Surveillance of the commodity markets

Introduction

1 The Bank's involvement in the commodity markets arose particularly from the need to develop exchange control arrangements after the War to permit the reactivation of these markets which were essential to both producing and consumer interests. It was also recognised that this business offered the opportunity for significant invisible earnings for the United Kingdom. These factors have led the Bank, with their general concern for the financial stability of markets, to maintain a general oversight of the commodity markets. This has involved the Bank in recent years in regular surveillance both of the markets' operations, e.g. the performance of contracts and the monitoring of excessive, possibly destabilising, positions; and of the regulatory régime administered by the market authorities.

The markets

2 Commodity markets have been a feature of City life for generations. In these markets there are specialist firms who deal in physical commodities (known as 'actuals'); and others who provide merchanting facilities in the course of international trade which may in some cases never touch the United Kingdom. Many combine both activities. Reinforcing this trade in actuals are the terminal markets, often described as 'futures markets'. The function of those who deal in futures markets is to provide a medium through which those who produce or consume or merchant commodities may 'hedge' against the inherent price risks. A hedge can be defined as the taking up in a futures market of the position opposite to that held in actuals, i.e. one who is long of actuals sells futures to protect himself against price fluctuations. For example, if a manufacturer using cocoa has agreed to buy beans for cash against delivery in six months' time, but is meanwhile unable to fix a firm selling price for his product, he may hedge his price risk by selling futures in the terminal market. As and when sales of his own product are arranged, he will 'lift' the hedge by buying futures to cancel out the previous futures sales contracts. Thus manufacturers are able to insure against fluctuations in the price of their raw materials. Futures markets—and forward transactions on the London Metal Exchange (LME), some of which are akin to futures and some of which involve physical delivery—are the commodity markets with which the Bank are primarily concerned.
In addition to surveillance of the LME and the London Commodity Exchange (LCE), close liaison is also maintained with the Grain and Feed Trade Association (GAFTA) and the Liverpool Cotton Association. The commodities dealt in on the LME and the LCE are described in the two paragraphs which follow; other commodities are of course traded in London, such as furs, hides and skins, jute, tea, timber, etc. but there are no terminal markets for these commodities.

3 The LME is the world's leading market for cash and forward trading in copper, tin, lead, zinc and silver. Its Board of Directors has authority over the market but the general administration of the LME is the responsibility of a committee of fifteen representatives, elected annually by the subscribing members. Currently there are twenty-nine 'ring-dealing' members. Representatives of these ring-dealing firms form the core of the market when they sit together in the ring during the two daily sessions. Bids and offers are called out in open outcry across the ring both for actuals for cash (settlement on the next business day) and for forward transactions up to ninety days ahead.

Forward contracts entered into on the LME are often taken to delivery, i.e. result in the physical transfer, by warrant on a specified warehouse in the United Kingdom or overseas, of metal of standard quality. But forward contracts are also used by producers and consumers to hedge against price fluctuations: when this happens the forwards take on the characteristics of 'futures' contracts. Any deal done is for one or more lots: one lot of copper, lead or zinc is for twenty-five metric tonnes; one lot of tin represents five metric tonnes; while for silver one lot is the equivalent of 10,000 troy ounces.

4 The LCE deals in futures in certain 'soft' commodities—cocoa, coffee, oilseeds and fats, rubber, soyabean meal, sugar and wool—of a particular standard of quality and to a specification laid down by the individual market association relating to each commodity involved. Although normally closed out before maturity by a reversing transaction, the contracts provide for delivery at specified ports in the United Kingdom and elsewhere for varying periods ahead (in the case of rubber nearly as far as two years ahead). These futures markets are open all day, in contrast to the LME, but there are four 'call' periods lasting about ten minutes each, when quotations are obtained under the supervision of a call chairman for the various delivery months ahead currently traded. This call procedure does not apply to the wheat and barley futures markets which are run under the auspices of GAFTA on the Baltic Exchange. As with the LME only floor members of the soft futures markets may deal on the LCE. In both markets they sometimes trade for their own account; but more usually they enter into bargains for third-party customers.

