Julia: **I'm Julia Schieffer, the founder and editor of** DerivSource.com

In this podcast we're examining if swap futures are failing to ignite interest among the buy side?

Despite existing exchanges honing their offerings and new platforms launching contracts, swap futures haven't so far not captured the buy side's imagination.

The benefits of swap futures are well documented - the economic flexibility of a swap with the inexpensiveness of a future, but trading really remains a relative drop in the ocean in the big overall derivatives picture and they haven't really made the dent predicted in the volumes of OTC contracts.

In this podcast, we speak to Lifan Zhang, principal at Catalyst in London, who explains the reasons for the lack of take-up and the catalysts that could help these products reach their full potential.

Here is DerivSource reporter, Lynn Strongin Dodds speaking to Ms Zhang.

Lynn: Hello, we are here today with Lifan Zhang, principal consultant at Catalyst to speak about swap futures. Before we begin, would you like to give us a little bit of background on your job and your role at Catalyst?

Lifan: My name is Lifan Zhang, I'm a principal consultant at Catalyst Development Ltd, I work within the risk and clearing and regulations space as a specialist. My background is within the risk management and clearing space. I have experience covering multiple asset classes in my previous roles, primarily covering the main asset classes including interest rate products, fixed income, equities and commodities.

Lynn: The first question I will ask is about some statistics, it says that the picture has improved but the questions is really why haven't swap futures taken off as predicted? A recent study by Clarus Financial Technology showed that OTC IRS still account for 99.5% of volumes on US denominated IRS. What do you think are some of the main stumbling blocks?

Lifan: We all know that in the recent few years the regulation had been adding a lot of pressures to banks with increased trading costs when it comes to clearing, margin cost and all the new capital requirements. Let it be capital buffer, leverage ratio, SA-CCR or the fundamental review of trading book. So swap futures have been coming across as a new class of product to reduce margin cost and cost of capital.

The first of the likes was launched by CME and Eris Exchange in late 2012, and they were expected to gain momentum over time. However, it has not turned out to be the case, at least in the past three years. So a couple of things might be able to help explain what happened; one is the slight delay in the kick-in date of bilateral margining for systematically important financial institutions. The rules were pushed out by 9 months with the IM and VM of the largest banks starting in 1 September this year, and the VM requirement will be phased-in for the following six months, but IM not until four years later. So some of the market players might not be feeling the pinch until the regulations are fully factored. Bearing in mind that for bilateral margining to apply both entities have to be covered by the regulations. Also, the Basel Capital Requirements are not fully in place yet, with many of the standards becoming effective in the next 3 years. Another possible reason could be the fact that the majority of the interest rate markets still prefer the flexibility that comes with the OTC IRS, although they can see the benefit that comes along with the swaps futures contract.

Lynn: Do you think once the regulations are bedded down the swap futures will gain traction and will the regulation be the main catalyst or will it be that buy-side participants will be more used to using swap futures or the existing products that are available today?

Lifan: It is still relatively early days, but once the regulations around margining and capital are fully applied it will hit the trading cost and the bottom line, so we may expect to see some change in the trading activity for swap futures.

Lynn: In terms of the benefits for the buy-side, what do you think are the main advantages for firms to use swap futures?

Lifan: I think we've mentioned it so far, the swap futures, the product they provide simple and cost efficient access to interest rate swaps for hedging purposes. It can help lower the margin and lower the clearing fees when being compared to OTC interest rate swaps. At the same time, many CCPs they're offering cross-margining for swap futures without the listed interest rate or fixed income product they clear within the same service, so that's also an added benefit for the buy-side as well.

Lynn: What would you say are the main disadvantages?

Lifan: This potentially lies within the nature of a listed derivatives product. It's the standardisation in the contract, so that means market participants they may still prefer the flexibility they can get from the traditional OTC markets, although margin might be lower for the product but there are other associated costs with clearing and exchange traded contracts, for example the default fund contribution, and that is not a small overhead for a clearing firm.

Lynn: Last year we saw GMEX enter the fray - do you foresee any other type of platforms coming to the market this year or perhaps next?

Lifan: Actually GMEX and NLX Exchange and ICE actually are all new entrants to the market, especially for NLX Exchange, they've launched a Canadian contract, and ICE have also launched a new contract of swap futures. There were a couple of other exchanges that have looked into similar products, such as LSE Group and Eurex, so the market already seems to be a bit over crowded with a number of big players but I think there's always opportunities for newcomers, especially if they can find a niche and product that caters for the market needs.

Lynn: As with any industry initiative, do you think that there will also be consolidation going forward?

Lifan: I think that's the nature of the market. There's always possibility for consolidation, we know that right now there are a handful of exchanges offering swap futures, however CME and Eris Exchange they seem to be the main players so far and they have decent open interest and volume in their offerings, so we could see consolidation in the future.

Lynn: Just in general, how do you see the market developing?

Lifan: I see the next two or three years to be a crucial phase for the exchanges to build their volume as banks when they are more and more challenged by increasing trading costs and smaller profit margin, so maybe with the right innovation and tweaking of the products, swap futures can win over the market eventually.

Lynn: Thank you very much for your time and your insight. It's been much appreciated.

Lifan: Thanks Lynn. Thanks for the opportunity.

Julia: Thank you for listening to this podcast. If you would like to see the transcript of this recording please go to the podcasts notes page on DerivSource.com. This podcast is available via iTunes and also via the free DerivSource app so you can listen on the go at any time.

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