchange (ICE) is a leading operator of global exchanges and clearing houses which strategically acquired NYSE Euronext, the leading equity, equity options and fixed income derivatives market operator. ICE then converted cleared energy swap contracts to economically...
equivalent futures contracts beginning in October of 2012. In 2013, ICE stated that more than 50% of its daily trading volume in energy futures was previously traded as swaps.

During the same period, CME Group Inc. (CME), also one of the largest exchanges in the world, stated that significant amounts of new trades were migrating to its exchange platforms from the OTC market and that nine in 10 energy trades executed on their proprietary ‘ClearPort’ system were executed as futures, as compared with one in 10 energy trades prior to last year. In February of 2013, CME reported a 78% decline in profits for Q4 2012. This decline was attributed in large part to declines in its energy-based swaps businesses. In each case, the beneficiary appears to be futures exchanges.

Futurisation has occurred on a larger scale in the energy market thus the energy market has driven the discussion of futurisation as ICE and CME migrate trades to their exchanges as swap futures. Energy companies that once primarily traded swaps now look to trade futures. Swaps were historically used by energy companies seeking to hedge unique exposure to wholesale production costs and retail prices through bespoke transactions. They were typically better hedges for energy exposure given their flexibility. Now, with some of that flexibility removed and the regulatory burden increasing, swaps do not enjoy the same advantage. Some estimate over US$9 trillion in notional daily trading volume has migrated from the energy swaps to futures exchanges. Over 95% of the former energy swaps at ICE are now traded as futures, while at CME Group the amount exceeds 85%. New oil, natural gas and electricity futures contracts are almost identical to the swap transactions energy companies have commonly used to hedge financial exposures.

Basic interest rate swaps may also be hurling towards large scale futurisation by entities seeking to circumvent the cost of Dodd-Frank and EMIR compliance, particularly given that interest rate swaps comprise the largest swap product class totalling approximately US$379 trillion in notional trading value outstanding and are also easily converted into swap futures. Eris Exchange, a US-based futures exchange offers interest rate swap futures.

The pros and cons of trade migration and futurisation

Considerations in favour of futurisation

There are considerations working in favour of trade futurisation as well as against it. Some financial hedges would benefit from permanent migration to a futures exchange, others would not. A comparative analysis of each contributing factor may shed light on whether futurisation will occur on a large scale in the face of new swap regulations. Considerations encouraging trade migration to futures exchanges are as follows:

• Regulatory arbitrage encourages market participants to pick more advantageous regulatory schemes for cost saving, accounting, tax or other purposes. The comparative clarity of regulatory schemes now favour futures. The regulatory arbitrage window will narrow to the extent administrative or judicial interpretations, decisions, comment letters and mandates close loopholes and foreclose its perceived benefits.
• Futures require less margin (initial and variation) as they are margined based on one day value-at-risk (VAR) while swaps are margined at five day VAR. For more customised swaps, additional margin in excess of five day VAR may be required.
• Futures and swap futures margin will aggregate to form a larger overall margin pool, thereby creating margin efficiencies. The stronger the margin pool the more liquidity is available to the market.
• Futures are less costly to trade when compared to swaps trading under Dodd-Frank. Swap counterparties face additional costs as dealers will likely pass increased registration and compliance costs to end-users in the form of larger spreads or higher fees.
• Futures infrastructure is stable while new rules governing swap execution, clearing and reporting remain unsettled and sometimes unclear. New swap rules will be challenged, nuanced and exemptions sought by market participants before the new infrastructure settles.
Financial institutions seeking to comply with more stringent capital requirements under Basel III are likely to seek balance sheet reductions through futurising certain trade portfolios, where possible, to reduce costs.

Considerations favouring traditional swaps

Conversely, there are reasons hedging on a futures exchange for some swap end-users is not beneficial and traditional swaps remain a better hedging option. Some of these reasons are as follows:

- Many swap counterparties hedge customised risks not easily traded on futures exchanges due to trading limitations. For example, an entity seeking to hedge a particular exposure may require 30 futures contracts to hedge against a risk ordinarily covered by only 2 swap transactions. Protections available through swaps trading is more readily tailored to the unique nature of most end-user risk.
- Some end-users looking to hedge financial risk are exempt from registration and clearing requirements and enjoy fewer reporting requirements.
- Futures exchanges lack sufficient product depth for swap users looking to hedge risk. Maintaining thinly traded swap products on a futures exchange is inefficient and not cost-effective.
- Swaps provide synthetic access to broad and unique risk exposures. Trading in financial products is continuously evolving, making new products more amenable to swaps trading. A few examples of products difficult, if not impossible, to futurise, are inflation swaps, weather swaps and carbon emission swaps, which are not easily traded on futures exchanges.
- Attempts to futurise unique financial exposures may leave a party vulnerable to basis risk. Basis risk is the mismatch between exposure and the instrument used to hedge that exposure; the risk that the value of a futures contract or swap transaction (or series of transactions) will not move in line with that of the underlying exposure. The lack of flexibility in futures trading may increase basis risk and may threaten an entity’s ability to properly book the transaction under hedge accounting rules.
- Generally, a small number of banks and financial institutions act as ‘Swap Dealers’ and exercise influence over the swaps market. Given the economic investment and market entrenchment of institutions already registered (or likely to register) as ‘Swap Dealers’ or ‘Major Swap Participants’ under Dodd-Frank, these entities will continue to introduce and offer swaps.
- Futures markets are not well suited for complex financial hedging and swap providers will continue to provide this function.
- The segregation of customer collateral in futures exchanges requires improvement. The new swaps model improves the segregation of margin into separate customer accounts. In terms of margin protection, the new swaps clearing model surpasses that of futures and significantly reduces the risk that trade margin will be lost in the event a clearinghouse fails.

