Tradition

Real price transparency marks a new benchmark

In recent years, questions have been asked about the stewardship and methodology used to determine ISDAFix, with allegations of improper behaviour coming to light. As the FEMR receives its responses on benchmark reform from a range of industry participants, the OTC swaps market has declared itself transformed and ready for change.

The criticality of a trusted, reliable and accurate mid-swap reference price such as ISDAFix can best be illustrated by the size of the global debt issuance market. According to the Bank of International Settlements, outstanding debt issued by corporates, supras and sovereigns in 2013 totaled almost USD 23 trillion. Absent an efficient debt issuance market, real economies are unable to operate in changing macroeconomic environments.

Over the last 30 years, interest rate swaps (IRS) have traditionally been traded either directly or via voice brokers over the phone. This has meant that suitable reference pages utilised by issuers when pricing a debt issuance have always been based on indicative prices provided by brokers – a process that has since been found to be flawed and open to manipulation.

For issuers, the quality of the reference pricing page they use is central to ensuring that their bond is issued at the correct market level, and that investors receive their bonds at the correct, market yield. The flaws of using indicative reference pages is that they fail to validate whether a trade can actually be done at that price, as the pricing is not firm and the depth of available liquidity is far from clear. Furthermore the spread that the issuer has to cross between the bid and the offer may mean that an issuer has to pay a large premium in order to hedge its risk profile.

However, times have changed and the market has evolved significantly in recent years. The advent of more stringent regulation, combined with the adoption of electronic trading in interest rates swaps, has led a more reliable and accurate data reference methodology emerging.

Since late 2010, banks have started to trade interest rate swaps between themselves on electronic platforms (knows as Central Limit Orders Books, or CLOBs), allowing voice and electronic price provision to co-exist and complement each other. This much improved quality and quantity of information combines the tried and trusted methods of voice trading with firm electronic pricing.

By adopting this method, platforms such as Trad-X (part of Tradition SEF in the US and a registered MTF in Europe) receive irrefutable prices from at least 11 banks across all liquid tenors every day. This new model removes any guesswork and enables the market to actually know, not only the accurate pricing level and spread between the bid and offer, but also the depth of liquidity on either side of the mid. Having this reliability allows the CLOB to then provide this pricing on to its reference screens used by issuers and their syndicate managers.

The imposition of the Dodd Frank Act and associated SEF rules have made the CLOB pre-eminent, with the voice broker as subordinate contributor to the liquidity pool – thereby solidifying the firm price displayed on the screen as the market price. The existence of such firm irrefutable pricing accompanied by significant volumes means that, in essence, the utilisation of reference screens based on an indicative view of the market by voice brokers is outmoded and outdated. As a measure of progress, Tradition (via it's SEF Platform) executes 95% of its IRS business through the Trad-X CLOB – executing on prices displayable to its customer base via screens, API access and interaction with its voice brokers.

CLOBs provide certainty of execution as well as a transparent reliable reference price. Such reliability can be backed by a full audit trail extracted at any point in time. Accordingly, an issuer can request the price movements over a period of time surrounding the time of issue. This order book replay would provide best bid and offer and full depth of pricing to enable the issuer to see the real market price. It would also provide any syndicate management team and/ or the relevant swap desk executing the swap with full validation for any price it agreed with the issuer or swapped in to the market.

After allegations of manipulation came to light, the benchmark calculation and methodology process was transformed. Today, ISDAFix is administered by the ICE Benchmark Administrator (IBA), and over the coming weeks, it will start snapshotting the relevant ISDAFix time for the covered currencies and aggregate of streams provided by the five submitting MTF CLOBs. In essence, this means that ISDAFix will be moved from an indicative view to a firm irrefutable aggregated reference price.

In addition, IBA and the submitting MTF CLOBs will have full audit trails of any submitted streams, which will be designed to rebuild the confidence of the market in this benchmark. This is a big step forward for transparency.

It is clear that the swaps market has been transformed in recent years as a result of regulatory requirements and customer demand. The current utilisation of hybrid electronic solutions has been achieved in a regulatory environment spearheaded primarily by the Commodities Futures Trading Commission (CFTC) in the United States, which has introduced new levels of transparency, efficiency and fairness. Movement of reference screens from singular voice indicative screens – of which one has become the market standard – to an aggregated irrefutable CLOB submitted reference screen is a natural and obvious next step.

Such a move would give the market and regulators alike confidence of the entire level of pricing of a debt issuance and any subsequent swap, and as such, warrants deeper examination as part of the FEMR. The technological barriers are low and the volume of trading now supports the quality of the pricing. In addition, it would provide a depth of liquidity unparalleled and unproven in the voice market and remove any ability to manipulate the mid swap price.

For regulatory authorities and policymakers around the world, it would provide a new level of transparency and audit capability that would enable them to better monitor this market, identify and manage risk more effectively and, ultimately, have confidence in primary debt issuance and the secondary swap market. Market participants have recognised the benefits of adopting a reference screen based on irrefutable electronic pricing that is fully tradeable; it's now time for regulators to do the same.

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