Exchanges Drawn to the Index Business

By Dan Barnes

Market operators are moving into the business of producing indices and other pricing benchmarks as a way to diversify their revenue sources and gain control over a strategic asset.

On June 26 the London Stock Exchange Group announced a $2.7 billion agreement to acquire Frank Russell Company, an asset management company based in Seattle. LSE officials said one of the main attractions of the deal is the company's indices, which are widely used as benchmarks in the U.S. equity markets and as the reference price for a large number of exchange-traded funds and listed derivatives. Analysts of the exchange industry say owning the indices will diversify LSE's income and give it greater control over an important source of intellectual property.

The deal, LSE's second big step into the index market in the last three years, is the latest in a series of transactions that have brought many of the world's leading equity benchmarks under the control of exchanges. LSE made its first move in 2011, buying a 50% stake in the FTSE Group. Deutsche Börse has had control of the Stoxx family of indices since 2009, when Dow Jones sold its stake in the company to the German exchange and its Swiss partner, SIX Group. CME Group bought the Dow Jones family of indices in 2010, and then entered into a partnership with McGraw Hill in 2012 to combine the Standard & Poor's and Dow Jones families of indices into one company.

"LSE is actually a latecomer to this game," commented Johannes Thormann, exchange analyst in the equity research team at HSBC. "FTSE was not a bad business but effectively it was just U.K., Italy and emerging markets, with a focus on China and Asia. If you want to be an index bulge bracket, then you have to cover the U.S. and find something for Europe. For the price they paid, the Russell deal made a lot of sense."

LSE has not said yet what it will do with the rest of the company, which manages nearly $280 billion for investors and provides a variety of advisory and execution services, but analysts expect the exchange will look for an opportunity to spin it off.

In Focus: The Russell Index Business

A closer look at the economics of the LSE-Russell deal shows why exchanges are so keen to expand into this business. LSE officials have said that adding Russell's index business will deliver higher returns for shareholders by both increasing the size of LSE's existing index business and extending its reach into the U.S.

"With this acquisition we are strongly positioned for the changing dynamics in the global indices market with a best-in-class offering, which we believe will help deliver outstanding returns for our shareholders," Xavier Rolet, LSE's chief executive, said when the deal was announced in June.

The Russell 2000 index is the most widely used index for measuring the share performance of small and midsize companies listed in the U.S., and Russell indices are widely used by institutional investors to benchmark the performance of their portfolios against the market. LSE estimates that the revenues from Russell's index business have been growing at a compound rate of 10% per year since 2011 and it expects the business to benefit from continued growth in passively managed investments tied to equity indices.

Russell's index business also will complement LSE's FTSE subsidiary, which produces more than 250,000 indices across 80 countries. Approximately $186 billion in exchange-traded funds are benchmarked to FTSE indices, up from $143 billion in 2013 and the fourth largest among index providers. In the 12 months ending in March, FTSE produces revenues of £174 million ($296 million), up 30% from the previous year. Of that amount, 60% came from annual subscription fees for data and analytics and 40% from licenses for index-based products. Clients include pension funds, asset managers, ETF providers, investment banks, consultants and data vendors.

Morgan Stanley analysts Bruce Hamilton and Anil Sharma estimate that once the Russell deal is completed, the combined index business will account for more than a quarter of LSE Group's total profits, roughly equivalent to LCH.Clearnet's contribution. They also project that Russell's index revenues are likely to grow by 14% per year over the next three years.

"We estimate that group profit contribution from index increases from around 18% to 28% post-deal, assuming the business is left intact, further evidencing the [LSE's] shift from a cash equity exchange to a global post-trade infrastructure and index provider," they said in a note published in June.

Value to Exchanges

Why are exchanges like LSE, Deutsche Börse and CME so attracted to the index business? The most obvious reason is the money to be made from licensing indices to companies that offer investment products based on those indices, such as exchange-traded funds and structured products, and selling data and analytics to asset managers, investment banks and other financial institutions.

