The commodity futures markets

This article[1] reports the results of a survey of firms operating in the London commodity futures markets conducted by the Bank at the beginning of this year. The results indicated that:

- *firms in the survey traded futures contracts covering a total of thirty commodities during January 1986, four fifths of which were placed with UK exchanges;*
- *few firms in the survey may be considered to be large employers compared with companies in the industrial sector and only six employed staff overseas;*
- *client business predominated in participants' portfolios, with firms serving a principally European client base;*
- *following the downward trend in earnings over the last four years, the London commodity futures markets appear to have entered a new phase of re-appraisal and consolidation;*
- *there is general support for moves towards more integrated markets, including the increased participation of independent ('local') traders;*
- *commodity options will probably be an important growth area in the London markets in the next few years.*

In general, participants in the survey felt that the London commodity futures markets would need to be flexible in responding to changing circumstances in order to remain competitive with their counterparts overseas. Events in the survey period (December 1985 to April 1986) were strongly influenced by the suspension of tin trading on the London Metal Exchange (LME) on 24 October last year following the default of the International Tin Council (ITC). This default, and the failure of subsequent lengthy efforts to arrive at a negotiated settlement of the ITC's obligations, led to heavy losses for some firms. These losses are not reflected in the profits data included in this article, which in most cases covered periods ending before October 1985. As a result, a marked deterioration in profits may be expected this year for those firms which were most adversely affected.

Introduction

The commodity futures markets, some of which were established over a hundred years ago, have long played an important part in the role of London as an international financial centre.[2] Yet, perhaps surprisingly, apart from exchange turnover and price data, there has been only limited aggregated information available on companies in these markets and on their activities elsewhere in the world. This article reports the results of a survey of firms active in the London markets, undertaken by the Bank between December 1985 and April 1986, in an attempt to fill that important gap.

The survey was designed principally to establish the current distinctive features and international positions of UK commodity futures markets and firms. In this respect, it reflects the future shift of emphasis in the Bank of England's interest in the commodity markets from that of market surveillance—a function which from 1987 onwards will be shared by the Association of Futures Brokers and Dealers (AFBD) and the Securities and Investments Board (SIB)—to a more general concern with issues of a structural nature which have an important bearing on the health and efficiency of the London markets.[3] A subsidiary aim was to obtain data of use in refining the estimates of net commodity earnings in the UK balance of payments statistics. (Current estimates are based on a survey undertaken by the Bank of England between June 1974 and May 1976, the results of which were published in the March 1977 *Bulletin*: see also Appendix I.) The focus of the enquiry, accordingly, was the UK commodity futures markets rather than the

(1) Written by Fiona G Ashworth of the Bank's Financial Supervision—General Division.
(2) For the purpose of this article, the term futures is used to include LME contracts, which are more strictly forward contracts between principals.
(3) The Bank of England's role in the commodity markets was discussed in 'Surveillance of the commodity markets' in the September 1978 *Bulletin* page 398 and 'UK commodity markets' in the September 1975 *Bulletin* pages 244–50.

markets in physical trade or financial futures. Nevertheless, in order to establish the relative importance of the UK commodity futures markets for participants in them, some background information was also requested on the activities of firms on other futures markets in the United Kingdom and overseas and on their physical merchanting business.

The survey consisted of two parts. The major component was a statistical questionnaire circulated to ninety-three firms in London; these included most of the major participants in the commodity futures markets and a sample of smaller, more specialised companies. The other element in the survey was a series of interviews with twenty-five of the firms which had been recipients of the questionnaire. The interviews covered issues which were qualitative rather than quantitative in nature with a view to building up a fuller picture of the current condition of the market and the major influences on it. Further details on both parts of the survey and on the terms which were used in the questionnaire are included in the appendices.

