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Research Note

ISDA 2015 Research Year in Review

In 2015, ISDA's research team continued to produce proprietary research and analysis on key market trends, including market liquidity, fragmentation, cleared volumes, swap execution facility (SEF) trading and compression. This research plays an important role in enabling market participants and policy-makers to better understand and shape decision-making on important policy issues.

ISDA will continue to track industry trends throughout 2016, and will provide thought leadership in an ever-evolving derivatives landscape. In this report, we summarize key pieces of research ISDA published in 2015, which lays the foundation for continuing work.

TRACKING THE US DERIVATIVES MARKET

In its quarterly series on derivatives transaction data, ***SwapsInfo Third Quarter 2015 Review***, ISDA found that approximately 80% of interest rate derivatives (IRD) and credit default swap (CDS) index trades by notional amount were cleared. Nearly 60% of IRD and more than 70% of CDS index trades by notional volume were executed on a SEF.

The research team used daily data sourced from ISDA's proprietary ***SwapsInfo.org*** website to compile the report. SwapsInfo is designed to promote transparency in derivatives markets by collecting and aggregating trades that are reported to US swap data repositories.

This year, ISDA will introduce a separate tab on the website that will display more in-depth SEF trading data. The ISDA research team will also begin to gather data from European trade repositories to publish on the site, in an effort to further promote pre- and post-trade transparency across regions.

IDENTIFYING FRAGMENTATION

ISDA's research team was among the first to examine whether US regulations have caused global derivatives markets to fragment along geographic lines. The evidence showed the emergence of separate liquidity pools as market participants outside the US opted to execute trades among themselves for certain products.

The average monthly share of total euro interest rate swap (IRS) notional volume transacted exclusively between European counterparties was at 73.4% in the third quarter of 2013, before the US SEF trading regime was implemented. That percentage had grown to 89.4% by the first quarter of 2015, and 88.6% in the three months to June 30, 2015, according to an ISDA report entitled ***Cross-Border Fragmentation of Global Interest Rate Derivatives: The New Normal?***.

This report built on previous ISDA research that demonstrated how European dealers have begun to trade exclusively with other European counterparties in the market for euro-denominated IRS after the SEF rules came into force on October 2, 2013. Further evidence of this trend emerged following the introduction of the first US trading mandates in February 2014, a process known as made-available-to-trade (MAT).

This is one example of how differences in the timing and substance of domestic rule-making are affecting cross-border derivatives trading. European authorities are currently crafting their own rules on trading venues and trade execution through the revised Markets in Financial Instruments Directive and associated regulation (MIFID II/MIFIR).

In the meantime, more than 50% of end users that responded to an April 2015 ***ISDA Insight Survey*** said the market was fragmenting along geographic lines as a result of inconsistent regulations across jurisdictions. More than 50% of those said this was having a negative impact on their firm's ability to manage risk. Close to 40% of respondents felt derivatives market liquidity had deteriorated over the previous year.

EUROPE: MEASURING MARKET LIQUIDITY

Working with a committee of market participants, ISDA's research team helped provide a response to the European Securities and Markets Authority (ESMA) on its instrument classification proposals within the MIFID II/MIFIR consultation paper. The end goal was to ensure accurate grouping of interest rate and credit derivatives with similar liquidity profiles for the purposes of properly applying pre- and post-trade reporting requirements.

ISDA's recommendations, in its response, were designed to promote measured hedging opportunities, ensure manageable transaction costs and foster market stability in large and customized trades. Following detailed data analysis, ISDA recommended definitions to properly categorize derivatives instruments and identify illiquid products. Miscategorizing an illiquid instrument in a liquid bucket runs the risk of impinging on market-making in these infrequently traded but crucial risk management instruments. For example, ISDA found that single-name CDS contracts referencing more than 99% of entities are, in fact, illiquid, as are the vast majority of single-currency fixed-floating interest rate swaps.

To this end, ISDA recommended a more granular classification system that groups instruments with sufficiently similar characteristics, and suggested more frequent recalibration of that system to reflect changes in an instrument's liquidity over time. ISDA also proposed increasing the number of times an instrument should trade each day in order to be classified as liquid.

In addition, ISDA recommended lowering the thresholds used to determine whether a customized transaction should qualify for a pre-trade exemption and whether a large transaction should be flagged for delayed reporting under ESMA's guidelines. This exercise underscored the importance of establishing proper metrics by which instruments should be measured to ensure liquid and stable markets for customized derivatives.

ANALYZING THE IMPACT OF CLEARING AND COMPRESSION

As regulations have shaped a new market framework, it has become increasingly difficult to clearly understand underlying derivatives market activity. Publicly reported notional outstanding figures are used as a broad indicator of derivatives positions, but this data is distorted by clearing and compression activity.

For this reason, ISDA's research team analyzed the effects of clearing and compression in the IRD market in its most recent ***Derivatives Market Analysis: Interest Rate Derivatives*** report. The act of clearing trades inflates the size of the market, as a single bilateral trade is counted as two cleared trades once novated to a central counterparty. Total notional outstanding in the IRD market would be 40% lower without clearing, ISDA's research found.

