White Paper

The Future Landscape for Swaps Trading

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REGULATORY BACKGROUND

In the US, the swaps trading landscape will be defined by the emerging Dodd-Frank rules. In Europe, it originally appeared that EMIR would enforce similar clearing rules to the US but would not enforce the same pre-deal transparency requirements. However, when the MiFID II consultation document was published in December 2010, the proposals went significantly beyond what the European market had expected. It now appears that the impact of MiFID II (originally scheduled for publication in July 2011, now to be published in September 2011) will be broadly similar to the US requirements.

The table below compares the Dodd Frank regulations to the expected MiFID II requirements.

	US	Europe
DEALING	Exchange / Swap Execution Facility ("SEF") for all clearable swaps	Exchange / Multilateral Trading Facility ("MTF") / Organised Trading Facility ("OTF") for liquid, standardised trades
CLEARING	All standardised trades Corporate Exemptions	All standardised trades Corporate Exemptions
TRADE REPORTING	Ordinary Trades – 15 sec Block Trades – 15 min	Ordinary Trades - 1 min Block Trades - 2 hrs

The remainder of this paper focuses on the trading landscape that might evolve for OTC swaps as a result of legislation on both sides of the Atlantic.

IMPACT ON SWAPS MARKET MECHANICS

Today 88% of interest rate derivatives transactions are executed using "voice execution" with price discovery being achieved through one-to-one voice services and single dealer platforms. In future, neither of these will qualify as SEF's but they may well continue as execution facilities for non-standardised or block trades, or as routing mechanisms to SEF's. ISDA has said that it considers that there are 2,000 standardised interest rate swaps ("IRS") executed globally on an average day. The benchmark swaps trade about 200 times a day while most other swaps trade less than 20 times a day.

From comments by market participants to the regulatory bodies, we would expect that IRS will be executed via a range of models designed to suit the liquidity profile of the contracts being traded:

1. For the more frequently traded benchmark and short dated swaps, a fully automated **Central Limit Order Book (CLOB) Model**, requiring multiple dealers to compete for participant business by posting continuous executable two-sided quotes. This may involve the major swaps dealers being obliged to operate as "market makers" to ensure liquidity and could also incorporate limit orders.

2. For the less liquid swaps, the dealers would not want to quote on an order book. If forced to do so, they would widen their spreads to a level where business fails to transact. In these circumstances, it is likely that a **Request for Quote ("RFQ")** system will operate with the CFTC already suggesting a condition that there must be a minimum of five quotes per request. The regulators desire for transparency means that this may be a "Transparent RFQ" approach, where requests and quotes in terms of both price and volume would be available to the public. FXall have suggested to the CFTC that, based on their experience in the FX markets, users should be able to select a limited number of counterparties from whom they wish to receive a quote, rather than displaying the need to disclose a position to the whole market. This would involve the request and quotes being visible only to the parties involved. This is a potential solution for executing block trades and is effectively an automated version of today's voice execution method.

3. For the really liquid swaps, trading only a few times a day, or even a few times a month, the most suitable method of automated trading would be a periodic “Reverse Auction” or “Nearest Match” approach. As the auction progresses, the offer price decreases as sellers compete with their competitors until the buyer accepts an offer. Major swaps dealers will be familiar with this process as it will emulate the LCH auction process which all members must practise as part of the default handling process.

Tradeweb already offers CLOB and RFQ in the OTC swaps market and feeds trades through to LCH for clearing. To date 60% of their vanilla swaps traded exceed $50m notional. The market average size in the swaps market is $400m. In the interdealer market, anticipating regulatory change, ICAP resurrected their iSwap system in September 2010 and now transact 20% of their swap business electronically.

