AFMA

SWAPS REFERENCE PRICE TRANSACTIONS GUIDELINES

Australian Financial Markets Association

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1. Guidance Key Points

- Dealers may hedge for such purposes and in a manner that is not meant to disadvantage the Client.
- Dealers should be aware of and manage the possible conflicts of interest related to the formation and observation of the reference price inherent in reference price transactions.
- Dealers should communicate their hedging practices to their Clients in a clear manner meant to enable Clients to understand their actions in the market.
- Dealers should ensure that the sole intention behind their hedging is risk mitigation.

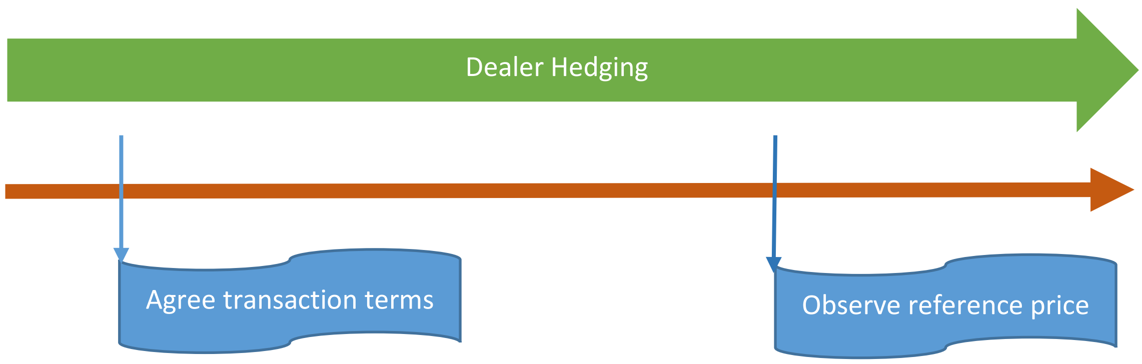
2. What These Guidelines Are About

2.1. Scope

These Guidelines have application to market participants in the Australian interest rate swaps market and set out certain expected behaviours of wholesale market participants that enter into a type of transaction common in the interest rate swaps market known as reference price transactions (RPT). The Australian interest rate swaps market includes various types of Interest Rate Swaps, Basis Swaps and Cross-currency Swaps, referred to by the generally understood market term 'swaps' in these Guidelines.

2.2. What are Reference Price Transactions

Participants enter into a type of transaction known as a RPT which includes transactions known as a closing price order, end of day order. All terms (including financial instrument, buyer, seller, notional, settlement date) except the execution price, are agreed and specified at the outset of the transaction. A mechanism to determine the execution price is also agreed then, through later market observation of a reference price. The following timeline lays out the sequence of events in a RPT and makes clear the fact that the Dealer will in most instances be hedging its exposure under the RPT from the time the transaction terms have been agreed, and that this hedging may continue through and beyond the reference time.



Since the transaction entails a risk transfer, the liquidity provider of that risk (the Dealer) will at its discretion hedge that risk, and this hedging activity can take place before, during or after the reference time (as illustrated in the timeline in the diagram above). Hedges executed before the reference time could exert market pressure on the price of the underlying instrument, and thus affect the reference price level. From a commercial perspective, the ability to hedge the RPT before the reference time means the Dealer may be able to offer the Client a lower spread than would otherwise be the case.

The nature of the RPT means that the Client eliminates uncertainty over the difference between the reference price and the execution price. Thus it might appear that the risk is passed to the Dealer at a cost equal to that difference, if any, between those two prices. However the Client (and the asset owner if different) bears the risk that market activity following agreement of the RPT, including any Dealer hedging of the RPT, could result in adverse price movement for the Client before the reference time.

The Dealer's risk, on the other hand, is that it is unable to hedge the RPT at the same or a better price than the execution price of the RPT and thus incurs a loss. In addition, Dealers sometimes hedge an RPT with closely related financial instruments and so in those cases must also manage the associated portfolio risk - that the instruments traded as part of the hedging strategy do not match the value of the RPT.

3. Reference to ethical principles

These Guidelines are supplementary to the AFMA ***Code of Conduct*** and should be read in conjunction with this code. In particular, these Guidelines reference ethical principle 4 which is about acting fairly and honestly with clients, ethical principle 9 concerning ensuring the integrity and confidentiality of records, and ethical principle 10 which deals with identifying and managing potential conflicts of interest.

