Europe's new world of risk

Every week, another alarm about European sovereign and banking risk. Is the euro tottering? Could European states default? Derivatives are central to managing credit, interest rate and currency risks – but in this unsettling new environment, those risks are changing. **Elise Coroneos** asks whether the derivatives market is fit for the task.

Mounting debt, a common currency entering new waters of instability, disparate fiscal polices across the euro zone, countries on the verge of default and fears that others could follow – the architecture of European finance is being shaken as it has not been for decades.

Derivatives were invented to cope with these kinds of risks – but they can only do their job if firms are still willing to use them. And as the risks change, market participants may find they need to use instruments in different ways, or even invent new contracts.

On the horizon is another threat – that regulators will reshape the market too radically, making it harder for participants to achieve their objectives.

But even before we know how regulations are likely to be redrawn, dried-up money markets have already been reshaping derivatives markets all on their own.

The shocks to European government bond markets, especially those of Greece, Spain and Italy, and quantitative easing by the ECB, have reverberated in a flight to quality, resulting in the yield on German bonds dropping across the curve to record low levels over the last few weeks, according to Basil Kaye, head of strategy at London-based proprietary trading firm Met Traders.

Exchanges on a roll

Eurex, where the 10 year Bund, five year Bobl and two year Schatz futures are traded, had a record month in May as interest rate volumes surged alongside equity derivatives.

So did NYSE Liffe, where interest rate trading hit a new high of 71.4m contracts, including 17.5m Three Month Euribor Options, 28.1m Three Month Euribor Futures and 12.9m Three Month Sterling Libor Futures.

"Options volatility has really come in from the cold," says Paul MacGregor, director of fixed income derivatives at NYSE Liffe in London. "Certainly, on the short term interest rate futures and options trading, we are averaging very high volumes this year."

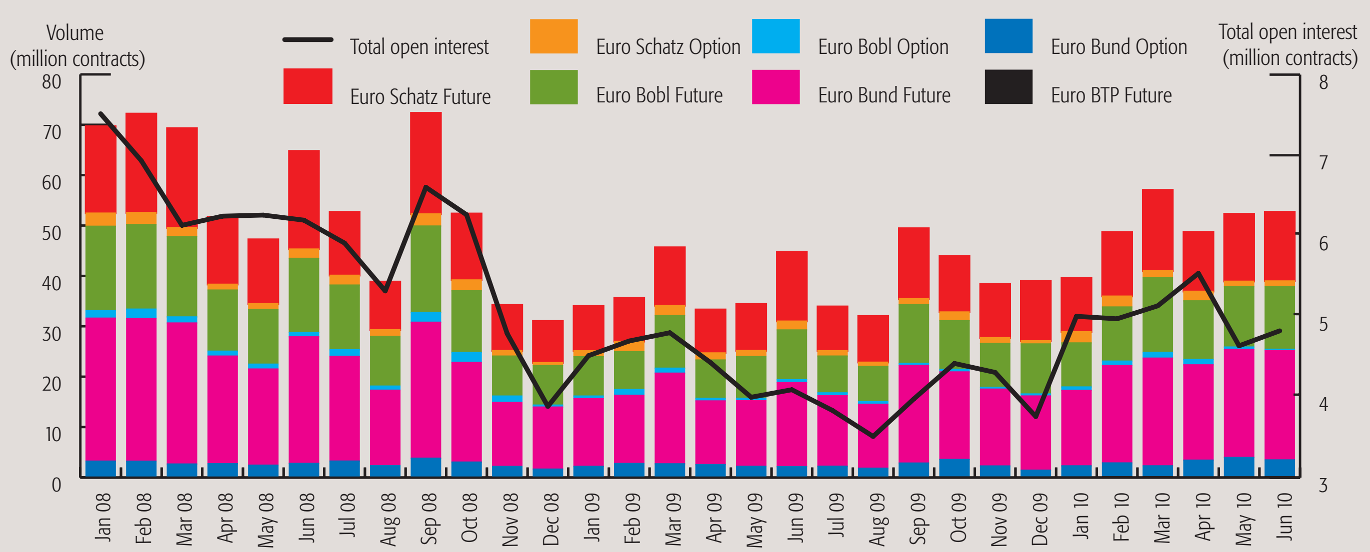
The reason, he argues, is that many participants are taking stances on future European Central Bank policy by trading Euribor options. "While it is not all about situations like Greece – we have been seeing this flux in volatility for a while now – certainly the uncertain environment created by the destabilising of economies in southern Europe has generated even more options volatility," MacGregor says.

