Last minute uncertainties in the swap market as the 2 October Dodd-Frank deadline approaches

- As the 2 October 'go-live' date of SEFs approaches, European-based inter-dealer brokers are reporting that most of their non-US swap-trading clients would prefer not to trade with US banks who do not have non-guaranteed non-US-based affiliates of their US parent. This is leading to the creation of US and non-US liquidity pools.
- In contrast to most of their peers, two US banks[1] have been slow to demonstrate how they will deal in the non-US pool. Given the importance of these two banks to the market, this could mean greater volatility and wider spreads. It could also provide opportunities for non-US swap dealers, including three leading European banks.

Less than two weeks remain in the run-up to 2 October 2013, the date from which registered Swap Execution Facilities (SEFs) must be operational and providing a platform for 'required' and 'permitted' products:

'Required' products (i.e. offered for trading on SEF, trade reporting handled by SEF, central clearing mandatory)	'Permitted' products (i.e. offered for trading on SEF, trade reporting handled by SEF, central clearing optional)
IRS ▪ USD; EUR; GBP; JPY ▪ Fixed-to-Floating; Basis Swaps ▪ Out to 50 yrs OIS ▪ USD; EUR (EONIA); GBP (SONIA) ▪ Out to 2 yrs FRA ▪ USD; EUR; GBP ▪ Out to 3 yrs ▪ CDS Indices ▪ USD: (CDX IG; CDX HY) ▪ EUR: (iTraxx; X-Over; HiVol)	▪ Inflation Swaps ▪ Interest Rate Options ▪ FX Options ▪ NDFs ▪ Commodity Swaps ▪ Equity Variance Swaps

Source: Tricumen.

Four years in the making, CFTC rules formulated under Title VII of the Dodd Frank Act are in the final stages of imposing a new regime in which the trading of key OTC derivatives must be migrated onto SEF platforms which facilitate execution, trade reporting and central clearing. As the 'go-live' date of SEFs approaches, European-based inter-dealer brokers are reporting that most of their non-US swap-trading clients wish to remain off-SEF and avoid trading with US counterparties, preferring instead to continue trading bilaterally among themselves while they wait for EMIR to implement its own European version of Title VII of Dodd-Frank – which is unlikely to be concluded until 2015.

Many non-US counterparties are motivated to avoid trading with a US person because any such swap trading which exceeds specified de minimis thresholds qualifies the non-US counterparty as a Swap Dealer or Major Swap Participant; a status which brings them under CFTC jurisdiction and imposes registration requirements and other responsibilities. Many non-US counterparties are keen to avoid this. As a result, the swap market outside the US is dividing into two distinct pools of liquidity:

(1) Non-US counterparties who wish to avoid trading with US persons and are staying off-SEF; and

(2) US persons, many of whom will have to trade on-SEF; and non-US Swap Dealers & Major Swap Participants, who will have to trade on-SEF. About a quarter of swap trading business in Europe involves firms which are (a) US firms; or (b) branches and affiliates of US firms located outside the US; or (c) foreign firms based in the US.

[1] Names of all banks are omitted from this, public, version of the report.

Many counterparties in category (1) above are trying to avoid trading with counterparties in (2 a-c), for fear of breaching de minimis thresholds with the latter and becoming classified as a Swap Dealer or Major Swap Participant.

Meanwhile, to avoid being shunned by the majority of the European-based swap market and thereby isolated to a minority liquidity pool, some firms in (2b) are trying to avoid classification as US persons. They can do this by claiming to be non-US-based affiliates of US companies whose swap business is not guaranteed by any US parent.

