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EVOLVING WITH SWAP TRADING

Transition, Challenges and the Way Forward

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Table of Contents

Introduction

On May 16, 2013, the Commodity Futures Trading Commission (CFTC) approved four rules and issued guidance that would effectively move bilaterally traded swaps onto electronic execution platforms. In essence, the rules create the standards for interested parties to register and operate a Swap Execution Facility (SEF), and require that all cleared swaps trade on SEFs or Designated Contract Markets (DCM). Market participants who applied before August 5, 2013, which was the effective date of the rule, received a temporary registration with the hope to gain a first mover advantage.

Significant debate and issues persist around the process of Made Available to Trade (MAT), differences between the regulatory treatment of SEFs versus DCMs, and limitations of the Broker/Dealer ownership stake in SEFs to avoid possible conflicts of interest. A bit of back and forth, seems to be inevitable before all interested parties can converge to a clear resolution on these issues.

The new rules necessitate a review of the existing operating model for all market participants. Swap dealers need to evolve their services to protect their market share while interdealer brokers have to consider new alliances to facilitate liquidity discovery through a hybrid voice and electronic trading service. Investors on the other hand, are monitoring the impact on transaction costs during liquidity discovery in conjunction with the costs related to spreads, collateral transformation and access to capital.

Financial Institutions have to assess the impact of these changes across the organization. Operations personnel need to extend existing processes and create new ones. Technology organizations need to plan system extensions to support new functionality, which will span across front office analytics, new order types, connectivity for access to external liquidity, risk management, collateral transformation and securities lending. These technology and business considerations create a major challenge to the thinly run operations and IT functions that are now asked to support new functionality, processes and controls. This paper discusses the business and technology challenges market participants have to consider in preparation for the standardization and electronic trading of swaps.

Business Strategy Considerations

The most recent set of rules issued by the CFTC reduce the Request For Quote (RFQ) requirement from the original five participants to two in the first year, and then three participants in the second year. In addition, the Commission has allowed voice trading, which effectively permits interdealer brokers to maintain their current business model.

Swap dealers must address these new challenges to protect their franchise, remain relevant, and increase their influence during the evolution of the new market structure. A key consideration is the ability to provide a hybrid voice and electronic trading service coupled with capital commitment and liquidity discovery. These services will help continue the inflow of deals from their clients and enable dealers to participate in the more lucrative, large, non-standard transactions. The new environment also creates the need to address the electronification of orders, risk controls, client credit limits, and pre-trade decision support to respond to the electronic RFQ's 15 second response limit. The 15 second limit would also warrant a closer look for possible protection against predatory trading.

Limitations placed on SEFs ownership to avoid potential conflicts of interest, will require the sell side to form alliances and electronically connect with other market participants. In addition, brokers need to closely monitor the evolution of the MAT process to standardize and allow swaps to trade on SEFs. Knowing where liquidity can be found for a specific product will affect the quality of service and impact the transaction costs.

An emerging product consideration is the futurization of swaps (futures contracts offering swap like protection) that is driven by the simple and well understood nature of futures trading and margin requirements. Market centers developing these future products are claiming that collateral on futures will be less burdensome and provide considerable advantage to market participants. Large asset managers and other institutions with access to collateral that will qualify for posting at a central clearing house will continue to trade both - swaps and futures, while maintaining a lower cost of collateral. This may change as the market develops and pressure increases from top management to lower the overall trading costs, to which collateral contributes. Another factor related to the choice between trading futures or swaps is the need for market participants to hedge balance sheets in accordance with FAS 133. Currently, futures do not qualify for hedging under FAS 133.

New Model Considerations - Front Office & Operations

The ownership limitation on SEFs along with the futurization of swaps creates an interesting challenge for brokers as they are forced to form alliances and provide access to other venues in search for liquidity. To add to the operational difficulty of multi-party interactions, operations along with the front office, compliance and risk organizations need to monitor the process by which partner and non-partner SEFs "Make Available to Trade" any swap subject to market and participation requirements.

The fragmentation of liquidity introduces an added layer of complexity to both the front office and operations, as pre-trade analytics, risk, trade management processes and controls must be reviewed and adjusted, internally. In parallel, client credit limits should be monitored across the entire market before a transaction in authorized.

In order to provide "Best Execution", it is imperative to keep track of all possible products, trading venues, and order types to be utilized while a "very smart router" for swaps searches for liquidity. Services around the facilitation of this 'liquidity seeking' process creates opportunities for agency type SEFs to vie for the commissions pie, while dealers look for market making opportunities and revenue opportunities in wider spreads.

Another area of focus is the interaction of an RFQ with an order for a standard product on a SEF. As a result, an evolution is under way of order types to facilitate the clients trading strategies, especially those for block trades. If the past is any indication, regulators have left it to the market to determine what the participants prefer. Regulators tend to intervene only when their perceived general principles and guidance appears to have been compromised or market behavior exceeds the expected tolerance level.

IT organizations are reviewing the new requirements and prioritizing the work necessary to enable new trading capabilities while keeping a close eye on controlling the market and counterparty risk.

Impact on Technology

Technology organizations have to address a new layer of complexity in an already complex and busy IT environment. Over the past few years, IT organizations have been trimmed to minimal levels making it very challenging to effectively respond to new projects and requirements that seem to come in waves. They must now address areas that will require new functionality or extensions to existing functionality such as:

- Pre-trade analytics and decision support to respond to a deal in 15 seconds
- New products and related attributes to support orders, deal parameters and risk characteristics
- Extensions to risk systems to address capital considerations, collateral transformation, securities lending, and risk based P&L monitoring and reporting
- Connectivity to industry utilities for access to sources of liquidity
- Booking and monitoring of trade lifecycles
- Front office functionality for liquidity aggregation and possible matching in a “service” environment prior to being forwarded to a SEF for execution

Figure 1: Areas of Technology Investments

Post the 2008 financial crisis, the industry has seen an exponential increase in new regulations that must be addressed. Operations and technology organizations already spend a considerable amount of time and money on “running the bank”. At the same time, they have been reducing their workforce in reaction to the fundamental shifts in revenue generation and pressures to reduce costs.

As a result, Capital Markets firms must now engage with third party service providers to address the regulations and become compliant within the prescribed timeframe. Technology Service providers that have invested in developing subject matter expertise on regulations and the resulting technology changes to address the regulatory, operational and technology challenges are well positioned to support their clients, introduce new services and remain compliant with the new rules.

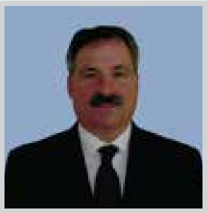
While selecting the best partner to work with, financial institutions should look for third party providers with a global presence. Such providers are better positioned to address the challenges their clients face across regions both in terms of - required changes for compliance, risk management, and process controls as well as corresponding changes to systems and technology infrastructure. In parallel, financial institutions have the opportunity to take advantage of Business Process Outsourcing and Managed Services models to help reduce their cost structure and realize a competitive advantage.

The Road Ahead

Market participants will be in a constant state of change as the interaction with SEFs - both electronically as well as via voice evolves, and swaps are standardized and Made Available to Trade. New revenue opportunities in market making, collateral transformation and a more efficient use of the balance sheet can be affected by the quality of execution that service brokers are able to provide.

The new model for swap execution necessitates interaction with multiple external parties for access to liquidity. Connectivity to external venues is necessary along with a comprehensive risk management and trade lifecycle processes and controls. Technology and Operations will have to work closely with the front office to provide new services and address the new market, counterparty and operations risk.

About the Authors



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