The flight to quality has stimulated trading in Eurex's futures on the ultimate safe haven asset – German government bonds. Bund, Bobl and Schatz futures volumes have all risen since February, when the upheavals in market sentiment towards European sovereign debt really began.

But after a big dip in late 2008 and 2009, the products are not yet back to record volumes.

"Our Bund and Schatz futures have both reached the volume levels from 2007, which reflects the flight to quality during this sovereign risk crisis," says Nadja Urban, product manager for fixed income derivatives at Eurex in Frankfurt. "Volumes have benefited

Eurex's main interest rate contracts



Source: www.fointelligence.com

from recent developments around Greece, Italy and Spain."

Hedging to the fore

The river of European interest rate trading may be running at fuller spate, but beneath the surface its character has changed. There has been a marked shift in flow dynamics in the market, says Don Smith, head of strategy and economics at interdealer broker Icap in London.

"One of the biggest changes in recent months has been a shift from trading derivatives for the purposes of speculation, to trading becoming much more of a hedging-related activity," Smith argues. "This is due to the fact that Europe has seen a significant number of proprietary derivatives trading desks close, which has had consequences in the type of flow that is going through the market and the type of trading that is being done."

A research paper published by Massachusetts-based Tabb Group in April 2010, entitled *European Derivatives 2010: The Buy-Side Perspective on Equity Options, Futures and Swaps*, revealed hedging to be the biggest driver of European equity derivatives activity this year.

Second was 'exposure', followed in third place by 'equitisation for cash management'. Leverage was a distant fourth on the list.

Miranda Mizen, head of European research at Tabb Group, says that of those surveyed, a majority expected to have a higher equity derivatives turnover this year than last. Many said it would be as much as 20% to 40% higher.

"We got many comments indicating that people are looking for new avenues of alpha in the wake of the credit crisis," Mizen says.

Yet despite the vogue for hedging, there is still much trading of the yield curve, according to Peter Herrmann, a broker at the London office of JB Drax Honoré, the world's largest broker of Liffe's short term interest rate options.

Many comparisons can be drawn, Herrmann argues, between the current situation in Europe and that of Japan in the 1990s, when there was a pronounced flattening at the front of the money market curve.

"Then, as now, all the activity is in the five and 10 year sectors because people simply do not know what to expect in the short term. So we were seeing a lot of people putting on trades that roll up the curve to the front contract," he says.

Risk-aversion reigns

In interest rate swaps, the largest derivatives market, volumes have not been much impaired by the European debt crisis, says Smith at Icap – but the nature of flows has changed, from speculative to hedging-related.

Borrowers issuing fixed rate bonds and swapping to floating rate, for example, has become a much more important component of trading flow.

Futures market participants, Smith believes, have become a lot more risk-averse, partly because there are fewer participants and less speculative flow in the market after the closure of prop trading desks. "We are finding that players are much less married to their positions than they were before," he says. "The greater risk that exists in the markets at the moment is making people far less willing to ride out a market move when it goes against their position."

In addition, the lower levels of overall trading in European futures until recently meant that large players with big positions could move the market – another factor that created aversion in the general population of participants.

Short term uncertainty

As proof of traders' wariness about the short term interest rate outlook, MacGregor at NYSE Liffe points to the fact that open interest for sterling short term interest rate futures two years hence is now 10%, a historic high.

"We have seen open interest migrating further and further up the curve," MacGregor observes. "There has also been a larger than normal interest in butterfly trading, an indication that people know interest rates have to move at some point."

Another trend at NYSE Liffe has been a dramatic increase in pack and bundle trading, both in Euribor and sterling. Packs are sets of four consecutive quarterly interest rate contracts, while bundles are multi-year groups of packs.

The one and two year bundles, which became more popular over the past year in the wake of the credit crisis, are in demand again because of the European turmoil.

"In an uncertain world, it is a good way of taking a long term interest rate futures position in a short term interest rate future using multi-month strategies," says MacGregor.

The creation of a €440bn European Financial Stability Facility to support teetering economies and their bond markets has highlighted the fractures within the euro zone and has many investors asking: 'What is the exit strategy for the euro?'

"While the stand of the ECB is that an exit strategy is not needed, just this super-fund, the reality is that the market still has question marks over that," says MacGregor.

Basis swaps mushroom

Another result of the crisis in Europe has been the rapid development of the basis swap market.

Traditionally, most interest rate swaps have been straightforward fixed-floating rate swaps tied to six month money market rates. But the contortions in money markets have squeezed the appetite for medium term unsecured lending.

