

MARKET view

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grows by demand

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Juan Pablo Córdoba Garcés,
Bolsa de Valores de Colombia

OMX signs Bolsa de Valores de Colombia

OMX has signed an agreement with Bolsa de Valores de Colombia (BVC) to provide a new trading system to enhance BVC's IT infrastructure. BVC is OMX's first exchange customer in South America.

"With this new trading system, BVC will have a world-class, state-of-the-art trading platform that will bring BVC in line with international standards and will contribute to its strategy of attracting international institutional investors to our market," says Juan Pablo Córdoba Garcés, President, Bolsa de Valores de Colombia.

Market data will explode with MiFID and NMS

New research from TowerGroup suggests that compliance with the EU Markets in Financial Instruments Directive (MiFID) and the US Regulation National Market System (Reg NMS) will require up to a 900 percent increase in the amount of market data being published by 2012.

"Regulatory compliance will pave the way for firms to completely automate the trading process," says Tom Price, senior analyst in the Securities & Capital Markets practice at TowerGroup and author of the research. "Once all the players have done so, the winner in the hunt for liquidity will be whoever can process the data the fastest."

European exchanges lead the world in IPOs

During the first half of 2007, the value of initial public offerings by European issuers on European exchanges rose 45 percent to USD 52.2 billion from USD 36.2 billion over the same period a year ago, according to financial information provider Dealogic. This compares with USD 40.2 billion in the Americas, up 13 percent from USD 35.6 billion a year ago, and USD 30 billion in Asia-Pacific (excluding Japan), up 2.4 percent from USD 29.3 billion.

The growth of Russia, where deals rose to USD 14.9 billion from USD 2.4 billion in the same period in 2006, was a major contributing factor to the growth of European listings. Russia moved up to third place worldwide behind the US and China, according to Dealogic.

SWX and virt-x launch new trading platform



To address the rising demand for algorithmic trading and direct market access, the SWX Swiss Exchange and virt-x, its London-based securities exchange, announced the

launch of a new, high-performance trading platform. The platform is based on X-Stream technology from OMX and is already in use at SWX for trading warrants and structured products. The platform currently operates 500 quotes per second and has a round-trip latency inside the SWX system of just under five milliseconds, according to Jim Gollan, Chairman of virt-x.

The project will be implemented in four phases over three years. The first phase was launched in summer 2007 with the migration of international bonds to the new platform. Equity trading is scheduled to follow in summer 2008.

FINRA begins operations

The National Association of Securities Dealers (NASD) and the NYSE Member Regulation officially combined and commenced operations as the Financial Industry Regulatory Authority (FINRA) on July 30, 2007.

The new organization is the US securities industry's largest nongovernmental regulatory organization and is responsible for the oversight of more than 5,000 securities firms and 666,000 registered representatives.

FINRA will handle all functions previously overseen by NASD, including market regulation under contract for NASDAQ, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange, as well as the member regulation, enforcement and arbitration operations of NYSE.

MICEX and HKEx sign agreement

The MICEX and Hong Kong Exchanges and Clearing Ltd. (HKEx) have signed a memorandum of understanding that lays the foundation for the development of a close cooperation between the two exchanges, including exchanging experience and information on implementing new exchange products, technology development and the organization of exchange-based markets. The exchanges say that their cooperation will contribute to developing their countries' capital markets and help improve their competitiveness with the globalization of financial markets.



ILLUSTRATION: ISTOCK PHOTO

Canada's Pure Trading goes live

Pure Trading, a fully electronic facility of the Canadian Trading & Quotation System (CNQ) went live in mid-September, trading in three pilot stocks.

The new market is powered by X-Stream from OMX and offers a fully electronic alternative to trade stocks that already appear on other Canadian markets. Pure Trading has signed 65 investment dealers that together handle 95 percent of Canada's equity trading volume.

Capital market growth in emerging Europe

Capital markets are relatively new to Central and Eastern Europe, having started some 15 years ago after most countries in the region regained their independence. The region's exchanges have been trying to build a complex infrastructure and comply with new regulations practically overnight. They have made a good start, but they can do much more to promote the capital markets and take advantage of the opportunities that exist in Europe today.

