Clearing is good for swaps, regulation is good for futures

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The market has been talking about this since at least 2009: swaps clearing will reduce systemic risk and take most of the counterparty risk out of the swaps market. Yet despite this risk reduction, regulators still seem determined to make the swaps market either look like the futures market or migrate its volume over all together.

I'm over simplifying of course, but there's some truth to it. Over the past 6 months we've been conducting research examining both ideas: the impact of clearing on systemic risk and the swaps market, and the cost of trading futures as compared to comparable swaps. The pair of studies included over 100 interviews with investors and dealers as well as quite a bit of quantitative modeling via a very big spreadsheet. We found that investors believe the increased cost of clearing swaps is largely worth the benefits received and systemic risk has in fact been reduced, but even with those benefits in hand, futures do in fact provide considerable cost savings over swaps in many cases. So while investors will begin to put new risk on via futures rather than swaps over the next 12-18 months (not just swap futures, but futures), those taking this leap will be a subset of the market leaving the cleared swaps market robust albeit slightly smaller. In short, there is room for both products to thrive. The caveats behind these statements are long and nuanced.

The caveats are in fact what took up most of the page space of the research reports in question. Understanding if futures have yet to take share from swaps, if futures should start to take share from swaps if clearinghouses are too-big-to-fail and if the cost to investors must pay to ensure safe clearinghouses requires much more than a yes or no answer. Investment strategy, tolerance for basis risk, holding period, FCM fees, running IM rates, turnover frequency and other related factors can all change the result of the analysis.

When it comes to derivatives regulation the devil is very much in the detail; a fact of life we've all grown to accept over the past few years. The conversations at FIA's conference in Boca Raton last week were about those details - skin-in-the-game, margin methodologies, product selection and more. I see this dive into the details as a sign of progress; no longer are we debating if clearing makese sense or if SEF trading must be via an RFQ of 1 or 5, but instead the nitty gritty of creating a market that will stand the test of time. With that, we leave you with our two new research papers that will hopefully help you understand the nitty gritty a bit more, and make up your own mind as to how the market will develop. As I've said many times in my research career, the numbers are what the numbers are.

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