The London Metal Exchange

*The **Governor** comments[1] on some of the issues and challenges facing the London Metal Exchange in the aftermath of the tin crisis and in the transition to a new regulatory structure; and notes, in particular, the importance for success of flexibility of response to changing conditions, and the need for a regulatory environment that is both effective and efficient.*

I was very pleased to be invited as your guest at the London Metal Exchange's Dinner this year. As your Chairman has made clear, this dinner comes at a critical time for the LME, a time which is likely to be seen in future years as a watershed in its history. It is, of course, the first dinner to take place since the tin crisis erupted last Autumn. It is also probably the last before we see important changes in the regulatory environment in which the Exchange operates and within the Exchange itself. I would like to consider both of these subjects in a few moments.

I am told that the LME Dinner had its origins in an annual gathering organised by your Golf Society. Plausible as this sounds, I do not propose to explore any of the deeper significances of this remarkable fact; but it does give me the opportunity to point out that in a recent contest between the respective golfing societies of the LME and the Bank, the Bank scored a rare and satisfying victory. No doubt the sporting tradition continues even as I speak; I am well aware that many of you have substantial open positions riding on the length of my speech. I should have liked to test the theory of efficient markets by telling you now exactly how long it is going to take: but after such an excellent dinner I have to say that your guess is as good as mine.

The tin crisis, in contrast, cannot be considered in light-hearted vein. The International Tin Agreement had, of course, operated in some form both before and after the Second World War. As long ago as 1943, the International Labour Office identified intergovernmental commodity regulation as a potentially important tool of trade policy. More significantly, in 1974 the United Nations General Assembly brought international commodity agreements to the centre stage of international trade policy. The Agreement must thus be seen as an instrument which had been sanctioned at the highest international level. And in this context, it must surely be considered extremely regrettable that the International Tin Council, an organisation which was after all a creature of governments, should default on its obligations as it did in October of last year.

With litigation in train, you will understand that like your Chairman I must exercise great restraint in anything that I say on this subject. But while no financial solution was reached to the crisis, I should like to remind everyone here that the British Government not only expressed its willingness to meet its own share of the legal commitments of the International Tin Council outstanding on 24 October 1985, but also made every effort, through diplomatic and political channels, to persuade its fellow member governments to do the same. In addition, the Government participated actively and constructively in attempts to bring about an orderly financial settlement. Those negotiations should, I believe, be singled out for comment. You yourself, Mr Chairman, were indefatigable in co-ordinating the efforts of the LME and, if I may say so, you represented your market's interests with enormous courage and determination. I should also repeat publicly my commendation of Peter Graham of Standard Chartered Bank and Ralph Kestenbaum of Gerald Metals, for their attempts to secure a workable solution to the problem. I know that they were tireless in their efforts and in their ingenuity, which deserved better than to fail when a successful outcome seemed so close.

As you know better than anybody, the repercussions of the tin crisis are likely to continue for some time to come. But despite all that happened, it is the case that the LME has retained its position as a commodity market of the highest international rank. Transactions which converge on the Exchange represent a vast number of business decisions taken by producers and users of metals throughout the world and many key representatives of these industries are here tonight. Its leading position in aluminium, lead, zinc and nickel markets remains virtually unchallenged. And in the copper market, where there is strong competition from the United States, it has held its own despite relatively depressed trading levels on both sides of the Atlantic.

Let me say, too, that the LME is also distinguished by great integrity. Realistically, however, we must recognise that integrity is a *necessary*, but not a *sufficient* condition for long-term prosperity. This is particularly true at the present, for all commodity futures markets face the twin challenges of depressed conditions in many of the underlying physical trades, and the opening up of new and

(1) In a speech at the annual dinner of the London Metal Exchange on 7 October.

attractive investment opportunities in other markets, notably in financial futures.

These challenges defy simplistic solutions. Commodity futures exchanges, for example, can do little to bolster underlying conditions in the physical trade. But they may nevertheless be able to construct a market place which is capable of competing vigorously for the pool of business which is available. In my view, the exchanges which are most likely to succeed in the future are those which place a premium on operating in an efficient, competitive and, above all, a flexible manner. This will involve moving swiftly to identify and to exploit new opportunities as they arise—even if, as may well be the case, such opportunities represent a radical departure from established practice.

