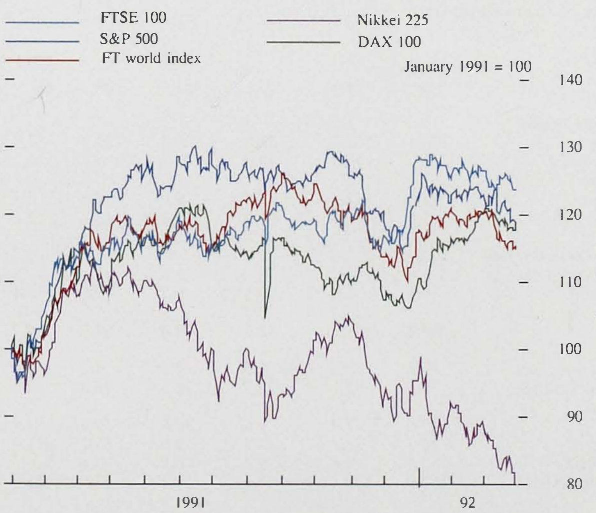
Financial market developments

Continuing weakness was seen in the major stockmarkets . . .

Continuing subdued economic activity kept stock prices in many of the major markets weak during the first quarter of 1992 (Chart 1). In Japan, the equity market fell throughout the quarter, against the background of a faster than expected economic slowdown and continuing political and financial scandals. Prices reached their lowest level for five years during the quarter (and subsequently slipped further) and daily turnover of Japanese equities dropped to a ten-year low in February. Concern over the timing and strength of the US recovery depressed the US equity markets towards the end of the first quarter, despite the cut in the discount rate in December. In Europe, stock markets generally rose during the quarter, but turnover in some major markets slackened towards the end as domestic political uncertainties deterred investors. A number of other exchanges (Hong Kong, Malaysia and Mexico) posted notable price gains over the quarter and stock markets in some developing countries gained from further foreign participation, through more issues of American Depositary Receipts and through privatisations of large state-owned institutions, such as Mexican banks.

Chart 1
International equity indices[a]



(a) Daily prices.

. . . but capital market issues were at record levels, despite growing uncertainties

Gross new issues in the international and US domestic bond markets reached record levels in the first quarter, stimulated by lower dollar interest rates at the beginning of the year and the desire of many borrowers to refinance outstanding debt. Towards the end of the quarter, however, bond prices weakened in the United States and some European countries, reflecting the scale on which paper had been issued in some currency sectors, together with political and longer-term inflationary concerns. European bond yields, which had begun to converge last year, diverged again as confidence over the pace of European monetary integration wavered.

Weakness in the Japanese market helped prompt an official response . . .

The weakness of the Nikkei helped to prompt the Japanese authorities to cut the official discount rate by 75 basis points at the beginning of April and to front-load fiscal expenditure into the first half of the fiscal year 1992. The ruling Liberal Democratic Party and the securities industry earlier put forward various proposals to support the market. These included encouragement by the Ministry of Finance for higher dividend payments, a reduction in withholding tax on dividends, moves to promote more institutional investment and specific measures to control futures arbitrage trading. Some of these proposals have already been partially implemented, but neither these nor the announcement of the interest rate cut and fiscal adjustments produced an immediate improvement in market sentiment. Foreign investors may also have lost some of their earlier confidence in the market towards the end of the quarter, although they remained net purchasers of Japanese equities.

. . . but added to pressures on Japanese banks

The 3,200 point fall in the Nikkei over the quarter (equivalent to 14% of the end-1991 level) is particularly significant for Japanese banks, which are able to include 45% of the market value of unrealised gains on securities holdings in Tier 2 capital. Moreover, the depreciation of the yen against the dollar over the quarter (of around 4%) will have increased the value of banks' dollar-denominated assets in yen terms. In broad terms, a 1,000 point fall in the Nikkei is estimated to reduce the capital ratios of city banks by around 0.2 of a percentage point and a 4% depreciation of the yen against the dollar is estimated to bring average ratios down by some 0.1 of a percentage point. The banks have responded to these pressures in a number of ways. They have increased capital by issuing subordinated debt and for over a year have been gradually reducing their international assets by cutting back their participation in syndicated lending and their interbank activity. Their domestic bank lending appears to have been less affected. In addition, since the start of the year, Japanese banks have been allowed (temporarily) to include non-cumulative preference share issues by overseas subsidiaries as Tier 1 capital, where approved by the authorities.