5 These markets are international in character, not domestic. The proportion of foreign involvement varies from time to time, and from one commodity to another, but the main weight of activity originates from abroad. Commodity markets provide a valuable contribution to invisible earnings: in the Bank's March 1977 *Quarterly Bulletin* a range of £200–250 million was given for the year 1975/76, but the level of earnings depends upon turnover which itself reflects the trend of world trade.

The Bank's relationship with the markets

6 Before the War the commodity markets in the United Kingdom formed a part of the sterling system; produce came mainly from the Commonwealth, all trading was in sterling and London was the natural centre for futures markets in which to hedge against sterling price risks. During the War the commodity markets closed, as supplies became more and more the responsibility of government. After the War trading was returned to private hands, but the reopening of the commodity markets, and in particular futures markets, called for caution at a time of scarcity of foreign currency resources. The Bank pressed their view that the London futures markets should be permitted to reopen, so that sterling area producers and consumers buying and selling actuals could protect themselves from exposure to price changes. To guard against the possibility

of foreign exchange restrictions being avoided through commodity dealings, exchange control schemes were designed in the late 1940s/early 1950s as the markets reopened. Participation in the schemes was restricted to UK firms recommended by the relevant market associations and approved by the Bank. The schemes enabled participants to deal promptly with non-residents of the Scheduled Territories (i.e. the non-sterling area) through the operation of sterling and foreign currency accounts for the automatic payment and receipt of deposits and margins, and the settlement of differences. Participants were also given permission to hold stocks abroad, because otherwise international trade in actuals would have been frustrated. Basic to the schemes were the Memoranda of Understanding between the Bank and the market associations (a 1952 example is provided in Appendix 1). Briefly, the associations were called upon:

(i) to confine membership to merchants, agents, brokers, dealers, refiners and others having a continuing interest in the import or marketing of the commodities covered by the separate scheme;

(ii) to equip themselves with disciplinary powers; and

(iii) to consult regularly with the Bank regarding the general position of trade, the conduct of the market and the proper and orderly conduct of the markets and their members.

Close liaison between the Bank and the various market associations has continued for nearly three decades. There are regular formal liaison meetings between the representatives of the individual market associations and the Bank, supplemented by informal day-to-day contacts between Bank officials and market personalities.

7 The exchange control requirements are monitored through monthly returns from participants in the schemes. These enable the Bank to follow the pattern of individual trading and to aggregate the figures for the attention of the market associations if that seems desirable. Beyond that, the Bank will pass the name of any member of his association if disciplinary action seems to be needed, e.g. in respect of excessive stockholding or excessive long or short positions, which could indirectly involve currency speculation. Paragraph (d) of the specimen Memorandum of Understanding at Appendix 1 illustrates the nature of the regulatory relationship between the Bank and the market.[1] The Bank's aim has been to encourage the markets under the Bank's guidance to regulate themselves. The Bank's ultimate sanction lies in the withdrawal of exchange control consents.

Financial security of contracts and speculation

8 The Bank's relationship with the LME and the LCE in the exchange control context has naturally led them into the field of prudential surveillance of the markets. The Bank are concerned about the sanctity of contracts, and the honouring of bargains in markets with which they are known to be associated. With this and the possibility of undesirable speculation in commodities (see paragraph 11) in mind, particularly in the context of the boom in commodity prices in the early 1970s, the Bank had begun pursuing a policy of even closer relationship with the commodity markets. In 1974, when some ministerial concern was felt about the effect on prices of the workings of the LME and the LCE, the existing system of regulation and the Bank's increasing involvement in it were explained, and it was accepted that the Bank were in a position to keep watch on the markets, reporting whenever necessary to Whitehall. The Memoranda of Understanding between the Bank and the market associations originally devised for exchange control purposes were extended in 1974 (specimens are provided in Appendix 2) from participants in the exchange control scheme to all market members, so that further information might be gathered on market activity. (Participants are those who need exchange control concessions to speed up the manner in which they deal daily with non-residents, but associations have other members who deal mainly with UK residents for settlement in domestic sterling.)

