

December 2016

MTS Swaps

Interest rate swaps – electronic trading and the new regulatory reality

The world of interest rate swaps is changing. Electronic trading and central counterparty clearing are transforming the broader OTC derivatives market, as buy-side participants seek the ability to improve transparency and meet new regulatory requirements while continuing to trade swaps in order to hedge interest rate movements.

Meanwhile, large global banks, regional and domestic banks are making provisions for the existing and upcoming regulatory changes and adapting their business models to enhance customer loyalty and facilitate increased levels of trading with the buy-side.

Regulatory changes in the US have driven execution of swaps to much more tightly regulated platforms, namely exchanges and swap execution facilities (SEFs), with European markets scheduled to follow with the implementation of EMIR and MiFID II. This new regulatory structure is causing substantial shifts in the overall swaps market structure, and introducing a plethora of new challenges for market participants. The table below summarises the key regulatory initiatives which have the greatest direct impact on the interest rate swaps business of buy-side organisations.

Heading	Requirement	European Status	US Status
Reporting obligation	All IRS trades must be reported to an authorised Trade Repository	Implemented 2014	Implemented 2013
Clearing obligation	All trades in defined derivative classes, including IRS, must be cleared through an authorised CCP.	Beginning 2016 Category 2 participant: Q1 Category 3 participant: Q3	Implemented 2013
Trading obligation & transparency	All trades in defined derivative classes, including IRS, must be traded through an authorised multilateral platform. Minimum pre-trade & post-trade transparency requirements apply	Beginning 2018 (MiFID II framework agreed in 2014)	Implemented 2013

Disclaimer: This is MTS's interpretation of the upcoming regulatory impacts and landscape, but given the complexity of the regulation we advise recipients to undertake their own due diligence.

The buy-side challenge

The rules implemented as a result of both the Dodd-Frank act in the US and the upcoming EMIR/MiFID II in Europe, as summarised in the table above, will lead buy-side institutions and banks of all sizes to evaluate different options for reporting, execution and clearing, and put in place new arrangements, procedures and documentation with trading venues and clearing houses. This is a substantial piece of work and as such could have major time, cost and efficiency implications.

Under the new regulations, applicable transactions will have to be routed through regulated platforms, subjecting them to pre- and post-trade disclosure rules, including specific requirements relating to block trades. Those disclosures could make it more difficult for a traditional market-maker to hedge client business and the end result, many dealers argue, will be a higher proportion of smaller trades, which means an increase in reporting workload for buy-side counterparties.

There will also be costs involved with setting up regulatory-compliant arrangements for trading and clearing swaps, as a result of higher legal fees and staff costs involved with reviewing, understanding

and negotiating the new swap arrangements and documentation.

For cleared swaps, each counterparty will be required to post both initial and mark-to-market margin, with a range of options relating to forms of collateral and levels of segregation.

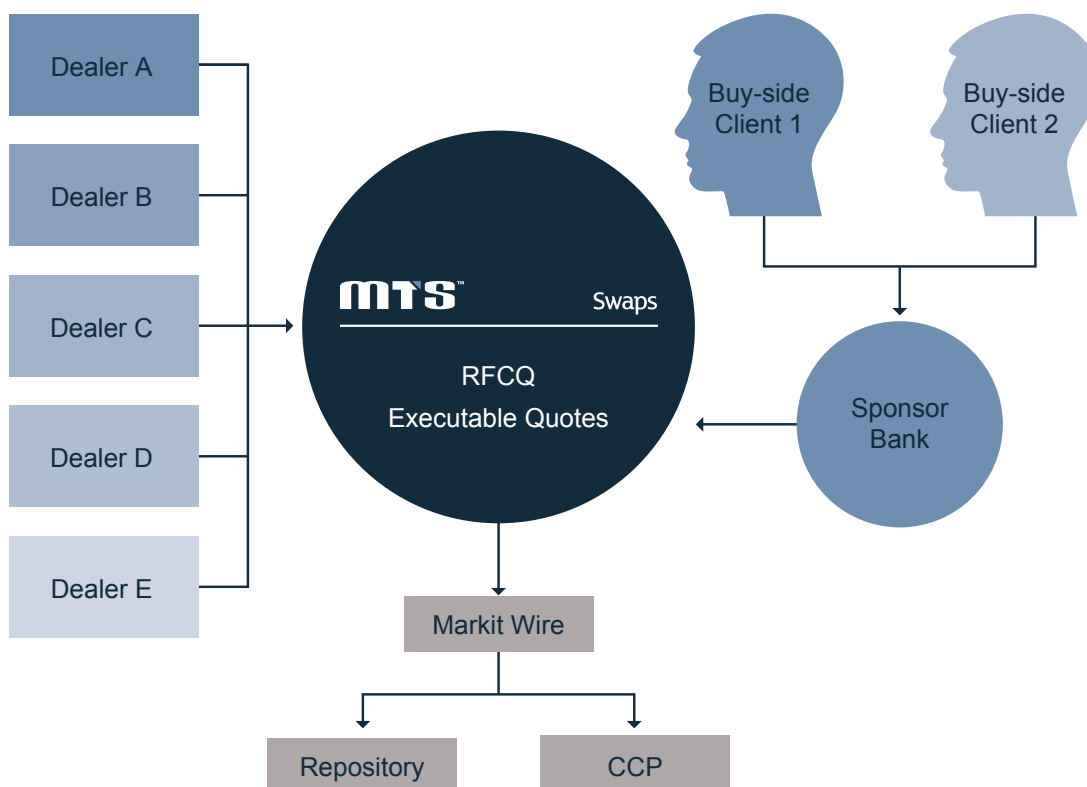
For non-cleared swaps, minimum collateral posting requirements will be imposed, and there will be costs involved with the reporting requirements of utilising the commercial end-user exception.