THE FUTURE LANDSCAPE - COPING WITH MULTIPLE SEF’S

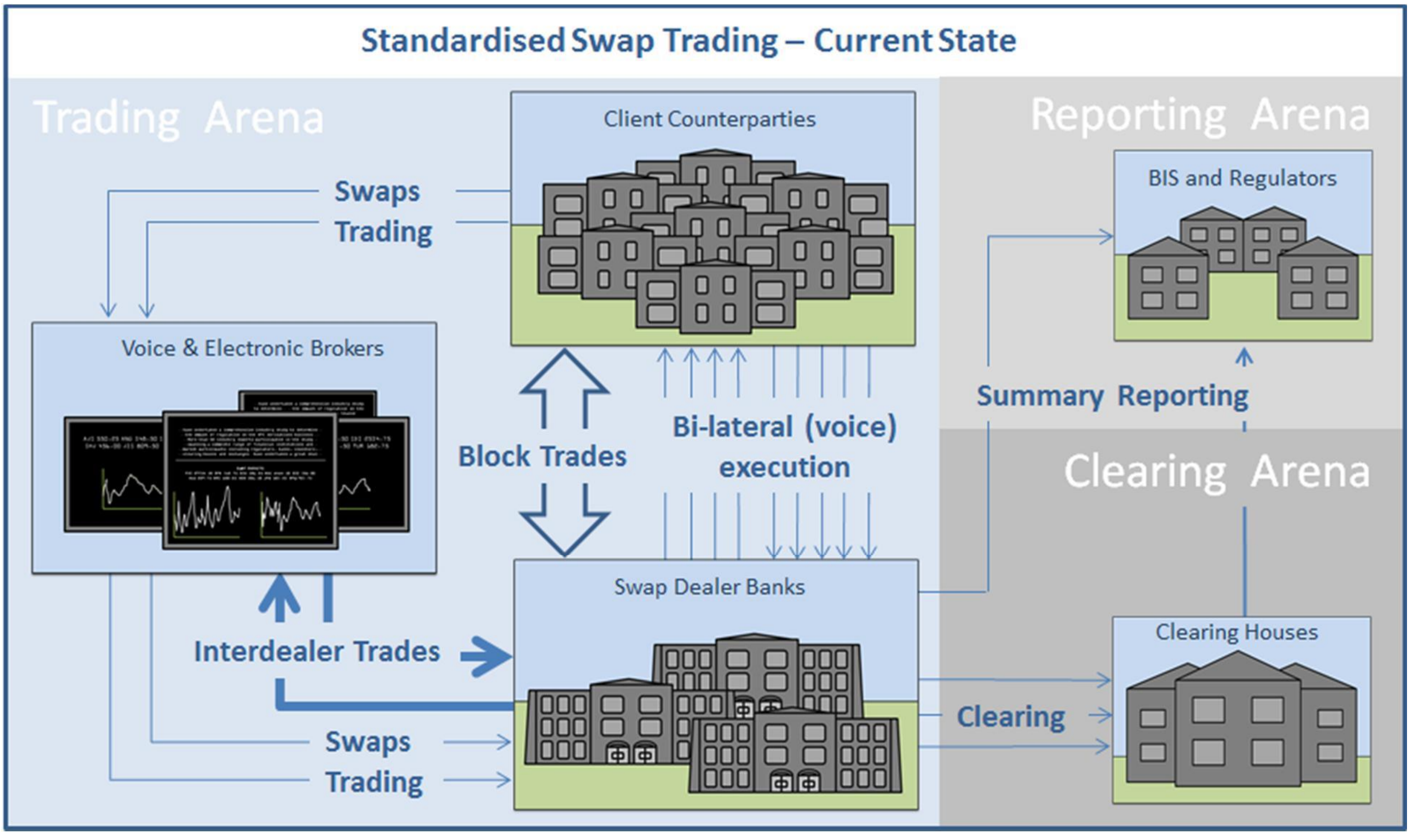
There is speculation that the SEF’s for rates and credit could generate income of up to $3bn a year. Consequently, organisations such as ICE, GFI, ICAP, BGC, Tullett, MarkitServ, Tradeweb etc. are all believed to be applying for registration as a SEF and there may be other groups (of banks) who are joining forces to get around the maximum 20% SEF ownership rule.