Japanese accounting conventions mean that the extent of banks' exposures to bad and doubtful debts is unclear. Bad debts (relating in particular to the depressed domestic property sector) are gradually being reported, however, and contributed to a series of downgraded credit ratings of Japanese banks and to a weakening of banks' share prices relative to the overall market, which continued into the second quarter. The price/earnings ratios of Japanese banks nevertheless remained high relative to their major competitors during the first quarter, at around 50 for the city banks, compared with less than 20 at most UK, US and German banks.

Banks continued to feel the impact of bad debts . . .

Banks worldwide reported mixed results during the quarter. Profits increased at a number of banks in Germany, Spain, Portugal and some Asian countries. However, in the United Kingdom, the United States and Scandinavia, banks' profits continued to be affected by charges for bad debts relating to, for example, commercial real estate and consumer lending, despite higher earnings from capital markets subsidiaries and some success in reducing costs. Relatively depressed property prices not only continued to raise concerns over some banks' exposure to the sector, but also weakened investor confidence in some sectors of the capital markets, which caused difficulties for some borrowers in refinancing their debt. To a lesser extent, bad debts have also begun to affect the results of banks in a number of other countries, including France and Switzerland.

Securities firms continued to benefit from buoyant bond and equity issues in the first quarter, although intense competition among underwriters in the euromarkets may have left some firms with large amounts of unsold paper towards the end of the period. The outlook for Japanese securities firms grew worse during the quarter. Many expect to report lower earnings or net losses for the year ending in March. Their fee and commission income has been hit by the low prices and low turnover of domestic equities and a lack of investor confidence following a series of financial malpractices.

. . . which reinforced moves towards mergers and rationalisation

The problems facing the financial sector in a number of countries, together with increased competitive pressures, have reinforced the trend towards mergers and rationalisation both within and between countries. Many European banks are continuing to forge links with other banks through takeovers or cross-shareholdings or by developing joint products, such as automated electronic transfer services for corporate clients. For some smaller and medium-sized banks, the motivation appears largely to be defensive, against the increasingly competitive environment in the financial services sector. Some of the larger European banks, however, particularly in France and Germany, have continued to raise capital this year, despite meeting the BIS capital adequacy guidelines. This may have been in part to cushion their capital ratios against further bad debts, but it may also be a precursor to expansion of their operations. Several of the larger US banks continued to sell assets and announced staff cuts during the quarter, while the trend towards mergers continued at some of the regional banks. Some foreign banks (including Dutch and Irish) nevertheless continued to expand their US presence. In Japan, in addition to the forthcoming removal of barriers between banking and securities business through the setting up of new subsidiaries, the authorities have apparently accepted the need to relax restrictions on shareholdings where support operations between banks and securities houses are involved. Separately, several smaller Japanese securities firms have announced mergers or link-ups in recent months.

New debt issues and turnover in international capital markets

Overall financing activity was still at a high level

The level of financing activity in the international capital markets remained high in the first quarter in most sectors (Table A). Many corporate borrowers came to the market to raise new funds or to refinance existing debt at lower interest rates.

Table A
Total financing activity:(a) international markets by sector

$ billions, by announcement date

	1990	1991				1992
	Year	Year	Q2	Q3	Q4	Q1
Fixed-rate bonds						
Straights	172.1	262.4	62.0	60.0	59.3	87.3
Equity-related	33.0	43.8	20.0	11.8	4.7	6.3
of which:						
Warrants	*22.6*	*31.8*	*13.1*	*9.6*	*3.6*	*5.3*
Convertibles	*10.4*	*12.0*	*6.9*	*2.2*	*1.1*	*1.7*
Bonds with non-equity warrants (currency, gold, debt)	0.1	1.0	0.1	0.2	0.6	0.4
Total	**205.2**	**307.2**	**82.1**	**72.0**	**64.7**	**94.7**
Floating-rate notes	57.6	21.5	6.5	4.5	4.2	6.1
Euronote facilities	70.6	92.1	27.3	16.3	26.5	18.9
of which:						
CP	*47.6*	*37.4*	*9.6*	*10.5*	*10.2*	*3.9*
MTNs	*20.2*	*53.1*	*17.5*	*5.6*	*16.2*	*15.0*
NIFs/RUFs	*2.8*	*1.6*	*0.2*	*0.2*	*0.1*	*0.1*
Syndicated credits	165.0	139.4	31.5	29.1	37.4	25.8
Total	**498.4**	**560.2**	**147.4**	**121.9**	**132.8**	**145.5**
Memo: amounts outstanding						
All international						
Bonds(b)	1,472.3	1,648.3	1,451.9	1,547.3	1,648.3	. .
Euronotes(c)	111.2	144.9	129.5	136.9	144.9	156.2
of which, EMTNs	*21.9*	*38.5*	*26.6*	*31.4*	*38.5*	*41.0*

. . not available.

