City markets and the global challenge

How will old-line institutions adapt to the global and virtual financial markets of the 21st century? Professor Daniel Hodson gives a glimpse of the future.

The two great Chicago exchanges, the Ceres-topped building of the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange, were founded on the commodities that made the mid-West of the US rich, such as wheat, soya and pork bellies. London, in contrast, as a great international mercantile centre, developed exchanges for its wide range of activities. These included equities, soft commodities, metals precious and non-precious, shipping and, most recently, financial derivatives. Similar patterns developed all over the world, the underlying activity bringing participants and liquidity to the relevant exchanges, and then contributing significantly to maintaining the importance of that activity to the city and its prosperity.

They shared, for the most part, a number of characteristics:

- they are co-operative, that is, owned by their participants, who may be a combination of traders and brokers, individuals, partnerships and corporate entities;
- they trade by open outcry on a trading floor; and
- there will have been a common purpose in their origin: to create a central market in the commodity – financial or physical – for the benefit of the owner/ participants and the community at large.

But what will the exchange of the future look like? Will it be able to provide the same economic benefit to its participants and to the community in which it resides as it had in the past?

Shape of things to come

The exchange of the future will be a limited company with shareholders who are independent of its participants. There is every reason to suppose that today's trend towards shareholder-owned exchanges – and away from the traditional co-operative structure – will continue.

Its trading platform – the method by which it puts buyers and sellers together – will be electronic. The combination of the distributive power of electronic trading combined with its relative cheapness, is likely gradually to close exchange floors wherever they exist. Electronic trading has demonstrated its ability to simulate, in most respects, the so-called benefits of open outcry. Indeed, the exchange will take the fullest possible advantage of the opportunities afforded by technology, and its ability to distribute globally and to customise within a general framework. Thus, users and traders (in effect, investors) will trade on the exchange from screens anywhere in the world, but always with the intermediation of a so-called member of the exchange, who will be responsible for monitoring their creditworthiness and will have electronic means of controlling their exposure. The electronic messages from investors will pass through the members' systems to provide such control.

The selection of the exchange may soon become automated. Sophisticated car buyers are familiar with the e-commerce providers who find exactly the car you are looking for and at the cheapest price. You specify the make, model and colour, and they will tell you exactly where the vehicle is to be found. Such technology will soon become standard in respect of exchange trading, and as some equity markets in particular become split into a number of different pools of liquidity, so it will become increasingly important.

Daniel Hodson

Pools of liquidity

The investor will probably be indifferent to the exchange on which the transaction has been performed and indeed to its city of origin or owners. In such circumstances it's hard to argue against the suggestion that pools of liquidity in the same product will merge simply because de facto electronics are making that happen anyway. There has long been a conventional wisdom in derivative contracts that in head-to-head competition on a single contract only one exchange per time zone can survive. In the case of the German bund futures contract, the open competition between LIFFE and the DTB/Eurex lasted a long time, but it was based on a very important product differential – that between open outcry and electronic trading. This process is set to continue.

In equities, however, the situation is different and the current trend is towards the creation of more rather than less pools of liquidity. Thus, in the exchange arena, Tradepoint has set itself up as a direct competitor to the London Stock Exchange (LSE) and has begun to build up respectable liquidity in many stocks. Furthermore, recent history has seen the rise of unregulated off exchange matching engines which, acting nominally as a broker, put buyers and sellers together. Instinet is one such, on both sides of the Atlantic, while the proliferation of electronic communications networks (ECNs) in the US has created a profusion of ponds of liquidity.

I cannot see how they can survive as separate entities. The aforementioned process will inevitably lead to these ponds merging as seas and most likely turning in the long run into one ocean of liquidity.

Regulatory environment

The regulatory environment in which the exchange will operate in the future will vary, although the basic principles will be closely harmonised, as country regulators work more closely together. The continuing role of the intermediary – clearing member/ broker – will remain the fulcrum of the regulatory system, with far more onerous obligations on the retail broker serving the person on the street, than on the wholesale broker dealing with sophisticated investors who can for the most part look after themselves.

What will the pricing and financial structure look like? The marginal cost of trading is tiny and as long as liquidity is shared or has the capacity to be shared between exchanges, exchange trading will be based on penny transactions. For the most part exchanges will provide a commoditised and cheap service. Furthermore, they have never – despite their glamour and central role in financial marketplaces – been huge institutions. The capital value of some of the biggest (the LSE or LIFFE, for example) has never been significantly more than a few hundred million pounds and is now probably falling. This is in stark contrast to the multibillion pound value of many of their participants and also their suppliers, some of the activities of which they will increasingly resemble.

In this regard I single out Reuters, which in company with others has brought, through its real price feeds, global transparency to the market, and which, through Instinet, Dealing 2000, and so on, has moved itself into the exchange arena. Another example is software manufacturers, since software is increasingly the stock in trade of exchanges. Thus the highly successful Swedish OM exchange, an early entrant into the electronic arena and producing its own software, is metamorphosing itself into a software house. And, of course, the global networking and distribution is essentially a telecommunications function.

Finally, in the globally distributed electronic markets of tomorrow it is hard to see how exchanges will be able to look for past levels of support from the local community government or institutions, such as the central bank. They will cease to be that important to the financial community and any pull they may have will be increasingly based on lingering sentiment and not on the hard facts of commercial life.

