Latin lessons for all

Emerging market exchanges would do well to look to the example of Brazil's BM&F, reports André Cappon

Under the impetus of international bodies such as the IMF, IFC and the regional development banks, emerging economies have been in the process of developing exchanges, notably derivatives exchanges. Given the growth history of exchanges worldwide, this seemed a good idea, but recent developments are challenging this thesis:

- Several leading established exchanges, such as the CME Emerging Markets division, Austria's Ötob, Nyse and NASD, through their ADR programmes, are successfully offering emerging market derivatives and securities, in the reassuringly regulated environment of established markets.
- A rapid process of consolidation among major exchanges has started in the last year. Several mergers have already occurred, in Europe and the US, and the multiple global alliances of US and European exchanges are the first steps towards 'virtual mergers'.
- The OTC market is converging towards the exchange market, thanks to standardisation of contracts and clearing facilities through existing clearing houses.

So, does it still make sense for an emerging economy to build a derivatives exchange, at this stage of the game? The answer is a definite 'yes'. Furthermore, rather than replicate the traditional futures exchanges, new emerging market derivatives exchanges should invent a more appropriate business model.

Exchanges, both stock and derivatives exchanges, are essential for emerging markets.

First of all, emerging economies must build capital markets. As economies develop, their degree of 'monetisation', measured as the ratio of financial assets (ie, deposits, stocks, bonds, mutual funds, insurance reserves, pension funds) must grow. Over time, as the economy grows and becomes more sophisticated, the mix of financial assets changes.

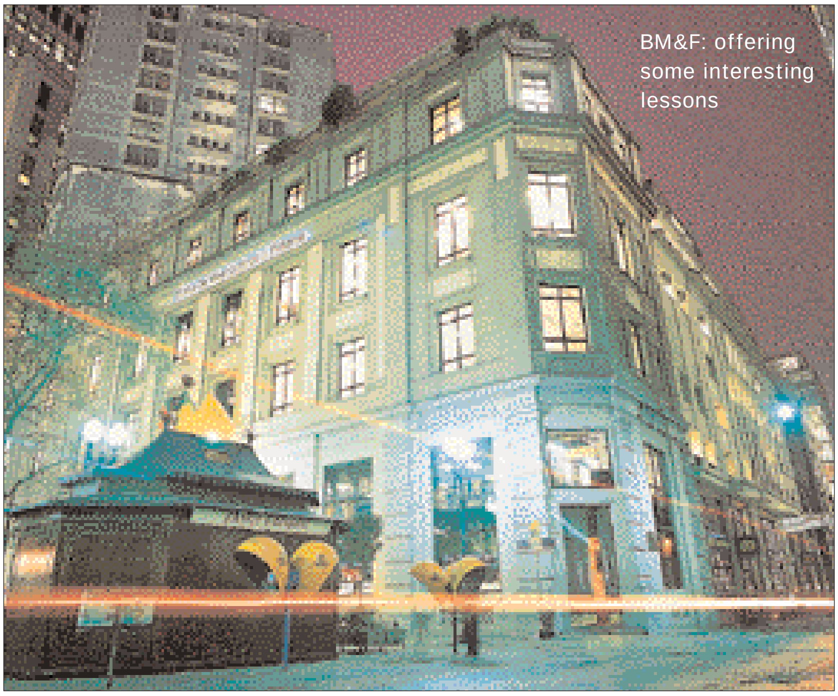
Commercial bank intermediation of savings has been clearly shown to be insufficient and even dangerous, as illustrated by the bank asset-quality crises in Latin America and most recently in Asia.

In the long run, the financial systems of successful economies must evolve towards a capital markets model, where savings are intermediated through securities and effective risk management can be provided through derivatives. A secure, liquid, capital market, and a strong base of institutional investors (eg, pension funds, mutual funds and life insurance companies) are key ingredients of development.

Second, while global markets may offer good access to capital, they must not be a substitute for a local market.

Global markets welcome emerging market products when there is already a critical mass of liquidity and strong investor interest. That means they are there when there is a bull market. The moment the market turns bearish, the global investors tend to rush out. This 'hot money' phenomenon has ravaged emerging economies many times: the Tequila effect in 1995, the Asian crisis now, are vivid examples.

