

INVENTING A NEW MARKET

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New exchanges and markets launch all of the time and most fail. Few people have had such success in creating not only new markets but completely new categories of markets as Richard Sandor.

Sandor, largely credited as the father of financial futures, created the first interest rate futures with Ginnie Mae futures at the Chicago Board of Trade in the 1970s. While Ginnie Mae's did not become a hit, the 30-year Treasury bond, also created by Sandor, would become the largest futures contract in the world and set the Board of Trade off to a new era as the leader in long-term interest rates.

For most innovators, or inventors as Sandor prefers to be called, that would be enough. But Sandor went on to invent an entire new market category with environmental markets.

The Chicago Climate Exchange launched in 2003, which was followed by the Chicago Climate Futures Exchange and the European Climate Exchange, which were all connected under Climate Exchange Plc. before being purchased by the InterContinental Exchange in 2010.

Sandor is not done; he launched the American Financial Exchange (AFX) in December through a joint arrangement of the Environmental Financial Products, LLC (EFP) and the Chicago Board Options Exchange. AFX is an electronic marketplace for small and mid-sized banks to lend and borrow short-term funds. EFP is an incubator company that specializes in inventing, designing and developing new financial markets. Sandor is its Chairman and CEO.

AFX, which launched as an over-the-counter market to trade interbank loans, expects to eventually list futures and options contracts based on a proprietary index it will create. It will focus on 1,740 community and regional banks with between \$500 million and \$125 billion in assets, which hold a combined total of \$4.7 trillion in assets.

“We view having an index interest rate that is truly set by market forces as a real plus in today's environment,” noted Bill Sirakos, Senior Executive Vice President and Capital Markets Division Head at Frost Bank in San Antonio, Texas in the initial AFX announcement. “The potential for growth in the use of the AFX is quite high, both among commercial banks as well as, eventually, today's commercial paper issuers.”

AFX plans to bring the best of exchange trading including standardization, transparency and a rules-based process, to interbank lending and reduce transaction costs through an electronic market in the process.

When we spoke to Sandor, AFX had only been up and running for a couple of weeks but it traded \$50 million in overnight loans on the Friday before we spoke. “It is going well, it is meeting or exceeding our expectations,” Sandor says.

AFX is meant to be an interbank market for small-to-medium-sized banks. It is electronic and transparent. CBOE is a partner and service provider. They operate the platform and make sure the trades are compliant with the rulebook and will oversee the regulations spelled out. Northern Trust is the settlement bank.

“The AFX never touches the money,” Sandor says. “The loan is consummated, the lending bank forwards the funds to Northern Trust, Northern then transfers them to the borrowing bank.”

AFX has much greater plans than just operating a trading facility for small banks. It will develop the Ameribor Index, which will be an overnight interest rate benchmark of small- and medium-sized banks.

“It will reflect their cost of funding and therefore should be an excellent tool for benchmarking assets that will closely correlate with their borrowing rates so that they can better [perform] asset liability management,” Sandor says.

He would not commit to Ameribor replacing Libor but says it will be complementary.

“There has been no index for small banks,” Sandor points out. “We looked at the pulse of the world: London has Libor, Europe has Euribor, even China has Chibor, and there is no American benchmark (short-term) interest rate. So we are trying to create an American-based interest rate benchmark. It is pretty remarkable that we don't have our own interest rate.”

Sandor says Ameribor will fill a need. He points out that there are roughly 1,800 small- and medium-sized banks that they are targeting as customers. These banks have not had a benchmark to use or to hedge their overnight loan risk.

“We are filling a need. Just as with financial futures or emissions trading, markets get used in ways that we can understand and very often people use them in creative new ways which we can't [always understand before a market is created],” Sandor says. “We

think we have a cost-effective way for small- and intermediate-sized banks to borrow and lend. There is no benchmark and we are trying to fill that need. It is my experience over the past 40 years that people will take the central marketplace and create financial products around this benchmark in order to minimize interest rate risk or to optimize asset liability management.”

A BETTER HEDGE

The Ameribor Index has the potential to provide a better hedge for small and medium-sized banks.

“If we are right, it will provide a better hedge and closely reflect the funding cost that they face; not theoretically but actually and a reference rate that is established among their peers,” Sandor says. “Ultimately this will reduce the cost and yes, we have done the analysis and we think there is commercial logic in what we are doing.”

AFX has been a little secretive in the early stages. It hopes to launch the Ameribor Index in the first quarter through a series of auctions that will set the price for the index.

Sandor pointed out at an event on the day AFX launched that “mid-sized U.S. banks are disproportionately responsible for lending to small businesses, directly contributing to job creation and economic growth in the real economy.”

Despite this, they have not had a vehicle to hedge their risks. “An efficient and transparent market can benefit participants and the economy as a whole by providing an efficient way to borrow and lend money, as well as generating indices that truly reflect the bank’s cost of funds,” he notes.

While new markets are hard to get rolling, Sandor has been through this a few times and has a five-year timeline.

“This is no different from any other market. Whether it is interest rate futures, whether it is stock indexes, whether it’s energy; in my experience, zero-to-two years is infancy; two-to-five years is teenage to young adult and five-to -5 years is maturity,” Sandor says. “We think it is going to follow the path of other financial innovations and our initial step is to plan for the infancy and that is where it is for the next couple of years.”

“We anticipate futures and options products based

HIGHLIGHTS

AFX release the following highlights on its two-month anniversary.

- Trading surpassed \$500 million in loans executed on the platform since inception
- Trading ranged between 0.28% - 0.54% since the Federal Reserve raised their target interest rate with a median rate of 0.52%
- The number of participants has more than doubled since the exchanged launched in mid-December



AMERICAN FINANCIAL EXCHANGE

Source: AFX

on the index but that will come after we gain significant liquidity. Somewhere three to five years from now.”

Many people have pointed out that the small- to medium-sized banks in the United States have come under particular pressure from Dodd-Frank, and while Sandor believes that AFX will help reduce some of that burden, Dodd-Frank regulations were not behind building AFX.

“Regulation is not the driver of why we are creating an efficient market. Will an efficient market be a benefit in light of increasing costs in association with the banking sector? Yes, but that is not the driver,” Sandor says. “The trading that was not uniform nor regulated in the OTC market, bilateral market, is now coming under a central transparent market that is regulated by the rulebook as enforced by the CBOE.”

While Sandor has been a part of several successful market launches, he is not sure what part of a value proposition offered in a new market will attract customers. “The treasury market created a risk transfer business. There wasn’t even a field called asset liability management. This is hard to categorize. It is too early to tell all the products that will be created off this index once it gets started.”

In the end Sandor saw a need for risk management and created a product to serve that need. History suggests that volume will follow. ▲

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