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised placements. Issues which repackage existing bond issues are not included. Figures may not add to totals because of rounding.
(b) BIS adjusted figures, including currency adjustment. Includes issues of fixed-rate bonds and floating-rate notes.
(c) Euroclear figures.

Supranational organisations were among the largest group of borrowers on the international capital and credit markets in the first quarter, partly reflecting the IBRD's long-awaited ¥250 billion global bond issue (Table B). For much of the quarter, demand for bonds issued by European supranational organisations was underpinned by Italian investors, who are exempt from withholding tax where Italy is a member of the supranational launching the issue. Towards the end of the quarter, however, this demand for new paper may have subsided as investors' needs were met.

International banking developments

After falling for three successive quarters, the international activity of banks in the BIS reporting area showed significant growth in the fourth quarter of 1991. Their outstanding cross-border assets rose by $112 billion and cross-border liabilities by $59 billion. The growth in cross-border assets was largely accounted for by increased interbank business (with outstanding cross-border claims between reporting banks rising by $85 billion after a cumulative $230 billion decline in the first three quarters of the year). This reflected a partly seasonal build-up of interbank balances between continental European banks at the end of the year, sizable movements of dollar funds between the United States and other major financial centres and a large volume of circular flows between Japan and other Asian centres.

Estimated new international bank lending (net of redepositing in the interbank market) doubled from $15 billion in the third quarter to $30 billion in the fourth quarter, but remained well below the quarterly average for preceding years.

Countries outside the reporting area were net borrowers of funds from the BIS-area banks, taking up $17 billion, the largest amount of outside borrowing since the second quarter of 1982. Nearly half of this was new lending to countries in Asia; the largest rise in claims was on China ($3.7 billion), which also increased its outstanding deposits by $4.4 billion. Outstanding claims on Latin America rose by $2 billion, while outstanding deposits fell by $2.8 billion, owing partly to the repatriation of flight capital. Banks' claims on Eastern Europe rose by $2.9 billion, almost entirely owing to new, officially-guaranteed lending to the former Soviet Union.

The London market

The cross-border business of banks in the United Kingdom fell on both sides of the balance sheet in the fourth quarter of 1991—liabilities by $4.1 billion and claims by $9.2 billion. The main decline in overall activity was within the BIS reporting area and was more than accounted for by a drop in interbank business with Japan, with liabilities down by $8.7 billion and claims by $10.9 billion. Increased claims on the United States of $6.5 billion (of which $3 billion was in the interbank market) were offset by an equivalent fall in interbank claims on offshore centres (mainly Singapore and Hong Kong). Overall, cross-border interbank claims of banks in the United Kingdom fell by $11.9 billion, more than accounting for the total fall in claims. During 1991 as a whole, UK banks'. cross-border liabilities fell by $38.9 billion and assets by $44.2 billion (in contrast with sharp rises in 1990). Cross-border interbank claims fell by $78.8 billion, of which $37.1 billion related to Japan.

Business with countries outside the BIS reporting area continued to be muted in the fourth quarter. The largest movement was a fall in liabilities to oil exporters of $2.7 billion, owing to a drop in deposits from Saudi Arabia and Kuwait. Claims on Eastern Europe also continued to fall.

British and 'other overseas' banks increased their shares of cross-border business, from 13.7% to 14% and from 41.1% to 41.5% respectively, mainly at the expense of Japanese banks (whose share declined from 30.8% to 30.2%). These figures will be restated, however, owing to the change in the reporting