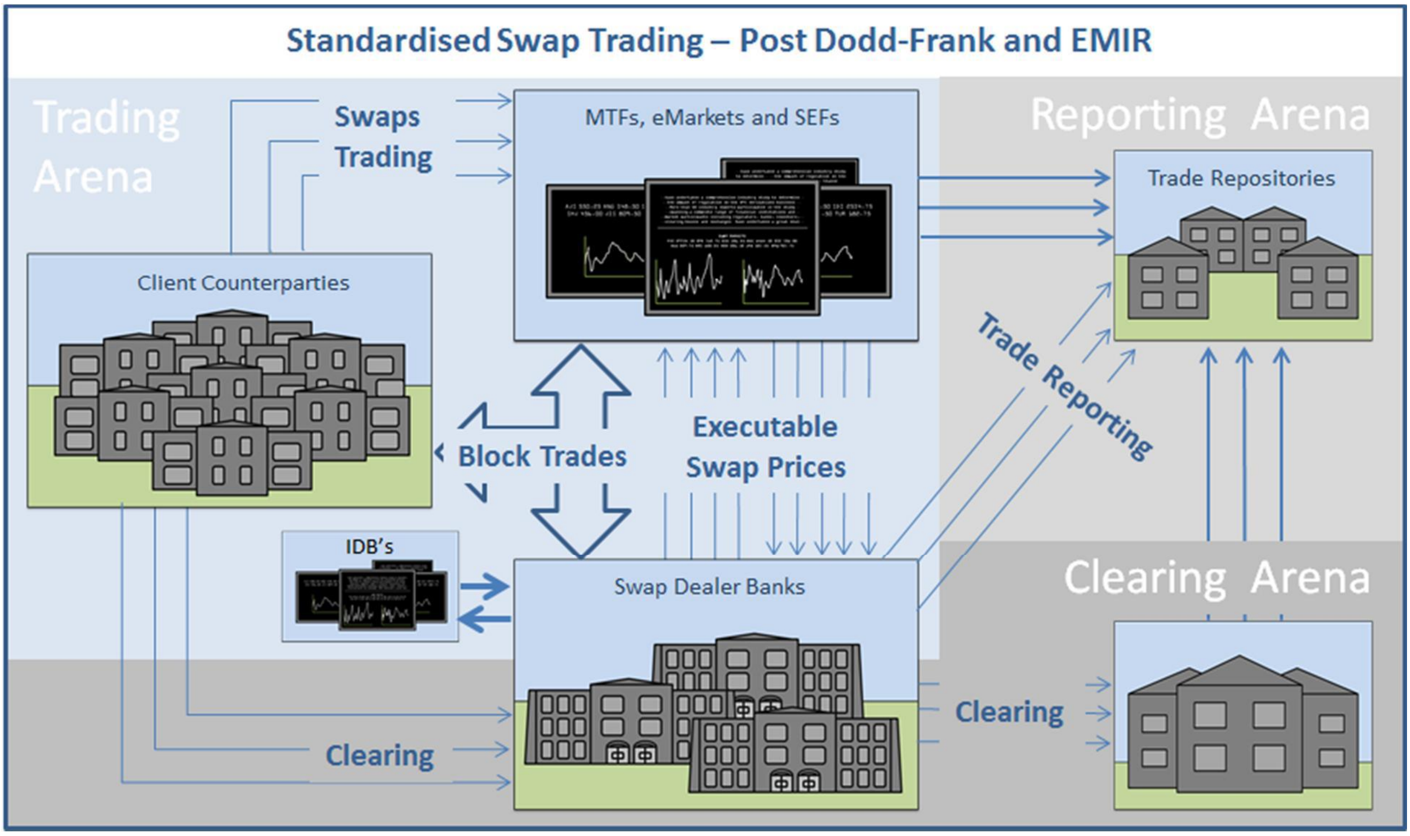
We would expect that business will ultimately be concentrated in two or three venues but there will probably be a transitional period of two to three years where we will have multiple SEF’s. We would also expect that the IDBs will create dealer only SEFs and that other providers will cater for the dealer to buy-side (and buy-side to buy- side) market.

So, are the single dealer platforms, which banks built at great expense, now dead? We would say not necessarily. They will not be allowed to function in the same way as before as they will breach the requirement for SEF’s to display multiple prices. In the US, this rule, still to be finalised, appears to be moving towards a “five competing prices” definition. There is some (in our opinion legitimate) dealer push-back on this as an arbitrary definition of competitive pricing which could work against end user.

Nonetheless, a SEF price to an end user will have to come from more than one (dealer) counterparty and, therefore, the existing operation of single dealer platforms will not be allowed. However, the problem of disseminating prices from perhaps 20 SEF’s will require “price aggregators” and many of the banks are planning to adapt their single dealer platforms to provide this price discovery function, probably linking directly back to the SEF quoting the best price. This will allow the banks with market leading platforms to control the channel, even if they will only execute if they are the best price.

Illustrated below are the current main execution flows for swaps and how we would expect these to change once the new regulations have been implemented. The future emphasis will be on flows through the platforms/SEFs rather than the current state of mostly bilateral voice trades directly to the dealers or via voice brokers.


Standardised Swap Trading – Current State
Trading Arena
Client Counterparties
Reporting Arena
BIS and Regulators
Swaps Trading
Voice & Electronic Brokers
Summary Reporting
Block Trades
Bi-lateral (voice) execution
Clearing Arena
Swap Dealer Banks
Clearing Houses
Interdealer Trades
Clearing
Swaps Trading


Standardised Swap Trading – Post Dodd-Frank and EMIR
Trading Arena
Swaps Trading
MTFs, eMarkets and SEFs
Reporting Arena
Trade Repositories
Client Counterparties
Trade Reporting
Block Trades
Executable Swap Prices
IDB's
Swap Dealer Banks
Clearing Arena
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NEW PRODUCT DEVELOPMENT - WILL THERE BE LEAKAGE TO ALTERNATIVE PRODUCTS?

The move to electronic trading will drive further standardisation of the swaps market. When this happens we will see more volume in the benchmark swaps and there will be a trend towards more fungibility between swaps and interest rate futures markets. It is probable that this increase in volume will come from greater trading activity by existing OTC swap dealers *and* new entrants to the market. The combination of further standardisation and fungibility with futures, greater transparency on pricing and central clearing should encourage the smaller professional trading groups into a market which hitherto has been dominated by a few large players, transacting relatively infrequent but large size trades. Both existing and new players will play more actively in the exchange traded instruments as they develop.

