Introduction

Around a year ago, as part of our preparatory work for the UniCredit T2S market workshops in London, we commissioned a series of thought leadership papers. These included a briefing on the likely evolution of pan European infrastructure. This paper is the product of a review, by the UniCredit GSS Executive Committee, focusing on the Austrian and CEE infrastructure. This takes place against the background of the merger discussions between the Warsaw and Vienna (CEESEG) markets, but it is not limited to the geographies affected by such a move.

It is worth noting that the key rationale for merging infrastructure is (a) to achieve economies of scale by operating off common platforms and sharing common functions as appropriate (b) enabling a single connection with uniform messaging from and to clients across a broader range of infrastructure (c) benefitting from scale to improve the robustness of the infrastructure and (d) harmonising process including any downstream routing (e.g. CCP and CSD linkages for an Exchange). In addition, CCP mergers should enable reduction of collateral needs and allow harmonised collateral rules whilst larger Exchange units should be more attractive to remote members and thus improve market liquidity.

We are not attempting to guess what will happen. We want to identify options and assess how they would affect our clients. We are apolitical in this analysis for we are present in many countries whose institutions could be the drivers or targets for any change. We are also shareholders in some of these institutions. And we recognise that Austria and the CEE, although a logical grouping of countries, is not an island; some opportunity or challenge could well come from countries outside of the region in the light of the growing internationalisation of markets.

The current market structure across CEE

The region is dominated by the big three markets, Austria (and its Czech and Hungarian partners), Poland and, especially, Russia. The market capitalisations at 2012 year end illustrate this point:
The CEE Infrastructure model – now and for the future

At Exchange level the dominant cross border Group in the region is CEESEG, the CEE Stock Exchange Group (owned 52.59% by Austrian banks and 47.41% by Austrian listed companies).

It encompasses the markets of Budapest (50.45% owned), Ljubljana (100% owned), Prague (92.74% owned) and Vienna (100% owned). In its 2012 Annual report, CEESEG noted that Ljubljana, Prague and Vienna are now on the same trading platform (Xetra) while Budapest shareholders have approved their market’s migration to this platform.

The Budapest Stock Exchange owns 46.67% of the Hungarian CSD (Keler) and 11.9% of the Hungarian CCP (with a further 74.5% being owned by Keler itself). The Prague CSD and CCP are 100% owned by The Prague Stock Exchange, while CCP Austria is 50% owned by the Vienna Stock Exchange. The Austrian CSD is owned by OeKB, whose shareholders are the major Austrian banks and other financial institutions.

CEESEG has also data vending and index arrangements in Bosnia, Macedonia, Romania and Serbia.

The Warsaw Stock Exchange is approximately equal in size to CEESEG, but its strategy has been to gain regional traction through cross listings rather than direct participations in other entities. It does though have small minority stakes in the Romanian and Ukraine Exchanges. It owns a third of the National Securities Depository (KDPW) with the balance being held equally by the National Bank of Poland and the Polish State Treasury. KDPW, in turn, owns the Polish CCP.

The WSE undertook an IPO in 2010 and sold over 60% of its shares for approximately EUR 500 million. However, the Polish state retains 35% of the shares with 51.7% of the voting rights. Although the Polish privatisation plan sees further likely sales of the Polish state holdings, it is unclear if these will be accompanied by a “golden share” or other rule which could impact any future merger or acquisition plans.

The table below compares the Warsaw and CEESEG markets by several key performance indicators, namely number of listed securities, market capitalisation (EUR billion), the number of MiFID designated liquid stocks and the number of remote members:

The Moscow Exchange (Micex-RTS) owns 100% of the National Clearing Centre and 99.99% of the National Securities Depository. The Moscow Exchange is 22.47% owned by the Central Bank of Russia and 34.7% owned by five major banking institutions including EBRD (5.81%) and UniCredit (5.71%). Russia has recently restructured its market and created a vertically integrated model to promote Moscow as an international financial centre. It has stated that it wishes to enhance its links to the former CIS region and also the rest of CEE.
The CEE Infrastructure model – now and for the future

The benefits and challenges of today’s market structures

The table below, showing data for the four CEESEG markets, noted in the 2012 CEESEG report, is likely to be a good surrogate for regional flows into CEE from the US and key European countries:

In our thought leadership paper on pan European infrastructures last year, we suggested that, over the next decade, there would be technological convergence at trading levels. We see Xetra (Deutsche Boerse) and UTP (NYSE Euronext) as the major pan European trading platforms of the future, although one should not overlook the local tailoring that occurs in many markets where they are adopted. CEESEG has selected Xetra and the WSE has selected UTP as their respective trading platforms.

It is also important to note the growing role of MTF and similar structures (including dark pools) in high volume trading counters in the region. It is estimated that these entities account for around 30% of activity in the FTSE 100 and Euro STOXX 50 shares; such coverage could extend to major counters across CEE. With the growing cross border investment into the CEE region, the MTF challenge for the traditional Exchanges should not be underestimated.

