

THE BOND BUYER

PARTNER INSIGHTS

Electronic Trading is Poised to Transform Institutional Trading of Municipal Bonds

The average daily trading volume for municipal bonds in 2015 was \$8.6 billion, according to SIFMA.¹ Trading volumes may be significant, but inefficiencies remain.

Municipal bond trading is hampered by a fragmented market that makes finding liquidity challenging. There's a lack of automation, with the majority of trades still completed over the phone. Manual processes not only increase costs, but they are prone to errors. However, electronic trading is now poised to transform how institutional investors and dealers approach secondary trading in muni bond markets.

Regulators are also looking more closely at the market for muni trading. A February 13, 2015 statement, U.S. SEC Commissioner Luis Aguilar stated that inefficiencies and lack of automation in municipal bond trading results in "billions of dollars each year in unnecessary fees, transaction costs, and interest expense."²

Secondary trading of municipal bonds is in desperate need of a transformation. For an example of what that transformation may look like, consider how the introduction of electronic trading significantly impacted the trading of high grade (HG) and high yield (HY) corporate bonds more than a decade ago. Today, approximately 20% of trading in the U.S. high grade markets takes place electronically.

Although there are differences between the corporate and municipal bond markets, the benefits of electronic trading will improve municipal bond trading, just as it has transformed the corporate bond market.

Here are three ways that electronic trading technology can accelerate that transformation by providing additional liquidity that improves pricing, eases regulatory compliance, and improves trading efficiency and reduces costs.

1. Broader Liquidity and Improved Pricing

Electronic trading allows investors to simultaneously query multiple dealers in an auction format versus the traditional sequential search, significantly opening up the number of potential trading counterparties and expanding the liquidity pool for all market participants.

Additionally, on an all-to-all electronic platform, dealers and investors are able to anonymously see and respond to orders even if they did not receive the inquiry directly.

2. Ease Regulatory Compliance

Electronic trade blotters record every transaction—including bids and offers—to provide an audit trail. For example, a trader can easily answer compliance questions surrounding best execution by proving that they canvassed electronically and traded at the best level.

3. Trading Efficiency and Reduced Costs

An electronic investor-to-multi-dealer request for quote (RFQ) model that submits a bid or offer to multiple dealers simultaneously not only increases the number of trades but results in cost efficiency. Analysis conducted by the University of California, Berkeley¹, showed an increase in cost savings, in corporate bond markets, when the number of dealers in competition increased, through using electronic RFQ to submit inquiries.

The broader the universe of trading counterparties, the more likely a trade request will match two participants. And, stated simply, more trade volume equates to greater profitability for all counterparties.

An electronic trading platform enables straight through processing by providing connectivity between dealer and investor order management systems (OMS) for both pre-trade and post-trade. This connectivity allows the investor to send and review trades to and from the OMS. Reporting and updating occur automatically.

Conclusion

The high grade and high yield corporate bond markets have benefited significantly from electronic trading. Those same benefits-- additional liquidity, better pricing, easing of the compliance burden, and reduced costs—will translate to the municipal bond market as well.

¹<http://www.sifma.org/research/statistics.aspx>

²<https://www.sec.gov/news/statement/making-municipal-securities-market-more-transparent-liquid-fair.html>

³'Click or call? Auction versus Search in the Over-the-Counter Market', Terence Hendershott, Ananth Madhanvan, September 2012