The London commodity futures markets

The term commodity generally refers to primary or semi-manufactured goods as opposed to manufactured products. Commodity trades may be either 'physical' or 'futures' in nature. The physical markets are distinguished by the fact that contractual obligations are usually bilateral and not readily transferable: they confer an obligation to buy or to sell specific goods in agreed amounts now or at or within a stipulated time in the future with the price or pricing basis agreed in advance. A futures contract, in contrast, is standardised and may therefore be transferred without difficulty. It may be defined as an obligation to buy (to take delivery of) or to sell (deliver) 'lots' (goods of a completely standardised quality traded in standardised quantities) at a specified price on an agreed date in the future. In view of the functions that futures contracts fulfil, considered in more detail below, only a small percentage run to delivery. It is also possible to take out or to grant an option on a futures contract. An option confers the right (but not the obligation) to buy or to sell a futures contract at some time in the future on specified terms.(1)

Operations in commodity futures markets serve a variety of functions. Key among them is the desire of producers, consumers and merchants to insure ('to hedge') against adverse changes in price. One method by which they do so is to buy and sell futures contracts to offset uncovered commitments in the physical commodity so that, if the price changes, losses or gains in one match gains or losses in the other. Although this form of hedging cannot usually provide complete protection against adverse price movements, because of differential movements in prices between types and qualities of a particular commodity it can substantially lessen the risks involved. Producers, manufacturers and merchants also use the futures markets to establish a firm pricing basis for the sales or purchases they envisage making in the future. In addition to these 'trade-related' interests, commodity futures markets are also used by individual investors and by firms trading on their own account to attempt to profit from (correctly predicted) movements in prices. Such participants, by increasing liquidity and market efficiency, are a necessary ingredient in creating a favourable operating environment for hedging activities. Options, finally, are particularly attractive from the point of view of takers (purchasers) as a method of limiting risk in markets where it is difficult to predict price movements, but where the range of such movements is potentially wide.

London's role as a centre for commodity trading owes much to the rapid expansion of its entrepôt business in the physical trades from the eighteenth century.(2) A wide range of commodities is currently traded on the physical markets. The London commodity futures markets, in contrast, were established somewhat later and are more specialised in nature. A feature of futures business is that such trade is usually conducted within the framework of an organised exchange.(3) In London, the exchanges in question are:

- the London Metal Exchange (LME), for aluminium, copper, lead, nickel, silver and zinc;(4)
- the London Commodity Exchange (LCE), for cocoa, coffee, sugar and rubber;(5)
- the International Petroleum Exchange (IPE), which is closely associated with the LCE, for crude oil and gasoil;
- the Agricultural Futures Exchange (AFE), for (European) wheat, barley, soyabean meal, potatoes and meat;
- the Baltic International Freight Futures Exchange (BIFFEX), for contracts based on cargo rates.(6)

Mention should also be made of the London Gold Market (LGM) and the London Silver Market (LSM), both of which fulfil an important function in respect of price determination. However, neither may be considered a futures market in the sense defined above and neither, accordingly, was included for detailed consideration in the survey.(7)

(1) For background information on options, see J Parry, ed. *Guide to World Commodity Markets*. New York, 1982.
(2) See, for example, *The History of the London Commodity Markets*. Commodity Analysis Ltd. London, 1978.
(3) No figures are available on total off-exchange transactions. However, according to anecdotal evidence gleaned from the survey, such transactions do not represent a high proportion of total transactions in London. In the United States, in contrast, all transactions except for an exchange of physical commodities for futures contracts must be placed across the floor of an exchange.
(4) Trade in tin was suspended in October 1985.
(5) Trade in rubber and soyabean oil futures has been dormant in recent months. In April of this year, the London Rubber Terminal Market Association launched a new futures contract based on a rubber price index.
(6) BIFFEX was not included for detailed consideration in the survey since contracts were based on an index rather than on a primary commodity. However, several firms reported that they engaged in transactions on BIFFEX in January 1986.
(7) However, a few respondents mentioned that activity in these markets formed an important part of their overall commodity portfolio in January 1986. The London Gold Futures Market was closed in 1985.

An important aspect of the functioning of the London commodity futures market is the part played by the International Commodities Clearing House Ltd (ICCH), which provides clearing services for most of the soft commodities. In effect, ICCH, like clearing houses elsewhere in the world, becomes guarantor to the financial obligations of the underlying contract and accepts responsibility for its financial performance to ICCH members. Its other functions include the management of physical deliveries and the monitoring of members' positions.(1) Discussions are also underway at the LME for the introduction of full, independent clearing arrangements; these are considered necessary in order that the exchange meet one of the SIB's basic criteria for recognition as an investment exchange under the forthcoming financial services legislation.