On the flip side, compression – touted by regulators as a much-needed operational risk procedure – cancels out offsetting trades and can make it appear that the market is shrinking. This is because publicly reported data reflects post-compression activity. Overall, IRD market size has been reduced by roughly 62% through portfolio compression.

COMPRESSION IN THE IRD MARKET

Global banks have worked to reduce derivatives notional outstanding on their balance sheets in response to the Basel III leverage ratio requirement. For this reason, compression has picked up pace, as outlined in ISDA's ***The Impact of Compression on the Interest Rate Derivatives Market*** report.

Market participants have used a variety of portfolio compression services to replace old transactions with newer trades of lower notional value but equal risk. The market's shift to central clearing, coupled with technological advancements, has allowed for a brisk uptick in compression services over the past few years. A majority of this activity is now taking place at the clearing-house level.

Compression is expected to further pick up pace, in tandem with increased cleared volumes, as the European clearing mandate is initiated this year[1].

MARGIN FOR NON-CLEARED DERIVATIVES

Demand for high-quality collateral to meet margin requirements for non-cleared derivatives is among the issues that will take center stage in the coming year. At the end of 2015, US prudential regulators[2] and the Commodity Futures Trading Commission[3] published non-cleared margin rules that will be phased in from September 2016, in line with a timetable published by the Basel Committee on Banking Supervision and International Organization of Securities Commissions[4]. The rules will require covered counterparties to post initial and variation margin on non-cleared derivatives, with strict limits on the types of collateral that can be used.

In an ***ISDA Insight Survey*** published in January 2015, roughly 65% of end-user respondents said they were "very" or "somewhat" concerned about complying with margin rules for non-cleared derivatives.

ISDA's research team followed up by polling market participants and analyzing a breakdown of collateral types in its ***ISDA Margin Survey 2015***. The research showed that the 14 largest banks[5] use cash to meet three quarters of margin for non-cleared derivatives. This leaves 25% of collateral in government bonds and other instruments. ISDA will examine the impact of the non-cleared margin rules as they become effective this year.

The research team is also working with a committee of market participants to streamline data collection and overhaul future margin surveys to better reflect the transfer of collateral among counterparties.

[1] European authorities announced in August the adoption of rules for central clearing of interest rate derivatives to meet G-20 commitments http://europa.eu/rapid/press-release_IP-15-5459_en.htm?locale=en

[2] https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf

[3] http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf

[4] https://www.bis.org/publ/bcbs261.pdf

[5] A 'large' firm is defined as one that has more than 3,000 active non-cleared ISDA collateral agreements

CONCLUSION

Mitigating systemic risk through transparent and efficient markets has been an overarching goal of global regulators. As regional authorities continue to press on with implementing the Group-of-20 goals, the industry will continue to change shape.

In 2015, ISDA's research team tracked the many ways in which the changing market structure has affected derivatives markets. The team has launched new research initiatives and continues to provide in-depth analyses to regulators on the industry's behalf.

Through its research, ISDA will continue to advocate for the industry and provide thought leadership in an effort to steer the market towards further stability and uniformity.

APPENDIX

- ***Cross-Border Fragmentation of Global Interest Rate Derivatives: The New Normal?,*** October 2015:
  http://www2.isda.org/attachment/Nzk2NA==/Market%20fragmentation%20Oct15%20FINAL.pdf
- ***Derivatives Market Analysis: Interest Rate Derivatives,*** January 2016:
  http://www2.isda.org/attachment/ODEwOA==/Derivatives%20Market%20Analysis%20Jan%202016%20FINAL1.pdf
- ***ISDA Insight Survey,*** January 2015:
  http://www2.isda.org/attachment/NzE3Ng==/ISDA%20Insight%20End%20User%20Survey%20January%202015%20FINAL.pdf
- ***ISDA Insight Survey,*** April 2015:
  http://www2.isda.org/attachment/NzU0NA==/April%202015%20Insight%20Survey%20Slide%20Results%20FINAL.pdf
- ***ISDA Margin Survey 2015,*** August 2015:
  http://www2.isda.org/attachment/Nzc4MQ==/Margin%20survey%202015%20FINAL.pdf
- ***ISDA Response to ESMA'S MIFID II/MIFIR Consultation Paper, 2014,*** March 2015:
  http://www2.isda.org/attachment/NzI5Nw==/MiFID%20II%20CP-%20ISDA%20Final%20Response%2002-03-2015.pdf
- ***SwapsInfo Third Quarter 2015 Review,*** November 2015:
  http://www2.isda.org/attachment/ODAyMQ==/ISDA%20SwapsInfo%20Q3%202015%20Review%20FINAL1.pdf
- ***The Impact of Compression on the Interest Rate Derivatives Market,*** July 2015:
  http://www2.isda.org/attachment/Nzc1OA==/Compression Report July 2015 FINAL.pdf

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ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

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