Recently two new products have been launched specifically to capture this potential leakage from the OTC market into exchange traded instruments:

1. PLUS_DX has launched a new IRS Index Contract which clears through LCH. If the NYSE takeover of LCH happens, then NYSE's SwapNotes would also be cleared through the same organisation and the benefits of margin offsets become too big to ignore.

2. In the US, Eris Exchange has also introduced an Interest Rate Swap Future, clearing through CME.

Participants benefitting from FAS 133 exemptions for hedging transactions will not move to futures unless the authorities agree to remove the exclusions on futures as hedging instruments.

IMPACT ON MARKET PARTICIPANTS

We would expect that, overall; the combination of the changes will positively impact market volumes in terms of number of transactions. It is probable that this will also encourage growth in notional volume but we would expect the average trade size to be smaller in the post regulation world than has been the case in the past. The table below shows the market participants by type, the estimated number of participants in each group and how we see the breakdown in terms of positive and negative impacts for each group. The observations are focussed on the impact of the regulations on swaps *dealing* but also reflect opportunities and threats for execution volumes and market share which arise from other areas of legislation (e.g. central clearing).

In summary:

- The **voice brokers/IDB's** risk losing business to the electronic markets and are therefore rushing to build systems which will qualify as SEF's/regulated markets. There is significant opportunity for "first mover advantage"
- The major **Swap Dealing Banks** stand to gain from the opportunity to act effectively as market makers driving liquidity and increasing deal volume but there is a cost to providing the infrastructure and additional effort in making a continuous market. Providing clearing and other prime services may well reinforce the dominance of the few in terms of market share
- **Tier 2 Banks** may find, particularly in the US, that the regulatory target of widening SEF access to the 'buy-side' means that some of their traditional customers will become pricing competitors
- **All price makers** will find that increased transparency will lead to customers expecting tighter pricing on deals
- **Large Corporates** / **Financial Institutions** may, if they can meet the entry targets, qualify as end user participants. Increased transparency, both pre and post trade, should enable corporate treasurers to see true market prices and negotiate tighter prices with their bankers

Participants (#)	Positive Impacts	Negative Impacts
IDB's (20)	+ Significant increase in volumes + Major opportunity for "first mover advantage" in providing a SEF	– Voice brokers risk losing business in "standardised" trades to other electronic markets/platforms – Cost of SEF platform development – In US, may not control >20% of the voting rights in the SEF – therefore, may require restructuring of ownership and boards
Major Swap Dealers - Providing Full Prime Broker facilities (7-10)	+ Acting as a market maker on a SEF provides an opportunity to profit from increased liquidity of trading + Opportunity to capture additional execution business from banks who decide not to provide 'client clearing' + Offering cross product margin offsets could secure additional execution market share	– Additional infrastructure and plethora of messaging protocols required for links to multiple SEF's, multiple CCP's and the SDR (Swap Data Repository) – In the US, it may be necessary to set up a separate legal entity to satisfy the 'push-out' regulation – Additional funding required for multiple CCP Guarantee Funds – Potential loss of netting and therefore increased margins due to holding positions across several CCP's
Large Swap Dealers – Providing Client Clearing (~10)	+ The Prime Brokers will not take on every client who approaches them and there is an opportunity to pick up these (lower volume) customers + A more limited offering – 1 CCP per product – could be a more cost effective proposition for clients who are predominantly trading in one geographic region	– Additional infrastructure and plethora of messaging protocols required for links to multiple SEF's – Clearing through one CCP may limit the number of potential counterparties – restricting ability to trade or requiring 3rd party clearing arrangements – Risk losing customers who trade across multiple regions
Large Swap Dealers – The Rest (15-20)	+ Customer flow drives much of the swaps trading in many of these banks. Most of this will be from exempted corporates and there will be no mandatory clearing	– Still need access to SEF's and infrastructure for trade reporting – Need to establish a relationship with a full clearing member to enable give-up of those client trades that require clearing
Other Banks (2,000 – 3,000)	+ SEF's and 'price aggregators' will provide improved price transparency + Central clearing may enable them to act as an execution counterparty to more clients	– Need to establish a relationship with a full clearing member to enable give-up for all trades that require clearing
Corporate & Financial Institutions (20,000 +)	+ If they can meet the entry targets, they have the opportunity to qualify as end user participants on SEF's + Increased transparency will enable buy side (particularly corporate treasurers) to see true market prices and negotiate tighter prices with their bankers	– Companies will need to gain exemption as an end user for strategic risk hedging – Speculative trading in swaps will be subject to the full clearing regulations and entail handling and funding of daily margin calls

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If you wish to discuss any of the views expressed in this paper or require further information, please do not hesitate to contact us:

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