Emerging economies therefore need strong *local* capital markets, which should not live in isolation. Capital and currency controls are acceptable only in extreme conditions. It is best to have local capital markets *coexisting* with global capital markets. They will sometimes compete, eg in the case of ADRs for blue chip companies, and more often than not co-operate, through arbitrage mechanisms. Local institutional investors will usually favour the local markets, which they understand better, but will also seek a degree of global diversification. Global investors will move from market to market, seeking superior returns and risk diversification.



BM&F: offering some interesting lessons

A strong stock exchange and a strong derivatives exchange are therefore keystone institutions for emerging economies. Stock exchanges have typically been around for a long time. Derivatives exchanges, in many cases remain to be built.

When an emerging economy turns

to the task of building a derivatives exchange, the temptation is to copy the model of the successful, traditional exchanges in the US and Europe, notably the Chicago giants. Those models worked well in the past, but may be completely obsolete in the world of electronic trading. Furthermore, they were never fully applicable to emerging market conditions.

The most successful emerging markets derivatives exchange, the Brazilian BM&F, offers some interesting lessons in this regard. BM&F developed highly original and innovative solutions to the particular challenges of risk management in a volatile emerging economy.

Indeed, emerging markets pose special challenges. In the typical emerging market, relative to a developed market:

- financial institutions tend to be less experienced in trading and risk management; less well capitalised and often more speculative
- brokerage firms tend to be small and poorly capitalised
- regulators tend to be less experienced and under-resourced
- disclosure standards are often deficient
- the legal system tends to be less prepared to deal with compliance problems, market manipulation and even fraud

To address these challenges, the successful derivatives exchange in an emerging market needs to compensate, by being stronger, tougher, better capitalised and more profitable than its peers in developed economies.

The successful exchange needs to be very good in the risk management area and build a well-capitalised, tough clearing house, which should play the role of the tough cop. At BM&F, for instance, the clearing house demands margin deposits on a gross basis from customers and brokers, and insists on knowing the identity of clients and their positions. This is unheard of in the traditional US and European model, where it would be considered excessive interference in the affairs of members. In Brazil, it has been of great help for policing excessively speculative behaviour.

The successful emerging markets exchange, as illustrated by BM&F, might choose to behave in a somewhat 'paternalistic' manner towards its members. For instance, BM&F is in charge of the members' back-office processing, which has the benefit of reducing overall costs and helping supervision.

The exchange should also choose an appropriate economic model, ownership structure and governance process. The traditional Chicago philosophy of the exchange as a quasi non-profit co-operative of members is not appropriate in emerging markets. It should make a reasonable profit in order to build up capital, as a cushion against the unpredictability of emerging markets. The traditional ownership structure, ie ownership of the exchange by the floor community, leads to a situation of 'the inmates in charge of the asylum', and to a very difficult governance process. Innovative ownership structures, which perhaps separate ownership rights from user rights or trading privileges, should be considered by a new emerging markets exchange. (Incidentally, these lessons are also useful for the traditional Chicago exchanges…)

With regards to trading method, new emerging market exchanges should clearly choose electronic trading. They have the tremendous benefit of being unencumbered by the traditional open outcry system and its floor population, and they can thus readily leapfrog to the modern way of doing business.

Electronic trading is capturing a growing share of the world's derivatives trading volume. It offers clear cost advantages, both to members (who no longer need expensive floor teams) and to the exchange (which no longer needs a floor, floor inspectors, etc). It supports a perfect audit trail and 'straight-through processing' from front to back office. More importantly, it enables exchanges to link up electronically, forming global networks or confederations of exchanges, thus providing seamless connectivity for the global investor and broker.

To sum up, derivatives exchanges in emerging markets are still very much needed. They have the opportunity of doing things right and adopting an appropriate business model. Rather than copy obsolete models, they should boldly and imaginatively invent themselves. ❖

André Cappon is president of The CBM Group, a New York-based strategy consulting firm specialised in capital markets.

-