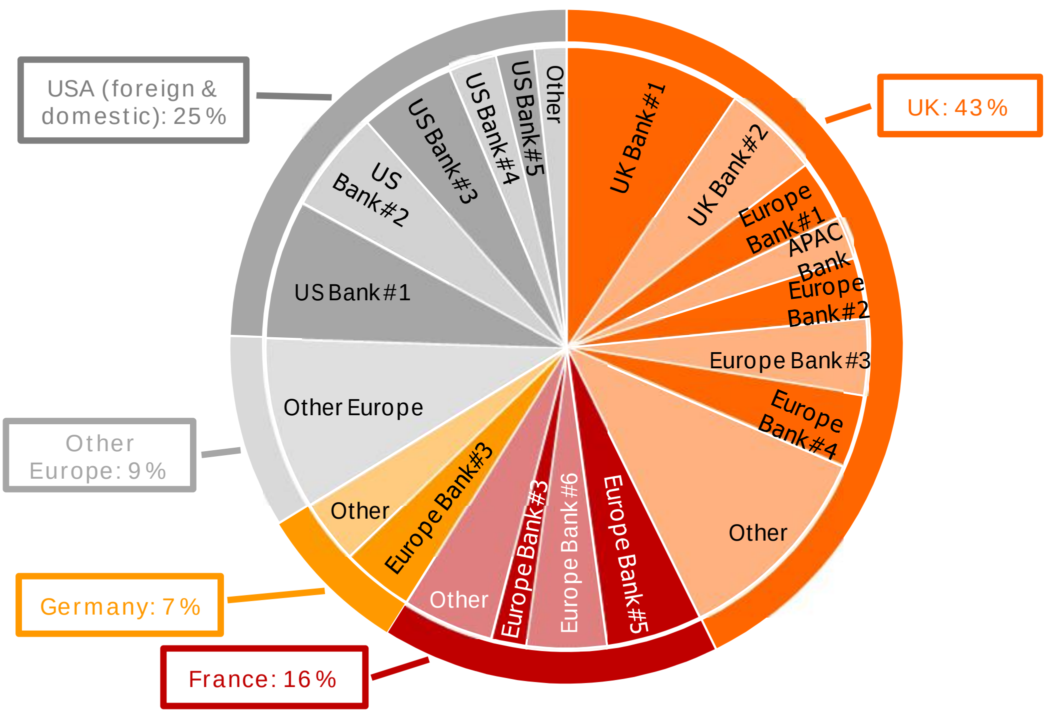
The swap-trading businesses of three top-tier US banks in the UK have long considered themselves in the clear, by virtue of being non-guaranteed non-US-based affiliates of US parent companies. However, two of their US peers (both of which are believed to be guaranteed affiliates) have been slow to clarify their status or come up with a solution. This has led to much aversion from non-US firms anxious to remain off-SEF.

In the past few days, however, one of the two latter banks in London has confirmed that it will now conduct its London-based swap trading through a non-guaranteed affiliate of the parent company, but one which may not be fully on-boarded by the various newly-established SEFs in time for the go-live date of 2-October. There remains less clarity as to whether the other bank will adopt a similar fix to their guaranteed/non-guaranteed status; in the meantime, the UK-based swap trading entity continues to be viewed by most of the European market (and most likely the CFTC) as a US-person.

Our sources confirm that these two banks - both of which are important players in the European swaps market and are included in the chart below - have thus far failed to clearly present themselves to the market as non-US persons, if indeed that is what they are, or plan to be. Consequently, many non-US swap counterparties are particularly wary of trading with these two firms, at least until the non-US status of their UK-based swap-trading operations becomes more widely accepted and/or relied upon in the marketplace.

The economic impact of all this will surely be detrimental to both of these banks, but with swap market liquidity bifurcated as it is at present, there will also be broader ramifications for the wider market: it will most likely mean greater volatility and wider spreads in each separate liquidity pool, while over time, price anomalies will be arbitraged away by the non-US Swap Dealers (the main ones being the three European leaders) who will be able to straddle the two liquidity pools.

IRS market in Europe:
London-based interdealers swap activity by bank (1H13) (bank names omitted)



Source: Tricumen estimates.

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