Mention should also be made of important administrative changes which are in train at the LCE. The LCE became a limited company, LCE (1986) Ltd, in March of this year with the aim of centralising policy on issues such as marketing, business strategy and the provision of services. (Prior to that date, the LCE was an umbrella organisation, with the main administrative and financial functions vested in a series of market associations for each commodity.) The LCE is planning to move to new premises at St Katharine Dock early next year and Mr Saxon Tate, the first full-time chairman of the LCE, has stated that he plans to use the move as an opportunity for the Board to revitalise the LCE's business. Serious consideration is being given to an open plan trading floor, such as those in Chicago and New York, and a licensing system to enable independent traders ('locals') to transact a variety of contracts.(2)

Commodity futures contracts traded elsewhere are too numerous to itemise separately. However, the most active markets—both in volume terms and in respect of the range of contracts traded—are located in the United States. Commodity futures contracts are also traded in Australia, Brazil, Canada, France, Hong Kong, Malaysia, the Netherlands, New Zealand and Singapore.(3)

A major influence on the level of activity and the performance of firms in commodity futures markets in London and elsewhere is the actual and expected level and movement of prices in the underlying physical markets. Following the recovery in primary product prices in 1979/80, prices fell back, reaching a trough in 1982—the first year for which data were provided by firms in the survey. In real terms, the price of industrial raw materials in that year was at its lowest point for at least twenty-seven years and real food prices were at their lowest since 1971.(4) The price recovery which followed reached a peak early in 1984 but real prices have been falling ever since. At the beginning of 1986, in consequence, partly as a result of the influence of the crisis in the tin market, real prices were well below their 1982 trough levels.

The results of the survey

General

The results of the survey are presented by subject below. (As indicated earlier, the definitions used have been relegated, for ease of exposition, to Appendix II.) It should also be noted that firms who participated in the survey are not referred to individually for reasons of market confidentiality.

Coverage and response rate

In practice, events in the tin market at the beginning of 1986 made it a difficult time for a questionnaire on the commodity futures markets. The response rate of 72 per cent (sixty-seven of the ninety-three firms originally approached) was therefore considered to be satisfactory—particularly given that a few firms were unable to complete the questionnaire on account of major re-organisations that they were undertaking.(5) It was also agreed that it would not be relevant for a few of the smaller firms to reply since they had recently either ceased to engage in or engaged in only minimal futures market activities.

It is difficult to judge with precision the proportion of the UK commodity futures business which has been captured by the survey since at least some firms included 'off-exchange' transactions in the section relating to their futures portfolios. There is also the problem of double-counting inherent in the portfolio analysis of firms operating in the same markets. However, the main purpose of the exercise was not to establish precise figures but rather to gain an insight into the workings of the UK futures markets and firms. To this end the statistical data was complemented with anecdotal information obtained from the interviews. In terms of market membership, every commodity futures market in London was amply represented with participants holding an average of six memberships. Firms in the survey probably covered at least half and in some cases a substantially higher proportion of turnover on the London exchanges in January 1986.

Ownership structure

All but two firms in the survey were limited companies, the balance being partnerships. Most of the limited companies were subsidiaries of other companies and only seventeen had subsidiaries of their own. The pattern of

(1) For further details on the ICCH, see ICCH *The Role of the International Commodities Clearing House Limited in providing Clearing and Guaranteeing Services for Futures Markets.*

(2) An interesting recent review of changes which are being contemplated was provided in *Futures and Options World*, vol 177 (January/February 1986).

(3) For a survey of US futures contracts, see 'Trading Facts and Figures', *Futures Magazine: 1985 Reference Guide* (1985). For general information on these and other markets see, for example, ICCH, *Commodities and Futures Yearbook 1984/85* (London, 1985) and Parry, *Guide to World Commodity Markets.*

(4) The measure of real prices used here is the dollar index deflated by the dollar world price of manufactured exports. For further details on this subject see page 172.

(5) However, it was not possible to use data provided by one of the firms since they related largely to the activities of the firm's parent overseas.

ownership among commodity firms was also characterised by the strong equity interests of overseas residents. Over a third of the firms in the survey, for example, had overseas shareholders; in most of these cases, these held 100 per cent of the company's voting share capital.