Financial security

9 For the LCE contracts in soft commodities, the settlement system gives security through the intervention of the International Commodities Clearing House (ICCH), an independent company in which no member firm of the LCE has a financial interest.[2] In the course of clearing daily futures contracts, the ICCH in effect becomes the principal, taking over and guaranteeing these contracts and accepting responsibility for their performance. As the intermediary in the closing out or settlement of futures contracts entered into by LCE members, the ICCH (with whom the Bank are in close and continuous contact) enforces strict rules about the deposits and margins required from its members; thus it automatically and independently imposes financial discipline on the markets. Whenever necessary the ICCH will vary the level of deposits for contracts, both as regards individual members and as regards individual commodities, increasing deposits on occasions up to, and even beyond, 50% of the value of an outstanding contract. In this way the ICCH ensures that at all times it has complete financial cover; and at the same time, by varying the level of the cover it requires, it discourages the establishment of excessive positions. LCE dealings particularly lend themselves to the use of a clearing system because, since the soft futures markets are largely hedging markets, purchase and sales contracts tend to be closed out before the time of physical delivery. Only a tiny percentage of contracts run to delivery.

10 Although the LME is used as a hedging market, it deals primarily in physical metals, so that a clearing house on ICCH lines would be inappropriate to LME settlement. For some time the Bank have taken the view that it would be right for the LME to introduce a system which would demonstrate to all a greater degree of financial security, and reinforce the simple guarantee fund to which all members subscribe. The Bank pressed this need on the Board of Directors, which set to work to devise a new arrangement. There were numerous legal and practical difficulties, but these have now been substantially overcome and agreement has been reached within the LME for the establishment of the Metal Exchange Monitoring Operation (MEMO). This will show by daily monitoring the forward

[1] If '. . . in their [the Bank's] opinion an excessive position or unwarrantable speculation or any other undesirable situation or practice is developing, the Executive to take steps to check its further development, using if necessary its disciplinary powers on individual participants.'

[2] The pre-war clearing house for the soft futures markets, the London Produce Clearing House as it was then called, was a publicly-quoted company (of which Antony Gibbs and Sons were secretaries and managers) until 1950. In that year, and before these markets reopened, the clearing house was sold as an investment to United Dominions Trust. Its name was changed to the International Commodities Clearing House and it has operated as a profit-making subsidiary of United Dominions Trust ever since.

position of LME ring-dealing members, one with another, and so disclose trading by any member beyond the open position which the Board will establish for each member. It is hoped that the system will be fully operational later this year.

Speculative activity

11 It cannot be said that speculation in terminal markets is either good or bad: it is a question of balance. If speculative forces come to dominate a market they can produce unwarranted and undesirable movements in prices. On the other hand, the terminal markets cannot operate efficiently unless a measure of risk-taking is present, because trade interests alone are never likely to produce an exact balance of risk. Unlike the commodity markets in the United States where speculation plays a dominant rôle in balancing the markets, the London markets are predominantly used by trade interests on both sides of the market. The Bank's surveys confirm that the LME and the LCE are fully justified in claiming that they are traders' markets, and not highly speculative. In the early 1970s the Bank began to intensify surveillance by increased monitoring beyond the well-established procedures for ensuring that foreign exchange restrictions were not being circumvented by trading through the commodity markets. This has now developed into organised regular surveys into forward trading on the LME, and all futures positions on the more important soft commodity markets on the LCE. The 1974 extension of the Memoranda of Understanding to all market members [in particular the second part of paragraph (c)[1] of the 1974 Memorandum of Understanding with the LME and paragraph (d)[2] of that with the sugar market, provided in Appendix 2] paved the way for the gathering of more comprehensive data. The aim of these surveys is to enable the Bank to identify trends in the proportion of trade to non-trade activity, and where necessary to persuade market authorities to take steps against the building up of excessive positions. The data come from the ICCH in the case of the soft commodity markets, and from individual dealers in the case of the LME. There can, of course, be difficulties of identification, particularly where a London house is dealing for account of an overseas broking house. The Bank do not have the capacity to carry their enquiries beyond the United Kingdom; to attempt to do so would undermine the international use of the markets. Surveys take place as a matter of routine every week for the main soft commodities and every month for metals; but when prices are moving rapidly, trends need to be watched on a daily basis. In the case of the ICCH, this is possible through their computerised clearing system. In the case of the LME, arrangements have been made for the larger firms responsible for the bulk of the trade to produce information from their own computers as and when required by the Bank.

