A promising future

Euro Swapnote® – an on-exchange futures contract referenced to the European interbank curve – promises hedge fund managers a cost-effective solution that meets regulatory requirements and enhances a fund's strategy. **Stephen Cottrell**, Director, Product Development, FICC, NYSE Liffe discusses the benefits Swapnote® offers the industry

With a good mix of market participants, Euro Swapnote® captures the economics of the swap curve through a futures vehicle. It complements NYSE Liffe's existing short-term interest rate Euribor® futures contracts. Available at the most liquid end of the curve, the contract can be unwound without the overhead of legacy cashflow management and is also fully compliant with regulations in the US and Europe. The new instrument gives hedge fund managers the benefits of a futures contract while opening the market to different sources of proprietary capital that can now access the swap curve. As it grows in volume and liquidity, Swapnote® will provide hedge fund portfolio managers with greater diversity within a fully compliant standard cleared futures contract. Brokers believe Swapnote® could provide hedge fund clients with a solution that fits regulatory mandates in a cost-efficient and strategy-enhancing manner. With all the benefits of a futures market – price transparency, multilateral counterparties, clearing, netting and margin offsets with other futures positions – Swapnote® provides hedge funds with another choice of instrument. It also offers an efficient way to hedge swap book risk, increasing the scope for wider participation in the swaps market by hedge fund managers through a greater range of potential market counterparties.

HEDGE FUNDS REVIEW: How does Euro Swapnote® give better/more exposure to the European interbank curve?
Stephen Cottrell: Euro Swapnote® complements NYSE Liffe's existing short-term interest rate Euribor futures contracts, extending the price discovery offered via the futures market through two years, five years and out to 10 years. As Swapnote® directly references the swap curve, it offers closer correlation to European interbank risk/exposure than traditional bond futures.

HEDGE FUNDS REVIEW: How does Euro Swapnote® compare to a future?
Stephen Cottrell: Euro Swapnote® is a futures contract, in the purest sense of the word. The contract has many characteristics in common with traditional bond futures, in terms of pricing, trading, clearing and margining. However, Swapnote® is specifically designed to capture the economics of the interbank (or swap) curve, rather than bond curve. As Swapnote® is a futures contract, it is fully supported and available via the same standard front-office and back-office infrastructure as other futures.

HEDGE FUNDS REVIEW: What strategies are most likely to use it?
Stephen Cottrell: The most obvious strategies that come to mind are trading the credit spread between the European interbank and sovereign curves (for example, synthesising the asset swap) and trading the threes-to-sixes basis in the Euribor curve. Both of these strategies can be traded via pure futures now trading Swapnote® alongside existing bond and short-term interest rate futures. However, the most straightforward of all will be 'curve play' strategies. With Swapnote® available at the most liquid futures tenors (two, five and 10 years), curve steepening and/or flattening strategies can be easily transacted and, importantly, all of these strategies can be efficiently unwound without leaving behind the overhead of legacy cashflow management.

HEDGE FUNDS REVIEW: Who is trading Swapnote®?
Stephen Cottrell: Swapnote® has a healthy mix of market participants. Bank desks are using Swapnote® to hedge interest rate swap risk. Asset managers are seeing Swapnote® as an effective use of their capital, with the additional benefit of Swapnote®, as a standard/cleared futures contract, from an internal compliance perspective. As a cash-settled futures contract, Swapnote® is opening up the market to new sources of proprietary capital, which, for the first time, can now readily access the swap curve. Finally, brokers are increasingly seeing the opportunities presented by Swapnote® as their clients are looking for solutions that fit within the up-and-coming regulatory mandates.

HEDGE FUNDS REVIEW: Why should a hedge fund manager consider using Euro Swapnote®? What benefits does it provide?
Stephen Cottrell: Like all market participants, hedge funds are spending valuable time and resources understanding how the changing regulatory environment will impact their business model. Not just in terms of their own operation, but also how their traditional market counterparties are impacted and whether there will be continuity in their relationship. Swapnote® brings all the benefits typically associated with a futures market: price transparency, multilateral counterparties, clearing, netting and margin offsets with other futures positions. Additionally, for larger transactions, Swapnote® is fully supported by the exchange block trading and other wholesale trading facilities.

