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SIFMA Asset Management Group

Rationale for Market Agreed Coupon Contract for Interest Rate Swaps

Many market participants have used bilaterally pre-defined, fixed coupon interest rate swap (IRS) structures bilaterally for years; however, different end-users have used different structures. The Asset Management Group (“AMG”) of the Securities Industry and Financial Markets Association (“SIFMA”) believes that the proactive development of a market agreed coupon (“MAC”) swap may be in the best interests of many market participants, irrespective of size, as clearing and exchange trading becomes mandatory and other new rules come into effect. These cleared swaps contracts would not create upfront funding issues at exchanges. No or limited initial technology build-out should be required for futures clearing merchants (FCMs) or clearinghouses. In addition, we believe that systems build-outs may be more scalable for smaller market participants that choose to use “MAC” structures. Additionally, we believe that “MAC” contracts would help users keep the identity of end users and trading strategies private and may help promote liquidity and price transparency. “MAC” contracts may also facilitate trading on swap execution facilities (SEFs) in a request-for-quote (RFQ) environment, as well as position management. We hope that these factors will also lead to more price transparency and lower initial margin requirements to reflect increased liquidity within a narrower field of standard trades.

One key benefit of “MAC” swaps will be easier and more efficient portfolio compression. Compression is the process of unwinding positions which have the same or similar dates and coupons and are in the opposite economic direction (e.g., a 10 yr. pay fixed swap and a 10 yr. receive fixed swap). Compression reduces the number of line items in a portfolio, as well as counterparty risk, and reduces the number of collateral movements when positions are with different entities. Pricing compressions involves more market parameters when dates, coupons, and conventions are variable within a portfolio. Compression is naturally simplified when the terms for two swaps are identical in all ways except the direction, as would be the case with “MAC” swaps; and is further simplified in a cleared environment where trading in opposite directions organically reduces parties’ open interest in any one “MAC” swap (i.e., does not create a new line item). We believe that “MAC” contracts will reduce or eliminate time-consuming unwind processes and market inefficiencies and improve transparency associated with bid/ask spread risk.

We believe that “MAC” swaps will be beneficial notwithstanding the development of deliverable interest rate futures. Market volume has not yet increased substantially in deliverable interest rate futures, even though they have been available for trading for some time. “MAC” swaps will allow for more flexibility in that a full spectrum of maturities



can be made available on an ongoing basis. Further, only U.S.-based interest rate swap futures have been launched to date, whereas it is envisioned that “MAC” swaps will be denominated in other currencies such as Euros, British pounds, Japanese Yen, Canadian Dollars, Australian Dollars, etc. Additionally, “MAC” swaps should streamline execution and improve the process for choosing a cash unwind, a roll to a future start date or a simple continuation of the physical swap upon the effective date. Therefore, “MAC” swaps should present another alternative to the choice between bespoke interest rate swaps and deliverable interest rate futures.