Richard Repetto, analyst at Sandler O'Neill, commented that the growth of passive investment strategies has encouraged exchanges to acquire index providers. Passive strategies seek to simply replicate market performance and typically rely on indices as their benchmarks. Owning the index effectively gives an exchange control over this asset and a steady stream of revenue that is less subject to the ups and downs of trading.

One of the biggest examples of this trend is the rise of the exchange-traded funds industry in terms of both the total size of assets under management and the range of sectors and regions that they cover. According to the Investment Company Institute, a U.S. trade association, the global ETF industry had $2.3 trillion in assets under management at the end of 2013, with the vast majority invested in ETFs that track various equity indices and sub-indices. In the U.S. alone the number of ETFs has grown from 119 to 1,294 in the last decade as fund managers have expanded their offerings to an ever greater variety of regions, sectors and industries.

A related segment of index business is the licensing of indices to exchanges. According to the latest numbers from FIA, 2.56 billion equity index futures and options traded in the first half of 2014, roughly a quarter of the industry's total volume. In some cases, such as the DAX futures and options listed on Eurex or the Kospi 200 futures and options listed on the Korea Exchange, the futures and options contracts are based on indices created by the exchanges themselves. In many other cases, however, the exchanges license the index from a provider, and in some cases the provider is one of its competitors.

For example, Intercontinental Exchange pays LSE to provide a license for the FTSE 100 futures and options listed on Liffe. ICE also will depend on LSE, once it completes the Russell acquisition, for the right to offer futures and options on futures on the Russell indices. Another example is CBOE Holdings, which licenses the S&P 500 from S&P Dow Jones Indices, which is one-quarter owned by CME.

A further wrinkle is the use of exclusive licenses, which blocks other exchanges from listing a competing version of the contract. For example, CBOE has an exclusive license for options based on the S&P 500 index, but not for options on ETFs based on the same index. As a result, CBOE has the entire SPX options market to itself, but less than a third of the SPY options market, with the rest of the trading spread among 10 other U.S. options exchanges.

Exclusive licenses do not last forever, however. Under the terms of the licensing agreement between ICE and Russell, ICE has the exclusive right to offer futures and options on futures based on the Russell indices until July 2017. When the agreement expires, LSE could choose to renew the license on an exclusive basis, or open the negotiations to other exchanges, or even launch its own futures and options based on the Russell indices. When ICE and Russell agreed to the exclusive license in 2007, Russell futures were also being traded at CME. After the agreement took effect, CME was forced to cease trading in its versions of the Russell futures and transfer the open interest to ICE.

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Barrier to Competition?

The index business therefore has an additional strategic value for exchanges that trade derivatives. Ownership of an index gives an exchange control over a key intellectual property asset, protecting it from competition and preventing other exchanges from taking away its ability to offer futures and options based on that index. Control also means that it is easier for an exchange to launch new products based on that index or variants of that index.

On the other hand, there is a possibility that regulators will step in and prevent exchanges from using their ownership of indices to block competition. In Europe, the recently approved MiFID II legislation includes a ban on exclusive licensing of benchmarks. Both CME and ICE commented in their annual reports that this poses a risk to their profitability. "If unlicensed trading of any index product where we hold an exclusive license were permitted, we could lose trading volume for these products which would adversely affect our revenues associated with the license and the related index products," ICE said.

In addition, some exchanges have challenged the right of index providers to control the use of their indices in the derivatives markets. In January 2013, The Order Machine, an alternative trading system based in Amsterdam, began offering an unlicensed version of options on the AEX index in competition with Liffe, the owner of the index and the main marketplace for AEX options. Liffe took TOM to court, but succeeded only in forcing the exchange to alter the ticker symbol to avoid infringing Liffe's copyright.

Courts in the U.S. have been more supportive of the index providers' intellectual property rights. In May 2013, S&P Dow Jones Indices and CBOE won a long-running dispute with International Securities Exchange, a rival options exchange, over CBOE's exclusive licenses for options based on S&P and Dow Jones indices. After years of litigation, the Supreme Court decided against hearing an appeal filed by ISE seeking to overturn a lower court decision that blocked ISE from selling options on those indices without a license from the index provider. That brought the dispute to an end and reinforced the value of indices to their providers.