12 The surveys provide a basis for discussion with market associations of ways and means of correcting excessive non-trade activity, with the Bank either reinforcing or spurring action. There are a number of ways in which speculation can be discouraged, e.g. by the market authorities themselves, or the ICCH, calling for higher deposits; by the market authorities decreeing an increase in the size of a minimum lot; or ultimately by the market authorities recommending their members not to accept orders from non-trade sources, though the latter are not necessarily identifiable when instructions originate from broking houses overseas. In approaching the problem the authorities must always have in mind that the London markets are international, not simply domestic.

13 There have been a number of occasions when the Bank have pressed their views. For example, in 1976 the Bank became concerned about the increased amount of non-trade activity in the zinc market, and in May of that year the Committee of the LME, after a series of discussions with the Bank, advised ring-dealing members not to accept new business from non-trade sources. This ban was lifted in July 1976, after further surveys had revealed that a more normal relationship between trade and non-trade interests had been restored. From time to time over the years the positions in tin and lead have also been the subject of discussion between the LME and the Bank. In the soft commodities the ICCH in conjunction with the relevant market association has frequently affected members' positions by substantial increases in the deposits it requires; most recently, with the Bank's active support, in the cocoa and coffee markets in March and September 1977 respectively.

Financial assistance

14 During the 1960s a number of overseas sterling area countries, in the course of developing their local commodity markets, began invoicing their commodities in local currency. Forward exchange cover between the local currency and sterling was not, however, always available from local central banks: in such cases UK traders were unable to cover the currency risk. When sterling was devalued in 1967 many local currencies did not follow, so UK traders who had purchased for local currency and onsold through the London commodity markets on a sterling basis suffered exchange losses. The amounts involved were not large in national terms but were difficult for some smaller commodity firms to absorb. To ensure that bargains were completed, and with the reputation of the London international markets in mind, the Bank made loans totalling some £3½ million in respect of 80% of the net expected losses. The loans were repayable over five years at 5% per annum interest. Repayment of capital and interest was made in full in all cases.

Bank of England,
June 1978.

[1] '... the Bank of England may require members of the Exchange to provide such additional information as is necessary for a clear evaluation of their overall trading position.'

[2] '... the Bank of England and the clearing house used by the market to consult together regarding the trading positions of members of the market. The Bank of England may require members to provide such additional information as is necessary for a clear evaluation of their overall trading position.'

Appendix 1

Memorandum

Exchange Control Act 1947

London Metal Exchange

Metals

Dealings with buyers and sellers in any part of the world will be permitted to persons and firms recommended by the Committee of the London Metal Exchange subject to the exchange control arrangements set out in the Bank of England's Notice of today's date and to the following conditions:

(a) the Exchange to have a regular organisation, membership of which would be open to merchants, agents, traders and others having a continuing interest in the import or marketing of metals dealt in on the Exchange;

(b) the Executive of this organisation to equip itself with the powers necessary to enforce discipline on participants and to be responsible for using those powers to secure conformity with arrangements agreed from time to time;

(c) the Executive to be responsible for keeping itself informed on and to consult regularly with the Bank of England (acting on behalf of HM Treasury) regarding, the general position, trading and condition of the Exchange and such other matters as may relate to the proper and orderly conduct of the Exchange and its members;

(d) should the Bank of England (acting on behalf of HM Treasury) give notice to the Exchange Executive that in their opinion an excessive position or unwarrantable speculation or any other undesirable situation or practice is developing, the Executive to take steps to check its further development, using if necessary its disciplinary powers on individual participants;

(e) the monthly returns by participants referred to in paragraph VII of the Bank of England's Notice of today's date to be regarded as strictly confidential between the participant and the Bank, subject only to the following:

(i) the Bank may aggregate the figures contained in individual returns and supply a copy of the resulting aggregate return to the Exchange Executive;

(ii) if the Bank have given notice under (d) above and the Exchange Executive has in consequence indicated to the Exchange that discrimination should be used in the acceptance of business, and if the subsequent return of any individual participant suggests that that participant has failed to heed the Exchange Executive, then the Bank may pass the name of that participant to the Exchange Executive to whom, under the rules of the Committee of the London Metal Exchange, he will be required to furnish a copy of his return on request.

Bank of England,
11th September 1952.

Appendix 2

Memoranda

Exchange Control Act 1947

London Metal Exchange

This Memorandum comes into effect on the 9th December 1974 and, as from that date, replaces the Memorandum dated the 17 May 1967.