Currently in many Central and Eastern European countries, awareness of the securities business is still low, and participation is limited mainly to wealthy individuals and institutions. Most exchanges offer equities and some corporate bond trading. Government securities trading is often separate. Derivatives markets exist but are mainly OTC between market participants, with some exceptions such as in Poland and Romania. Trading volume is thin, and markets are extremely volatile. And while the exchange technology is generally capable, it lacks multi-asset functionality and does not support internationally accepted standards.

AT FIRST GLANCE that picture may appear gloomy, but a closer look shows that Central and Eastern Europe offer tremendous opportunities for members, investors and exchanges. Mutual and pension fund activity over the past five years have raised the level of professionalism in the market and, at the same time, increased awareness among potential retail investors. In addition, countries that want to join the EU must inspire trust in their economies by fortifying their capital markets. They are required to have certain regulatory frameworks in place to be considered for entry, and they must be able to comply with the various financial directives.

For the region's capital markets to grow over the long haul, more shares have to be made available for trading. Currently too many local blue chip companies have only around a 10 percent free float because major owners are afraid of losing control. Governments need to support capital market development by issuing treasury securities tradable in the stock exchange and by privatizing through initial public offerings. In addition, the product range needs to be expanded beyond equities to derivatives, warrants and exchange traded funds.

EXCHANGES CAN ALSO HELP grow their home markets by opening their doors to foreign participants. Local members may have lobbied to keep them out because they feared losing business to the large global players, their current customers. But the Nordic and Baltic market experience shows that admitting outside members can lead to increased liquidity and growth. When Copenhagen Stock Exchange joined OMX and further opened its market, for example, revenues of the domestic members increased by 55 percent, while the total market increased almost 100 percent.

Exchanges can better attract foreign investments by implementing European best practices to increase transparency and by preventing insider trading and market manipulation. And on the technology side, they can offer easy access and increase efficiency by migrating to systems that support an array of instruments as well as the standards deployed by the international market data vendors.

More important, exchanges can improve efficiency, reduce costs and expand their business through partnerships and consolidation.

Romania's RASDAQ, which was modeled on NASDAQ's electronic OTC market, merged with the Bucharest

Stock Exchange in December 2005, and the two entities integrated their markets and trading systems. Romanian market consolidation is still taking place while the Sibiu Monetary, Financial and Commodities Exchange, the main Romanian derivatives market, is looking for an international partner

In March 2007 the Zagreb Stock Exchange (ZSE) in Croatia merged with the other Croatian stock exchange, VSE, to create the largest capital market in the region. The ZSE now lists the shares of about 370 companies, and its market capitalization is the equivalent of about USD 54 billion.

Of course, the challenge for exchanges and their shareholders lies in selecting the right partners. Is this the right time to consolidate or to enter into cooperation with other exchanges? With exchange consolidation peaking and willing buyers on the market, now could be the right time, especially with industrial consolidation leading to the escape of some blue chips from the region's stock exchanges. ■

Henri Bergström,
Senior Vice President,
Corporate Development, OMX



PHOTO: PHOTO NYBLIN



European derivatives rising star

Italy's IDEM leverages existing technology and a new service model to spur growth.

BY SHERREE DECOVNY PHOTOS GETTY IMAGES, BORSA ITALIANA

THE IDEM, Borsa Italiana's equity derivatives market, is one of the fastest growing in Europe, based on contract trading volume. Its mission is to operate and grow an efficient, transparent and liquid market for listed derivatives by attracting an international member base and reaching out to educate private and institutional investors. IDEM's trading systems and network, combined with its new service model, provides the right technology platform to enable it to achieve these ambitious plans.

The IDEM started in 1994 by offering futures contracts on the MIB 30 index. Having grown at the rate of 31 percent per year for the past three years, the IDEM is now the third largest equity derivatives market in Europe by notional turnover. Its listings include futures and options on the S&P/MIB index, the benchmark index for Italy, and on 42 single stocks.