"Banks, money market funds and sovereign wealth funds have developed a strong preference to lend with much shorter maturities – three months or less," says Smith. "This has caused a dislocation between three month and six month money rates."

The standard six month swap market is still there, but there is an increasingly large and very liquid market now in swapping between three and six month floating rates.

"This is really a new market, which wasn't there in the same form before the crisis," says Smith.

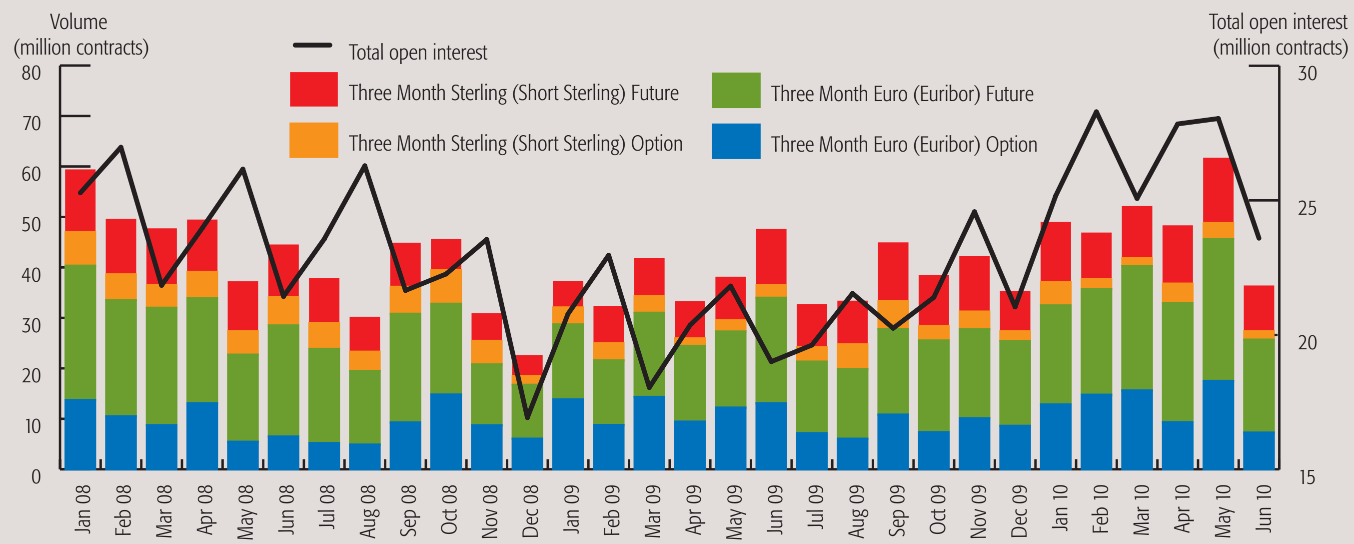
Now, instead of bond issuers selling fixed rate bonds and then swapping to six month Euribor, they are swapping to six month Euribor and then conducting a basis swap to move the exposure from six to three months.

"While this market has really taken off since last September, the current European situation is lending a hand to this market because money market conditions are still as illiquid as ever," says Smith.

Regulation: outlook uncertain

Regulation also promises to alter European markets, perhaps profoundly. But despite a year of consultation that market participants say has been helpful and constructive, there is still great

Liffe's principal short term interest rate contracts



Source: www.fointelligence.com

uncertainty about what exactly will change.

Some key differences have emerged between the way derivatives are being reformed in the US and how they are likely to be reshaped in Europe.

In the US, banks will be forced to siphon parts of their derivatives business such as junk-rated credit default swaps, equities and commodities (other than gold) into separate subsidiaries.

Most OTC derivatives, interest rate swaps, currency trades, investment grade credit default swaps and gold will be able to remain inside US banks. However, there is no such movement to break up derivatives desks in Europe. "In the EU, there is not a problem with universal banks," says Anthony Belchambers, chief executive of the Futures and Options Association in London.

Nevertheless, there are some clear areas of commonality between reform in Europe and the US.

It can safely be deduced that central counterparty clearing houses will emerge as more pivotal participants in the European business, as in the US.

Assuming that some kinds of derivatives will be newly subject to mandatory central clearing, the houses that perform this function are likely to find themselves on the end of substantially increased regulation.

"There will be a slew of new business, but it will come with a price tag for the clearing houses themselves, so clearing fees will inevitably be increased," according to Belchambers.

Regulated participants are also likely to face significantly higher capital requirements for some derivatives trades, especially those that are not cleared. These costs could be passed on to the end user – especially of bespoke OTC derivatives.