Cross-border business of banks in the United Kingdom

$ billions: changes exclude estimated exchange rate effects

	1990	1991					Out-standing at end-Dec.
	Q4	Year	Q1	Q2	Q3	Q4	1991(e)
Liabilities vis-à-vis:							
BIS industrial area	36.2	-39.1	-9.9	-32.5	6.8	-3.6	727.0
of which:							
United States	*10.4*		*-9.3*	*-10.4*	*8.0*	*-2.0*	*146.5*
Japan	*-4.3*		*-2.3*	*-1.6*	*0.3*	*-8.4*	*99.7*
'Offshore' banking centres	0.5	-9.3	-2.4	- 2.6	-1.3	-3.0	113.7
Sub-total	36.7	-48.4	-12.3	-35.1	5.5	-6.6	840.7
Outside reporting area:							
Developed countries	-1.2	—	- 2.8	1.5	0.8	0.6	35.2
Eastern Europe	0.6	-0.6	-1.9	0.1	1.2	-0.1	5.5
Oil exporters	5.0	-1.1	-0.2	3.2	-1.3	-2.7	68.6
Non-oil developing countries	0.9	1.7	-1.1	2.1	1.7	-1.0	61.0
of which, Latin America	*0.5*	—	*-0.2*	*0.9*	*0.1*	*-0.8*	*8.2*
Sub-total	5.3	—	-6.0	6.9	2.4	-3.2	170.3
Other(a)	-5.9	9.5	16.1	-4.9	-7.4	5.7	109.3
Total(b)	**36.1**	**-38.9**	**-2.2**	**-33.1**	**0.5**	**-4.1**	**1120.3**
Assets(c) vis-à-vis:							
BIS industrial area	17.6	-29.9	0.7	-24.6	-3.2	-2.8	743.5
of which:							
United States	*10.1*		*-12.0*	*-4.0*	*5.2*	*6.5*	*146.6*
Japan	*-2.6*		*-10.1*	*-10.8*	*-6.4*	*-12.1*	*187.9*
'Offshore' banking centres	-1.8	-16.3	-4.1	-5.3	-0.8	-6.0	114.2
Sub-total	15.8	-46.2	-3.4	-29.9	-4.0	-8.8	857.7
Outside reporting area:							
Developed countries	-0.4	-1.3	-0.9	-0.2	0.5	-0.8	32.9
Eastern Europe	-0.9	-3.2	-1.2	-0.7	-0.6	-0.6	13.7
Oil exporters	-0.1	-2.3	-2.5	0.3	-1.0	0.9	15.9
Non-oil developing countries	1.0	3.0	2.0	0.3	0.5	0.1	46.3
of which, Latin America	*0.5*	*2.1*	*1.1*	*1.0*	*-0.5*	*0.5*	*25.4*
Sub-total	-0.4	-3.8	-2.6	-0.3	-0.6	-0.4	108.8
Other(d)	-3.9	5.8	0.1	1.0	4.7	—	17.6
Total(b)	**11.5**	**-44.2**	**-5.9**	**-29.2**	**0.1**	**-9.2**	**984.1**

(a) International organisations, unallocated and international issues of securities.
(b) Includes business unidentified by sector.
(c) Including securitised lending.
(d) International organisations and unallocated.
(e) The fourth quarter 1991 figures for amounts outstanding have been reduced by about 3% in total, owing to a change in the reporting of swaps by some banks. Previously some banks were including notional principal amounts associated with cross-currency interest-rate swaps on their reported balance sheet. From December 1991 all banks are excluding these items from their balance sheets. Although this change has caused the amounts outstanding to fall, an adjustment has been made to the changes in liabilities and claims to exclude this effect.

of swaps (see footnote (e) to the table). This will have a particular impact on the share of US banks, whose restated share will fall from 14.5% to 11.3%. The US dollar's share of UK cross-border lending continued its long-term decline in the fourth quarter, falling by one percentage point to 47.7%. The share of the yen also fell, from 11.2% to 10.5%.

Provisional data for the first quarter of 1992 show that the international business of banks in the United Kingdom fell sharply on both sides of the balance sheet, with liabilities and claims down by $21 billion and $18 billion respectively. The fall was more than accounted for by Japanese banks, mainly owing to reductions in their interbank business, particularly in March as their end-year reporting date approached (reflecting a pattern seen in March and September 1991). American banks' liabilities fell modestly (by $6.1 billion), while claims remained flat. By contrast, 'other overseas' banks recorded sharp increases in both liabilities ($27.8 billion) and claims ($9.2 billion), mainly relating to overseas business. British banks' business grew slightly, with liabilities and claims up by $3.6 billion and $4.7 billion respectively.