Considering its performance during the first half of 2007, the exchange has a lot to boast about. Around 160,000 contracts per day valued at around EUR 6.5 billion changed hands across its screens. Moreover, it set a new trading

volume record (551,655 contracts) on May 8 and a new open interest record (4.8 million contracts) on June 14. During the same period, trading volumes in the S&P/MIB options increased 27 percent, and single stock option trading increased 33 percent.

"We are continuing to see increasingly strong demand for exchange-traded equity derivatives from private institutional investors as well as from proprietary traders; this makes IDEM one of the fastest growing exchanges in Europe," says Nicolas Bertrand, Director of Derivatives Markets at Borsa Italiana. "The appeal of the IDEM is definitely coming from its very active and liquid orderbooks. Our 25 remote clients, who have direct access to IDEM screens from abroad now account for 44 percent of the IDEM's trading volume. We are part of the global pool of liquidity. IDEM is not only the Italian market anymore!"

EUROPE IS ON THE CUSP of radical change as MiFID comes into effect in November 2007. The directive seeks to introduce more competition by breaking the monopolies of the



»...the strong demand for equity derivatives from private investors... is making IDEM one of the fastest growing exchanges in Europe.»

Nicolas Bertrand, Head of Derivatives Markets at Borsa Italiana.

exchanges and enabling best execution for European investors. Once the regulation comes into force, exchanges will compete based on their ability to attract liquidity.

To date, IDEM has been very successful in attracting order flow. The number of clients and market makers participating on the exchange has increased, spreads have tightened and more size is available on the bid and offer. "MiFID will increase competition, which is positive for the market and for our clients," says Bertrand. "We are well positioned to take on the new challenges that will arise from this new directive."

But the IDEM has worked hard to get where it is today. Over the past four years, it has worked closely with member firms to develop the market, including the launch of innovative types of orders and a state-of-the-art set of market maker obligations to support the liquidity of the market. This has resulted in a huge increase in the number of contracts traded on IDEM screens in 2007. The number of market makers has grown from 13 to 22 in the past three years. In addition, the market



In spring 2007, IDEM migrated to a new service model that is managed jointly by Borsa Italiana Group and OMX. The two companies operate and support the system, network and part of the infrastructure.

share of trades closed on the order book is one of the highest in Europe.

The IDEM also has been proactive in reaching out to educate investors. It realizes that, in order to run a fair and efficient market, it needs to make information about its products and services widely available. Only when investors understand the mechanics and the potential risks and rewards associated with equity derivatives will they have the confidence to trade on the IDEM. To this end, the exchange has held successful online trading expositions and seminars for retail investors. Similarly, on the institutional side it has been meeting with fund managers, who are becoming more active in derivatives trading. The constant and accurate flow of information to the market is also ensured by a new derivatives corporate action service available on the Borsa Italiana Web site (www.borsaitaliana.it/derivatives).

Technology has also been critical in allowing the IDEM to grow its

business, take advantage of opportunities and address challenges as they arise. “Technology is what links us to our clients,” says Bertrand. “We continuously invest to give our clients the best technology available to support their business on the IDEM.”

THE IDEM WAS AMONG the first exchanges to start using OMX’s integrated trading system for derivatives trading in 1994. The platform gives IDEM the ability to combine products and list strategies in real time. According to Bertrand, the fact that it is used in other leading derivatives markets and the ability to quickly develop and integrate new functionalities or products are significant benefits.

For more than a decade, OMX provided application support, development and major upgrade work, while a local Italian company handled infrastructure and operations. In April 2007, IDEM migrated to a new service model that is managed jointly by Borsa Italiana Group

»Technology has been critical in allowing the IDEM to grow in business.»

and OMX. The two companies work together to operate and support the system, network and part of the infrastructure.

Compared with the previous system, this model is more cost effective and enables the exchange to offer better service directly to members. The new hardware and connectivity solutions have decreased latency significantly. “As well, a new international customer service desk managed by Bit Systems, the technology arm of Borsa Italiana Group allows the exchange to stay closer to its clients,” Bertrand points out. Since OMX performs the same function for several other exchanges, the IDEM has achieved economies of scale and reduced risk.