Another potential cost is tighter rules on collateral. "If collateral that can support a transaction becomes cash or near-cash, a lot of end users are going to have to acquire that collateral from somewhere else, for example by taking out credit lines," says Belchambers. "On top of that, companies may be facing regular margin calls on a daily or intraday basis, which is a cost to cash flow."

Clearing new products

Besides the costs likely to come from operating in a more fortified regulatory environment, clearing houses will also be dealing with a new push for them to participate in monitoring potential threats to the system, putting another pressure on their cost structure.

ICE Clear Europe, the Intercontinental Exchange's European clearing house, expects to begin clearing west European sovereign credit default swaps in the coming months.

Jeffrey Sprecher, ICE's chief executive, discussed some of the intricacies of clearing sovereign CDS during the company's 2009 fourth quarter earnings call.

"Sovereigns present a unique risk and it's one that we're debating with the market and with regulators," he said. "For example, if you have an Italian bank that's writing protection against the default of the Italian government, what is that risk? And is it possible for an Italian bank to survive the collapse of its own government?"

ICE's clearing arm is also preparing to deal with other challenges that came to the forefront as the crisis unfolds, said Sprecher.

Already, ICE Clear Europe's buyside solution for CDS clearing, which will offer segregation of customer fund and positions, is expected to be launched later this year. In the US, ICE Trust began clearing index credit default swaps in March 2009 and single name CDS in December 2009.

A boon for exchanges?

Pre-empting legislation, many participants are already moving what were previously over the counter contracts on to exchanges. "The move on to exchanges and away from counterparty risk explains some of the fantastic turnover on derivatives exchanges over the past months," says Herrmann at JB Drax Honoré.

However, the question remains: once reforms have been completed, what will be the percentage of derivatives contracts traded on and off exchanges?

"It is impossible to call it," says Belchambers. "We don't really know what the capital costs are going to be between all the different strands of derivatives businesses."

According to Tabb Group's Mizen, more centralised trading is something investors really value. "Many of them have mandates as to whether they can trade listed derivatives or whether they can trade the OTC," she points out.

But Steffen Koehler, head of product development at Eurex, is yet not ready to categorically declare that regulation is going to bring new business for Europe's derivatives exchanges.

"Right now, a serious forecast on how our volumes will be affected by new regulations would be like looking into a crystal ball," Koehler says. "During the credit crisis in 2008, volumes increased, but the following deleveraging by some participants led to lower volume in 2009. The same applies for the upcoming regulation, as it can have a different impact on volumes."

Getting ready to grow

Despite the uncertainty as to how regulation will affect the market, Peter Best, NYSE Liffe's head of product development in fixed income derivatives, says the exchange has strengthened its core technology to be ready for higher turnover.

In terms of innovation, both NYSE Liffe and Eurex are poised to respond to the demands of the market as the next phase of the crisis evolves and regulation is announced and implemented.

"Going forward, the German bond futures product suite will continue to be the benchmark for the European bond market," says Urban at Eurex. "However, we are following developments to work out what the market needs. So, for example, if the EU were to decide to launch a European government bond, then we might consider whether it is worthwhile launching a contract with this as underlying."

NYSE Liffe is getting ready to launch two new Gilt contracts, one short and one medium term. "Gilts have been a flight to quality," says Best. "Instead of concentrating on the front months of the yield curve, which has always been typical in futures, we have been trying to build liquidity further out on the curve, where there was far less liquidity before."

Encouraged by the interest at the moment in volatility strategies, NYSE Liffe launched multi-serial Euribor options to enable intra-month adjustment. Best says they have so far exceeded volume expectations.

Another minefield for legislators to tiptoe through will be preserving end users' ability to hedge, by ensuring that it remains affordable, especially bespoke OTC products.

"If nothing else, one of the big lessons of the crisis is that we need to have the systems and controls to manage our risks," warns Belchambers. "But if hedging costs go up, we don't want them to go up so much that some institutions take their chances by going unhedged."

Europe's wake-up call

Although derivative trading is thriving and clearing houses are set for a boom, the wider outlook for Europe and its faltering money market liquidity depends on a recovery of confidence in the banking sector and a pick-up in economic activity, says Smith. "It will be a fairly slow recovery, with a continuation of these conditions at least until the end of the year, probably even two to three years before we return to a semblance of normality."

But despite talk of euro exit plans and hedge funds and other players betting against the currency and the ECB, Smith believes it will survive. "Simply put, what is happening is providing a catalyst for major fiscal and structural reform that needed to happen. This is just the catalyst to encourage closer integration in economic matters." ■