Why Consolidations in Municipal Evaluations Landscape Signal 'Tectonic Shift' for Industry.

A string of recent acquisitions in the municipal pricing and indexes space could bring “colossal change” to the market, participants said.

It began last October, when Intercontinental Exchange announced the purchase of Interactive Data Corp. for $5.2 billion. Then, in March, ICE announced the acquisition of Standard & Poor’s Securities Evaluations and Credit Market Analysis. Additionally, Bloomberg purchased Barclays’ Risk Analytics and Index Solutions business. The BRAIS are currently evaluated by IDC.

Stephen Winterstein, managing director of research & chief strategist at Wilmington Trust Investment Advisors, Inc., thinks it’s unlikely these acquisitions in such a short span are pure coincidence.

“How it shakes out is anyone’s guess. This appears to be the start of a game of musical chairs,” said Winterstein. “There were five major valuation services for municipal securities. Perhaps we are seeing only the beginning of a consolidation in that segment’s service providers.”

Winterstein noted there are currently three leaders in municipal fixed income indexing: Barclays (soon to be Bloomberg), S&P, and Bank America Merrill Lynch. He also said he could imagine a world where ICE is in both the municipal bond evaluation and index businesses.

“In light of their recent acquisitions, I wouldn’t be at all surprised to learn that ICE is developing its own family of fixed income indices, or planning to possibly acquire another index group – or, perhaps a combination of the two,” he said. “Further, the acquisition of IDC and S&P Evaluations may pave the way for ICE to create a municipal electronic exchange. After all, they are in the business of securities exchanges, so they certainly have the bandwidth, and now they have the data content to undertake such a challenge in the municipal bond market.”

There are more questions than answers on this topic but Winterstein said he firmly believes that this is going to be a “colossal change” and that no one knows what the end result will look like.

“I think there is a tectonic shift afoot in how munis will be evaluated and what index families will thrive,” he said. “Over the next six to eighteen months this could be a bigger deal than anyone is making it out to be now.

“What were the two leaders in municipal evaluations are now in the process of becoming one,” Winterstein said. “There are barriers to enter this niche marketplace and it’s a space that saw few players to begin with. It is a rapidly occurring confluence of transactions and circumstances within the municipal fixed income markets, over which many practitioners are scratching their heads.”

Tom Doe, president of Municipal Market Analytics in Concord, Mass., said the arrival of Wall Street giant Intercontinental Exchange Inc. into the municipal market is monumental and could have a serious lasting impact on the industry.

“I find this as potentially disruptive as when the futures markets went from an outcry of people on the floor to an electronic exchange,” Doe said. “That changed the data and the personality of the market.”

ICE owns the New York Stock Exchange and is the leading network of regulated exchanges and clearinghouses for financial and commodity markets.

Creating a pricing service monopoly has its potential advantages and disadvantages, according to Doe, whose firm is a leading source of municipal market analysis and commentary.

Chief among the “interesting” yet unanswered questions is price discovery, regulation, and how ICE will interface with the Municipal Securities Rulemaking Board, he said.

Kevin Strom, senior managing director and head of capital markets at Ziegler said that we have regulators and technology vendors who are driving hard towards a new world order, whatever that will eventually look like. On the other side, he said, there are broker dealers who are struggling to catch up on the technology and regulation front, and doing everything to control costs “while the vendors could increase costs and I assure you, the compliance and regulatory environment is raising everyone’s costs.

“This is a bad recipe if you’re on the dealer community side of the fence, so this is a big deal,” he said.

“The words oligopoly and monopoly come to mind,” Strom said. “My costs for pricing and data services are not going down in all likelihood, they are going up. If the Justice Department and regulators allow that to happen as it relates to bond markets where those two pricing services are the only relevant muni pricing services , I would argue that is not good.”

Doe said that consolidation of data pricing providers could make some of these issues more challenging, and could potentially introduce new concerns, including possible antitrust issues and the lack of diversity in a long-standing multifaceted, multi-vendor industry.

“It starts to shake the landscape” of the municipal market, especially at a time of heightened regulation and surveillance, Doe noted.

“You’ve had a quiet period where data was status quo, and everything went along and innovators brought technology into the market,” Doe said. “Now with this tech giant being very aggressive, with lots of money and lots of success and customers on the buy side, it gives them a leg up over something like Market Axess,” Doe explained.

The potential for ICE to lead the data pricing industry comes at a time when market participants are “struggling” to maintain liquidity and exchanges are trying to make it easier to comply with increased regulation, he said.

Doe said ICE’s leadership is entirely different than various other institutions, like Bloomberg or TMC Bonds, and Market Axess, contributing to market advancements like creating electronic platforms or tweaking technological improvements.

“Now you have ICE coming in buying the two largest data information providers that own buy side customers and influence every evaluation that goes on every investors’ statement – individuals and institutions – and they would own that,” Doe explained. “That’s incredibly powerful.”

