Addressing the Challenges of Post-G20 Interest Rate Hedging

In this article, ***Mike O'Hara****, publisher of The Trading Mesh – in conversation with* ***Hirander Misra, Andrew Chart*** *and* ***Philip Simons*** *- looks at how the new Constant Maturity Swap future from GMEX aims to help firms continue to hedge their interest rate exposures cost effectively in the post-G20 landscape.*

GMEX Global Markets Exchange Group

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Introduction

The reforms instigated by the G20 in the wake of the Global Financial Crisis have resulted in a number of structural changes to the world's interest rate derivatives markets, changes which are now starting to have a significant impact on market participants.

The G20's stated objectives to reduce systemic risk and increase transparency across global financial markets were clear, in that all OTC derivatives contracts should be reported to trade repositories (TRs); all standardised contracts should be traded on electronic trading platforms where appropriate, and cleared through central counterparties (CCPs); and non-centrally cleared contracts should be subject to higher capital requirements.

It remains to be seen how successful these initiatives will be in the long term. However, it is clear that in the short term at least, the increased capital & margin requirements have placed a greater strain on the financial resources of many firms active in this space. Likewise operational changes are also making it more difficult for firms to accurately hedge their interest rate exposures. Buy-side firms in particular are facing a range of new challenges around duration hedging.

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Increased swap costs

Historically, OTC interest rate swaps (IRSs) have been widely used by the buy-side to hedge their interest exposures. However, in this new environment, it is becoming much more expensive for firms to continue duration hedging using swaps.

"One problem with bringing OTC instruments such as interest rate swaps into a CCP environment is that firms will no longer be able to rely on their ISDA Credit Support Annex (CSA[1]) agreements", says Andrew Chart, Senior Director Origination and Structuring Prime Clearing Services at Newedge Group.

"Whereas previously cash flows would not occur between the two counterparties until a position reached a pre-agreed level (e.g. $10m), firms will now have to put up margin at a CCP and manage a daily cash flow as their positions are marked to market daily. Where do they find that collateral? This is a cash flow that they've never had to make before, which causes treasury and liquidity related

[1]A CSA defines the terms under which collateral is posted or transferred between swap counterparties to mitigate credit risk.

challenges for firms if their cash is tied up on deposit, or they are fully invested in higher yielding contracts", says Chart.

With standardised swaps being subject to 5-day VaR and non-standardised swaps requiring 10-day VaR, costs in some cases are going up by an order of magnitude, a situation that Chart and his colleagues at Newedge refer to as 'margin discrimination' when comparing to listed derivatives or similar products that attract a 2-day VaR treatment.

"With Basel III provisions, OTC instruments are likely to weigh heavier from a capital requirements perspective", says Chart.

"Firms will have to make increased capital and liquidity provisions to show they can cover these transactions. They won't be able to leverage up as easily as they could previously because of the new capital/position ratios that will force them to put more into their capital reserves to cover their trades and positions", he says.

The net result is that interest rate swaps are becoming prohibitively expensive to the buy-side. More and more funds are now being directed by their investment committees to pull out of the swaps market and to find alternative hedging mechanisms. But this is easier said than done.

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Challenges with swap futures

One of the problems facing the market is that there are very few viable alternatives to interest rate swaps for managing duration hedging, although a number of exchanges - including NYSE Euronext, CME and Eris Exchange - now offer various flavours of swap futures.

"From a buy-side perspective the products offered by those exchanges have a number of perceived disadvantages when compared with the swaps market, based on feedback market users have provided to us", says Hirander Misra, CEO of Global Markets Exchange (GMEX) Group, which, subject to FCA approval, will operate a new multilateral trading facility in London.

"Certain sections of the buy-side community are telling us that existing swap futures just aren't suitable for them to manage their duration hedging, because they don't provide a like-for-like hedge", he explains.

"Of course, there's no such thing as a perfect hedge but with current quarterly rolling swap futures, you don't get the granularity of duration hedging you get with IRSs. This makes managing the deltas extremely difficult because only certain points along the curve can be used. And as these swap futures expire every quarter, hedging longer term exposures means that the contracts must be rolled each time they reach maturity. Every roll leads to more transactional costs, which add up and eat into the value of the portfolio, particularly when done multiple times over the life of a hedge", continues Misra.

"Also, certain swap futures are or will be physically deliverable. So if a buy-side firm actually goes to delivery, they are faced again with the associated capital requirements and 5-day VaR of maintaining a swap position."

According to Misra, this is why, to date, no existing swap futures contracts have yet managed to build a critical mass of liquidity relative to the volumes seen in the OTC IRS market.