Buying an index provider is not the only way for an exchange to enter this business. It is also possible to create new indices. For example, CBOE created the VIX index, a measure of equity market volatility, and used that index to create a whole new family of volatility derivatives. Those products have been increasingly popular in recent years, especially after CBOE licensed the index to several exchange-traded funds. The funds not only drew more attention to volatility as an asset class, they also generated new demand for using futures and options to manage the flows of cash into and out of the funds.

"Close to 100% of the CBOE's futures business is based on VIX and around 40% of index options business is based on VIX," said Alex Kramm, analyst at UBS. "This means about 43% of total transaction fees and 29% of total revenue comes from VIX. And you could probably make a case that some of the other revenue lines, i.e. access fees, are partially driven by the VIX ownership."

The Next Frontier: Fixed Income, Credit and Commodities

Most of the acquisitions so far have focused on equity indices, but there is growing interest in other asset classes such as fixed income, foreign exchange and commodities.

This summer Barclays began talks with potential bidders for its fixed income index business, the largest in the fixed income sector. The business includes some of the most widely used indices for the corporate and government bond market, many of which it inherited through the acquisition of Lehman Brothers in 2008. The flagship of the group is the U.S. Aggregate Bond Index, a broad-based measure of the U.S. fixed income market, which is widely used by institutional investors to track the performance of their fixed income investments.

According to several news reports, a large number of companies have expressed an interest in buying this business from Barclays, including Bloomberg, ICE, Markit, MSCI and Nasdaq OMX. McGraw Hill and CME also are reportedly considering a bid, with the goal of merging the business into their S&P Dow Jones Indices joint venture.

LSE, which is also said to be on the list of potential bidders, already has a foothold in the fixed income sector. In April 2013, FTSE announced a partnership with TMX, the Canadian exchange group, to combine their fixed income indices businesses in a new venture, FTSE TMX Global Debt Capital Markets. One year later the joint venture bought the index business of MTS, which tracks the performance of the European government bond markets. The joint venture, which is 72.7% owned by FTSE, is now the third largest fixed income index provider globally with over $1 trillion in fixed income assets linked to its indices.

Benchmark Reform Brings Opportunities

Looming in the background is the Libor investigation. The London Interbank Offered Rate, which measures the rate banks pay each other to borrow, has been the most widely used benchmark in the fixed income markets and is embedded as a reference in trillions of dollars worth of loans, swaps and other fixed income products. Extensive investigations by government officials on both sides of the Atlantic revealed that Libor was so vulnerable to manipulation that comprehensive reforms were needed to overhaul the price setting process.

Similar reforms are underway for various other benchmarks in the foreign exchange and commodity markets. In those sectors, many of the existing benchmarks are not based on actual transactions, as is the case with the equity indices, but instead on information gathered by third parties from banks and other market participants.

This overhaul has created opportunities for the exchanges to take on the role of the benchmark fixer. For example, Libor itself is now produced and disseminated by an exchange. In February, the British Bankers Association formally handed over that responsibility to ICE Benchmark Administration (IBA), a newly created division of ICE that will operate the benchmark as a for-profit business.

IBA also won the contract to administer ISDAFIX, a set of interest rate benchmarks used to price over-the-counter swaps. Those rates previously were set by ICAP and Thomson Reuters, but earlier this year ISDA decided to shift to a new approach after ICAP was fined for manipulating Libor. The key feature that IBA offers is the ability to derive prices from actual transactions rather than on a survey of market participants.

"As part of its new responsibilities, IBA will transition the ISDAFIX calculation methodology from a polled submission model, where contributing banks submit price estimates, to a methodology based on actual and tradable quotes posted on multilateral trading facilities," ISDA said in April when it announced IBA's selection. "This change is designed to align the ISDAFIX benchmark with principles published last year by the International Organization of Securities Commissions for financial benchmarks, which were subsequently endorsed by the G-20 and by the Financial Stability Board."

