Insights

MTS Swaps

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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, 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 are driving 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.	Mid-to-end 2015 (ESMA standards detailing clearing obligations for IRS published in October 2014)	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 2017 (MiFID II framework agreed in 2014; technical standards to be finalised in 2015)	Implemented 2013

The buy-side challenge

The rules set to be implemented as a result of both the Dodd-Frank act in the US and EMIR/MiFID II in Europe, as summarized in the above table, will force buy-side institutions 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, all 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 finding a market structure that can balance banks' competitive drive for flow, is consistent with the new regulatory and capital landscape, and lets participants access the swaps market in a manner that suits their unique trading requirements.

Sponsored access

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

Alternative swaps market structures that are appropriate for the new regulatory landscape are now being discussed, and a number are being actively explored. One particular alternative attracting considerable discussion is the use of prime banks offering sponsored electronic access.

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 Dodd-Frank, MiFID II and EMIR, improving pre- and post-trade transparency for all market participants
- An increase in trading activity as buy-side participants 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 buy-side and sell-side trade relationships. 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, is set to launch MTS Swaps, a new platform 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, HSBC, Lloyds, RBC, Societe Generale 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.

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About MTS Group

MTS provides a professional trading environment for the interdealer marketplace, enabling primary dealers to access unparalleled liquidity, transparency and coverage. We deliver electronic fixed income trading, market data and indices and have over 500 unique counterparties and average daily volumes of €100 billion.

MTS Cash is a comprehensive and professional cash securities trading environment for the interdealer marketplace. The MTS Repo platform provides an order-driven market for the electronic transaction of repo agreements and buy/sellbacks, while ACM is an electronic auction platform that uses the MTS Repo technology to enable cash-rich investors to enter into secured money market investments via the tri-party repo mechanism.

MTS BondVision is a trusted and efficient multi-dealer-to-client electronic bond trading platform, delivering exceptional access for institutional investors direct to market makers. Through our US broker dealer, we provide US institutional investors with real-time pricing and the ability to trade with all the major European dealers on the BondVison platform.

MTS Credit delivers an electronic market for a wide range of multi-currency non-government bonds, including covered, SSA, corporate and financial bonds. MTS Swaps leverages existing MTS distribution technology to deliver immediate access to a diverse range of liquidity providers through your chosen prime banks.

MTS Data is sourced directly and exclusively from the MTS interdealer market and includes benchmark real-time data, reference data, reference prices and historical data, providing the benchmark data source on the fixed income market. MTS Indices are operated by FTSE TMX Global Debt Capital Markets,

in which MTS has a minority stake. They provide independent, transparent, real-time and tradable eurozone fixed income indices, based on tradable prices from MTS. MTS indices are tracked by (and can be traded via) around 40 ETFs in addition to numerous structured products.

Roger Barton
Founder, Financial Reform Consultancy

Roger Barton is the Founder and Managing Director of Financial Reform Consultancy, specialising in the strategic and practical implications of financial regulatory reform.

Previously, Barton was a Managing Director at Tradeweb, where he served as head of company's European and Asian business, and latterly Tradeweb's expert on the European regulatory landscape and pending financial reform of OTC derivatives trading. Until 2005, Barton headed European e-commerce at Goldman Sachs, during which time he worked with a range of e-commerce platform providers.

Earlier on in his time at Goldman Sachs, which began in 1994, Barton also acted as Co-Chief Operating Officer for the firm's futures business before moving to BrokerTec, to initiate the development of futures trading and clearing facilities. Before joining Goldman Sachs, Barton was extensively involved in the setting up

and subsequent development of the London International Financial Futures and Options Exchange (LIFFE).

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