4. Formation of the reference price

Dealers should be aware of and manage the possible conflicts of interest related to the formation and observation of the reference price inherent in RPTs. Conflicts may be particularly acute if the reference price is produced by the Dealer with whom the Client has executed an RPT.

5. Hedging

5.1. Handling hedging conflicts of interest

The possibility of market pressure arising from Dealer risk management activity, and the related potential conflict of interest between the Client and the Dealer, is the key characteristic of RPTs. Hedging is the management of the risk associated with an anticipated Client transaction, designed to assist the resulting transaction for the Client.

- Dealers may hedge for such purposes and in a manner that is not intended to disadvantage the Client.
- Market Participants should communicate their hedging practices to their Clients in a clear manner meant to enable Clients to understand their intentions and actions in the market.
- Dealers should ensure that the Client is aware of the key mechanics of RPTs, in particular the fact that hedging can take place before, during or after the reference time, by making clear in its terms of business or otherwise by disclosure to the Client that the Dealer observes these Guidelines and internal procedures.

5.2. Sole intention is risk mitigation

Dealers should ensure that the sole intention behind their hedging is risk mitigation.

Hedging is expected to be restrained and in keeping with the atmosphere of the market on the day. A Dealer should have regard to the effect its hedging of an RPT might have on the reference price and should balance the objectives of its hedging strategy against the possibility of putting undue pressure on the reference price, recognising that some price pressure is to be expected as risk is passed, particularly for large transactions or transactions in less liquid markets.

Specific factors to be considered in determining whether hedging practices are acceptable or not include:

a) Hedging should generally be at a pace consistent with normal market volumes at that time of day in the relevant instrument (adjusted as necessary for the volume implicit in the RPT itself, and recognising that this may not be possible for illiquid instruments).

b) Hedging should be designed to neutralise the risk of the Dealer portfolio (including all its RPTs), and should not be undertaken for the purpose of creating a new significant open risk position.

c) Hedging activity can take place before, during or after the reference time and although volatility can be due to many factors, a reasonable hedging strategy would not be expected to induce materially higher volatility of the reference price around the reference time and may mean hedging after that time needs to occur to mitigate such volatility.

d) Hedging should not result in undue pressure on pricing around the reference time.

e) Over-hedging (i.e. hedging more than required to cover the Dealer’s risk) should not take place other than where that is a necessary consequence of appropriate hedging activity, such as where the relevant hedging instrument is only available in a size greater than that required to hedge the RPT.

5.3. Management of aggregate position hedging

It is common for Dealers to be handling other Client transactions, or to be managing their own risk during the hedging time frame of an RPT, and all these activities are usually done on a portfolio basis.

Dealers should manage their aggregate positions in a way which is consistent with these Guidelines. It can often be impractical to assign individual hedging transactions to individual RPTs so in judging management of aggregate positions the outcome should be there is no disadvantage to various individual clients.

6. Restrictions on dissemination of information

Information regarding an RPT (whether pending or executed) or its associated hedging must be treated as confidential and must not be disclosed externally, except as required by law.

Internal disclosure must not result in another part of the Dealer firm profiting inappropriately.

The Dealer may offset the risk implicit in an RPT with other Client transactions, the Dealer’s own inventory or in the wholesale market but must keep details of the RPT confidential while doing so.

Illustrative Examples of RPT Hedging Behaviour

1. Hedging strategy

1.1. Acceptable behaviour

Client A has a floating rate debt obligation and would like to swap the floating rate payments for fixed rate payments. Bank X has entered into an agreement to provide debt hedging for Client A. Under this agreement, Bank X will transact an interest rate swap with the client where Bank X will pay floating rate interest and receive fixed rate interest. Since a reference price transaction entails a risk transfer, the liquidity provider of that risk (Bank X) will at its discretion hedge that risk, and this hedging activity can take place before, during or after the reference time. To hedge this position, Bank X will pay the EFP (exchange for physical) and sell futures ahead of the pricing of the transaction with Client A. As the deal is being priced, the dealer at Bank X keeps his offer prices in the futures market but doesn't cross the spread and sell at the bid. In this way he is accessing liquidity (by maintaining his offer in the market) but isn't influencing the price. After the deal has been completed and agreed to by Client A, the Bank X dealer continues to work his hedges in the futures market. The dealer at Bank X has demonstrated acceptable behaviour because he has been mindful of the potential impact of his hedging activities on the market by executing his hedging transactions in a manner that has had little influence on market pricing.

