Box D
Bank Bill Swap Benchmark Rates

Findings by the authorities in the United Kingdom, the United States and elsewhere that certain interbank reference rates had been subject to attempted manipulation have prompted reference rate administrators and standard-setting bodies to consider ways in which the governance and methodology of these benchmarks might be improved.

Following a period of public consultation, the International Organization of Securities Commissions (IOSCO) released its *Principles for Financial Benchmarks* (the *Principles*) in July. Reflecting concerns that benchmarks may not always have been representative of an underlying market, the *Principles* stress that benchmarks should be anchored in an active market and be derived from transactional data or other representations of market activity, such as executable quotes. The *Principles* identify benchmarks that are reliant on submissions from a panel of market participants as being subject to greater risk, including potential conflicts of interest.

To align with these *Principles*, the Australian Financial Markets Association (AFMA) has recently modified the process by which its bank bill swap (BBSW) benchmark rates are calculated. These rates, along with the overnight cash rate (published by the Reserve Bank), are the most important reference rates within the Australian dollar market.[1]

AFMA publishes BBSW benchmark rates for each monthly tenor out to six months, with each rate designed to reflect where prime bank bills and certificates of deposit (CDs) of that maturity are priced in the interbank market. (Currently, only the four major Australian banks are designated as prime banks.)

In the past, AFMA has relied on a panel of 14 market participants (both prime and non-prime banks) to each submit an assessment of where prime bank bills and CDs were priced at 10 am, Sydney time, to calculate BBSW. The transparent nature of the market meant there was generally little dispersion in the participants' submissions. However, following the controversy surrounding London Interbank Offered Rates (LIBOR) and other international benchmarks, banks have become less willing to participate in reference rate surveys that require a subjective assessment of market pricing. During the first quarter of 2013, four banks withdrew from AFMA's BBSW survey.

Effective 27 September 2013, AFMA no longer derives BBSW benchmark rates from a survey of market participants. Instead, AFMA directly collects executable quotes in prime bank bills and CDs from approved trading venues.[2] For each maturity, averages of the best bids and the best offers sourced from these venues are used to produce the benchmark rates.

To ensure that there will always be quotes with which to calculate BBSW benchmark rates, AFMA's conventions for the prime banks have been amended. These banks are now expected to make continuous two-way markets in prime bank bills and CDs in the period surrounding the setting of rates at 10 am. As well as a minimum parcel size, the conventions stipulate maximum bid-offer spreads

1 The Reserve Bank's process for calculating the cash rate is detailed on the Bank's website. For full details on how BBSW benchmark rates are derived, see Australian Financial Markets Association (2013), 'Bank Bill Swap (BBSW) Benchmark Rate General Conventions', October, available at <http://www.afma.com.au/afmawr/_assets/main/lib90031/bbsw%20general%20conventions.pdf>.

2 The venues currently included in AFMA's calculation process are ICAP, Tullett Prebon and Yieldbroker.

that prime banks may quote during this time. (Of course, other participants may be posting prices as well.)

The adoption of this convention has facilitated the change in AFMA's calculation process for BBSW and increased liquidity within the interbank market. While trading activity remains concentrated in the one-, three- and six-month maturities, the liquidity of the other monthly maturities has improved. Moreover, at only 1 to 2 basis points, bid-offer spreads within the market are generally well inside the maximums imposed on the prime banks.[3]

AFMA now publishes the volume of transactions executed in the period surrounding the setting of rates via those trading venues from which executable quotes have been sourced, with a one-month lag. Recent data indicate that around $750 million in trading activity occurs during this window on an average day. Additionally, a significant quantity of bills and CDs are also issued or traded at other times of the day. The outstanding amount of prime bank bills and CDs (with six months or less to maturity) is currently around $130 billion.[4]

3 Currently, prime banks must post bids and offers at a maximum spread of 3 basis points on one-, three- and six-month maturities and 4 basis points on two-, four- and five-month maturities.

4 Bills and CDs are grouped into half-month maturities for market trading. For example, a three-month CD purchased during the first half of November will have a maturity anywhere between 1 and 15 February.