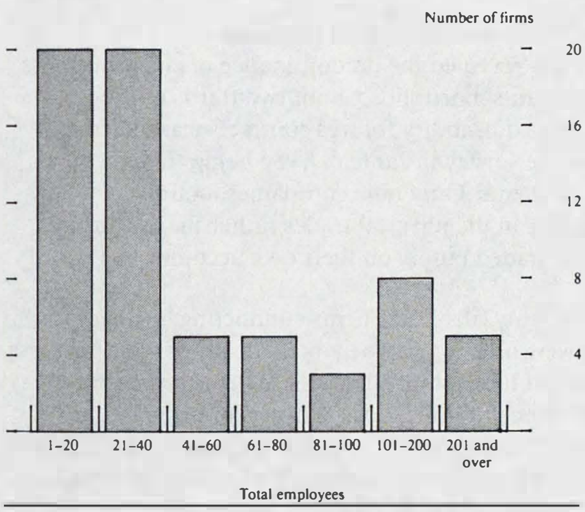
Capital structure

As in the case of ownership structure, the firms in question shared a relatively simple capital structure: only nineteen of the companies had issued shares other than ordinary shares; of these, about half were preference shares. Shareholders' funds, comprising issued share capital and reserves less intangibles (see Appendix II), ranged from about £57,000 to £65 million per firm and amounted to about £459 million in total, about four times the level of issued share capital.

Number of employees

An indication of the number of staff employed per firm by participants in the survey is provided in the chart. From this, it is clear that few of the participants in the survey may be considered to be large employers, particularly when compared with companies in the industrial sector.

Number of employees per firm



The total number of staff employed by all firms in the survey was 5,243. However, only thirteen firms employed more than a hundred staff and only twenty-six firms more than fifty. Twenty firms employed as few as twenty staff or less. It is not surprising, given their small average size, that only six of the firms in the survey employed staff overseas.

Some perspective was given on the firms' methods of recruitment and training by the series of interviews held with participants. Staff were recruited from a variety of sources, from school-leavers and university graduates at one end of the scale to experienced traders at the other. Most firms considered that the most important training took place 'on the job' and only a few organised formal training programmes. In-house training was supplemented by external courses from time to time—notably, those run by the London exchanges.

Table A
Average turnover; 1982–85
£ millions; *percentage changes in italics*

Financial year(a)	Turnover per firm	Change in turnover
1983	62.8	..
1984	90.0	*+43.3*
1985	68.3	*−24.1*

.. not available.

(a) The financial years to which reference is made in this and subsequent tables varied from company to company; however, they remained consistent from year to year for companies within the sample. The data refer to the thirty-six companies which reported turnover figures in each of these years.

Turnover

Accounting conventions vary markedly between companies involved in commodity-related activities. It is especially difficult to find a common measure of turnover. In these circumstances, it was felt most appropriate to ask firms simply to provide the measure of turnover that they used in their annual accounts—specifying precisely what they were providing. A wide range of definitions was used. The information received therefore offers an indication of changes in the *direction* in the total volume of business transacted although it cannot be used to compare performance between individual companies.

The results, summarised in Table A, refer to the average turnover of the thirty-six firms in the survey that reported turnover data for each year since 1983. The average turnover of these firms rose strongly in 1984, only to fall back—to near 1983 levels—in 1985. The decline in turnover in 1985 was broadly compatible with the turnover figures provided by the London commodity futures exchanges.

Profits data

In contrast to the turnover statistics, the profits data provided a sounder basis for comparative analysis. The aggregated results, presented in Table B, suggest that the trend in average earnings for firms in the survey has been downward for the last four years on both a pre-tax and a post-tax basis. This contrasts strongly with the upward trend in the profitability of industrial and commercial companies as a group since 1981.[1] Nevertheless, in spite

Table B
Comparative profits performance; 1982–85
£ millions; *number of firms responding in italics*

Year		Number of firms	Total earnings	Average earnings	Largest profit and loss: Profit	Loss
1982	Pre-tax	*26*	51.3	2.0	25.9	−0.8
	Post-tax	*26*	47.6	1.9	25.8	−0.8
1983	Pre-tax	*64*	93.1	1.5	24.0	−0.9
	Post-tax	*63*	63.9	1.0	14.4	−0.5
1984	Pre-tax	*66*	57.8	0.9	8.9	−9.3
	Post-tax	*65*	59.8	0.9	15.3	−5.2
1985	Pre-tax	*40*	21.9	0.5	6.8	−4.4
	Post-tax	*39*	17.0	0.4	3.8	−3.3

(1) See, for example, 'Company profitability and finance' on page 230.

of large individual losses sustained by some firms, average earnings remained positive in each year. Taken as a whole, the range of earnings narrowed in the four-year period.

