SEF volumes died last week – so when and where will they return?

February 22, 2014

Turned out the first week of mandatory SEF trading was a Big Bang, just in the wrong direction. Reported SEF volumes for interest rate swaps fell off a cliff for the week of February 17th, cliff signdropping 64% (revised down slightly as new data became available) from the 2014 weekly average SEF traded volume (thanks as always to Clarus for compiling the numbers). Digging a little deeper, it appears a big chunk of this drop came from the market formerly known as dealer-to-dealer, with dealer-to-client platform volumes faring slightly better ***only*** dropping by about half. Some of overall the decline can be attributed to schools being closed in New York and Connecticut and volumes going on Vermont vacations with the trading desk. But that is of course not the real story this year.

The dropped wasn't terribly unexpected. Using the November 1 no-action expiry as a guide, market participants we spoke with clearly stated their wait-and-see approach hoping someone else would find any kinks in the system before they did. This is a prudent approach, especially for asset managers, whose fiduciary responsibility tells them not to put their clients at any greater risk than is necessary. And despite CFTC guidance the week before, SEF governance issues, uncertainty around packaged trades and an insufficient infrastructure for bunched trade allocation also keep asset managers restrained through week 1.

Uncertainty alone can't keep market participants away from a mandate however. A mandate means SEF trading is, well, mandatory. The problem (or solution, depending on who you ask) was that the mandatory scope was so narrow that it was pretty easy to avoid. Going offshore was certainly a big option. Booking trades against LTD instead of LLC was an easy choice for funds incorporated offshore. The other approach was to book interest rate swaps with a forward starting date one day in the future, which has limited impact on the resulting exposure but keeps the trade from the mandatory bucket (which only includes spot starting trades).

I don't want to go so far as to call these options loopholes – I think a better way to describe them is options outside the limited scope of the MAT determination. Furthermore these "options" won't be around forever which further keeps them away from loophole status. The MAT list will slowly expand over the coming months and years and our research tells us that the CFTC and other global regulators are acutely focused on extraterritoriality. But in the mean time the SEF requirement is only a requirement for a select few.

Looking ahead the CDS (index) trading mandate this Wednesday (Feb 26) might prove more interesting. With CDX and iTraxx already liquid and standard, the option to go off-the-run or forward starting is less appealing. Sure you could trade the CDX.IG.9 but the wider bid ask spread is probably not worth the cost just to stay off SEF. Expect to see a much faster pickup of CDS on SEF, although again more slanted to dealer markets as dealers do the majority of CDS trading.

Looking longer term and bigger picture this first week's drop doesn't tell us much about what SEFs will do to the swaps market over the long run. What it does do in many ways however is level the playing field for the major SEF competitors, especially between the traditional client platforms. Volumes will need to slowly make their way on SEF (or DCM to be technically accurate) and as clients begin to wade further into the water they will have the option to pick the platform that best suits their needs knowing what we known today. So I wouldn't say that SEF volumes don't matter anymore, but we are finally out of spring training and entering the regular season.

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