Building a listed derivatives market for Risk-Free-Rates in Yen and Euro

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The move away from Ibor-referenced benchmarks to Risk-Free-Rates (RFRs) has been one of the most significant processes in capital markets for decades.

In listed derivatives markets, a host of new contracts have been launched to offer futures and options referencing the new rates and enabling a seamless transition away from Libor. Different jurisdictions have moved at different paces.

In Europe, the ECB began to officially publish €STR on 2 October 2019. Eurex supported this transition and started clearing the first €STR Overnight Index Swaps in November 2019. In January, the exchange launched three-month futures referencing €STR to complement the OTC offering with a listed product.

“This launch marked an important milestone in establishing €STR as the new benchmark risk-free rate and expands Eurex's Euro-denominated interest rates product offering,” says Iris Hui, Senior Representative of North Asia FIC Derivatives and Repo Sales at Eurex.

“With the launch of the Three-Month ESTR Futures, Eurex offers a listed, centrally cleared, and cash-settled solution to trading or hedging the new risk-free rate.”

The launch of €STR futures is part of Eurex’s strategy to be the home of the Euro-yield curve with a fully fungible product portfolio encompassing the short- and long-end across listed and OTC instruments.

“Customers will ultimately benefit from Eurex’s portfolio-based margin offsets across OTC interest rate swaps and listed fixed income products,” says Hui.

In Japan, the majority of interest rate swaps switched to TONA-referenced contracts upon the cessation of the publication of Libor in December 2021.

Kenuske Yasu, General Manager at Osaka Exchange (OSE), says: “OSE decided to launch 3-Month TONA Futures on May 29th, 2023, prior to future changes in the BOJ’s monetary policy. The contract is the first-ever short-term interest futures product on OSE, and our TONA Futures will provide another valuable tool for hedging and trading amid the normalization process with investors, in addition to existing 10-year JGB Futures.”

“Currently, JPY OIS is cleared at both JSCC and LCH, and there is a basis spread between the OIS cleared at the different clearing houses due to the differences in the investor base and demand and supply in each market. OSE's TONA Futures could become one of the great trading tools to acquire this basis spread.”

“If a highly liquid market is achieved through trading by a wide range of investors, it will provide an appropriate price discovery function for short-term zone Japanese Yen interest rates. It may then be possible to observe what expectations investors are forming for short-term interest rates through TONA Futures.”

Shun Yanagisawa, Japan head of futures, OTC clearing and FX prime brokerage at Citi, adds: “We need TONA futures for several reasons. Firstly, it is a futures contract, so it is standardized and transparent with a lower margin than OTC.”

“Secondly, the TONA futures allow you to trade the curve. Thirdly, there are access benefits. US persons are not allowed to clear JSCC swaps due to CFTC regulations. This creates a basis between LCH and JSCC in the swaps market. Futures markets have no such limitations. Anyone can join the market. Fourthly, you can offset margin between the JGB Futures and the TONA Futures and the JPY swaps cleared at JSCC. Finally, TONA Futures will be the critical hedging tool once the BOJ modifies its monetary policy and volatility returns to the short end of the yield curve.”

The Euro-transition is unique among most leading jurisdictions in that Euribor will still be quoted and Euribor futures and options will likely remain a key part of the trading landscape.

For Elad Hertshten, managing director of Futures First, this creates an opportunity for trading groups.

“Ultimately, I see €STR as a complimentary product to Euribor, creating opportunities for proprietary trading firms like ours to trade €STR against Euribor,” he says.

“This trade is a very good way to express credit risk. Also, if a one-month €STR contract were to launch, this could be equivalent to Fed Funds in the US.”

For now, both Eurex and OSE are focused on growing liquidity in the newly launched contracts and launching complimentary products.

OSE sees an edge in enabling investors to leverage the margin efficiency between the 3-month TONA Futures and longer-term JGB Futures contracts. In addition, Yazu sees benefits to international traders from the product specifications of the new TONA Futures.

“The specs of 3-Month TONA Futures are very similar to CME's 3-Month SOFR Futures, such as quarterly contracts reflecting TONA expectations between IMM dates and the minimum price fluctuation of a quarter basis points,” he says.

“The contract is also available during the same trading hours as JGB Futures, so overseas investors can trade during European and US time zones. 3-Month TONA Futures have 20 consecutive contract months to fulfill risk management needs out to five years.”

OSE has around 15 global market makers offering quotes in the new TONA Futures contract and has waived fees until the end of March 2024 in order to boost liquidity further.
Hui says that Eurex has banks ready to provide liquidity in blocks in addition to the market makers providing on-screen liquidity and that liquidity is expected to grow in €STR futures in the coming months.

“Our emphasis is on building a healthy and genuine market where volumes are from real users and clients can find the required liquidity. Traded volumes in the €STR futures at Eurex have started to increase in recent weeks and we would expect this trend to continue in the coming months,” she says.

Next up for Eurex is launching new products in its Euro short term interest rate suite to complement the existing products. 3-month €STR is the first step in expanding the product suite and functionalities launching in the coming months.

Eurex is currently developing inter-product spreads between €STR and Euribor as well as Schatz futures. Since the event took place, Eurex has also formally announced the expansion of its existing Partnership Program for interest rate swaps to include short-term interest rate (STIR) derivatives segment, with the aim of building an EU based liquidity pool in these products.