The IDEM has been very active in growing its product base in the equity derivatives segment and indeed has a growth that is very well balanced between all products, but there are plans in the works to diversify the product range to include commodities. The IDEM aims to leverage its current trading platform to launch an electricity derivatives segment called IDEX. Major players such as Nordpool, already use the same OMX technology, so there will be few application changes required.

PERHAPS THE MOST significant development for IDEM is the recent merger between Borsa Italiana and the LSE, which was completed on October 1. At this stage, the two organizations are evaluating the potential opportunities for capturing synergies between IDEM and EDX, the LSE’s derivatives market that is 24 percent owned by OMX.

To compete in today’s environment, exchanges must be able to offer high quality products and services to attract liquidity. They need to keep an eye out for partnerships that will enable them to grow their business and use technological innovation to their best advantage. The IDEM, Europe’s derivatives rising star, is doing all three. ■

The challenge: Developing further a successful and international market by bringing it closer to the fast evolving needs of its direct and final clients.

The solution: Leveraging technology by adding new products and innovative functionalities and by adopting a new service model managed jointly by Borsa Italiana Group and OMX. The two companies work together to operate and support derivatives trading, the entire infrastructure and the London network. This cooperation has led to reduced costs and risk, increased efficiency and improved service.

As safe as houses

Real estate securities are increasingly attractive to investors, yet until now there has been no central marketplace on which to trade.

BY HEATHER MCKENZIE ILLUSTRATION MÅNS ADOLFSSON

The global market for real estate securities is set to grow by nearly 40 percent during the next five years, according to RREEF Real Estate, a specialist real estate securities investment manager and part of Deutsche Bank's Asset Management division. Professional real estate investors such as money managers, funds, private investment vehicles, listed companies and institutions will push the market up from USD 9.8 trillion on December 31, 2006, to USD 13.7 trillion in 2011, according to RREEF.

Real estate securities are nothing new. For many years they have been used as a means of gaining exposure to real estate in the US, Australia and the Netherlands. What is new, says RREEF, is the increasingly global nature of the real estate securities markets. This has been driven by the introduction of real estate investment trusts (REITs) in more countries, the increased size of the market and the strong performance of real estate securities as an asset class.

"Real estate is the largest asset class in the world, and it is the only product that is 100 percent capitalized," says Leo Chamberland, President and CEO of Canada-based egX Group, which is launching egX, a global securities marketplace designed for the listing and trading of real estate securities and related financial products.

"Real estate accounts for more than 50 percent of the world's wealth, so you would expect that a well balanced stock exchange would have more than 50 percent of market capitalization represented by issuers of real estate securities," he says. "But that's not the case because the real estate and securities industries have never come together before."

The demutualization of stock



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Leo Chamberland, President and CEO of egX Group

exchanges, along with the advent of electronic trading technology, have enabled egX to develop a recognized exchange on which real estate securities will be traded. OMX has designed and implemented the egX trading platform. The company will also host, operate and manage the platform for egX.

The market will meet the investment objectives of aging populations that are seeking less volatile securities with a stable income stream, says Chamberland. Moreover, real estate listings are an important source of diversification in portfolios.

EGX GROUP IS PURSUING a global strategy and recently announced an agreement with a business consortium in the European Union to develop and implement an egX marketplace for Ireland and the UK. It will partner with the business consortium to develop and establish the new marketplace and acquire a non-controlling interest of the project.

According to Cohen and Steers, a New York-based investment manager specializing in global real estate securities, with USD 34.6 billion in assets under management, the UK is an attractive market. In its survey of global markets published on June 30, 2007, Cohen and Steers said: "... the United Kingdom, at current valuations, offers some of the best values in the global markets. Many real estate companies are trading at substantial discounts relative to their net asset values, while the quality of these companies is very high. As fundamentals remain sound, we believe that stock prices will revert toward underlying real estate valuations in the United Kingdom."

Cohen and Steers predicts that, globally, further growth in the real estate securities market will be driven by solid GDP growth and strong property fundamentals. The adoption by European countries of REIT structures will also help fuel growth. ■



Further growth in the real estate securities market can be driven by solid GDP growth and strong property fundamentals.

