The changing foreign exchange markets

*In the R A O Bridge Memorial Lecture[1] the **Governor** reviews the changes that have taken place in recent years in the nature of the foreign exchange markets and discusses some of the implications they have for the central bank, both as a supervisor and as an operator in the markets.*

*The past six years have seen a massive expansion of foreign exchange business, reflecting increases in the number and range of participants and the development of new instruments, aided by technological change. But new instruments present new problems of risk and control, and the involvement of institutions from outside the traditional banking sphere also complicates supervision of the market. The **Governor** emphasises that the main responsibility for control and supervision of foreign exchange operations must rest with the management of the institutions concerned. He goes on to describe the Bank's supervisory approach to the new instruments, and particularly to options.*

*The **Governor** reviews the recent development of the foreign exchange broking system, including the abolition of fixed scales of commission, and comments on the Bank's policy towards ownership links between banks and brokers. Finally he looks at the role of the central bank as an operator in the markets and at the lessons of recent experience of co-ordinated intervention, sounding a note of caution on suggestions for the establishment of target zones, lest too ambitious a scheme undermine the progress made towards a better relationship between the major currencies.*

It is both a privilege and a pleasure for me to be here to speak to you this evening on what is, I know, the most important date in your Association's calendar. The sense of privilege arises from the origins of this memorial lecture and from the line of distinguished speakers who have addressed you in previous years. The pleasure comes from the fact that it is, I think, entirely appropriate for the Governor of the Bank of England to deliver a lecture which honours Roy Bridge. Mr Bridge not only had a notably distinguished career in the Bank but was also known and respected in foreign exchange circles throughout the world for his work in promoting the highest technical and ethical standards in the market. His concern for the efficiency and health of the market was appropriately marked when he was elected the second President of the international FOREX organisation in 1962—the only British President of the ACI until the current President, Geoffrey Munn, was elected three years ago. In giving this lecture I pay tribute to Roy Bridge's contribution and achievements both in the service of the Bank of England and in the wider world of the foreign exchange market.

On a more personal note, I am glad to have the opportunity of making amends now for the occasion three years ago when I was unable, at the last minute, to address you. In matters of foreign exchange I am well aware that an opportunity lost may well have gone for ever. I am delighted that you have given me a second chance.

My predecessor as Governor of the Bank, Gordon Richardson, six years ago delivered the first of these Lectures with the theme of 'Liberty without licence'. Much of what he said at that time continues to be relevant today. But there have been considerable changes in the nature of the foreign exchange markets since Lord Richardson spoke. Hence my title this evening is 'The changing foreign exchange markets'. I should like to start by reviewing some of these changes and then move on to discuss some of the implications which they have for the central bank, both as a supervisor and as an operator in the markets.

Developments in the foreign exchange markets

Foremost amongst the changes, I suppose, is the enormous increase in the volume of business. Hitherto, there have been no accurate figures for the daily turnover in foreign exchange in London and we have had to rely on guesses at the size of the market. The Bank of England has therefore recently taken steps to fill this gap through a turnover survey over the past couple of weeks in which you were invited to participate. When the questionnaires have been collated and analysed, we hope to be able to give reasonably accurate estimates for the volume of foreign exchange business in London both in total and in each of the major currencies. In passing, I should like to take this opportunity of thanking you collectively for your co-operation in connection with this survey—and I hope you will return the questionnaires to the Bank as soon as possible. We recognise that it is a considerable burden upon you to provide the information we are seeking but we believe that it will be of widespread interest. We hope

(1) Delivered to the Forex Association London on 18 March.

that, when the aggregated results of the survey are published later this year in the Bank's *Quarterly Bulletin*, you will think the effort which went into providing the data was worthwhile.

New participants in the markets

But to return to my theme, I have no doubt that, had a survey been conducted in 1980 against which the results of the current exercise could be measured, we would find a massive increase in business over the six-year period. This increase has come about partly because there are many more banks active in foreign exchange in London than there were six years ago; but also the range of participants—players, as you would no doubt term them—has widened considerably in the period partly, in the case of sterling, as a result of the progressive effects of the ending of exchange control.