On average, firms in the survey relied on commission income for almost 60% of their total earnings in 1985, with little movement in the ratio of commission to trading income in the three years prior to that. In 1984, fourteen of the sixty-one respondents to this question relied entirely on commission income for their earnings, whereas only seven firms were similarly dependent on trading income. In a number of cases, firms relying entirely on commission income reported earnings which were either negative or well below average.

The interviews shed some light on commission rates and the way in which they were calculated. Many firms expressed the view that commission rates were currently too low and had been too low for a few years. Firms usually charged differential commission rates according to the type of client and the size and frequency of business booked. The finest rates were offered to trade customers, with an average of $\frac{1}{8}$% to $\frac{1}{4}$% of the contract value reported per 'round turn'. The range for private clients, in contrast, was much wider, partly reflecting the diversity of services provided.

The profits data also pointed to a change in the profile of the business of firms in the survey since 1983. Although it is difficult to speak with any degree of certainty about trends—since firms may have interpreted the definitions in different ways and fewer firms completed the section of the form relating to 1983—the contribution made by physical trade in commodities to the firms' gross earnings appeared to decrease in importance in this period (Table C). Financial futures, in contrast, emerged as a source of growing significance, albeit from a very low base in 1983. Nineteen firms, for example, reported an active interest in a wide range of financial futures contracts on both the UK and US markets. The contribution made by 'trade in and brokerage of commodity futures' to gross earnings also increased slightly in the same period.

Table C
Sources of gross earnings by sector
Percentage shares

	1983	1984	1985
Physical trade	44.2	35.6	26.9
Trade in and brokerage of commodity futures	41.3	44.8	46.0
Financial futures	0.8	8.1	15.9
Other	13.7	11.5	11.2

From the information provided, it was not possible to carry out a detailed analysis of the real rate of return on capital employed. However, the return on equity for firms in the survey of about 1.3% in 1984—calculated on both a pre-tax and a post-tax basis—was well below the average for industrial and commercial companies.[1] The interviews confirmed the general impression gained from the statistics that downward pressure had been placed on earnings in the last few years, with relatively depressed conditions in the physical markets, subdued turnover on futures exchanges and strong competition cited as the most important influences. This, in turn, had encouraged market participants to reconsider the general profile of their business and, in some cases, to expand into new areas such as financial futures.

The composition of the commodity portfolios of firms in the survey

General

Participants were asked to keep a detailed account of the composition of their commodity portfolios during January 1986. The results, therefore, offer a snapshot picture at a given point in time rather than a detailed record over a number of months. Turnover in January was, of course, depressed by the uncertainties which faced the tin market. However, these conditions probably applied—in varying degrees—to most participants in the London markets. The series of interviews held with market participants enabled some perspective to be given to the statistical information which was received.

Type of business and location of clients

The survey revealed the predominance of client business in participants' portfolios, about two thirds of the total number of commodity futures contracts transacted by firms in the survey in January 1986 being traded on behalf of clients. Only nine companies, mainly specialising in the physical trades rather than in futures business, traded purely on their own account.

Although only fifty-three firms conducting business for clients were able to provide a breakdown of their business by type and location of client, these firms represented over 90 per cent of the gross earnings of firms in the survey for the previous two years; they may therefore be considered a reasonable sample. The results, outlined in Table D, suggest that firms in the survey served a principally European client base. Well over four fifths of their total clients, for instance, were based in Europe, more than three quarters of whom were located in the United Kingdom. Similarly, about four fifths of the value of the firms' client business in this period stemmed from Europe, with UK clients accounting for two thirds of the European total. North America, in contrast, provided only 7.4% of the total value of client business, followed by the Far East, with 5.2%, and the Middle East, with 4.5%. In terms of client type, over a third of the clients in the sample were 'trade' in nature. However, there were wide variations in the pattern between geographic areas. Almost all North American clients, for example, fell into the trade category—perhaps because much retail business from this

(1) The return on equity was calculated by dividing the pre-tax and post-tax earnings of firms entering both of these sections of the form by their shareholders' funds. It was not possible from the information available to calculate the size of minority interests. It is difficult to find an equivalent measure for other companies in the same period. However, according to estimates in the *Business Monitor MA3* (sixteenth issue 1985), the post-tax return on equity before minority interests for all industrial and commercial companies was 7.9% in 1981 and 6.2% in 1982. There is no reason to believe that this ratio was substantially different in 1984.

