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A Perfect Storm

- Commentators cite a decline in volumes and lack of volatility as being the key reasons for a drop in rates trading revenues.
- Our analysis shows that the situation is more complex. Several regulatory, market and risk management factors have combined to create a 'perfect storm' in rates markets.
- We expect that some of the recent structural changes will remain, but the market volatility and revenue opportunities may improve as key central banks' policies and strategies diverge.

In the past few months, there has been much discussion on possible causes of a sharp decline in rates trading; various commentators attributed this to a cyclical lack of volatility; the impact of regulation; and banks' incorrectly calling some of the Fed's actions. In this note, we show that several factors have come together to create the 'perfect storm'.

Dodd Frank and CRD IV rules on SEFs and central clearing

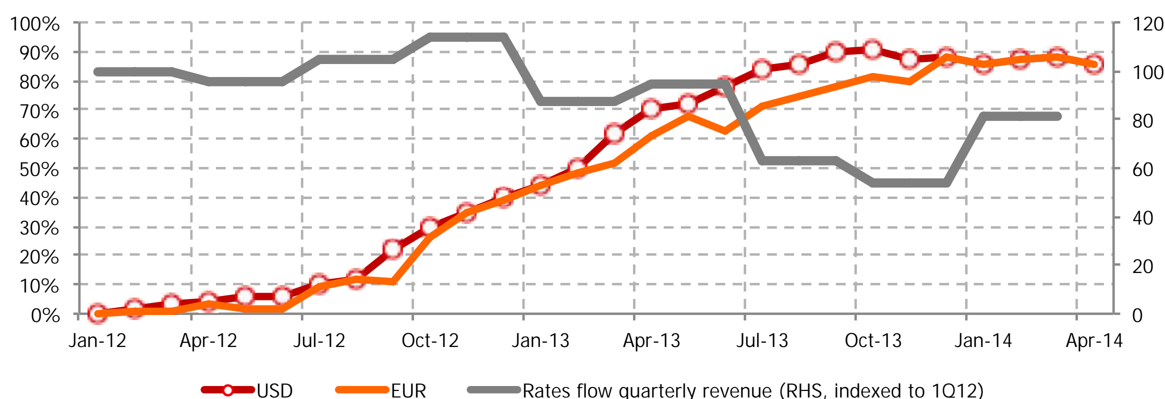
The introduction of the use of SEFs and requirement for central clearing is often seen as the single largest reason for the decline in rates trading revenues. This view seems valid: the percentage of USD and EUR client trades that have been centrally cleared has shot up over the last 12 months, coinciding neatly with the decline in rates trading revenues.

However, the picture is more complex. While it is true that centrally cleared trades cannot command the same prices (as the client pays for the counterparty credit risk in the form of collateral and margin) this should only impact banks that do not include counterparty credit costs in their product revenue calculations. In other words, any loss of client revenue should at least partly be offset by reduced credit costs.

A more significant factor is that the use of central clearing tends to favour electronic trading. But here too, the impact varies from one bank to another. Banks with strong electronic businesses have found the move to SEFs and central clearing less painful as trades captured by the new regime were already being transacted via an electronic (lower) margin route. Others have been seeing a more substantive move from voice-broking to SEF (i.e. electronic business) with an associated decline in margins.

Looking ahead, we expect the impact of central clearing will become more pronounced as trade types migrate to electronic fora.

Percentage of client swap trades cleared by currency



Source: ISDA, Tricumen research and analysis. Note: Rates quarterly revenue shown is aggregated for Top 12 peer group, comprising capital markets units of Bank of America Merrill Lynch, Barclays, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley, Societe Generale, and UBS.

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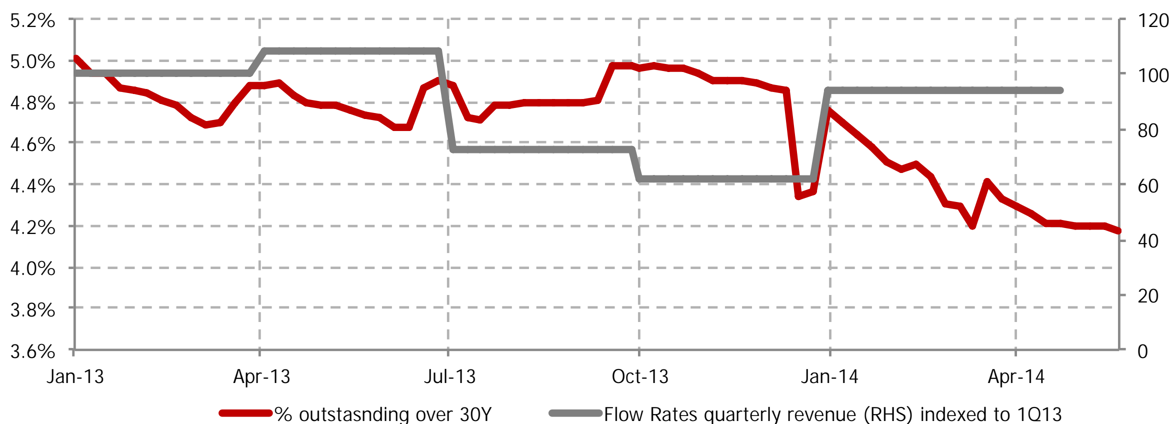
Basel 3