At CCP level, we forecast, in our paper, an increase in CCPs, initially, but then consolidation, especially as EU and other regulations raised the capital hurdles for CCPs. However, although we recognised the desire for regional consolidation by cross border trading houses, we also had to note the antipathy to any (costly) change from local brokerage communities in the different countries. It is for that reason that we felt consolidation would be more driven by regulation.

At CSD level, we saw a restructuring of the CSD concept. We felt that the notary function would continue to locate at national levels, quite simply because of the complexity of local property ownership law across the continent. We challenged the ability of smaller CSDs to maintain their independence, but felt they could become local hubs leveraging on third party (mainly larger CSD) technical infrastructures. In effect they would outsource their core processing, whilst retaining their ownership records and domestic client interfaces.

One year on, for CEE, the drivers are the same:

a) Several of the markets are small and lack activity/revenue. There is a risk that major companies in the region seek overseas listings to ensure greater liquidity.

b) Even where they have a primary listing in their home country, major counters risk being traded offshore, through MTF, depository receipts and traditional global Exchanges, thus depleting the revenue pool of national Exchanges.
The CEE Infrastructure model – now and for the future

c) The cost of regulation is a serious challenge for many markets, especially those located in the EU.
d) Infrastructure developments may create cost but little incremental revenue (T2S is a case in point with an estimated EUR 2 million minimum development cost per market)
e) The trading activity levels in cross border listings within the region remains weak and home market demand remains the major source of liquidity

However, there are drivers against a headlong consolidation, for a regional or pan European vertical or horizontal amalgamation of infrastructure, namely:

a) The small size of many regional markets mean they are close to their smaller companies and financial intermediaries and perhaps more responsive to their needs.

b) The core function of a national market is to enable capital to be raised, traded, cleared and settled in the local economy and the scale of local markets reflects the scale of local economies. The chart above highlights the challenge (around allocation of resources) a regional or global infrastructure would have, were it to cover major and minor markets. Even the market capitalisation of Moscow is not that much greater than the three major companies selected in the chart (Apple, HSBC and Nestle), while Slovenia (when measured by GDP) is smaller than the economically smallest US state (Vermont).

c) For many, the survival of stock exchange and related infrastructures is critical to the viability of their local financial centres. Economic nationalism has a play in many attempted M&A activities (including the aborted Singapore/Australian and UK/Canadian link ups).

d) Location of the mind of management is also critical, especially where the acquisition or merger is between two parties of similar size.

The potential for change in CEE

Change is inevitable within the region. The reality is that there is likely to be consolidation. Globally, the Exchange agenda is moving from local to global and from horizontal to vertical. This is definitely true of Deutsche Boerse and the London Stock Exchange Group with the major difference being in the extent of their vertical integration (in the case of Deutsche Boerse it is in trading, clearing and settlement whilst London is in just trading and clearing as well as settlement through Monte Titoli).

The region is not likely to see a “big bang” and some question if any change will be merger driven or acquisition led. As was seen from the US$500 million raised from the Moscow Exchange IPO, Russia would have the muscle, and potentially cash, to buy out other Exchanges. However, it is unlikely that
any other regional player could do so and thus they would be more likely to target share exchanges. And the WSE, despite raising a similar amount to Russia at its IPO, is unlikely to be able to go for a rights issue to pay for an acquisition whilst the balance of its capital remains in State ownership.

And we also have to consider the sequence likely in any such moves. The driver will undoubtedly be Exchange led rather than CSD or CCP driven. Indeed, the appetite for CSD assets is low, especially after the scale of the goodwill write downs experienced in the industry. The appetite for CCP assets is somewhat stronger, if the London Stock Exchange Group acquisition of LCH-Clearnet is to go by. But the major (all aborted) cross border transactions of recent times have definitely been Exchange led with derivatives taking an ever greater role over the more traditional stock and bond activities.

Within the region, there can, in reality, be only three core players. These are Moscow, Warsaw and Vienna.

**Moscow**, as we have already noted, has indicated interest in expansion into the former Soviet Union markets (where it will have advantages of language and often legal structures) and also the rest of CEE. But they have still a major task ahead of them if they are to create a genuine international financial centre in Moscow. There is already a Moscow, Mongolia and CIS Advisory Group, established by the City UK in its role as a lead partner of the Russian Government in the promotion of Moscow as an international financial centre. It would appear logical to progress an initiative in this area with Moscow becoming a hub for the region. As the largest, by far, economy and financial centre of the CIS region, such a move would appear logical. We would note that its CIS vision mirrors that adopted by UniCredit Group through its own Moscow business hub.

There is no indication that Moscow is looking actively at other CEE markets and it was not visible in the recent (abandoned) Bulgarian market privatisation initiative.

**Warsaw**, as we have already noted, has adopted a home/host approach to the region. It has sought out cross listings as a means of gaining volume over its Exchange. Additionally, the Exchange is one of the least vertically integrated ones in the region with the Polish Exchange owning just a third of the national securities depository and having no direct stake in the CCP.