Watch and learn

Trust has become an even more significant consideration for exchanges. Surveillance has matured and is now considered a critical tool in an exchange's trust building arsenal. Today's fast moving markets, however, are putting surveillance models and systems to the test.

BY HEATHER MCKENZIE ILLUSTRATION MÅNS ADOLFSSON

The ultimate task of any surveillance system is to preserve market confidence on a daily basis. And, as competition for listings and liquidity has increased, effective market oversight, surveillance and governance have become very tangible assets for exchanges around the world. Stakeholders must be able to trust that a marketplace can accurately and efficiently discover and handle market abuses and disruptions, such as dramatic price swings or unusual pricing patterns.

Many exchanges used to treat surveillance as a box-ticking exercise to please the regulators, says Audris Siow, Head of Business Development at Smarts Group, a developer of market surveillance systems. "However, now that competition is mounting, the style of execution has to be the best and fairest, and there's been a paradigm shift in the attitude towards surveillance and market supervision."

This is a view shared by Anders Ackebo, Senior Vice President and

Head of Surveillance at OMX Nordic Exchange. "If surveillance is conducted properly, it will help to create public confidence in an exchange and attract listing companies and trading volumes," says Ackebo.

FROM A TECHNOLOGY point of view, exchanges have traditionally handled surveillance in-house, with many larger marketplaces initially building their own home-grown systems. But market surveillance is becoming increasingly challenging. Algorithmic and program trading have added complexity to the trading process, while overall volumes are rising dramatically. In this environment, many exchanges have found it to be more efficient and cost-effective to rely on outside vendors for surveillance technology.

At the same time, trading is becoming more fragmented. Many markets are seeing new regulations that encourage the development of new trading venues that further distribute trading and increase competition.

»...there's been a paradigm shift in the attitude towards surveillance and market supervision.»

Audris Siow, Head of Business Development at Smarts Group.

"As cross-border activity continues to increase, we believe there will be a greater emphasis on detecting international fraud and also on the new types of marketplaces that are being created by new regulations such as the Markets in Financial Instruments Directive (MiFID) in Europe," says Magnus Almqvist, General Manager, Smarts Europe.

Historically, the large majority of share trading in any single listed company took place on one exchange. Today, investment companies execute orders over multiple venues. This puts completely new demands on market surveillance and market oversight. Real-time surveillance systems must be complemented by checking historical data from other marketplaces in





Surveillance, along with market monitoring, may in the near future become even more critical to the success of marketplaces.

order to detect any suspicious trading patterns.

A good surveillance program will incorporate proper processes for following the flow of information and be manned with experienced staff who know how to follow through when irregularities are discovered, according to Anders Ackebo. “While technology is critical, effective market surveillance involves more than simply installing the latest platform,” he says. “The processes in place and the people behind the system are equally important to a program’s success.”

In the past, political considerations have often prevented surveillance from being separated from exchanges. But with the rise of new trading venues there is also an increased demand

for innovative surveillance solutions.

According to Smarts Group’s Siow, some trading venues are beginning to consider outsourcing the entire surveillance function. “Outsourcing not just the development of the surveillance system but also the technical operations and even the business function itself to independent specialist firms can result in technology and cost savings,” she says.

NO MATTER HOW marketplaces choose to handle surveillance, one thing is certain: As competition and asset fragmentation increase and asset classes become more diverse, surveillance, will become even more critical to the success of the marketplace. Exchanges need to keep up. ■

Market surveillance functions:

- **Monitor markets.** Monitor and process a high volume of trading activity to ensure that participants follow the appropriate rules and regulations.
- **Generate benchmarks.** Continually determine what is “normal” for any market at any time, so “abnormal” events above defined thresholds can then be used to trigger alerts.
- **Generate alerts.** Analyze trades in real time to detect abnormalities that may suggest insider trading, market abuse or other irregular issues that need further attention.
- **Facilitate analysis.** Graphically show trading activity in a wide range of images, depending on the type of activity involved.
- **Manage cases.** Prepare form letters asking for more details, and provide other standard evidentiary material that may be used for subsequent enforcement, if necessary.

Source: Smarts Group

A passage to India

As one of the world's fastest growing economies, India is providing strong business opportunities for exchanges.