Varying interests in the futurisation debate

The potential for mass futurisation is better understood in the context of analysing the views of interested parties. Some behaviour is predictable by interest analysis. Each group will view futurisation and trade migration differently. The key interested groups are (i) regulators and self-regulatory organisations (SROs); (ii) exchanges, clearinghouses and swap execution facilities; (iii) Swap Dealers; and (iv) end-users.

Regulators and SROs

Regulators are charged with reducing systemic risk to avoid another financial meltdown through implementing, interpreting and enforcing rules. Their primary interest is to create and administer a level playing field, within each
They satisfy that obligation by creating clear rules governing trade execution, clearing, margining and reporting and by ensuring fair and uniform enforcement of those rules.

Some believe regulators favour futures over swaps, by creating a complex and more costly trade infrastructure for swaps; one which exempts some products and end-users and one with more stringent margin and reporting requirements. In fact, new swap rules have the benefit of hindsight into futures trading and the way swap markets and products operate. This allows regulators to create a regulatory infrastructure for the global swaps market as it trades today, understanding that market is inherently more complex and costly than other trading infrastructures. Therefore, regulators can create a more robust regulatory scheme. Regulators have no obligation to ensure uniformity in the treatment of swaps vs. futures. Their obligation is to effectively regulate each market separately.

If the implementation of new swap rules results in trade migration to futures exchanges, regulators are unlikely to take a position unless it affects the overall soundness of the regulated market. Ultimately, product innovation and risk assessment will determine the best hedge for an exposure. Market participants will exploit available loopholes, some until closed by regulatory amendment, interpretive edict or other clarification. However, regulators must view futurisation of certain swap transactions as a necessary occurrence, with indifference to trade migration.

SRO interests are aligned with those of regulators. They ensure uniform oversight and compliance with professional rules of conduct and customs within a particular industry. They enforce compliance practices for their members. SROs should likewise remain indifferent to trade migration or futurisation unless there is some broader impact to its regulated industry upon which to petition the applicable regulator for change.

**Swap Dealers and security-based Swap Dealers**

A Swap Dealer is defined by Dodd Frank as “a party that holds itself out as a dealer in swaps; makes a market in swaps; regularly enters into swaps with counterparties in the ordinary course of its business for its own account; or engages in any activity causing the person to be commonly known in the trade as a dealer or market-maker in swaps.” A relatively small number of dealers exert a substantial amount of influence over swaps trading. These entities include banks and financial institutions. They seek steady growth in swaps trading revenue and several will seek to establish registered swap execution facilities. These entities are more likely to bring regulatory attention to the unequal treatment of futures and swaps. These entities may exert pressure on regulators to resist futurisation while at the same time hedging a larger portion of their standard internal risk on futures exchanges to get better margin charges.

Given the financial innovation of swap traders and dealers, swap revenues will rise again as markets settle into the new regulatory scheme and end-users seek to hedge unique financial risks. Dealers have little to lose in the long term with futurisation of some trades.

**Futures exchanges and swap clearinghouses**

Exchanges and clearinghouses have similar interests. Each seeks to service customers by clearing transactions through processing and trade execution. They compete for new market share through customer service efficiencies and seek to expand product lines. We see this in recent acquisitions by ICE and CME aimed at growing business lines for both futures exchanges and swap clearinghouses. Futures exchanges and swap clearinghouses will each expand, receiving new market share in the form of both swaps and futures. These entities should remain indifferent to futurisation. The addition of innovative swaps will counterbalance the migration of standardised swaps to future exchanges. In the long run, these parties will welcome futurisation due to industry consolidation and the bespoke nature of swaps.

**End-users hedging specific risk**

Swap end-users enjoy exemptions from registration, clearing and reporting under Dodd Frank, provided they are...
non-financial entities using swaps to hedge specific risk. End-users will benefit from both futures and swaps trading based on hedging need. They may purchase futures to hedge standardised risk or swaps to hedge non-standardised risk. End-users should remain indifferent as they must properly analyse and hedge financial risk in the most liquid and cost-effective manner.

Given an analysis of these four primary groups potentially affected by futurization, we see most interested entities have little reason to be concerned over futurisation.

**Conclusion**

Futurisation is, in part, a result of financial innovation. Financial markets evolve as creative traders develop new products to manage increasingly complex financial risk within the applicable regulatory scheme. Entities will continue act in their own best interest to transact under the appropriate regulatory scheme provided regulators set clear rules under each scheme, futures or swaps. The sophistication of today’s financial derivatives was unforeseen 30 years ago when the now-basic interest rate swap was a complex financial instrument. We continue to innovate our way into managing all types of unique risks through countless regulatory cycles, some implemented with great trepidation. Although current regulatory changes affecting swaps are monumental, markets will continue to thrive. Some instruments become common standard as new ones are created. We create new synthetic risks and innovate our way into hedging those new risks (instruments such as variance swaps, CDS index swaps and swap-based ETFs). Products considered new and innovative not long ago, such as credit default swaps, are now standardised and tradable on futures exchanges, unimaginable a mere decade ago.

The process is cyclical. As financial innovation occurs and new hedging products are created, more standardised products move to futures exchanges thereby increasing liquidity. The cycle renews itself as today’s innovative financial products may also be ripe for futurisation one day. Understanding this cycle, whatever the catalyst, should ease any market concerns regarding futurisation and the migration of traditional swaps. A degree of futurisation is evidence of market innovation. Regulators must remain steadfast and vigilant in the process of implementation and some loopholes must be closed to avoid only regulatory arbitrage that would threaten the financial system again. Market efficiencies will present themselves as the new swaps infrastructure settles. The addition of innovative financial instruments, the growth of current swap use and more end-users entering the market will counterbalance the migration of standardised swaps to future exchanges.

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