Banks that are actively moving to Basel 3 standard are facing significant RWA penalties on certain trade types. As a result, many are reducing RWA-heavy transactions. One example of this is the reduction in ultra-long market, as evidenced by the fall in the percentage of outstanding OTC rate derivatives with a maturity of over 30 years.

Percentage of outstanding OTC Rate Derivatives with a maturity of over 30 years

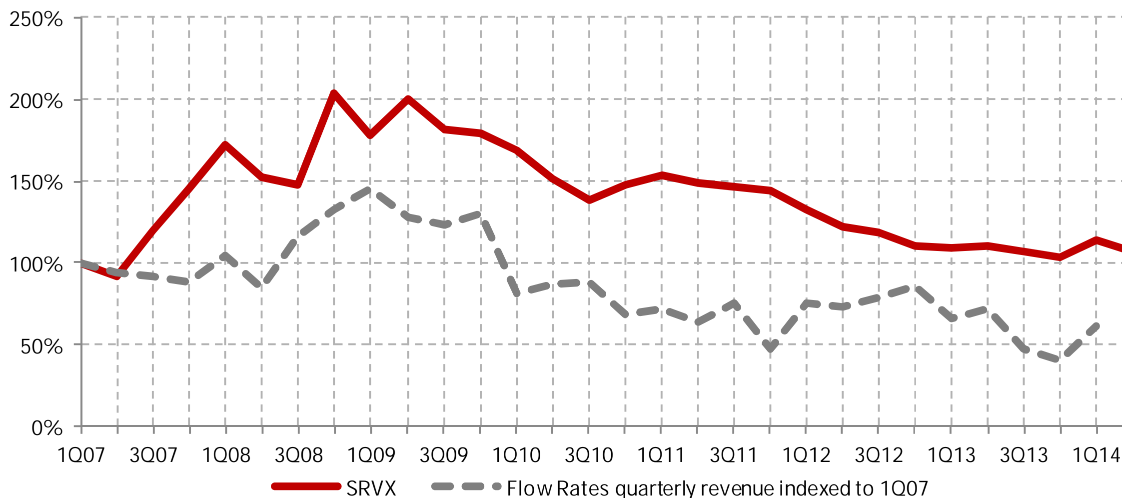


Source: US Federal Reserve Bank

A lack of volatility

Several commentators have cited a lack of volatility as being a major factor contributing to a reduction in trading revenue. There is some truth in this as volatility has indeed declined from 4Q08 and 2Q09 peaks. However, it has also, since early 2013, stabilised at levels that are above – albeit slightly - pre-crisis levels. We discussed the correlation between revenue and volatility in several product areas in our 'Revenue and (lack of) volatility' paper, published on 17-June.

Volatility (SRVX)



Source: CBOE. Note: SRVX = CBOE volatility index of IR swaps, based on 1-year swaptions on 10-year US$ interest rate swaps.