Dealings with buyers and sellers in any part of the world (excluding Rhodesia) will be permitted to persons and firms recommended by the Committee of the London Metal Exchange subject to the exchange control arrangements set out in the Bank of England's Notice EC Commodities 1 and to the following conditions:

(a) the Exchange to have a regular organisation, membership of which would be open to merchants, agents, brokers, dealers and others having a continuing interest in the import or marketing of metals dealt in on the Exchange;

(b) the Executive of this organisation to equip itself with the powers necessary to enforce discipline on members and to be responsible for using those powers to secure conformity with arrangements agreed from time to time;

(c) the Executive to be responsible for keeping itself informed on, and to consult regularly with the Bank of England (acting on behalf of HM Treasury) regarding, the general position, trading and condition of the Exchange and such other matters as may relate to the proper and orderly conduct of the Exchange and its members. The Bank of England may require members of the Exchange to provide such additional information as is necessary for a clear evaluation of their overall trading position;

(d) should the Bank of England (acting on behalf of HM Treasury) give notice to the Executive that in their opinion an Excessive position or unwarrantable speculation or any other undesirable situation or practice is developing, the Executive to take steps to check its further development, using if necessary its disciplinary powers on individual members;

(e) the information called for from members, whether contained in their returns under the Bank of England's Notice EC Commodities 1 or submitted in response to a requirement by the Bank under (c) above, to be strictly confidential between the member and the Bank of England, subject only to the following:

(i) the Bank of England may aggregate the figures contained in individual commodity position returns and supply a copy of the resulting aggregate return to the Executive;

(ii) if the Bank of England have given notice under (d) above and the executive has in consequence indicated to the Exchange that discrimination should be used in the acceptance of business or has otherwise introduced special restrictions, and if it subsequently becomes apparent that any individual member has failed to heed the Executive, then the Bank of England may pass the name of that member to the Executive, with whatever evidence may be in the Bank of England's possession, for disciplinary action to be taken.

Bank of England,
3rd December 1974.

London Sugar Market

This Memorandum comes into effect on the 9th December 1974 and, as from that date, replaces the Memorandum dated the 17 May 1967.

Dealings with buyers and sellers in any part of the world (excluding Rhodesia) will be permitted to persons and firms recommended by the Sugar Traders Association of the United Kingdom subject to the exchange control arrangements set out in the Bank of England's Notice EC Commodities 2 and to the following conditions:

(a) the market to have a regular organisation, membership of which would be open to merchants, agents, brokers, dealers, refiners and others having a continuing interest in the import or marketing of sugar;

(b) the Executive of this organisation to equip itself with the powers necessary to enforce discipline on members and to be responsible for using those powers to secure conformity with arrangements agreed from time to time;

(c) the Executive to be responsible for keeping itself informed on, and to consult regularly with the Bank of England (acting on behalf of HM Treasury) regarding, the general position, trading and condition of the market and such other matters as may relate to the proper and orderly conduct of the market and its members;

(d) the Bank of England and the clearing house used by the market to consult together regarding the trading positions of members of the market. The Bank of England may require members to provide such additional information as is necessary for a clear evaluation of their overall trading position;

(e) should the Bank of England (acting on behalf of HM Treasury) give notice to the Executive that in their opinion an excessive position or unwarrantable speculation or any other undesirable situation or practice is developing, the Executive to take steps to check its further development, using if necessary its disciplinary powers on individual members;

(f) the information called for from members, whether contained in their returns under the Bank of England's Notice EC Commodities 2 or submitted in response to a requirement by the Bank under (d) above, to be strictly confidential between the member, the Bank of England and the clearing house used by the market, subject only to the following:

(i) the Bank of England may aggregate the figures contained in individual commodity position returns and supply a copy of the resulting aggregate return to the Executive;

(ii) if the Bank of England have given notice under (e) above and the Executive has in consequence indicated to the market that discrimination should be used in the acceptance of business or has otherwise introduced special restrictions, and if it subsequently becomes apparent that any individual member has failed to heed the Executive, then the Bank of England may pass the name of that member to the Executive, with whatever evidence may be in the Bank of England's possession, for disciplinary action to be taken.

Bank of England,
3rd December 1974.