Two particular types of institution have become more active. First, there are the multinational corporations. They have always been an important feature of the market, mainly as customers of the banks. But a number of them have in recent years increasingly assumed a higher profile. In some cases they have set up in-house banking organisations through which they have acted as principals in the interbank foreign exchange market. This has meant that foreign exchange activities have come to be regarded as a profit centre in their own right by some major corporate operators. Secondly, there has been greatly increased activity in the market arising from the operations of investment houses. Their involvement in the exchange markets very frequently arises from their activities in other markets, in particular the capital markets. As the financial markets have developed over the years, barriers between the different markets have been broken down. Markets have become more interdependent, and the opportunity for profitable cross-market operations, in which a foreign exchange transaction is just one element in a complex financing package, has increased. The broadening of these markets to include active participants outside the traditional banking spheres is a development with potentially widespread ramifications which need to be carefully considered by the central bank responsible for the general oversight of the market.

Development of new instruments

The second change is that this upsurge in turnover has occurred not only in the conventional markets but also through the development of new instruments such as foreign currency options, forward rate agreements and interest rate swaps. To some extent business in these instruments may have replaced conventional business, in the sense that a corporate treasurer may now enter into a foreign currency option whereas six years ago he would have transacted an outright forward deal; or a bank may take out a forward rate agreement rather than do a forward/forward deposit transaction to hedge an interest rate exposure. Even so I have little doubt that the overall effect of the new instruments has been expansionary. The working of the market in these instruments will have been assisted by the publication of the British Bankers' Association's very successful booklets setting out standardised terms and conditions for trading in such instruments. I congratulate the BBA in taking an initiative which I believe has served to give London the lead over other financial centres in facilitating the trading of such instruments.

These two developments, more players and more instruments, have been accompanied, indeed I would say made possible, by another development since 1980, namely the progress which has been made in improving the technology available to dealers and brokers in the market. Without a sophisticated computer system, the techniques which have been developed for hedging exposures would not have been possible and it is very doubtful whether dealers and back offices could have handled the increase in business which has occurred.

Some would say that these developments are regrettable; that the improved technology has given greater scope for technical trading based on charts and short-term horizons; and that increased volume, new instruments, instant news and more players have generated greater exchange rate volatility. This may be so. But on the other side I think one should welcome the way that the market has developed new instruments to provide protection against the unpredictability of interest rate and exchange rate movements. One should also recognise the fact that, through all the ups and downs of exchange rates, the London foreign exchange market as a market has continued to function extraordinarily well. There have been relatively few occasions in recent years when I think the market has become 'disorderly' and the credit for this rests with those of you who have continued to make a market in the major currencies in foul weather as well as fair.

Changes in the broking system

In recounting market developments, I should perhaps pause and note one further, more parochial, change in the structural scene since 1980, namely, the abolition last year of fixed scales for brokerage here in the London market. The Bank of England assumed formal responsibility for the recognition and supervision of foreign exchange brokers in the late 1970s and, until the beginning of this year, issued scales for brokerage to be charged on foreign exchange and currency deposit business in London. This was, I am sure you will appreciate, an invidious task for the Bank. Sometimes it seemed that we could please *none* of the people *any* of the time. Some flexibility was introduced into the system in the early 1980s by the agreement that discounts on amounts of brokerage paid above a certain fixed level could be freely negotiated but, in the light of developments elsewhere in the City and, in particular, the prospect of the ending of fixed scales of commission in The Stock Exchange, we felt it was no longer appropriate for the levels of brokerage charged in these particular markets to be the direct responsibility of the Bank. There will no doubt be increased competition between the brokers as a result of the disappearance of

fixed scales and this in turn may in due course lead to changes in the structure of the broking sector, although we would not want the number of individual companies to be drastically reduced. But, whatever the advantages of fixed scales, we felt that market forces should now be allowed to have greater influence in this area as in so many other areas of your business.