As it is still majority government owned (by voting rights), the challenges of any acquisition strategy are four-fold:

- **a)** The reality is that cash resources are unlikely to be adequate for any meaningful acquisition
- **b)** In the event of a merger/acquisition, a structure would need to be found that was acceptable to all shareholders. If there were a major acquisition, such as the oft mooted and often discussed WSE-CEESEG link up, the dilution impact could be unacceptable to the Polish State
- **c)** Other national governments could, were the Warsaw Exchange to bid for an Exchange in their country, require some equivalence to the Polish government influence or the divestment of the whole, or part, of the government stake.
- **d)** The domicile of the parent grouping post an acquisition could be an issue as governments would want to be close to the mind of management given the role of an Exchange in their economies. This may be manageable by governance structures rather than just domicile.

**Vienna** has a vehicle in CEESEG and has acquired markets in the past. It has though not expanded geographically since 2008, although it has extended its product range (especially in data products and indices) and aligned, or agreed to align, trading technology.

CEESEG has, as Warsaw, a challenge in sourcing the right currency for any acquisition. It seems possible that they would have cash to acquire the smaller markets (and they did express interest in a
The CEE Infrastructure model – now and for the future

stake in the Bulgarian market before the privatisation plans were called off earlier this year). They do have links, through their data and index interests, with four smaller markets in the region, but all these (and Bulgaria) undertake a modest amount of trading. As such, those acquisitions would hardly be transformational.

As for Warsaw, Vienna would need to meet the four criteria we have noted above and it is interesting to note their insistence, when commenting on their recent and current discussions with the WSE, on a merger of equals as a basis for a transaction. It is also possible that cooperation agreements could be the first step in such a transaction – effectively an engagement rather than a full marriage.

In essence, a stock exchange led transaction is a possibility in the region. The CSD/CCP impact, especially if the result is a merger or alliance of CEESEG and WSE, will be modest as neither have direct “control” over their CSD or CCP (although CEESEG has indirect control of the Prague CSD and Budapest a major stake in the Hungarian CSD).

The question must also be raised if other Groupings could espouse an interest in the region. Again, external predators are unlikely to be attracted by the smaller markets for the fixed cost (especially management time and focus) of any acquisition would be hard to recover given the low volumes of trading. Thus there could only be consideration of an acquisition of the WSE in Poland or CEESEG in Austria.

Deutsche Boerse could be a candidate, especially for the Austrian market where it has close ties. But it has a clearer focus on the derivative, rather than the cash, markets at the moment and, after the abortive tie up plans with NYSE Euronext, shareholders may find such small acquisitions a distraction rather than a sound strategy.

NYSE Euronext appears more focused on its two core competences of trading and technology (with Euronext planning to move imminently onto the new UTP platform). Eastern Europe (as distinct from Western Europe or the Pacific rim) appears unlikely targets for it. However, it is the planned supplier of the UTP platform to the WSE.

Other major providers really do not have any traction with the region. Moreover, from outside the region, the paradox appears to be that the major players (we exclude Moscow as it is acquisition proof) are too small to merit the time and management cost of any transaction. However, should there be the development of a pan regional grouping, such views would change.

Conclusions

It would be rash to forecast exactly how the markets in CEE will develop but it is clear that:

a) The most meaningful and likely groupings are around CEESEG/WSE although only time will tell if it is feasible to create a merger of equals that brings the economies of scale, advantages of liquidity and value for cross listings that drive the success or failure of any such transaction

b) At the periphery of the region, Moscow’s moves for closer alignment of its financial centre and the CIS/Mongolian markets is logical and mirrors in effect the UniCredit hub strategy for the region

c) Any change will be Exchange driven and this remains a competitive area with the incursions of MTFs and similar platforms as well as the predatory IPOs and cross listings of markets such as London

d) Just as downstream development of a common CCP has been hard to achieve within CEESEG, the creation of such a vehicle across multiple markets is doubtful although loss of flow
The CEE Infrastructure model – now and for the future

(assuming the European code is adopted and cross linkages created) could drive change fast – if it ever happens

e) CSD mergers will be the last to come. Euroclear has found the technical and legal challenge complex even when it has ownership of markets. As we have already noted, we would though expect technology and operational “outsourcing” by many smaller markets to central hubs. To date, the ICSDs appear to have the most likely structure for such developments but they are being, or may be, challenged by custodian banks, bank owned CSDs and more remote service providers.

The status quo is definitely not sustainable if the region wishes to ensure the efficiency of its infrastructure. But we should not forget that there has been ample dialogue over the years and change will take place in two phases spread over many years:

a) The management agreement and creation of the structure for change (be it merger, acquisition, cooperation agreement or other)

b) The convergence of infrastructure to reduce costs, to enable harmonisation, to improve technical latency and ensure greater market liquidity.

GSS Executive Committee

May 2013