Table B
International capital and credit market activity by nationality of borrower(a)
Percentages of total issues announced

	1990	1991			1992
	Year	Year	Q3	Q4	Q1
United States	10	10	11	18	8
France	6	7	8	8	10
Germany	1	4	4	4	5
Japan	13	14	20	14	13
United Kingdom	12	12	12	11	8
Other OECD	37	32	25	25	31
International institutions	6	8	9	7	11
Eastern Europe	6	1	2	1	0
Other	9	12	9	12	14

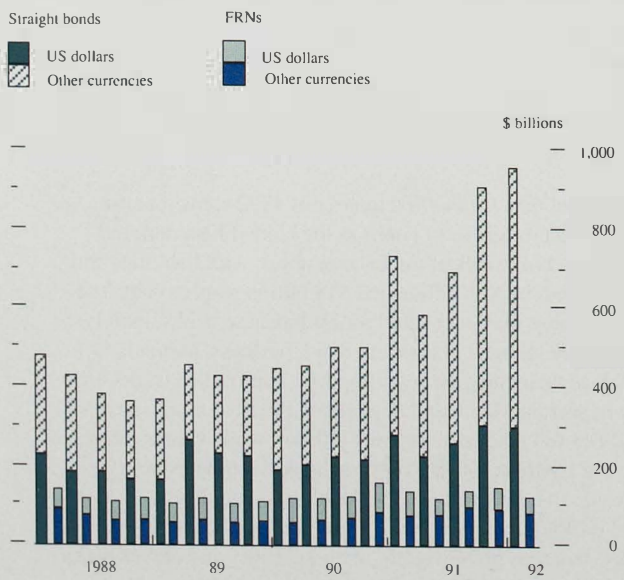
(a) Borrowing by East Germany is included in Eastern Europe in 1990 but within Germany from 1991.

US and Japanese borrowers issued slightly higher quantities of international bonds in the first quarter than in the previous quarter. US borrowers also increased their reliance on domestic equity and debt markets, taking advantage of narrowing spreads. Some Japanese borrowers, faced with a large quantity of expiring (out-of-the-money) equity warrants and convertible debt redemptions, have chosen to refinance their borrowings via fixed-rate debt, although others may have redeemed bonds out of cash reserves.

French borrowers, in particular from the electricity, oil and banking sectors, continued to be active in the international capital markets in the first quarter. UK borrowers were also more prominent than in the previous quarter in foreign bond issuance, launching twenty-three new issues with a total value of $3.5 billion, of which eleven were in US dollars and three were in Ecu.

Borrowing by developing countries also remained relatively high during the quarter, with further diversity in types of instrument and borrowers. Mexico became the first Latin American sovereign to launch a euro-commercial paper (ECP) programme and a Venezuelan company took the relatively unusual step of launching two eurobonds via its euro-medium-term note programme. Far Eastern countries continued to raise syndicated bank loans, among which aircraft finance for Asian borrowers remained prominent.

Chart 2
Straight bonds and FRNs: secondary market turnover



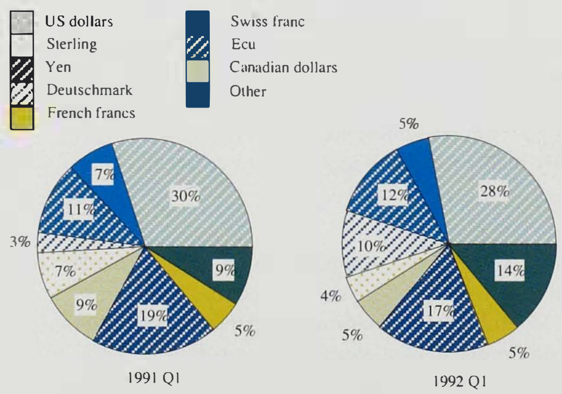
Source: ISMA.

More borrowers turned to the fixed-rate sector

International bond issues have been buoyant for well over a year, largely reflecting financial liberalisation, notably in France and Italy. In addition, as they face continued financial pressure from slower economic activity, private sector borrowers in many countries, including Japan, have turned to the fixed-rate sector to refinance the rising volume of redemptions in the international bond markets. Overall, turnover of fixed-rate bonds also remained strong (Chart 2).

Political concerns in some countries and related expectations of weakening exchange rates may have influenced the currency composition of international bond issues in the first quarter. The proportion of bonds denominated in deutschmarks and Ecu was relatively strong during the quarter (Chart 3), while the shares of the Canadian dollar, sterling and Swiss franc all fell.

Chart 3
Currency composition of fixed-rate bond issues(a)



(a) Including equity-related issues.

Few Ecu-denominated bonds were offered in the international markets during the second half of 1991. However, the EMU treaty agreed at the Maastricht summit may have led some investors to anticipate a revival in long-term interest rate convergence in Europe, despite the uncertainties seen in the first quarter. Issuers responded by offering some $15.7 billion of Ecu-denominated eurobonds in the first quarter, the second highest quarterly total on record in the sector. Issuance in the sector was further increased by the activity of European institutions (such as the Council of Europe and the EIB), many of which have particularly large funding requirements in the first quarter of the calendar year and which tend to favour the Ecu.