It is not clear how much potential profit there is in this business. IBA introduced a new commercial model in July that requires users to obtain a license and pay monthly fees if they use Libor in valuation or pricing activities, including collateral calculations and pricing curves, or as a reference rate in loans, mortgages, swaps and other types of financial products. ICE also plans to charge market data vendors, trading venues and clearinghouses that use Libor in various ways.

These fees could add up to a significant amount of revenue given the widespread use of Libor, but some users are resisting the change. The American Bankers Association and the Independent Community Bankers Association, two associations that represent thousands of small and medium-sized banks in the U.S., have said that the new fees may cause their members to stop using Libor. In July, ICBA wrote to ICE saying the new fees are "unfair" and "exorbitant" and urged ICE to curtail the impact on smaller institutions and incidental users.

Jeff Sprecher, ICE's chief executive, said in August that his exchange is listening to these concerns and "fine-tuning" its licensing practices. But he also said there should be no surprise that making improvements to the benchmark costs money. "There has been a lot of criticism by people that they wanted Libor to be better, but then when they're asked to pay for it, they're surprised," Sprecher said on a conference call with analysts.

More generally, some analysts are skeptical about the value of fixed income indices like the Barclays U.S. Aggregate Bond Index because they see institutional investors moving away from relying on these indices to guide their investment strategies.

"I'm not sure how material the earnings are going to be for exchanges from those benchmarks at the end of the day," said Christopher Allen, managing director for research coverage in capital markets at Evercore. "The challenge is that more assets in fixed income are moving to unconstrained portfolios rather than being index-driven. I would speculate that the appeal of a fixed income business in a rising rate environment would be less than for other, similar businesses. When we talk to asset managers here, they see less opportunity in index fixed-income products."

In addition to the Libor reforms, government officials also are pressing the fixed income market to diversify away from all of the "IBORs" that are based on bank borrowing rates. In a report issued in July, the Financial Stability Board, which represents the world's leading central banks, recommended that borrowers should instead use "risk-free" rates such as the rates paid on government bonds or the rates set by the central banks themselves.

Here as well there may be opportunities for exchanges. The Depository Trust and Clearing Corp., the main clearinghouse for the U.S. fixed income securities market, publishes several indices based on transactions in the repo market. Liffe launched futures contracts based on three of those indices in July 2012. The contracts have been only moderately successful, but if the market shifts to using the repo index as a benchmark for short-term interest rates, that would create demand for futures to hedge that exposure.

Commodity Benchmarks

There is also growing interest in commodity indices. This summer, Bloomberg and UBS announced a partnership that will expand Bloomberg's presence in the commodity index sector. Bloomberg is now responsible for governance, calculation, distribution and licensing of the bank's commodity indexes, which have been renamed the Bloomberg Commodity Index Family. The flagship index is based on the prices of futures contracts for 22 commodities, while a set of sub-indices measure individual commodities and sectors such as agriculture, energy and metals.

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>
> **JEFFREY SPRECHER**
> *CEO Intercontinental Exchange*

A key factor driving the agreement was the perceived need to demonstrate that the indices are free from the problems that have plagued other bank-sponsored indices. Bloomberg executives commented when the deal was announced that Bloomberg's involvement would ensure the "true independence" of the indices' pricing system.

CME has targeted the precious metals market, which historically has relied on the "London fix" for daily reference prices. Earlier this year the exchange partnered with Thomson Reuters to provide a new version of the silver market's benchmark, in which market participants offer buy and sell orders for silver bullion using an auction model until an acceptable price is reached. Previously prices were set by the London Bullion Market Association via a telephone discussion with a handful of banks.

It is not clear yet what commercial benefit CME will derive from this arrangement, which began operating in August. The exchange declined to comment, but according to press reports, the exchange is expected to begin charging fees after a six month introductory period.

What is certain is that the index businesses will continue to appeal to exchanges in the short to medium term, said Gaston Ceron, analyst at Morningstar. "I can't say what assets will draw buyers' attentions next but I expect index businesses to remain an alluring play for exchange executives to diversify their revenue stream while traditional revenue lines face challenges," he said. "When you buy an index business you might get a foothold in a market that you are not already in. Who knows where that might lead. You might find opportunities to cross-sell or conduct other business in that market."

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