The sell-side challenge

Optimising customer service in the derivatives space has become a key focus in recent years, as clients look for differentiating factors in an increasingly cost-sensitive environment. As the interest rate swaps market continues to evolve, banks are seeking innovative solutions to add value and stand out from the crowd to attract and retain clients while complying with new and emerging regulations.

The challenge is attracting and retaining clients, and trading swaps effectively and efficiently whilst complying with the necessary regulatory standards.

MTS Swaps execution protocol



Sponsored access

There is strong demand from buy-side institutions and banks that trade swaps on an occasional basis for a solution that will reduce the cost of having to set themselves up to trade through regulated venues and clear through CCPs and maximise the efficiency of the necessary arrangements.

While the sponsored access model has existed in other markets for a number of years, the technology now exists in the interest rate swaps markets to capitalise on the potential benefits of this model by enabling instant communication between both the sponsor bank and its customer, and the sponsor bank and the rest of the market.

As a result, sponsored electronic access through a prime bank looks set to be a viable alternative and an important step forward in improving cost control and efficiency whilst enabling orderly, efficient access for all participants.

Other benefits of applying the prime brokerage model to the interest rate swaps markets include:

- Simplified reporting and documentation requirements for buy-side institutions trading swaps via regulated platforms
- Improved market efficiency in the execution and post trade management of swaps
- Consistency with regulatory reforms in MiFID II and EMIR, improving pre- and post-trade transparency for all market participants
- An increase in trading activity as buy-side participants and banks gain instant access to better prices and deeper liquidity pools through their prime brokers. This model critically preserves and enhances the relationship between the buy-side customer and their prime broker, respecting and developing the role of each in the successful operation of the market
- It connects investors to all points of liquidity simultaneously and anonymously giving fair and equal access to the best prices available in the market at all times
- Banks are able to leverage existing relationships and enhance customer retention through best execution
- It increases a bank's flow business, and provides economies of scale for the back office in terms of clearing and settlement

In short, sponsored access offers an opportunity

for the regulatory objectives relating to interest rate swaps to be achieved without damaging important relationships between banks and their clients. These relationships provide benefits in a range of functions, not just provision of credit, and contribute to a more efficient market.

The MTS solution

MTS, Europe's premier fixed income trading venue, has launched MTS Swaps, a new platform registered and regulated by the FCA as an MTF, that will give buy-side institutions the ability to trade interest rate swaps electronically. The venture will use innovative technology to provide customer choice and will enhance transparency and efficiency in the euro-denominated swaps market.

The technology behind MTS Swaps has been developed with acute awareness of the upcoming regulatory environment in mind, enabling market participants to establish best practice and transparency ahead of any regulatory announcements.

Leveraging existing MTS distribution, technology and market expertise, the platform will enable buy-side participants to trade swaps with a diverse range of liquidity providers via a sponsor bank, giving them access to the best prices available in the market while allowing them to maintain and strengthen their relationship with their chosen prime bank.

Banks will benefit from the ability to enhance customer loyalty and facilitate increased levels of trading amongst the buy-side.

"In homogenous markets such as IRS, where liquidity could be fragmented by the multitude of new platform offerings, sponsored access models are a solution to consider for buy side firms aiming to participate in the new liquidity pools, but not willing to spend the time or resources to build access to all those venues."

Joséphine de Chazournes Senior Analyst Celent, a division of Oliver Wyman

A number of banks, including BBVA, BNP Paribas, Commerzbank, Lloyds, Crédit Agricole, Société Générale and UBS are supporting the platform from launch. MTS Swaps will support the full trade lifecycle from pre-trade price discovery and execution to post-trade reporting and connectivity to clearing. The platform will support interest rate swap trading via request for competitive quote (RFCQ) and executable prices.



Oliver Clark
Head of Product Development,
MTS Markets

As Head of Product Development, Oliver oversees all aspects of MTS' electronic global trading platforms, including design, specification, development, implementation and sales across all interdealer and dealer-to-client markets.

Oliver has over a decade of experience of electronic trading in the fixed income market, with a particular focus on fixed income and money market products such as repo, swaps, deposits, securities lending, government and corporate bonds.

In his 11 years at MTS, Oliver has held a variety of roles, including Repo Product Head and Head of Money Markets and Derivatives. During this period, he played an instrumental role in building and launching the MTS Repo market, MTS Swaps and the Agency Cash Management trading platform in addition to collaborating in the creation of RepoFunds Rate (RFR), a widely used series of daily euro repo indices. Oliver is also a long time contributor and member of the LCH Product Advisory Group and other industry bodies.

Prior to joining MTS in 2004, Oliver previously held a range of trading and broking positions at Prebon Yamane (now Tullet), Credit Lyonnais, Dawnay Day and later at Treasury Dealer. He is based in London.

Contact

To find out more about MTS Swaps, please visit our website or contact the MTS Swaps Team:

Email
swaps@mtsmarkets.com

Telephone
+44 (0)20 7797 4090

www.mtsmarkets.com

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