Table D
Type and location of client business during January 1986

Location of clients(a)	Number of clients	Per cent of total number of clients	Percentage share of total value of business(b)
United Kingdom	6,351	66.3	59.7
Overseas	3,223	33.7	40.3
of which:			
Europe	*1,925*	*20.1*	*19.7*
North America	*684*	*7.1*	*7.4*
Far East	*251*	*2.7*	*5.2*
Middle East	*231*	*2.4*	*4.5*
Other	*132*	*1.4*	*3.5*
Total	**9,574**	**100.0**	**100.0**

(a) See Appendix II for the geographic breakdown used.
(b) Total sterling value of commissions and fees earned from this source in January 1986 for firms in the sample.

area was booked through the commission houses and would have appeared under the trade category. In the United Kingdom, in contrast, non-trade customers provided the main source of business. No figures were requested on the breakdown of clients in terms of their shares of total lottage although the interviews suggested that trade clients dominated business in volume terms.

The interviews added flesh to the statistics in other ways. As might be expected, there were wide variations in the types of clients served by individual firms, with some interested only in large trade customers and others concentrating exclusively on the retail investor. The composition of their client base appeared to be instrumental in determining the ways in which firms marketed their services and the degree to which they were prepared to offer credit facilities. Eighteen of the twenty-five firms interviewed, for example, claimed to market their services actively. The methods used were surprisingly varied and ranged from advertising in the financial press and trade journals to the production of in-house newsheets and economic literature, 'mail shots', calling on clients, organising seminars and, in one case, the sponsoring of a golf tournament. Although only a few firms employed professional marketing personnel, twenty envisaged increasing their marketing activity in the next year or so in the face of strong competition for the current pool of business.

Few of the firms that were interviewed were prepared to offer credit as an incentive to obtaining new business. However, the extension of credit appeared to be necessary in some cases to retain existing business. In general, firms claimed to operate a strictly controlled and centralised credit policy, based on a regular assessment of their clients' positions. Firms with overseas parents generally referred credit decisions above a certain limit to their parent. Few of the firms interviewed were prepared to extend credit to individual speculators and half a dozen expressed a reluctance to offer credit facilities in any form.

Commodity futures contracts

The breakdown of the commodity futures business of firms in the survey by contract (the daily average number of gross longs and gross shorts) and by market revealed that they traded contracts covering a total of thirty commodities during January 1986. Twelve of these were traded on more than one market and 80% of total contracts were placed with UK exchanges. These covered seventeen commodities, namely, aluminium, barley, cocoa, coffee, copper, crude oil, gasoil, lead, nickel, pigmeat, potatoes, raw sugar, silver, soyabean meal, white sugar, wheat and zinc. (The LME tin contract was, of course, in suspension during this period.) US exchanges dominated the remainder, with firms trading futures contracts for twenty commodities there. These included cocoa, coffee, cotton, crude oil, gasoil, gold, leaded gasoline, live hogs, lumber, maize, orange juice, palladium, platinum, pork bellies, raw sugar, soyabeans, soyabean meal, soyabean oil, unleaded gasoline and wheat. These contracts collectively accounted for 17% of the commodity futures contracts transacted by firms in the survey during January. The remaining 3% was accounted for by cocoa, coffee and white sugar futures traded in Paris and potato futures in Amsterdam.

The composition of the commodity portfolios of individual firms varied markedly, with some firms specialising in only one or two contracts and others engaged in a wide range of futures transactions. It is notable, however, that about two thirds of the total lots traded by firms in the survey in January involved only four commodities—coffee, copper, aluminium and raw sugar. These commodities, together with cocoa, silver, gasoil, lead and gold, accounted for 90% of the total contracts the firms traded (Table E). Commodities not separately identified in the table each accounted for less than 1% of the total lots traded.