BY HEATHER MCKENZIE ILLUSTRATIONS GETTY IMAGES

With a GDP growth rate in 2006 of 9.4 percent, India is one of the most attractive of the world's new economic powerhouses. Once viewed as a risky market, India now attracts the world's leading investment banks, eager to benefit from the fast growing economy. Over the past few years, the Indian government has set out to relax the country's strict financial regulations and to promote foreign investment in India. Indian companies are raising money in the markets to further their growth strategies, and in turn, they are pumping money back into the economy.

"Changes to capital laws allowing repatriation of funds out of India have led to much higher cash inflows to India," says Richard Dour, sales Asia Pacific at OMX. "Indian companies are doing very well and are good at finding

new niches in the market. There are plenty of opportunities to invest in fast-growing companies."

This growth is being reflected in India's equity market, which according to Celent, outperformed most global markets over the past four years, with annual returns exceeding 30 percent each year. Market capitalization has reached USD 1 trillion, and Celent expects it to reach USD 1.4 trillion by 2009. In January, the NYSE Group, along with Goldman Sachs, General Atlantic and Softbank Asian Infrastructure Fund, each purchased a 5 percent stake in India's main market, the National Stock Exchange (NSE), from five Indian institutions. The agreement valued the NSE at USD 2.3 billion.

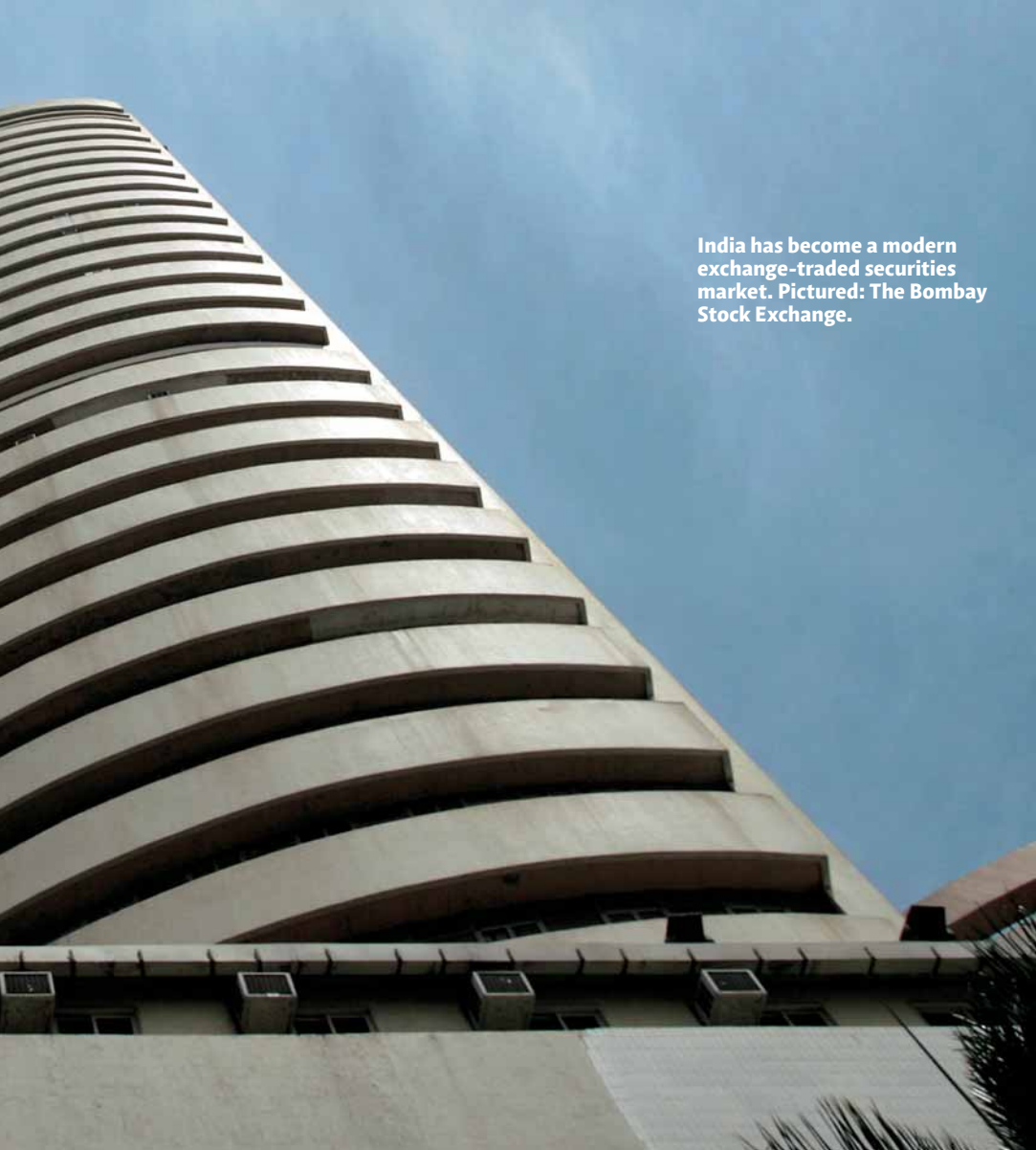
Similarly, the Bombay Stock Exchange (BSE) sold a 5 percent stake to the Singapore Exchange in March.

