Focus on total return futures

How innovation opens up investment opportunities

Eurex asks Edouard Pelier, head of delta one and collateral trading, equity and commodity products at UniCredit Bank, and Ziad Kerbage, executive director of the equity derivatives group at JP Morgan, why market participants should trade total return futures (TRFs), how they can be incorporated into trading strategies and how the TRF market will develop in the future

In general, innovation has flourished in both listed and over-the-counter (OTC) derivatives products, especially during the recent period where changes to regulatory regimes profoundly transformed the financial sector. Derivatives exchanges have always been involved in the field of financial innovation, with market participants constantly searching for new opportunities to do business or adapt to regulatory changes.

Increasing regulatory pressure with Basel III, the European Market Infrastructure Regulation, the second Markets in Financial Instruments Directive, the fourth Capital Requirements Directive and bilateral margining charges for non-cleared derivatives requires market participants, particularly banks, to seek more capital-efficient collateral and margin-efficient solutions.

Eurex's total return futures (TRFs) on Europe's most prominent benchmark index, the Euro Stoxx 50 Index – which was designed in close co-operation with market participants – is a good example of how innovative products have helped to not only adapt efficiently to new regulation, but also open up a market to new participants.

Eurex's TRFs enable firms to trade the implied equity repo rate for the first time and aim to replicate the payout on index total return swaps (TRSs), and are thus a natural example of successfully futurised contracts. Twenty billion euros in notional terms, 540,000 traded contracts and an open interest of more than €9.5 billion notional after one year confirm a strong take-up from major market players.

Eurex speaks to two London-based market-makers about TRFs – Edouard Pelier, head of delta one and collateral trading, equity and commodity products at UniCredit Bank, and Ziad Kerbage, executive director, equity derivatives group at JP Morgan.

What is a TRF? What are the main differences between a TRS and a TRF, and what are the key advantages of trading a listed solution over a classical swap?

Edouard Pelier, UniCredit Bank: A TRF replicates the performance of an OTC TRS. Both products have a very similar payout, both allowing the transfer of the total economic exposure of an equity asset, including market and dividend risk, without actually having to own it.



Edouard Pelier, UniCredit Bank



Ziad Kerbage, JP Morgan

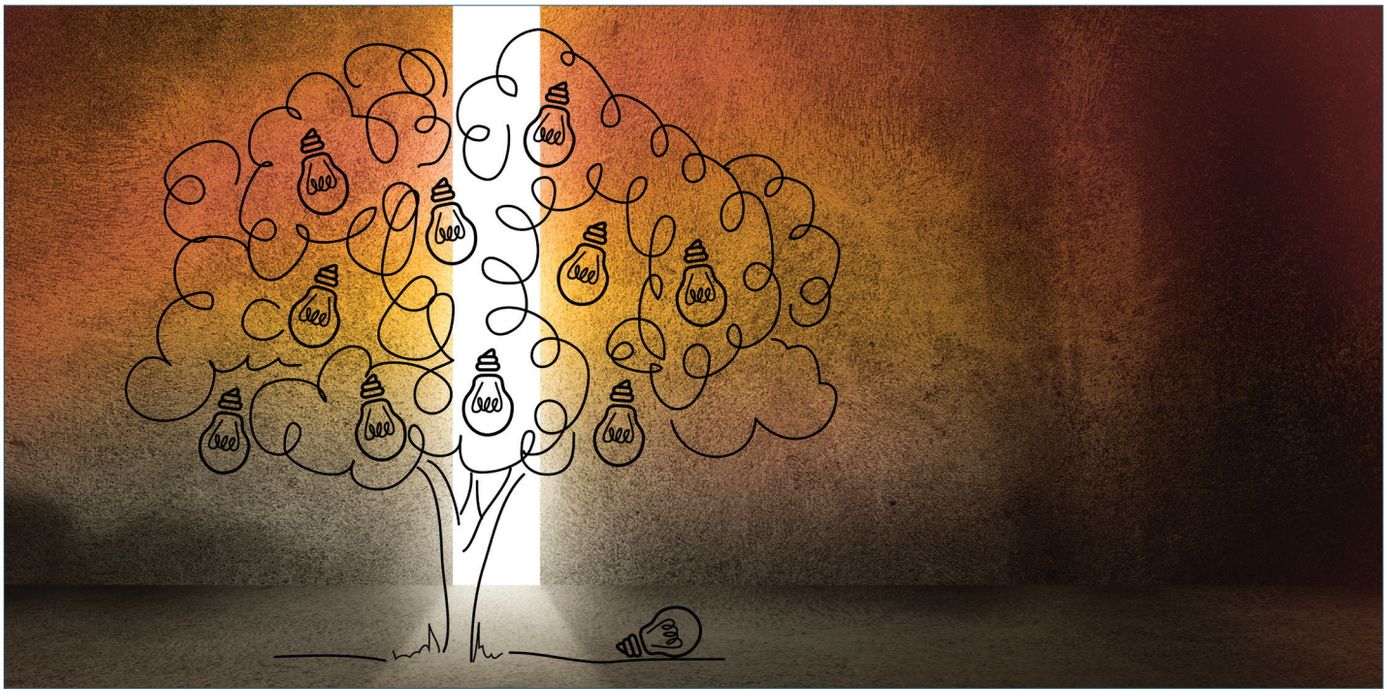
However, TRFs are a much more convenient and cost-effective way to benefit from a reference asset compared with TRSs. The key advantages are fourfold:

- TRF is a simple exchange-traded product permitting transparent quotes, valuation and liquidity.
- In the context of new regulations, TRFs alleviate the burden of bilateral margining for non-cleared OTCs.
- TRFs mitigate counterparty risks, with Eurex Clearing acting as a central counterparty.
- TRFs are margin-efficient as the net required margin could be offset against other Eurex products.

How can market participants incorporate TRFs into their trading strategies? Are there some examples?

Ziad Kerbage, JP Morgan: TRFs are usually traded either outright or as calendar spreads. They can also be traded versus other Euro Stoxx 50 derivatives, such as front-end futures or options.

They can be traded outright in the same way as 'normal' Euro Stoxx 50 Index futures. This would allow them to eliminate dividend and interest rate risks, while locking the implied funding spread. Through TRFs they can also trade longer-dated maturities and hence eliminate any potential futures roll risk. This would allow



them to benefit or take a view of the term structure of the Euro Stoxx 50 Index funding curve. For example, trading a December 27 TRF versus a December 18 TRF would allow market participants to take a view of the steepness of the funding curve between the nine-month tenor and the roughly 10-year tenor. In the same way, trading a December 19 TRF versus 'normal' June 18 futures would provide exposure to the implied funding on the three-month and 21-month tenors.

How does maturity impact liquidity bid/offer spreads? How are TRFs different from regular Euro Stoxx 50 Index futures?

Edouard Pelier: For most asset classes, maturity is key when it comes to liquidity, bid/offer spreads, volatility and profitability. This also applies to TRFs – the further down the curve you go, the wider the bid/offer, the lower the tradeable size and the more volatile the prices, but also the higher the yields will be.

Typically, front maturities will be quoted in 2–3 basis points (bp) bid/offer and are available in units of €250 million, whereas back-end maturities would be quoted in 3–5bp bid/offer and are available in units of €50–€100 million.

TRFs can be traded as a delta-neutral strategy to isolate and capture the repo levels, or outright to combine equity and repo exposure without bearing the dividend and roll risk of standard Euro Stoxx 50 Index futures.

What has the response of the market and end-clients been so far? What is the breakdown of users of equity index-based TRS? And, as market-makers, what have you observed on trading activity in the TRF since inception?

Ziad Kerbage: Traditionally, various types of market participants would trade TRSs – banks, asset managers, hedge funds, pension funds, and so on. Most clients would use TRSs as a carry trade, benefiting from the term structure of the Euro Stoxx 50 funding curve. This trade became even more popular with the compression of yields in other asset classes.

Since the introduction of the TRFs, we noticed that banks started shifting a significant part of their TRS trading into TRFs. We also observed a similar pattern from end-clients, as for them it can be a more efficient way to manage their counterparty risk exposure and reduce operational frictions. The volumes crossed on TRFs have so far been very encouraging.

Why should market participants trade TRFs?

Edouard Pelier: TRFs allow professional market participants to observe and benefit from the so-called repo curve priced by the market. Equity repos are a crucial parameter, formalising the necessity to incorporate regulations, financing, collateral and stock loan parameters into derivatives pricing.

Financial players can therefore trade TRFs for various reasons; to hedge a directional exposure in a cost-effective way, for example. Because of the term structure of the repo curve, selling longer-maturity TRFs – rather than short-term futures – will derive higher income for institutional investors. They could then take advantage of the steepness of the repo curve – for example, hedge funds have been involved in trading calendar spreads to correct supply-and-demand imbalances. Additionally, market players can source low-priced equities inventory for collateral purposes by selling TRFs against shares, receiving a positive spread. Finally, they can hedge repo risk, manage financial ratios – liquidity coverage ratios, net stable funding ratios, and so on – and reduce balance sheets, risk-weighted assets and mark-to-market risks. In this, banks have been significant TRF buyers.

Looking ahead, what are the most important factors that will contribute to growth in the TRF market? How do you expect TRF usage to progress in 2018, and is there still room for improvement?

Ziad Kerbage: As the TRF is a relatively new product, we believe marketing and education efforts could contribute to the growth in volumes as more and more clients look to switch from TRS trading to TRF trading, or even from 'normal' Euro Stoxx 50 Index futures to TRFs. We expect the volumes to continue growing in 2018, with more market participants trading them as they adjust their setup for this new product. With the bid/offers on the screen becoming tighter, and bigger sizes being displayed, we also expect the product to attract more liquidity.

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