Most firms in the survey traded UK commodity futures markets far more actively than markets overseas, although several firms were active in both. The comparative importance of UK and overseas futures markets for individual firms depended on the composition of their commodity portfolios. London was the only market available, for example, for lead, nickel and zinc and the only market traded by firms in the survey for barley and pigmeat. However, these contracts were of comparatively minor importance overall, accounting for only about 7% of the volume of the firms' commodity futures business in the sample month. The UK held a very strong position in terms of coffee, copper, silver,

Table E
Commodity futures contracts traded by firms in the survey in January 1986

Percentages

Commodity	Share of lots traded	Proportion traded on UK markets
Coffee	27.0	98.6
Copper	15.7	92.3
Aluminium	12.9	63.4
Raw sugar	10.2	62.7
Cocoa	7.0	80.4
Silver (LME)	5.9	89.2
Gasoil	5.1	85.6
Lead	3.3	100.0
Gold	2.7	—
Zinc	2.6	100.0
White sugar	2.2	0.8
Potatoes	1.1	99.7
Nickel	1.1	100.0
Other	3.2	64.6

gasoil and cocoa (in that order of importance), taking over 80% of contracts traded, with the remainder going to US markets. As indicated in the table, UK markets faced stronger competition in respect of aluminium and raw sugar (from the US) and from Paris for white sugar. Of the wide range of other contracts traded by firms in the survey, none was of major importance in volume terms and all were placed in US markets.

Options

Fourteen firms reported that options formed an important part of their commodity portfolio in January 1986. Of these, two thirds were transacted on the London market. Of the London total, about a third applied to metals and most of the remainder to soyabean meal, potatoes and coffee. Only a few options—covering aluminium, copper, gold, platinum, potatoes, soyabean meal, soyabeans, and sugar—were transacted in markets overseas; of these, all except potatoes (which were placed in Amsterdam) were transacted in the United States.

Overall, options were of minor importance in simple numerical terms compared with traditional futures contracts. However, their value as a source of income may have been far more significant, particularly for the five firms dominating the market. In the view of one firm, options provide traders with a useful alternative to taking an outright position. Several of the firms interviewed considered that the UK options market, although currently small, would grow in importance in the next few years. It was also felt likely that 'traded' (transferable) options would become an increasingly important feature of the London markets in line with developments in the United States.

The UK commodity futures markets

The interviews revealed that most firms considered that operating in the UK commodity futures markets offered distinct advantages for the conduct of their business. Most commonly cited were London's time-zone location between the North American and Far Eastern markets and its sophisticated financial infrastructure. Banking services, especially foreign exchange facilities, and the absence of exchange control restrictions were also felt to be major plus factors.

The overall impression gained from firms in the survey was that the London commodity futures markets have entered a new phase of reappraisal and consolidation. No dramatic increase in turnover was expected in the next few years. Nor was it considered likely that many new contracts would be introduced, although several firms felt contracts for cocoa butter and rapeseed might be worth introducing in London. One firm also revived the question of a gold futures market.

As indicated above, several firms held the view that the options market would grow in importance in the next few years. There were also strong indications from a number of firms that they were intending either to consolidate or to increase their financial futures business. In contrast, a few small firms which specialised in only two commodities saw no reason to diversify.

General support was expressed for moves toward more integrated markets, such as the changes under consideration by the LCE when it moves to St Katharine Dock next year. It was felt that such developments, if successful, would lead to a desirable improvement in liquidity, not least by providing a more favourable environment for the participation of 'local' traders. The firms which were interviewed considered that this in turn might enhance London's competitive position. They expressed a variety of views on the probable impact of the regulatory changes proposed under the Financial Services Bill. On balance, however, it was considered that the proposed structure would provide an environment which would be reasonably conducive to growth.

No clear pattern emerged from the interviews of areas that firms were planning either to enter or to leave. Strategies varied, logically, according to each firm's existing portfolio and client base. It is interesting to note, however, that firms were contemplating leaving only a narrow range of activities, most of which were commodity-related. New areas of business that were being considered, in contrast, spanned a wide spectrum. They included traditional futures business and closely related activities—such as commodity merchanting, commodity processing and the establishment of commodity funds—and departures into completely new areas, such as stockbroking, secondary dealing in the gilt-edged market, merchant banking and foreign exchange dealing.

Overall, it was hoped that the UK commodity futures markets would emerge in a more competitive condition from the recent period of sluggish profitability and growth they had experienced. Participants considered that their success in doing so would be closely linked to their ability to operate a flexible strategy in the face of changing conditions in the market and the keenly competitive operating environment.