HEDGE FUNDS REVIEW: Should hedge fund traders see the Euro Swapnote® as a threat or an opportunity? Is it replacing another instrument, or adding to the range of instruments available to hedge interest rate swap exposure?
Stephen Cottrell: Swapnote® is designed as a tool to support the interest rate swaps market, providing another futures instrument to support the price discovery process along the yield curve. A new instrument on the scene is bound to bring opportunity to some market participants and be viewed as a threat by others. More specifically, in the hedge fund community though, I can only see Swapnote® as a net benefit. In terms of direct usage, as the instrument grows and becomes more liquid, it is another asset to trade, providing greater diversity and choice to the hedge fund community. Also, in terms of indirect benefits, a liquid swap future provides the sell side with additional and often more efficient mechanisms to hedge their swap book risk, thereby increasing the scope for broader participation in the swaps market, giving the hedge fund community a greater range of potential market counterparties.

HEDGE FUNDS REVIEW: What kind of liquidity does it offer?
Stephen Cottrell: Liquidity is coming to the market through three quite distinct sources. First, the exchange operates a formal market-making programme, where participants are asked to post fully tradable bids and offers in the market, at depth, for a specified portion (typically 80%) of the trading day. Secondly, proprietary capital, which is the established means of support in any liquid futures market, is encouraged into the contract through a fee incentive programme (currently, Swapnote® transaction fees are fully rebated to all registered market participants). We are seeing a strong uptake of Swapnote® among the proprietary trading community. Finally, a number of large bank desks are increasingly seeing their clients preferring to trade their strategies using cleared instruments, such as futures; banks are able to supply liquidity directly to their customers even though they do not hold a formal market-making role.

HEDGE FUNDS REVIEW: How efficient is the Euro Swapnote® in terms of cost and expense?
Stephen Cottrell: Looking ahead to the pending over-the-counter (OTC) clearing mandate: OTC positions are set to carry a five day value-at-risk (VaR) initial margin requirement; whereas futures contracts will carry a two-day VaR requirement. So, in terms of use of capital, the futures market is set to offer greater capital efficiency. Furthermore, Swapnote® is already traded and cleared alongside other interest rate futures contracts, such as Euribor, short sterling and gilts, offering margin efficiencies of up to 80% when cleared as part of the same portfolio.

HEDGE FUNDS REVIEW: How does Euro Swapnote® meet new regulatory requirements?
Stephen Cottrell: From the outset, the new regulatory requirements coming from the US in terms of Dodd-Frank, and Europe in terms of the European Market Infrastructure Regulation, have sought greater transparency, standardisation, electronic trading and clearing for OTC products. It is no coincidence that these are all attributes of the exchange-traded futures market; the requirements were modelled off the futures markets. As a futures contract, Swapnote® is traded, cleared and regulated alongside all other futures contracts and, like all futures contracts, meets the requirements set out by the regulators.

HEDGE FUNDS REVIEW: How can hedge fund managers help to develop Swapnote®?
Stephen Cottrell: One of the key characteristics of futures contracts is that they are designed and made available for all market participants to trade. Consequently, with open access to all market participants, futures are able to become more liquid and, as they become more liquid, they become more attractive for market participants to trade; thereby creating a 'virtuous circle'. With greater control over and flexibility within their portfolio, hedge fund managers are in a stronger position than many other asset managers to assist at an earlier stage in developing this virtuous circle for Swapnote®.

HEDGE FUNDS REVIEW: What is your opinion on the futurisation of swaps? Is this going to help reduce costs, or create better trading efficiency?
Stephen Cottrell: Futurisation of swaps sounds like a transformation of swaps into futures. When one looks at the goals set out by the Group of 20 back in 2009 to transform the OTC markets, it was evident to all those who worked in the futures industry that the architects were seeking to encourage OTC products to be more futures-like. So, if anything, it is a surprise that it has taken until 2013 for the phrase to catch on. However, I do not believe that we will see all swaps traded as futures. Rather, swap futures such as Swapnote® have an important role to play in the evolution of the futures market. Swap futures allow a greater range of participants access to the price discovery process, they provide a vehicle for clearing standardised interest rate swap exposure through an instrument that can be truly netted down alongside other futures contracts. Also, as a nettable instrument, they provide a means of hedging swap book risk without further compounding the problem of cashflow management.

In summary, an established swap futures market will bring additional support for the interest rate swap market, bring a greater range of participants to the market, and netting means futures positions are inherently more efficient to manage. Therefore, with greater market efficiencies and greater participation comes greater opportunity to reduce costs.

Stephen Cottrell is director, product development, FICC, NYSE Liffe. He was appointed to this role in 2010 and is responsible for developing the NYSE Liffe interest rate business in Europe. Stephen has worked for the Exchange for more than 16 years and, prior to his current role, he worked for the NYSE Euronext Corporate Strategy team. Before joining the Exchange, Stephen worked at the *Financial Times*. He holds a Bachelor of Science degree in physics from The University of Reading.