In mentioning changes in the structure of the broking system, I ought to say a word about our attitude towards ownership of brokers, as this has been in the news recently. The Bank's attitude has its origins in the period before the Second World War when separation of principals and brokers was felt desirable to avoid the malpractice and conflicts of interests then prevalent in the market. The principle of separation was reconfirmed when the market reopened in 1951. It was given more formal expression in the mid-1970s in the so-called 'O'Brien Letters'. The fact that these letters are known as the O'Brien Letters has led some commentators to assume that the rules were introduced when Lord O'Brien was Governor of the Bank and have remained unchanged since. The position is that the rules were first issued formally in the mid-1970s when Lord O'Brien was President of the BBA. Moreover, we have not stuck rigidly to the rules set out in the first O'Brien Letter. Less than two years ago, following discussions with the banks and brokers, we changed the rule to allow shareholding links between individual banks and individual brokers, provided they were less than 10%. We did this because we felt that, with more mergers and links being formed in the City, it was no longer necessary or desirable to maintain the previous absolute ban on such links, except for shares in a quoted company, where up to 5% was permitted. But the easing in the limit to allow links of under 10% was deliberately chosen at a low enough level to prevent the shareholder exercising any great influence over the other party. In this way the neutrality of the broking system was clearly demonstrated and there was less likelihood of a suspicion of conflict of interest arising in relations between principals and brokers.

The maintenance of strong independent broking firms is an important feature of your market. Before we could consider changing the rule, we would want, first, to be satisfied that both the banks and the brokers were in favour of a change; and, secondly, to satisfy ourselves that such a change was in the interests of the foreign exchange market as a whole. Markets work in different ways and in response to different pressures. It does not follow that structures and practices that seem appropriate in one market should necessarily be allowed in others. We have to consider, in consultation with the practitioners, what is the best system for each market.

Supervisory implications

The changes which I have outlined mean that the markets in which you are operating each day are larger, more complex, and probably more hazardous, than ever before. These considerations underline the need for continued prudence and tight management control of foreign exchange and currency deposit operations. Moreover, the special features which have long been peculiar to these markets remain: relatively junior dealers have the power to commit their institutions for large amounts of money; and the costs of mistakes can be very high. In the long-established areas of foreign exchange trading these risks are probably well appreciated. But we cannot necessarily be so confident that this is the case with new instruments. The senior foreign exchange management in most banks have had direct experience of trading some time in the course of their earlier careers and understand the difficulties dealers face. But new instruments present new problems of risk and control. How then do we, as a central bank, react to these developments?

First, the developments emphasise the traditional need for vigilance and tight control systems on the part of managements. Whatever rules or guidelines the central bank may prescribe, the main responsibility for control and supervision of foreign exchange operations is bound to rest with the management of the institutions concerned. The environment in which you each ply your skills can change so rapidly: not only exchange rates, but the positions of individual institutions. Only those in, or close to, the front line can exercise the fundamental day-to-day control which is essential. This need for control extends beyond positions taken to questions of ethical standards. We like to feel that the standards in the London foreign exchange and currency deposit markets are the highest in the world and it is in all our interests that this situation should continue. The Bank of England has always sought to give a lead, and, with the help of banks and brokers in the market through the Joint Standing Committee chaired by the Bank of England, to promote the highest standards, for example, through the Guide to Market Practice. In this respect your markets are ahead of many others. But in these changing and turbulent times, it is more important than ever that the agreed procedural rules and standards of conduct in the market should be known and followed as closely as possible. To give one example, I mentioned the ending of fixed brokerage scales a moment ago. Free negotiation of brokerage carries its own risks and so we have stressed the importance in our view of these negotiations being handled in individual institutions at a suitably senior level and not left to dealers and brokers on the desks.

Options

I mentioned the problems of new instruments and would like to describe the Bank's supervisory approach to them, and particularly to foreign exchange options, in a little more detail. As you know, we have had a risk measurement and reporting system for foreign exchange in place since 1981. I believe it has served us well and it has proved capable of accommodating new instruments such as futures and more recently foreign currency options. Indeed, I think I can claim that the Bank was one of the first supervisory authorities to address the complex issues involved in options and to come up with what is generally regarded as a sensible and workable approach.

