Euribor renaissance at Eurex?

While some industry observers may have labelled the recently announced Euribor re-launch at Eurex Exchange as simply opportunistic and just another 'me too' product, Stuart Heath, Executive Director and Head of the UK Representative Office, Deutsche Börse and Eurex, says the initiative is far more than a tactical reaction to the changing competitive landscape.

Eurex originally launched its Euribor futures contract in direct competition with LIFFE in 1998 and although it still trades on the exchange its volume is dwarfed by that on the London-based venue.

The June re-launch not only lays down the gauntlet to LIFFE, it also provides an immediate challenge to the fledgling Nasdaq OMX NLX exchange, which on 31 May launched a suite of short-term interest rate products replicating not only Euribor but also the longer term Bund, Bobl and Schatz contracts traded on Eurex.

But while some may believe that the initiative is taking advantage of short-term opportunity and, in particular, the potential disruption of the impending move of LIFFE's open interest from LCH to ICE Clearing, Heath contends that it is part of a far broader strategic remit, which is further underpinned by recent technological enhancements at Eurex itself.

"The advantage to Eurex and Eurex Clearing is to cover the whole euro denominated yield curve, which enables our market participants to realise the appropriate offsets," he says. "It's very clear that the big issues from the OTC side are capital and collateral constraints, which mean that any way you can minimise margins and improve collateral efficiency is a major benefit. That is the long-term goal and motivation of our Euribor initiative."

Heath freely admits, however, that both internal and external influences have helped to make this an opportune moment to relight the fuse on Europe's most important listed short-term interest rate contract. "The facility and the opportunity now exist as well as the demand," he explains, before going on to outline the key drivers.

A highly significant internal factor is the recent migration to Eurex's new trading architecture. This brings important enhancements, including increased speed, mass quoting ability, a pro rata matching algorithm and market maker protection for futures but, perhaps most significantly for interest rate markets, permits new spread trading functionality.

The previous Eurex Exchange system allowed the trading of calendar spreads for futures with three maturities. Now, calendar spreads between all the maturities can be offered, bringing obvious benefits to those trading the full length of the fixed income yield curve.

As one might expect, the exchange does have incentive schemes in place, aiming to attract liquidity from different market segments. It is offering new trading and market making incentives for the three-month Euribor futures contract from June. A completely new market making scheme will initially run until the end of 2013.

"Prop shops will always look at fees, so if you pitch them appropriately then they will be interested in your product," says Heath.

"We have to have a sound reason why the market would migrate and we have to have a valid business case for the longevity of this. In that respect, longer term, it's the banks, broker dealers and swap users trying to merge their OTC and listed business who are our target because they see the opportunity offered by our long-term view on portfolio margining."

Long-term strategy

Interestingly Eurex is also looking to incentivise longer-term participants in the market such as pension funds and hedge funds by offering fee rebates for client orders relative to open interest held. It also further underpins Eurex's drive for clearing end client business in line with incoming regulatory changes such as CRD IV at the start of next year and mandatory client clearing expected to come into effect towards summer 2014.

But while the technology and the incentives are important in the bid to attract liquidity from various types of market participant, the underlying long-term strategy is firmly based around helping clients towards the best possible solutions to issues raised by the upcoming regulatory capital requirements.

Heath says that Eurex is "ahead of the curve" in terms of innovation in capital efficiencies, especially with its "more robust" individual clearing model where complete segregation is offered in terms of margin and positions, resulting in a lower capital charge for clients.

The new environment

Furthermore, with its new portfolio-based risk management approach in place, the exchange will be able to provide significant capital efficiencies across portfolios of listed interest rate contracts and interest rate swap transactions cleared through Eurex Clearing.

"In the new environment everything will be portfolio risk managed in the fixed income sector at Eurex," explains Heath. "We've already moved Euribor into the same margin group as Bund/Bobl/Schatz to provide immediate offsets under risk-based margining. This ties in with the whole long-term view of hedged instruments, if it's Euribor against swaps against bunds, for example, it will be seen in a default scenario as if it's a hedged position.

"Although in many ways Euribor is a small cog in a far bigger machine, the portfolio margining offering will only work properly with Euribor in it," says Heath. "We know that there are people with swaps in LCH who also hold Euribor futures there, but they are not cross margined and because they are charged a certain number of basis points per side that is starting to misprice the swaps market."

With the Euribor re-launch under way, following on from last year's successful introduction of the OAT French debt contract, it seems likely that other initiatives in the fixed income sector will follow.

Heath acknowledges the competition but feels Eurex is well placed to take advantage of the opportunities brought about by regulatory change with the holistic approach to the fixed income markets he describes.

"We're looking to establish a bridgehead in 2013, and in 2014, as the regulatory changes come through, the benefits of Eurex Clearing should start to come to the fore," he concludes.