»There is a huge potential for exchanges to grow in the next three to five years...«

Bevang Bhatia, SuperDerivatives

Under the deal, the Bombay exchange will collaborate with the Singapore exchange on listings and new products. In February, Germany's Deutsche Börse also bought a 5 percent stake in BSE, which is Asia's oldest bourse, set up in 1875. Total average daily turnover on BSE is USD 1.1 billion.

IN ADDITION TO the two stock exchanges, India has two commodity exchanges. Inaugurated in 2003, the Multi Commodity Exchange (MCX) is recognized for facilitating online trading, clearing and settlement operations for the commodities futures market across the country. It was recently granted a license to trade electricity. Also launched in 2003, the National Commodity and Derivative Exchange India (NCDX) lists about 57 agricultural, metal and energy con-



India has become a modern exchange-traded securities market. Pictured: The Bombay Stock Exchange.

just five years, India leapt from a state of primitive trading infrastructure to one of the most modern exchange-traded securities markets, comparable to the best in the world. The global investment community has been paying attention. Foreign institutional investors, mostly registered in the US and UK, invested USD 33 billion from 2004-2006, accounting for more than a third of equity market turnover in 2006.

BUT SUSTAINING GROWTH along the same trajectory is contingent upon continued regulatory reform. Currently, banks are not allowed to invest more than 5 percent of their capital in equities, nor can they take commodity futures positions. Similarly, pension funds can only invest 2 percent of their capital in equities, and the rest is typically put into corporate and government bonds. The Indian parliament is considering legislation to permit banks to invest 15 percent of their capital in equities and trade commodity futures. It is also planning to ease restrictions on pension funds.

“Once the bill is passed in a few months, liquidity and volumes will grow in India, and this will be a huge opportunity for banks and pension funds,” says Bhatia. “There is a huge potential for exchanges to grow in the next three to five years as market participants seek to deploy multi-asset strategies combining currencies, equities and commodities.” ■



India is planning to ease restrictions and encourage foreign investment.

tracts. India also has an OTC foreign exchange options market.

In the past decade, demutualization has transformed India's stock exchanges from traditional bureaucratic institutions into much more commercial organizations. “Historically, the broker members ran and controlled the BSE, for instance,” says Bevang Bhatia, country man-

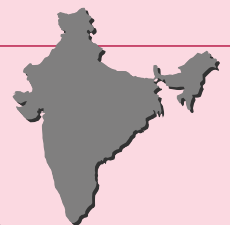
ager for India at SuperDerivatives, a provider of real-time derivatives pricing platforms. “As more mergers have occurred among exchanges internationally, the BSE has shifted to a professional management approach and increased transparency to the investment community.”

Technology has also had a major impact. The exchanges now have a strong trading and technology infrastructure, a paper-free securities market and T+2 settlement with straight-through processing. The NSE and BSE can introduce new products quickly, and their systems are sufficiently robust to handle algorithmic trading, although the Indian regulators are unlikely to permit it in the near future.