Let me illustrate this point by looking forward to the general prospects for world trade in commodity futures. I would suggest that there is scope for the volume of this business to expand in response to several important influences. In the first place, it seems probable that an even wider range of practititoners will become familiar with the valuable services that the futures markets can provide. One of the current demands of the Group of 77 developing countries, for example, is—and I quote—for 'training in the operation of international commodity exchanges and . . . in the potential benefits to be derived from taking part in such exchanges'. Discussions are due to take place on this subject under the auspices of UNCTAD in the course of the next year. These discussions will of course need to address the practical problems involved: but they need not be insurmountable and, if my assessment is correct, a worthwhile increase in the business of commodity exchanges could be secured in the medium term.

A second reason for optimism, at a more local level, is the increase in interest which has been reported in commodity options. In a recent survey conducted by the Bank, a number of firms that were interviewed considered that the UK options market, although currently small, would grow in importance in the next few years. It was also felt that 'traded' options would become an increasingly significant feature of the London markets in line with developments in the United States. The decision by the London Commodity Exchange to introduce traded options on its sugar, cocoa and coffee futures next year will obviously enhance this trend.

If commodity exchanges are to exploit the new opportunities that arise, they will need a management structure which can respond flexibly to changing conditions and a keenly competitive environment. With the appointment of a full-time chief executive eighteen months ago, and other changes which are currently underway, the LME clearly recognises the undoubted need to take steps to meet the new demands which have been and are likely to be placed upon it. As your Chairman has said, LME members are currently considering proposals for a major re-organisation of the Exchange's management structure. Despite the reservations that some of you may have felt about moving to an independent clearing system, I believe that the decision will in time be seen as a most significant and positive step in the development of your market; one day, perhaps, the doubters will ask why this step was not taken earlier.

Another pre-requisite for success will be a regulatory environment which is conducive to growth. With competitive international conditions, business is likely to gravitate towards centres offering the lowest transaction costs; transparent pricing mechanisms; the most liquid markets; the widest range of financial instruments and services; and the surest settlement and communications systems. The size and depth of such markets are obviously key factors. Moreover, no matter how sophisticated, no financial and commercial centre will flourish if potential users do not feel that it is safe.

The Financial Services Bill has been introduced here as one aspect of a much broader response to the growth of the financial sector and the rapid pace of innovation within it. This has resulted in the blurring of distinctions between the financial and other, related sectors. Increasing links between markets, and the products traded on them, requires a more comprehensive and co-ordinated approach to regulation. Here the commodity futures markets have a vital role to play. Great effort has been expended in the financial services legislation to try to arrive at an effective and efficient combination of legislative control and self-regulation. The solution now well on the way is a statutory requirement that is expressed in very broad terms, and a structure below it in which practitioners—at the level of the SIB and of individual SROs—will be closely involved in deciding on detailed rules and in directing their application.

The application of this new regulatory structure of the LME does provide a challenge. Your market has developed with trading arrangements of a unique character. To mesh them in with the broader principles being laid down for the financial services industry as a whole will require firmness to go hand-in-hand with flexibility. But this is what practitioner regulation is about. I am confident that it will be successfully achieved; and, even although this may involve changes in long-standing operational procedures, the LME, its members and its clients will reap substantial benefits in the long run.

The Bank, mindful of the inter-relationship between other financial markets and the banking system, has long had a tradition of contact with and monitoring of the commodity exchanges and the capital markets, as well as the money and foreign exchange markets. In this context, I would like to thank the LME for its help and co-operation over many years. I hope that the change in the regulatory environment will not mean an end to this relationship but rather a change in its focus. Although the Bank will be handing over to the Securities and Investments Board and the Association of Futures

Brokers and Dealers the surveillance function which it has hitherto exercised on an informal basis, it will continue to take a keen and active interest in the fortunes of the LME and other commodity markets in London. For, as your Chairman has pointed out, these markets not only have an important bearing on the overall health and efficiency of London as an international financial and commercial centre: they also make a major contribution to the United Kingdom's invisible earnings. The opportunities are there for the LME and other commodity markets to make a still larger contribution in future, and in seizing those opportunities you will have my fullest support.