
New Player Seeks to Revive VRDO Market.

Clarity Bidrate Alternative Trading System, a division of Arbor Research & Trading, LLC, is signing up investors and lining up potential issuers for an attempt to "revolutionize and rejuvenate" the variable rate demand obligation market.

"Our goals include deepening and broadening the market, a high degree of transparency, centralizing the market and using competitive pricing," Clarity's chief executive officer and president, Robert Novembre, said in an interview last month. The trading system "will give us a healthier, more honest market, with increased liquidity, much greater pre-trading/ execution information and transparency."

VRDOs are long term municipal bonds with floating interest rates that are reset periodically, typically weekly. Along with auction rate securities, the securities were attractive to municipal issuers because they allowed for the sale of long-term obligations using lower short-term interest rates. They offered investors a better return than traditional money market investments.

In 2008, however, the collapse of Lehman Brothers triggered a run on the securities. The average VRDO rate shot up to almost 8% from under 3%, as investors worried about whether banking institutions that provided liquidity facilities to back the securities would be able to meet their obligations, according to a June research report from the Federal Reserve Bank of Atlanta. .

Issuance of VRDOs has fallen to about $11 billion in 2014 from nearly $120 billion in 2008, according to the Municipal Securities Rulemaking Board. The par value of VRDOs outstanding has slipped to $207 billion from $222 billion in March 2014.

"The market has incredibly low yields [and it] doesn't look like an industry that needs more buyers," said Matt Fabian, partner at Municipal Market Analytics. "I think it is likely to continue to shrink for the foreseeable future."

According to Novembre, Clarity is built around the lessons learned from the financial crisis. The system promotes transparency, offering real-time empirical data not available in today's market, pre-trade/execution information and competitive pricing, he said. The system seeks to level the playing field, promoting a deeper and wider investor base. By providing easy access and a place where investors and issuers can meet directly in an unbiased market not influenced by a middleman, the system should increase the potential for new issuance, Novembre said.

Clarity's goal is two-pronged: one, to offer better security structures and two, to offer an efficient marketplace, where all parties can benefit with Clarity's success, Novembre said.

The system is intended to help liquidity providers assess risk and market depth better, and allow issuers to price in a deeper, broader, competitive market and, ultimately, give investors more product to buy.

"This market place has been the same for the last 30 years while everything else in the world has changed, in many ways due to technology," Novembre said. "The time is now. This market is begging for technological advancement, centralization of the marketplace and from a market perspective, it's becoming a matter of when, not if short rates go up, making the Clarity model ever more meaningful to issuers and investors."

"This was a multi-year process, and not an easy one, but we ultimately want to be the go-to place for variable rate debt," said Novembre. "In our view, we created more efficient structures and much needed and improved marketplace, leveling the playing field and augmenting the depth of investors and issuer base."

Michael Decker, a senior managing director of research and public policy at SIFMA, said some issuers' experiences using VRDO products during the crisis made them more wary of the risks.

"However, an even bigger factor is that banks are offering direct loan products or accepting placements as an alternative to public VRDO products," said Decker.

Another problem facing the VRDO market is that it is so compressed, according to Fabian.

"There are only so many buyers and that puts a downward pressure on supply due to the Volker rule and you have incredibly low yields," he said, referencing the SIFMA Municipal Swap Index, which was at .02 for the first fourteen weeks of the year . It reached as high as 0.11 on May 20, but, as of July 8, it was down to 0.04. The Volcker rule places limits on certain speculative investments by banks.

According to the MSRB, the number of interest rate resets on municipal variable-rate demand obligations also hit a new low of 133,896 in the first quarter of 2015, the lowest quarterly number since the MSRB began collecting the information in April 2009, the board said. Previous MSRB reports have noted a decline in the VRDO market since 2009.

Novembre said Clarity isn't hanging its hat on biddable VRDOs, as it also has a platform for biddable tender option bonds, biddable market liquidity variable rate securities, and biddable floating rate notes. The former two require liquidity facilities and the latter two don't.

"We are introducing competitive pricing to all of these markets, with centralization of the market place, which we believe will centralize liquidity," he said. "We designed Clarity to be extremely user friendly, easily accessible and highly transparent. Clarity is designed to be an ATS where issuers and investors meet directly, so there is no middle man that could cloud up the market, using their own balance sheet."

THE BOND BUYER

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