Swap Curve Product Offers Independent Valuations

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Eris provides first swap curve to gauge OTC swap valuations.

To date few nonfinancial corporates have jumped on the swap futures bandwagon but it's likely they will, and the Eris Exchange is continuing to make the financial product more attractive for users of over-the-counter (OTC) swaps. Its latest innovation is the Live Eris Swap Curve, which provides a free source of real-time valuations and analytics for not just Eris's Standard Swap Futures but also OTC swaps.

"The Live Eris Swap Curve takes advantage of the significant depth of order book liquidity across the 2-, 3-, 4-, 5-, 7-, 10- and 30-year Eris Primary Standards contracts to produce high-quality, real-time valuations and analytics across the entire curve of listed Eris contracts," said Eris Exchange CEO Neal Brady in a statement.

Unlike traditional futures contracts, Eris's swap futures do not have be renewed at monthly or quarterly intervals and can be held for the entire duration of the hedged asset or liability. In addition, the exchange-traded product is significantly less expensive than OTC swaps, and it is eligible for hedge accounting treatment—a necessity for many corporates.

Jeff Bauman, managing director of derivative sales for the fixed-income group at futures commission merchant (FCM) R.J. O'Brien & Associates (RJO), said that since large wholesale FCMs now source liquidity at Eris, to gain access to a new account base, the wide and deep OTC market is essentially driving Eris's prices. Consequently, Eris's new swap curve provides transparency that was previously unavailable, when market participants typically relied on their banks for quotes.

"The Eris swap curve now provides users of corporate derivatives with a free streaming pricing service that is not only for Eris contracts but all Libor-based derivative instruments. Corporates can see a live streaming market in interest rate swaps," Mr. Bauman said.

In today's OTC swap market, a corporate swapping a fixed-rate bond offering to floating rate must rely on its bankers to provide a fair-market swap rate, a notion participants in NeuGroup meetings have frequently expressed doubt about. For example, a corporate borrows $500 million in fixed-rate debt when five-year Libor is 225 bps and the company's credit spread is 300 bps, for an all-in rate of 5.25%. Corporates have relied on their banks to mark-to-market the swap, but the only way to determine whether a given rate is accurate is to call several other swap dealers, a task for corporates that are often short on time and resources.

If the bank imbeds 30 bps in take-home pay into the swap rate, unbeknownst to the corporate, that amounts to an additional 1.5% upfront, or $7.5 million that the corporate is paying over the five-year life of the swap.

"With the Eris swap curve, market participants can now see where the market is and keep everything in balance," he said.

Geoffrey Sharp, Managing Director at Eris Exchange, said that the Live Eris Swap Curve may be accessed via a MS Excel spreadsheet on a real-time basis, and doesn't require complex technology or systems.

"It's free, and it will allow market participants to independently evaluate their own existing OTC swap positions and compare them with an equivalent Eris position," he said.

In general, exchange-traded products are significantly less expensive than OTC products. Mr. Bauman said RJO was recently called by a regional broker-dealer because it had introduced Eris Standards to a corporate account. The corporate was looking to do a $50 million interest-rate swap, and its risk-management advisor estimated that to do an OTC swap would cost approximately $1 million to set up.

The broker-dealer then compared the equivalent of 500 Eris swap futures and determined it would cost about $2,000 to execute the transaction and about $10,000 annually to carry it at an FCM, Mr. Bauman said.

One of the biggest impediments to most nonfinancial corporates hedging with exchange traded derivatives, except for a few giant tech companies and other corporates large enough to support sophisticated trading desks, is the requirement to post initial and variation margin. The manpower and technology to do that efficiently imposes an additional cost. Eris is betting that new margin requirements that have recently gone into effect will prompt corporates to look more closely at swap futures. Even though nonfinancial corporates are exempt from the new requirements, their bank counterparties are not and almost certainly will imbed their higher costs in the swap rates they offer, increasing their customers' cost of OTC swaps.

Glen Capelo, managing director at Mischler Financial Group, a boutique investment bank and institutional broker, has spoken mainly with cash-rich technology companies about the product. In general, the corporates view swap futures as making “a lot of sense,” he said, but for those that haven’t yet embraced the futures market posting initial and ongoing variation margin remains a hurdle.

However, corporates are beginning to recognize the additional costs to trade OTC swaps as banks seek to pass on their higher capital requirements and various fees, he said, and over time the benefits of swap futures will likely become more apparent. “The product is much more efficient when it comes to capital, taxes, accounting, everything,” he said. “It’s a superior product to at least have in your toolkit. You don’t need documentation and a lawyer, and there’s no paperwork with it; it’s a much truer instrument when you’re dealing with the complexities of securities.”

Corporates tend to have multifaceted relationships with their banks, and there are other reasons besides costs that prompt corporates to tap the OTC markets, but swap futures may address some of their needs. Another obstacle to using exchange-traded futures, however, has been the difficulty in receiving hedge accounting treatment for those transactions, to reduce volatility in a company’s earnings as the hedge’s value changes.

RJO teamed up with Eris Exchange to release a series of case studies last fall demonstrating how Eris’s swap futures are in fact eligible for hedge-accounting treatment.

Under current accounting rules, hedges must closely match the hedged asset or liability to be considered effective and achieve hedge accounting treatment. GFM Solutions Group, hired by RJO’s Fixed Income Group to conduct the accounting studies, found that the “ineffectiveness” resulting from the mismatch between Eris standards and the hedged asset or liability to be negligible. The consultancy also found that the ineffectiveness resulting from applying Standard futures contracts as cash flow hedges amounted to less than 0.025% in any given period, and as fair value hedges to less than 0.2%. That ineffectiveness will be reported in earnings for cash flow hedges and fair value hedges.

New hedge accounting guidelines soon to be finalized should make the process even easier for both cash flow and fair value hedges. Today, derivative end-users must first establish that a cash-flow hedge will be effective and then regularly assess and measure its effectiveness. Cash-flow hedges will require an initial assessment to establish effectiveness, acknowledging that the terms are not identical but that the contract will effectively offset the underlying exposure’s changes in value. Then changes in the hedge’s value will be recorded as if they are effective, requiring only qualitative assessments that critical terms of the underlying exposure have not changed.

Similar changes that will favorably impact the effectiveness of Standard contracts used as fair value hedges.