1.2. Unacceptable behaviour

Client B has a floating rate debt obligation and would like to swap the floating rate payments for fixed rate payments. Bank Y is part of a group of banks executing a hedge for Client B. The deal is expected to reference a market price at or around 10am. Since a reference price transaction entails a risk transfer, the liquidity provider of that risk (the dealer) will at its discretion hedge that risk, and this hedging activity can take place before, during or after the reference time. The dealer at Bank Y starts paying EFPs and selling futures at 9:00am. As the time approaches 10:00am, the trader refers her paying interest in EFPs and starts aggressively selling futures which pushes the price of the futures contracts lower and pushes up the implied interest rates, which increases the hedging cost for the client as the reference rate to lock in a fixed rate will now be fixed at a higher rate. As soon as the deal prices the dealer withdraws her offers in the futures market causing the price to rise as the market reverses the selloff. The dealer at Bank Y has demonstrated unacceptable behaviour because she executed transactions in the market with the purpose of influencing the rate that will be eventually given to the client.

2. *Pricing integrity*

2.1. *Acceptable behaviour*

Client C wishes to receive fixed interest on $200 million of a 10 year AUD Interest Rate Swap at 2pm Sydney time and agrees with Bank X to transact at 1 basis point from the midpoint of the bid-offer spread of the EFP. At 1.55 pm, the 10 year EFP is quoted at a bid/offer price of 25/24 in the broker market and the dealer at Bank X joins the market offer at 25 in order to hedge Client C's transaction at a fair market price. The dealer at Bank X is asked by the broker if he would agree to trade in the middle of the spread with an interested counterparty and he agrees to do so. The 10 year EFP trades in the market at 24.5 and Bank X receives $100m at 1.58pm. At 2pm the midpoint of the bid offer price quoted to the client on 10 year EFP is 24.5 and Client C's 10 year EFP transaction is priced at 23.5 basis points. The dealer at Bank X has demonstrated acceptable behaviour because he has been mindful of the potential impact of his hedging activities on the market by executing his hedging transactions in a manner that has had little influence on market pricing.

2.2. *Unacceptable behaviour*

Client D wishes to receive fixed interest on $200 million of a 10 year AUD Interest Rate Swap at 2pm Sydney time and agrees with Bank Y to transact 1 basis point from midpoint of the bid-offer spread of the EFP. At 1.55pm, the dealer at Bank Y observes the 10 year EFP quoted at a bid/offer price of 25/24 in the broker market and immediately gives the bid at 24 in $200 million. The dealer at Bank X then quotes a two way price to the broker of 23.5/22.5 which becomes the current market price. At 2pm the midpoint of the bid offer spread in 10 year EFP is quoted to the client as 23 so the all in price for Client D is 22 points. Client D deals at this price. At 2.01 pm Bank X refers their two way price in the broker market. The dealer at Bank Y has demonstrated unacceptable behaviour because he has executed transactions in the market with the purpose of influencing the rate that will be eventually given to the client. He has shown a price to the market which may not reflect where the true market price should be.

3. *Providing liquidity*

3.1. *Acceptable behaviour*

It is a quiet trading session in the EFP market with little volatility. Broker A asks the dealer at Bank X to provide a two way price (quote a bid and an offer). Over the course of the trading session, other dealers counter the prices provided and in some cases join the bid or offer. The dealer at Bank X eventually trades in some small market parcels but maintains her two way price with Broker A. The dealer at Bank X has demonstrated acceptable behaviour because she has quoted her prices with the intent of providing market liquidity and a fair market level.

3.2. Unacceptable behaviour

It is a quiet trading session in the EFP market with little volatility. Bank Y is expecting Client E to call through with a large transaction. The dealer at Bank Y asks Broker B where the market price is being quoted at. There is no live price but Broker B informs the dealer at Bank Y where the last price was quoted at. The dealer at Bank Y provides a two way price to Broker B but it is one basis point away from the last market price. The dealer's price is traded a number of times in standard market parcels but he maintains his quote in Broker B. As a result, Client E's transaction is priced off the quote shown by the dealer at Bank Y. After the deal has been completed and agreed to by Client E, the dealer at Bank Y withdraws his two way quote from the market causing the price to revert to where it was before he had quoted Broker B. The dealer at Bank Y has demonstrated unacceptable behaviour. He was not providing genuine liquidity to the market because his purpose in quoting the Broker was to create an artificial level that would influence the rate that was eventually given to the client.