Before describing what this is, and drawing some conclusions from our experience, I would like to explain why we needed to act early in 1984. Options are very different in nature from other instruments. The distribution of both market and credit risks between writers and buyers of options is asymmetrical, the buyer in theory having the possibility of a large profit, the writer an unlimited loss if he does not hedge his exposure. The buyer risks his premium and the writer's ability to perform, whilst the writer faces no credit risk once the premium is paid.

I believe that the rather painful lessons which some banks have learned in the past year or so will prove to have been very valuable in conditioning attitudes to this business. Periods of great volatility in exchange rates did result in losses for a few banks which were manageable but the post mortems have led to some scaling down of business. Some banks have decided to leave the field altogether. Since we cannot rule out further volatility, a significant degree of caution is clearly wise.

Our policy, in simple terms, rests on making a distinction between those banks which have demonstrated to us a sophisticated approach and those which are either working towards this or are only interested in limited scale activity. Besides considering the knowledge and experience of the dealers we pay particular attention to a bank's whole approach to this business. For example, we wish to be sure that the senior management of banks are clear precisely which transactions their dealers are permitted to undertake, that they have set limits to control the risks, that they have a system of monitoring not only the current profits but also potential losses should exchange rates or the market's perception of volatility change, and finally that adequate resources are devoted to the business. Regrettably, decisions are sometimes taken to embark on new areas of business with little regard for the increased workload put on the support functions of back office staff, financial control and accounting. For the more experienced, we take account of the exposure calculations produced by their own mathematical formulae in our assessment of open foreign currency positions against guidelines. For the rest, we adopt a deliberately 'worst case' view.

This approach may be capable of being developed in other areas of banks' business. It is attractive in principle because it does allow some differentiation between institutions and, as you know, we believe as far as is possible in tailoring our supervision to the particular circumstances of individual institutions. This obviously has to take place within the framework of general principles applied fairly to all the banks we supervise.

Off balance sheet exposures

With the exception of options, the risks involved with new products appear to us to be in principle no different from those associated with traditional banking business. However, they do not for the most part result in conventional balance sheet exposures and often present considerable risk measurement problems. The challenge for both individual bank managements and also bank supervisors is to devise appropriate ways of recognising, measuring, and controlling these perhaps familiar risks such as foreign exchange, interest rate and liquidity risks which are no longer associated with any underlying asset or liability. As well as measuring and controlling specific individual risks there is, moreover, a growing need to develop a fully integrated approach to the management of a bank's total risk portfolio.

The Bank has reviewed how to capture the credit risks arising from a number of off balance sheet activities including foreign exchange instruments. It is clear that there are credit risks in many of the newer instruments which need to be captured in the risk asset ratio measure in some way. Following a number of informal discussions with bankers and auditors last year, the Bank will shortly be publishing a consultative document to form the basis for further and wider discussions with banks and other interested parties on how these credit exposures might best be captured within the risk asset ratio system currently employed. We look forward to stimulating and constructive discussions which will, I hope, produce reasonable and workable solutions to many of the very difficult issues with which we are all grappling.

For some years now, we have been engaged in discussions on supervisory issues with colleagues in other countries both bilaterally and in international groups. The paper on off balance sheet exposures recently published by the Basle Supervisors' Committee and which deals particularly with the kinds of instruments I have been discussing is an example of the sort of work being undertaken at the international level. While it would be unrealistic to expect too much too soon from such international co-operation, the proposals put forward during the past year or so by the Federal Reserve Board and the Japanese authorities—and indeed our own forthcoming consultative document—do demonstrate I think a significant move towards convergence on supervisory issues.

The central bank as an operator in the exchange markets

I come now to the last part of my talk, where I would like to say a little about the role of the central bank as an operator in the exchange market. In so doing, I commend to you some wise words of Sir Winston Churchill: 'There is no sphere of human thought in which it is easier for a man to show superficial cleverness and the appearance of superior wisdom than in discussing questions of currency and exchange'.

