Synthetic innovation

The increasing accessibility of synthetic products means they are gaining favour with alternative and institutional investors. Dan Barnes reports
nvestment fund managers in the Americas are being offered an increasingly wide range of synthetic products and are viewing these as increasingly attractive routes to gaining exposures. Swaps are providing financing for trades that were previously the preserve of more complex physical transactions, while futures are offering lower-cost alternatives to certain swaps. Physical access to instruments via securities lending and repurchase agreements (repo) is still fundamental to portfolio optimisation, and supports collateral provision. But dealers are keen to also provide synthetic alternatives in order to meet client needs in the most efficient way.

“We see collateral optimisation as the end goal and the various wrappers that we offer are the tools to achieve that end goal,” says Jurrie Reinders, head of structured equity finance at Societe Generale. “So when we face our clients we do not actively differentiate between securities lending, repo or synthetics, either for single names or indices. They will be served by one desk.”

Regulation has added to the cost barriers associated with certain tools. The Dodd-Frank Act requires that swaps be subject to central clearing where appropriate, with initial and variation margins applied as a risk measure whether the derivatives are cleared or traded bilaterally. The additional costs this imposes has had an effect on the appeal of more complex instruments to investors.

“We have seen a shift towards listed products away from OTC products for flow instruments,” says Julien Climent, senior trader for structured equity finance at Societe Generale. “The introduction, and continued use, of initial margin and increased requirements for CSAs [credit support annexes] between financial counterparties have led to a large shift to listed products and we have captured a significant part of these flows.”

At the same time the increased capital requirements of Basel III have affected the use of repo, a major source of collateral financing.

**Pressure on repo**

The net stable funding ratio (NSFR) and the liquidity coverage ratio (LCR), which impose standards for calculating liquidity, both have a direct impact on the repo market. The NSFR penalises short-term funding, increasing the cost of short-term repo, and reduces the supply.

The LCR makes short-term funding less attractive to banks. Meanwhile, holding high-quality liquid assets (HQLA) is made more attractive so consequently firms strive to find the right assets to meet LCR requirements around the reporting date, straining supply.

“By limiting the financing activity to priority accounts and netting large amounts of their transactions, banks have effectively reduced their net balance sheet by 80%,” says Stephen Malekian, head of US business development at repo platform Elixium. “You can see that allocating the 20% of balance sheet that is left across the largest accounts at the banks, there will be a lot of institutions that are essentially going without.”

He says that this is encouraging asset managers to look at alternative methods of supporting collateral access, including platforms such as Elixium. “They now have the option to do this...”
business with other buy-side firms,” he says. “You no longer need a financial institution to stand in the middle of that trade as credit intermediator, at an off-market price, to gain access to the financing markets.”

Sunil Hirani, co-founder and chief executive of interest rate swap-trading platform trueEX, says that his firm is also seeking to take advantage of the problems existing in bilateral markets by providing electronic access to a wider range of tools. “We started with swaps, rolled out swaptions and our goal is to expand into cash, government debt and then into repo and to provide futures and packaged transactions,” he says. “We are providing access to buy-side firms so that they can execute and process their entire rates book. When we started rolling out swaptions, a lot of clients talked about inefficiencies in the repo space, so we are pursuing that.”

Yet there are indications that sell-side firms in the US are coming to terms with the impact that regulation has had on their own use of repo more effectively than in other jurisdictions. “European banks are currently somewhat less advanced than their US counterparts in re-optimising their business models in the face of [the LCR and NSFR],” said Yves Mersch, European Central Bank executive board member, at the GFF summit on January 26 2017.

Consultancy Finadium noted in a recent report that because dealers have typically struggled to get the right levels of HQLA on their balance sheets at quarter end, rates have spiked. Yet in December 2016, as US dealers closed out their books for the year, while optimising their financial and risk capital ratios, “there was no explosion in spreads nor scramble for cash,” the report states. “Banks were largely prepared for their need for cash and HQLA, two inputs into calculating the Leverage Ratio and LCR. While not all banks have yet to incorporate the NSFR, this did not seem to matter as far as repo was concerned.”

This implies the repo market will see less pressure from sell-side demand, somewhat improving its ability to support the buy side.

**Standardised documentation**

While swaps users have been challenged by the increased costs imposed by regulation, asset managers can leverage International Swaps and Derivatives Association (ISDA) master agreements to get access via a dealer to innovative products that offer exposure. “Most hedge funds have three-to-five prime brokers, and eight or nine ISDA relationships,” says Tim Collins, head of delta one sales at ING, says. “Once you get the ISDA in place you don’t have to build out the prime broker side, you can get access to the expertise that ING has with very little beyond the ISDA.”

The development of new swaps tools is increasing interest in this approach. For example, Bloomberg’s launch in March 2017 of standardised total return swap (TRS) contracts based on the Bloomberg Barclays Indices of high yield and investment grade US credit offers a new route to potentially illiquid assets.

The director for US fixed income at a major Canadian asset manager says: “Instead of going
out and buying a basket of individual bonds, you can get credit exposure via credit default swaps (CDS), you can get exposure via various credit exchange-traded funds (ETFs) and now you can get exposure via TRS, which look like they are going to start being much more liquid."

Although swaps can provide access to emerging markets, other routes to Latin American markets have improved in recent years. When capital controls are lifted, as in Brazil in 2013 and Argentina in 2015, the need for synthetic access reduces. On Brazilian BM&FBovespa market cash trading accounted for 96.3% of total trading value in February and foreign investors accounted for 49.7% of market participation.

David Lewis, head of Americas trading at Franklin Templeton Investments, says: “We don’t use derivatives to get exposure to Latin America equities. [Historically] it was really only used in those markets that had currency restrictions, such as Argentina at one time. We operate directly in most of these countries and in Brazil specifically, where we have a local office that trades futures and options.”

However for hedge fund managers without the infrastructure to put feet on the ground across markets in the Americas, access via synthetic instruments is still an appealing option. ING recently launched a portfolio swap platform that allows it to mimic a physical prime broker, allowing a buy-side firm to be long and short in the same swap.

“One of the key benefits is that it’s much quicker to set up than a physical prime broker. It requires far less infrastructure on the buy side than a physical prime broker. It’s basically covered under a market-standard ISDA and a CSA instead of a bespoke prime brokerage contract,” says Michael Baudo, ING’s regional head of financial markets Americas and global head of securities finance. “Portfolio swaps are much better at market access, especially for emerging markets such as Latin America. You have a lot more flexibility to do offshore transactions to access an illiquid or emerging market in a much faster fashion.”

Where barriers exist to liquidity or accessibility that are hard to overcome using physical instruments, derivatives can be structured to overcome them. Increasingly, listed instruments that do not carry the collateral costs of swaps are helping to alleviate the burden on the trading desk. “Smart traders are looking at derivatives and cash, looking up and down the capital structure, and are able to go long and short,” says the Canadian asset manager. “Optionality adds value – if you have 50 tools you could use and someone else has one tool, you will win.”