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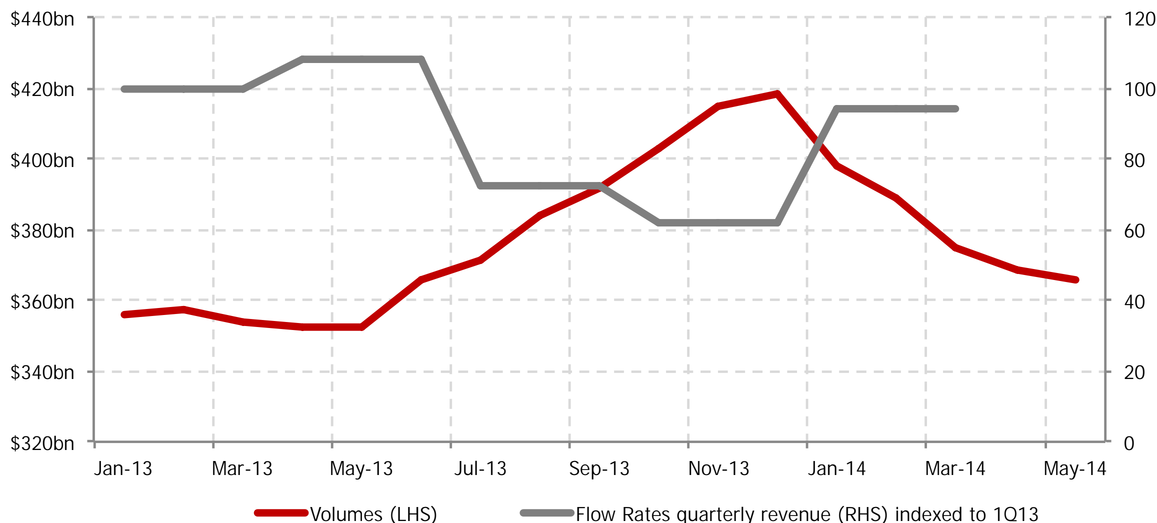
Reduced client volumes

Reduced volumes are not a key reason for a decline in rates trading revenue. The Fed data shows a healthy growth in US interest rate swap volumes in 2H13, followed by a sharp decline in 1H14; flow revenues, in sharp contrast, declined in 2H13, before rebounding in 1Q14.

US Swap average daily volume

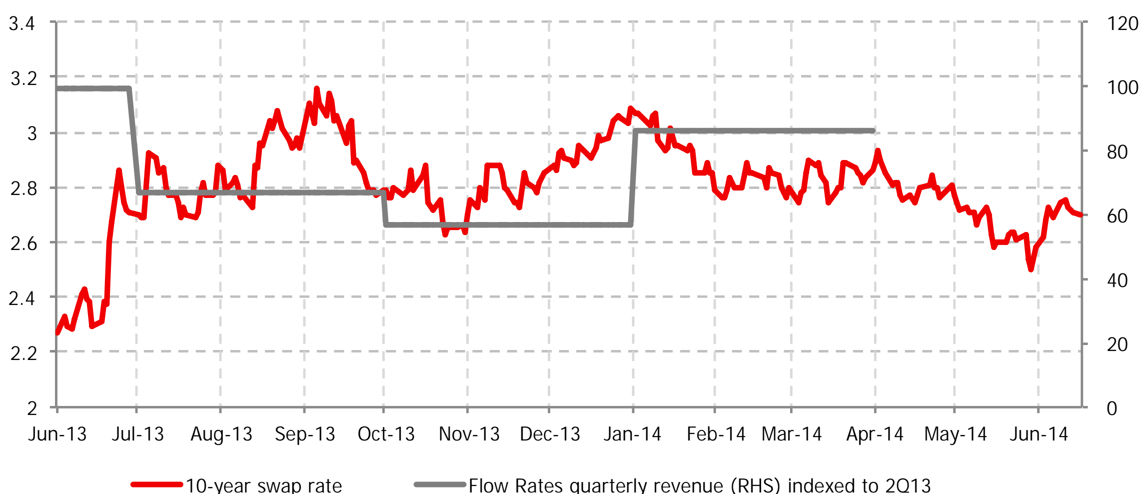


Source: US Federal Reserve Bank. Notes: Flow Rates quarterly revenue shown is aggregated for Top 12 peer group, comprising capital markets units of Bank of America Merrill Lynch, Barclays, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley, Societe Generale, and UBS.

Trading losses

An integral part of any rates trading operation is spotting risk management opportunities arising from central banks' rate announcements. Occasionally, though, incorrect positioning leads to risk-related losses, most recently in Sept-13 and Feb-14 when several banks incorrectly called the Fed's moves.

10 Year Swap Rate



Source: US Federal Reserve Bank, Tricumen analysis.

Conclusion

In summary, we see a decline in rates trading as having been caused by the 'perfect storm' of several factors. In 2013, revenue was impacted by SEFs and central clearing, RWA cuts and risk losses. The latter two factors continued into 1H14 and were coupled with a decline in volumes. Looking ahead, we expect the impact of regulation to remain; however, as rates start to rise in major economies, and probably out of sync with each other, volatility and client flow may return to the market.

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Situated near Cambridge in the UK, Tricumen is almost exclusively staffed with senior individuals with an extensive track record of either working for or analysing banks; and boasts what we believe is the largest capital markets-focused research network of its peer group.

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