Deutsche Börse: unclear futures

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Summary

The European Commission's rejection of the combination of Deutsche Börse and NYSE Euronext in 2012 was one of the biggest merger stories of the year. The speculation this week that the Chicago Mercantile Exchange (CME) might have its own plans for the Frankfurt exchange raised the question of whether such a tie-up might also fall foul of European competition regulators. A CME-Deutsche Börse deal would almost certainly attract regulatory attention, but not for the same reasons that sank the NYSE deal last year.

When the Deutsche Börse-NYSE Euronext merger was rejected by the European competition authorities in February 2012 many observers concluded that the scope for mega-mergers between global financial exchanges had probably been exhausted. The search for consolidation and global scale among the largest exchanges had come up against the European regulator's desire to enforce diversity and competition, and the regulators had had the last word.

Deutsche Börse clearly felt badly burned by regulators over NYSE-Euronext and it was quick to reject any speculation this week over merger talks with CME. The Frankfurt institution explicitly flagged in its denial that it had no intention of unnecessarily provoking Brussels again. But Deutsche Börse shareholders seem to have liked the idea of a merger and the exchange will soon need to set out a vision of its post-NYSE strategy. So, firm denials aside, if we indulge the idea of a CME-Deutsche Börse merger, could we expect the same regulatory hostility?

Deutsche Börse and NYSE Euronext had two key arguments why the merger was not a threat to competition. Both were rejected by the European Commission. First, they argued that Eurex's German-bond linked derivatives and Liffe's short term interest rate futures were different products that did not compete against each other. The Commission disagreed.

Second, they argued that the market for exchange traded derivatives is global, and that even if Deutche Börse and NYSE's platforms did compete against each other on benchmark futures, the merger would have relatively little impact on competition in this global market. Indeed it would beneficially create a European champion capable of competing with major exchanges in the US and Asia. The Commission – controversially - rejected this geographical scope argument, arguing that the EU was a market in its own right for derivatives. But for good measure EU Competition Joaquin Almunia concluded that the merged entity would have such a large global share of euro-denominated derivatives that even if the market were global the combination would still be a major check on competition.

The line of argument with CME and Deutsche Börse would be very different. CME has a small line in euro-denominated futures, but is focussed on Eurodollar derivatives. Eurex's key products are German bond futures. Assuming that the Commission sustained its judgment on the European nature of the derivatives market, the fact that Liffe and Eurex would remain competitors would presumably be key.

If the Commission approves the trans-Atlantic Intercontinental Exchanges-NYSE merger that was announced and notified for regulatory approval in December 2012, then a CME-Deutsche Börse case would look stronger. Indeed, instead of talk of a European champion, the line of argument would no doubt focus on the need for a competitor for ICE-NYSE Euronext. However a CME-Deutsche Böurse merged entity might actually be too strong – competition authorities may not like the idea of a derivatives exchange that would be by far the largest global player (Fig 1).

Less than free exchanges

But in a hypothetical CME-Deutsche Börse merger approval the Commission may also have other worries. Rather than rerunning the logic of the Deutsche Börse–NYSE case the Commission might focus not on the exchanges these companies operate but the clearing houses they have both attached to their exchanges. CME received regulatory clearance to clear interest rate swaps in London this month creating a new competitor for LCH Clearnet (now almost owned by the London Stock Exchange) and Deutche Börse's Eurex Clearing. The Commission has explicitly tried to nurture a more diverse and more competitive landscape for clearing in Europe – writing such an objective into the new European Market Infrastructure Regulation- and might be reluctant to see even a small new manifestation of this snuffed out.

Fig 1: Share of global market for short and long term interest rate derivatives 2011 (% contracts)

Source: WFE/IOMA Derivatives Market Survey April 2012

In this respect a hypothetical CME-Deutsche Börse merger might resurface an important tension in the European market for exchanges and clearing houses. The global push to see over-the-counter derivatives (the kind that helped crash firms like Lehmans in 2008) moved onto clearing systems after the banking crisis has created an obvious incentive for exchanges to acquire clearing houses as a way of increasing their vertical integration and offer to traders and buyers.

But the European Commission would also like to see more competition among clearing houses for derivatives, just as it would in CDS clearing. Breaking into the vertical silos created by exchange-clearing house tie-ups like Eurex or NYSE Liffe has long been part of this. The European Commission had initially proposed rules requiring that the owners of such clearing houses offer open access to them for listed derivatives in order to facilitate the creation of new products and the development of challengers to the big incumbent exchanges. After lobbying from Frankfurt and Berlin, the European Parliament seriously watered down open access rules from draft law last year, citing concerns about the stability impacts of wider access.

Before it blocked the Deutsche Börse-NYSE merger last year the Commission tested remedies for the combination that included requiring Deutsche Börse to define terms on which competitors might have access to its derivatives clearing platforms. When the European Commission blocked the merger it probably calculated that it would achieve the same end through new open access rules. With the European Parliament now threatening to take that option off the table, the European Commission would surely look all the more closely at the idea of reducing the number of derivatives clearing houses in Europe further.

None of this is likely to be lost on Deutsche Börse, which is probably why it moved so quickly this week to deny merger rumours. But the Frankfurt exchange still faces a challenge to set out to its shareholders its alternative to the NYSE strategy which was derailed by Brussels last year. It has set out organic growth plans based on new services in Asia and its data and IT businesses. But given CME's desire to keep up with ICE in Europe, the pressure to look at a merger will probably persist. If they are tempted, the question will be if the exchanges can chart a course that works for both their shareholders and their regulator.

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