

Futurisation of Swaps Set to Continue

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'Futurisation' is a new term coined to describe the trend of parties using futures contracts, instead of using OTC derivatives, to achieve their hedging or other trading objectives. Futures are designed as commoditised contracts of standard durations, which are transacted on futures exchanges and cleared through clearing systems. OTC contracts, on the other hand, can be as bespoke as the parties desire.

In the new regulatory world after the passing into law of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the European Market Infrastructure Regulation (EMIR), certain (typically standardised) categories of OTC derivatives subject to the mandatory clearing requirement will now, like futures, be cleared through clearing houses (often also referred to as CCPs).

As futures have escaped some of the regulation under Dodd-Frank and EMIR, which applies to the OTC world, the futures market now appears to be a more attractive option for many market participants. As new standardised swap-like futures contracts emerge and as the choice available to futures market participants widens, more customers' trading needs will be met. Indeed, futures trading, provides many advantages.

Prior to Dodd Frank and EMIR, futures markets were already subject to regulation whilst the OTC swaps markets were virtually unregulated. However, the regulatory balance has now shifted such that OTC contracts are now becoming more tightly regulated than their futures cousins.

There are many facets to this, for example, uncleared swaps will be subject to mandatory margining and other risk mitigation requirements, whilst cleared swaps will be subject to clearing processes under prescriptive rules which do not necessarily apply to futures. To take just one example of a shifting balance, the CFTC recently indicated that initial margin should be calculated using a minimum liquidation time of five days for swaps, whereas margins for futures are set on a one day liquidation time, meaning a lower margin for futures.

The futures markets have traditionally been seen as stable even somewhat dull markets offering investors transparency and liquidity in well defined exchange-traded products. Crucially, from a risk perspective, market participants can enter into and exit positions quickly and efficiently.

OTC derivatives are an entirely different beast. Whilst OTC contracts are typically of fixed duration, with no right of optional early unwind/termination, futures contracts can be exited at any time.

The only possible legal impediment to unwinding a futures position is refusal of the order (unlikely, given that any order to unwind will be risk-reducing) or something going wrong in the give-up process. Many market participants believe that OTC markets with sufficient liquidity operate in the same way, but, in reality, these markets are structured very differently, and dealers are entitled to charge a (sometimes substantial) fee for allowing a counterparty to unwind earlier than the scheduled maturity date. I would also argue in favour of the legal documentation framework for futures, which is well established.

The new regime for OTC derivatives will involve, for uncleared OTC contracts, possible new credit support documentation to cater for new mandatory margining requirements for uncleared swaps. For cleared OTC contracts, customers will need to enter into new documentation with clearing members.

This new documentation is untested and still evolving. As for customer protection, while EMIR and Dodd Frank require that, for OTC contracts, clearing houses and their clearing members offer customers the option to segregate customer funds. segregation is expected to be offered at a price. Other than that, clearing arrangements for OTC contracts and futures will be broadly similar.

Make no mistake, the futures environment is not perfect and could benefit from improvements. However, as more new swap-like products emerge on futures exchanges, swap activity is likely to drift accordingly, at least until the new OTC market matures and a new balance between the two emerges.