As Celent senior analyst Sandeep Hebbar points out in a recent report, in

India

- > Geographic size: 2.973 million square kilometers
- > Population: 1.129 billion
- > Language: Hindi is the national language, but English is commonly used in business and politics.
- > Government: A federal republic comprised of 28 states and seven union territories
- > Natural resources: Coal (India's reserves are the fourth largest in the world), iron ore, manganese, mica, bauxite, titanium ore, chromite, natural gas, diamonds, petroleum, limestone, arable land
- > GDP: USD 4.164 trillion
- > GDP growth rate: 9.4 percent
- > Workforce: 509.3 million



Source: CIA's The World Fact Book

Credit where credit is due

As the market for credit derivatives continues to explode, exchanges and clearing houses have a role to play.

BY SHERREE DECOVNY ILLUSTRATION MÅNS ADOLFSSON

The over-the-counter (OTC) credit derivatives market has grown exponentially over the past few years. Given its popularity, some exchanges have now launched their own products to share the market's success. While it is still early and unclear whether the exchanges have a solid business case to successfully penetrate this market, potential opportunity certainly exists.

The Credit Default Swap (CDS), which is a product driven off the US and European corporate debt market, was the first blockbuster credit derivatives product. As dealers became more comfortable with the pricing technology, they developed new products, such as credit indexes and tranches of asset-backed and collateralized debt securities, that were rapidly taken up by the market.

According to the International Swaps and Derivatives Association (ISDA), the notional principal outstanding volume of CDSs grew 32 percent in the first half of 2007, rising from USD 34.42 trillion at December 31, 2006 to USD 45.46 trillion at June 30, 2007. Analysts project this growth to continue.

Today, European and US banks (and to some extent Japanese banks) tie CDSs to specific loans on their books, such as commercial auto loans. The insurance industry uses contingency-based swaps to hedge catastrophic event risk. The asset-backed credit derivatives market, known as the ABX, is now the barometer used to gauge the health of the US residential real estate market.

Currently the credit derivatives market is repricing risk following the US sub-prime debacle, but according to Don Fewer, Senior Managing Director of GFI Group, a leading credit derivatives interdealer broker in New York and London, it will not have a long term damaging affect on the market. "The credit derivatives market is being tested by fire, and it seems to be passing all the tests," he says. "Capital continues to flow into credit derivatives,

illustrating the confidence in the market and the recognition that they are legitimate instruments."

Until recently, these instruments have been traded strictly OTC, but some exchanges are now moving into the space. For example, Eurex and the Chicago exchanges introduced exchange-traded contracts in 2007.

GFI's Fewer warns that OTC dealers are not optimistic about the viability of exchange-traded credit derivatives. He notes that a similar product, the interest rate swap futures contract, never gained significant

»Capital continues to flow into credit derivatives, illustrating the confidence in the market...«

traction because dealers prefer the flexibility of the OTC markets. Exchanges offer the benefit of central counterparty clearing, yet the OTC dealing community is working to provide its own facility soon. In fact, GFI and ICAP are both shareholders of the Clearing Corporation, the former Board of Trade Clearing Corporation.

BUT HENRIK PAULSSON, President, Derivatives Markets at OMX, believes that exchange-traded structured products and credit derivatives are here to stay. "Exchanges and clearinghouses definitely have a role to play in this space given the complexity of the products as well as the need for collateral, clearing and overall transparency."

As Aite Group Senior Analyst Brad Bailey points out, short-dated interest rate swaps are hedged with Eurodollar futures contracts, which leads him to believe there is an opportunity for exchanges to develop an equivalent for the credit markets. In particular, contracts based on indices such as iTraxx and Dow Jones CDX have good potential.

"In five years or even less, credit derivative traders will rely on OTC as well as exchange-traded credit products for hedging their credit positions," he says. "I see greater granularity in the type of products that will be offered, and many of those will be on exchange."

When choosing markets, traders will have to balance the flexibility and anonymity of the OTC market against the simplicity and ease of the exchanges. In addition, the different cost structures need to be factored into the equation. Clearly this is a space worth watching. ■



Market View

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