The constant maturity approach

In order to address all of these challenges, GMEX recently announced the launch of its Constant Maturity Future (CMF).

The CMF is a new breed of swap futures contract linked to GMEX's proprietary IRSIA index, which is calculated in real time using tradable swap prices from the interbank market. By accurately tracking every point on the yield curve in this way, retaining its maturity

throughout the lifetime of the trade and being traded on the rate, the duration hedging capability of the CMF is much more closely aligned with an IRS than other swap futures contracts that have set durations and expiry dates. This is the key for the buy-side, according to GMEX's Misra

"The CMF gives you the closest approximation a futures contract can to the way in which the OTC interest rate swap market moves and is traded on a daily basis", he says.

"Additionally for example if you want to hedge a 30 year Gilt issue that rolls down to maturity, given the CMF offers every annual maturity from 2-30 years you can gain a very granular hedge by periodically rolling the appropriate number of 30 year CMF contracts down the curve to 29 year CMF contracts. Rather than rolling quarterly, this can become a simple middle office, daily or periodic hedge tool. The advantage being that there is no quarterly brick wall by which point you have to roll", adds Misra.

As a listed futures contract, the CMF comes with all the advantages that futures offer over swaps in terms of cheaper margin (2-day VaR as opposed to 5-day); electronic trading capability and accessibility; clearing through a central counterparty; and reporting via a central trade repository.

And with no quarterly roll and no deliverable element, the disadvantages typically associated with other swap futures are removed.

GMEX IRSIA CMF - a new and unique way to hedge and trade interest rate exposure



Diversity of market participants

In order to create liquidity in any market, a diverse group of participants - including both makers and takers - is required.

"We've thoroughly researched the market and it's clear that anyone who hedges interest rates needs a product like this", says GMEX's Misra.

"The buy-side need it for their duration hedging; the sell-side also have IRS exposures that they need to hedge more cheaply; all the banks are capital constrained and have fixed income exposures that they need to hedge; futures players like it because it's a standardized IRS futures product that will see natural buy-side flow; electronic market-makers and proprietary traders like it because it gives them opportunities to arbitrage the CMF against other interest rate instruments; corporates with sophisticated treasury and hedging requirements and even insurance companies who currently run naked exposures because they've assessed the alternatives and deemed it cheaper to take one-off hits than run expensive hedges".

Clearing

The IRSIA CMF will be centrally cleared by Eurex Clearing (subject to final agreement at the time of writing). This arrangement will offer a range of advantages around collateral and margin offsets. For example, it will be possible to offset the margin for the IRSIA CMF against the margin for correlated assets such as Bund/Bobl/Schatz and Eurex-cleared OTC IRS. Such offsets and incentives will significantly lower barriers to entry for market participants given that existing Eurex clearing membership will apply.

"With the introduction of the new Basel III capital rules, the cost of clearing is now determining not only which instruments are used for hedging but where they are cleared", says Philip Simons, Head of Sales and Relationship Management at Eurex Clearing.

"Market participants will inevitably use the best tools available that manage the risk. This will include OTC IRS, traditional futures and options as well as new instruments such as GMEX's IRSIA CMF".

According to Simons, what will be crucial is the ability to clear all instruments at the same CCP with appropriate cross-margin benefits. This will not only reduce the cost of funding but - more significantly - reduce the cost of capital, through a combination of maximising netting benefits for exposure at default, having an efficient default fund and minimising the funding costs.

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"The higher the risks the higher the costs of capital as reflected through higher initial margin and higher default fund contributions which will inevitably be passed on the end client", says Simons.

"Capital and operational efficiency will drive liquidity in the future".

Operational considerations

The IRSIA CMF will be traded on an electronic market, operating on a Central Limit Order Book via GMEX's own proprietary matching technology. Request for Quote and the facility to report negotiated trades will also be available.

GMEX will offer access to the market via its own trading screens as well as third party vendor products. Most firms may prefer to trade through screens such as those provided by ISVs such as Fidessa and Trading Technologies, many of which offer functionality for trading spreads or running other cross-instrument or cross-market strategies. For direct electronic access, GMEX provides a well-documented API, which is available in both FIX and Binary format.

Execution and prime service brokers such as Newedge will offer DMA and potentially Sponsored Access, as well as value-added services such as cross-product margining and linked margin financing of correlated portfolios.

Finally, trade reporting will be performed automatically via the REGIS-TR Trade Repository, resulting in true straight-through processing from pricing, execution and clearing through to reporting.

For more details, visit **www.gmex-group.com**



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