Some of you may recall that after the Williamsburg summit in 1983, the Finance Ministers of the Summit countries endorsed the conclusions of the so-called Jurgensen Report on exchange market intervention. The Finance Ministers' statement recognised that the role of intervention could only be limited; that it could counter

disorderly market conditions and reduce short-term volatility; and on occasions express an attitude towards exchange markets. But that it would normally only be useful when complementing and supporting other policies. The statement concluded that the Ministers were willing to undertake co-ordinated intervention in instances where it was agreed that such intervention would be helpful.

One of the reasons why the ability of any individual central bank to influence its exchange rate is limited is the enormous volume of business in the major currencies compared with the comparatively modest levels of most countries' exchange reserves. But the psychological effect of co-ordinated intervention can have an impact greater than the sum of the individual contributions: furthermore, the reserve constraint is eased if the United States authorities are actively involved. If, say, *all* the major central banks are selling dollars, the European central banks will be losing reserves, but the US authorities will be gaining reserves; and vice versa. This may not help the central bank which is losing reserves but it allows greater scope for intervention in total.

The main event in this context last year was the so-called Plaza meeting of the G5 last September. At that meeting the G5 Ministers and central bank Governors expressed their view that changes in economic conditions in their countries had not been reflected fully in the exchange markets; that some further appreciation of the main non-dollar currencies against the dollar was desirable; and that they stood ready to co-operate more closely to encourage this. You will all be familiar with events since then. There has been much more frequent and substantial intervention by G5 countries in the exchange markets and the markets now seem more disposed to take account of the views of officials on exchange rates—excessively so, some of you may think—as well as of official actions. I would not want to suggest that the course of events since the Plaza meeting means that exchange market intervention can work wonders or that the views expressed at the Williamsburg summit were too modest. But I think that experience since the Plaza meeting shows that forceful co-ordinated action by the major countries in the exchange markets can play a major role in producing a more satisfactory relationship between exchange rates and that we may have leaned too far previously in the direction of leaving everything to market forces.

Of course, there were other reasons for the success of the Plaza agreement. First and foremost it was a US initiative and the US authorities were seen to be in whole-hearted support of its provisions. There had been episodes of co-ordinated intervention in 1984 and early 1985 but on these earlier occasions I think the market felt that the US authorities were somewhat lukewarm in their support. The Plaza agreement and its aftermath showed clearly that the US authorities were concerned about the strength of the dollar and the protectionist pressures to which this was giving rise, and that they were prepared to take action to reduce them.

Some commentators have suggested that the 'success' of the Plaza operation means that we could go further and set up a system of target zones or the like for the major currencies. I will conclude with a few comments on that issue.

The first is that any move towards greater management of exchange rates requires not only exchange market intervention but also the political willingness on the part of the major countries to adapt their domestic policies to exchange rate considerations. This is more important than the technical design of any system. I think it is still too early to tell whether the progress which has been made in this respect since the Plaza meeting could be converted into a long-term commitment of this sort.

Secondly, there is a great deal of difference between the sort of pragmatic agreement and co-operation which we have seen since the Plaza meeting and the quite specific requirements of a system where exchange rates had to be maintained between known margins. The existence of such margins could become a challenge to the market. We would not have the option which we now have of letting the rate move and then deciding whether to act: we would have to act to prevent the rate moving. Although the EMS has shown what can be achieved in a system of fixed exchange rates, it must be remembered that the commercial, trading and institutional links between the member countries are strong and the degree of political commitment to make the system work, to which I have just referred, palpably exists. It would be an altogether different problem to try to keep all the world's major currencies within a framework of that sort, albeit with wider margins.

For the time being, I think that we have to proceed gradually, to feel our way forward and try to agree on how we should respond to changing developments, both in the major economies and in the exchange markets. If we attempt too ambitious schemes there is a risk that these could come unstuck and undermine the progress which has been made towards a better relationship between the major exchange rates.

I have covered a lot of ground this evening. Much has changed in the exchange markets since Roy Bridge was in his heyday. But I am sure that he would have been pleased to see that the London foreign exchange market continues to be the world's leading foreign exchange centre. He would also recognise that this pre-eminence has not been easily won and is in large measure due to the standards of integrity and professionalism which he did so much himself to promote. It is as important as it ever was that we should all—participants and supervisors—do our part in future to ensure that these standards are not eroded.