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What price independence?

Commoditised, relatively small, potentially abandoned by their civic sponsors, looking to undergo not only change but competitive buffeting over the foreseeable future, and possible extinction – what price independence for most exchanges? It is hard to avoid the conclusion that they will for the most part have only two choices:

- either merge into mega exchanges with global capacity and a wide product range including both derivatives and equities, to create the operating economies of scale, critical mass and ability to absorb the impact of change; or
- become operating divisions of larger entities with comparable business interests.

> The greatest barrier will be local pride and the continued perception of the importance of strong local exchanges in the competition between rival financial centres

What strategies should they pursue to ensure survival in the exchange jungle? There can be no guarantee, although several factors undoubtedly make their continued existence more likely. Liquidity in key contracts must be at the head of the list, with economies of scale sufficient to ensure the cheapest possible pricing. More than one exchange clearing at the same clearing house could be a significant additional attraction. And a trusted, flexible system of regulation, able to assure a fair trading environment may ultimately be a decision factor as fractionalised equity markets come back together.

A focused strategy

The first, and fundamental issue is always to pursue a focused commercial strategy with a long-term objective and without regard to short-term consequences. During the titanic struggle between LIFFE and the Frankfurt-based DTB (now Eurex) over the German bund futures contract, the differences in strategic approach could not have been more marked. The DTB set itself the target of repatriating, as it saw it, the bund contract in which LIFFE had been able to build up a dominant position before the DTB's launch, and was prepared to pursue that ideal for as long as it took. First, the DTB calculated that only an electronic platform could succeed against an established open outcry contract, but that it needed to have actual and perceived liquidity. Achieving the latter involved continuous and loyal support from local Frankfurt banks with the consequence that the percentage market share – for literally years – stayed magically around 30%. The joke in the LIFFE market was that if the DTB's share fell to 25% in the morning, it was mysteriously and with great mathematical precision back to 30% in aggregate at the end of the day.

The perspicacity and determination paid off, of course, and the cool and surgical way in which the DTB slowly strangled the LIFFE bund in the last few months of the latter's life by a combination of rapidly increasing distribution, marketing incentives and pricing tactics was in stark contrast to the inability of its competitor to identify a commercial strategy or easily to identify commercial tactics to meet the challenge.

A new blueprint?

Is it time to consider a new blueprint in the light of future commercial realities? The recently announced NASDAQ (the very successful screen-based US stock market) initiative to set up a rival European equity exchange is undoubtedly the first shot in a global market campaign, quite probably based on US/European competition. And this is a contest into which a merged CME/CBOT – if it were to occur – would surely be tempted to be drawn.

But NASDAQ is a long way ahead of the other great US exchanges, in terms of structural and trading platform terms, and Europe has very significant assets – including three world-class exchanges (Eurex, the LSE and LIFFE) with either complementary or overlapping product ranges, a commitment to electronic trading, and of course a for-profit motivation and outside shareholding. Europe also has a state-of-the-art and, importantly, independent, clearing house, in the London Clearing House (LCH) co-operatively owned by the global financial community, which will probably soon also become the central counterparty on the LSE and which has a multicurrency product range, including dollar and euro denominated over the counter, that is, bilaterally agreed, products.

One template to be considered, as a bulwark against renewed competition from across the Atlantic is, therefore, a pan-European exchange based on broadly distributed ownership, containing each of these entities and cleared by the LCH, who could remain independent and in co-operative ownership.

A first step could be to create a rapprochement between LIFFE and LSE, building on the opportunity created by joint use of the LCH, which could lead to a closely co-ordinated London approach, or perhaps even a merger. This would be a strong bargaining platform with Eurex, from which could stem the creation of a European holding company to acquire the constituent entities and fund the resultant mega exchange. In due course the sheer momentum of such an entity would suck in other European and non-European entities. And what an exchange… a robust and dominant European equity franchise with a stranglehold on European derivatives, cleared at what would become the world's largest clearing house, able to take on the US giants – and perhaps challenge them in the future on their own territory.

What are the barriers?

It would require a leap of faith, but what are the realistic alternatives? Probably the greatest barrier will be local pride and the continued perception of the importance of strong local exchanges in the competition between rival financial centres, in this case London and Frankfurt. What has to be accepted (and already is, I believe, at least in London) is that the power and importance of a city in global market terms is moving rapidly away from the strength of its traditional exchanges. Specific instances of this include the encouragement given to Tradepoint in London over the years, to OM, the Swedish exchange and very recently and quite explicitly to the NASDAQ initiative. Thus, the creation of the European mega exchange will not have an impact on the outcome of the London/Frankfurt rivalry, the latter in itself not being an unhealthy fact of European financial life.

The City of the future

Gone are the days of the great exchange as a symbol of local power and wealth, and indeed I would argue that continued support of such a notion may stand in the path of progress. Far more importantly, is an open door policy to both overseas and local exchanges, forcing them to pay court to their users in the users' own location, by means of at least appropriate local levels of sales, marketing and technical staff.

So, as supporters of the City of London, we need not fear for the fate of the London Stock Exchange and LIFFE – the past and current symbols of our success. What may be far more relevant in the future will be the importance of the City as measured by the attention paid to it by rival overseas exchanges, represented by the number of local employees. On that score I am sure that it would have a significant (and increasing) global lead. ■

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