Among other questions is whether the current evaluation models, such as the Barclays indices, for example, are calculated, he said.

“You have a legacy of triple-A bond insurance to solidify the basis for the triple-A benchmark,” Doe said. “But, you bring somebody in who’s in control of the evaluation process do they dictate how things are looked at, and can they provide regulators with a better context instead of several vendors?”

“The municipal market does everything off of the high-grade curve, so are those days numbered?” Doe continued. “Will models change and the behavior of the market change?”

On the other hand, Doe said the arrival of ICE into the municipal data pricing industry could open new avenues to the future.

“They tend to go into different markets that were behind in technology and have been able to transform a market place,” Doe said of ICE. The move could be a real positive for the market – one that “brings it into the 21st century,” he hinted.

Still, Doe said there are wrinkles to be ironed out before the market adapts to a new way of operating with respect to data pricing and evaluations.

“Large sums of money coming into a market place is disruptive, for sure, but hopefully to the positive,” Doe said.

“Other institutions have done positive things for the market place and anything that ICE would do, hopefully, the market adapts and the industry only gets better with technology coming into the world of disclosure.”

At a time when the municipal market is heading toward increased transparency, the concept of data pricing consolidation hurts rather than helps the industry, and further limits the already error-prone process, according to John Mousseau, managing director at Cumberland Advisors.

“I think we need more pricing services, not less,” he said.

“No pricing service is totally correct. Most miss the market when it is in transition to either a higher coupon standard or a lower one, and they misprice it most on premium bonds,” Mousseau explained.

Limiting the number of pricing services to a monopoly doesn’t add value for clients, and makes comparisons virtually impossible, he noted. “With more than one service at least you can see some degree of difference. How would one compare just a one-source price?”

Ron Valinoti, president at Triangle Park Capital Markets Data who has worked for both IDC and S&P, said the potential disappearance of one of the two major pricing services could have wide-ranging implications for the muni market.

“The other firms are newer, especially to the municipal business,” said Valinoti, whose own firm is aggregating data based on observable market data. “Without one of these two familiar services, the market’s concern is you have to go out and employ one of these other services. And that’s a lot of work.”

But beyond the impact for mutual fund portfolio managers, Valinoti said, the data provided by the big pricing services is so pervasive throughout the muni business that it has secondary market effects too. Traders often have to check a screen carrying that data before they can execute a trade, Valinoti said, because the estimated price can sometimes diverge significantly from the actual price someone is willing to pay for a bond at that time. The data provided by the services also makes up a part of the compliance systems broker-dealers use to determine a fair price for a bond in the case of securities that haven't traded recently.

"It's pretty far-reaching," he said.

Valinoti said that all the pricing services try to do "a credible job" of reaching their conclusions, and it is ultimately incumbent on firms who rely on them to do their due diligence in making decisions about how and if they will restructure their policies and procedures to match the new landscape. Many mutual fund companies are currently required by their policies to use two of these services, said Valinoti, though a "bigger, better mousetrap" emerging from the purchase could actually improve price discovery in the muni market, he said.

"If the justice department thinks it's a good idea to allow these dominant firms to merge because the benefit on other side of the fence, like a more efficient marketplace or a new municipal exchange, or more access to market information, then that would be very interesting news to our marketplace," said Strom. "But it doesn't deal with keeping the vendors honest in terms of the future prices they will charge if they dominate a sector of a marketplace."

Strom said that it's safe to say that the regulators from the SEC to FINRA to the MSRB think the muni retail market is pretty inefficient, and that it is dominated by mom and pop investors that need more protection as the end user of bonds through direct purchase, or via money managers and mutual funds.

"As a marketplace, and with our regulators, we will have to find a balance between these forces," said Strom.

The Department of Justice declined to comment on whether it is investigating the acquisitions. It is common for the DOJ to not comment on ongoing investigations.

ICE also declined to comment, as a spokeswoman for the company said that the proposed acquisition of the Standard & Poor's Securities Evaluations business has not yet closed.

Strom said that he isn't sure if ICE creating a muni exchange or other products is a good thing or not, but that he believes it might not work out well for retail investors in terms of cost.

"If the new monopoly or oligopoly in town doesn't have some controls, or regulatory input, in terms of what they charge for their services, just like regulators want more controls on our side of the industry. I would think this topic would need to be dealt with somehow," said Strom.

Strom said that when it is all said and done, the landscape will certainly look different than it does today.

"Small dealers that have dominated the local muni business for 100 years, with its millions of CUSIPs that don't trade every day, will have to adapt," he said. "The big question is whether, in a new world order, where technology and access to information and data rule the day on one side, can that be balanced against monopoly or oligopoly behavior by vendors with pricing, on the other side of the fence?

"Time will tell whether these dealers in this industry can survive the way we know them today," Strom said.

The Bond Buyer

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May 2, 2016