Appendix I
Form taken by the survey

The questionnaire

The questionnaire was divided into four sections. Section A asked for background information on staff numbers, ownership structure, the firms' membership of terminal market associations in London and the proportion of the firms' voting share capital held by overseas residents (Questions 1 to 6). Part B then went on to request some general financial information regarding the firms' capital, turnover and operating results (Questions 7 to 9). Firms were also asked to attempt to assess the proportion of their pre-tax earnings attributable to commission and to trading income (Question 10) and to gauge the contributions to their gross earnings of: physical trade in commodities; other trade in and brokerage of commodity futures; and trade in and brokerage of financial futures (Question 11). The final question in this section, Question 12, asked participants to estimate their earnings from overseas residents in the two years prior to January 1986. (It was not possible to incorporate the results of this question in this article since a full analysis will take some time. However, it is planned that they will be used to improve the estimates of net commodity earnings for the UK balance of payments statistics in due course.)

The third section of the questionnaire, Part C, asked firms to provide a more detailed breakdown of their commodity portfolios during January 1986. Information was requested on the firms' client business, including an assessment of the number and location of their clients and an indication of whether or not the clients were 'trade' (principally engaged in the physical trades or in commodity broking) or 'non-trade' in nature (Questions 13 and 14). Question 15 then asked participants to indicate the composition of their commodity futures business in terms of the daily average number of lots traded in London and overseas markets (where applicable) in the same period. Part D, finally, gave firms an opportunity to list any other business, including options, which in their view constituted an important part of their overall commodity portfolio.

The questionnaire was prepared with the benefit of advice from those active in the industry with the objective of making it as 'user friendly' as possible. Since there are wide variations in accounting practices between commodity firms, estimates were considered to be quite acceptable in many cases; greater precision was only requested when it was felt that material would be readily available from the firms' annual accounts or where a specific format was needed for balance of payments purposes.

Interviews with market participants

The interviews with twenty-five firms embraced a range of market participants—from the very small to the very large, from those specialising in trade business on their own account to those specialising in client business, those with UK parents and those with foreign parents, and from those active in only one or two futures markets to those active in a range of markets, including financial futures. (Measured in terms of total staff numbers, turnover and pre-tax profits, the firms interviewed were slightly larger than the average in the survey.)

The interviews attempted to cover a variety of common themes. Their purpose was to complement the statistical material provided in the questionnaire with general information on the ways in which firms operate in the London commodity markets and their reasons for doing so. It was also hoped to gain some insight into the general prospects for these markets.

Subjects discussed included the firms' policies on issues such as commission rates, the granting of credit and training. Participants were also asked whether they were considering entering any new areas of business or leaving or substantially reducing their activities in any areas in which they were currently active. There was usually some discussion also on the subject of the firms' client base and the ways, if any, in which they marketed their services. Part of the interview, finally, was devoted to the firms' perception of London as an international financial centre and their view of the prospects for the commodity futures markets here.

Appendix II
Definitions used in the survey

Overseas residents denoted a person or institution resident outside Great Britain, Northern Ireland, the Channel Islands and the Isle of Man.

Shareholders' funds denoted issued/paid-up capital plus reserves (unappropriated profits, share premiums and capital reserves) less intangibles (goodwill and formation expenses not written off).

Voting share capital denoted shares carrying the right to vote in normal circumstances at general meetings of the company.

Gross earnings denoted earnings before offsetting overheads and tax.

Pre-tax earnings denoted the amount of profit/loss after deducting all expenses.

Post-tax earnings denoted the amount of profit/loss before any minority interest share or appropriations to dividends and reserves.

Trading income denoted the amount of profit/loss earned by dealing or trading on the firm's own account.

Commission income denoted the amount of profit/loss derived from dealing or providing a service for third parties. It excluded in-house transactions and business executed for an overseas subsidiary which did not appear on the firm's own book.

Middle East followed the Department of Trade definition, that is: Afghanistan, Algeria, Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, United Arab Emirates, Arab Republic of Yemen, Democratic Republic of Yemen, Israel, Cyprus, Malta and Turkey.

Far East included China, Hong Kong, Indonesia, Japan, North Korea, South Korea, Malaysia, Papua New Guinea, Philippines, Singapore, Taiwan and Thailand.

Trade clients denoted clients engaged in the physical trades in the commodity in question. (Brokers were also included in this definition.)

Non-trade clients denoted clients who were not engaged in the physical trades.