Gross US corporate debt issued in the domestic market ($75 billion in the first quarter) was particularly buoyant in January following the Fed's discount rate cut, which for a time was thought to mark the low point of the current interest rate cycle. Low US interest rates also contributed to a revival in US junk bond issues (below investment grade), which totalled $7.5 billion in the first quarter. Junk bond prices rose during 1991, helped by buying from a wide variety of investors such as pension funds, insurance companies and short-term funds. This helped to halve the yield differential between junk bonds and US Treasuries over the year. Many of the new junk bond issues refinanced maturing debt, which might be viewed by some participators as less risky than the issues made in the late 1980s to finance management and leveraged buyouts. Nevertheless, since the US economy is still relatively subdued and doubts remain about the creditworthiness of some of the country's larger companies, concerns have been expressed that yields on junk bonds may have been pushed too low.

The level of euro-commercial paper (ECP) outstanding, which had remained flat for a year, rose by a substantial \$8 billion to \$86.5 billion in March. Issuers may have switched to shorter-term finance because of an oversupply of longer-term paper and because of pressures on bank-supplied credit, while uncertainty over interest rates in March may have led some investors to prefer short-term floating-rate assets. Japanese companies may also have increased their commercial paper issuance ahead of their year-end reports.

The euromarkets and domestic markets continued to converge

Further convergence between euromarkets and domestic markets was evident during the first quarter and may, over time, influence firms in how they meet their future global financing needs. In the bond markets, several Japanese domestic issues were syndicated using the fixed price re-offer method, a technique relatively common in the euromarkets but still rare in Japan. The lower fees charged under this method may help the authorities' continuing efforts to nurture a domestic corporate bond market.

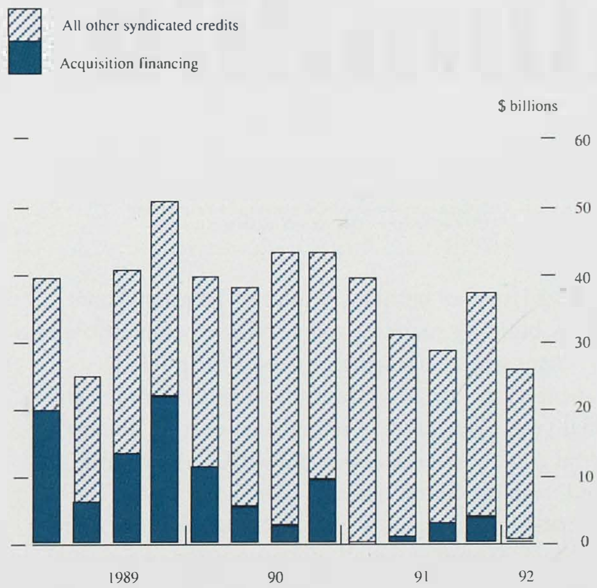
In the euro-medium-term note (EMTN) market, there were further underwritten bond issues via EMTN programmes. Bond issues via MTN programmes have to date been more common in the US market, but more are expected in the euromarkets as borrowers make use of the flexibility of EMTN documentation to minimise their overall cost of funds. This type of issue does not at present offer the liquidity of large public eurobonds, but provides an alternative to smaller privately-placed eurobonds. The quarter also saw the opening of a French franc domestic MTN market.

There were also several interesting developments in domestic commercial paper (CP) markets. More foreign firms established borrowing facilities in the French franc and deutschmark CP markets. The first dual and multi-currency programmes were launched in the deutschmark sector (allowing issues in currencies other than the deutschmark), both by German borrowers. These may encourage overseas investors to participate in deutschmark CP, although with ratings still rare, investment may be restricted principally to well-known names such as the Treuhandanstalt (which doubled its programme to DM 10 billion in response to strong interest from both domestic and overseas investors).

Syndicated credit activity was subdued

The value of total loans announced in the international syndicated credits market during the first three months of the year was below the high level of the previous quarter, which had reflected a few particularly large loans. For over a year, demand for international bank credit has eased off as a result of sluggish growth in the major economies. This has contributed to a decline in acquisition finance (Chart 4) and the desire of many borrowers to restructure their balance sheets in favour of equity and the currently low coupons on fixed-rate debt. Tighter banking covenants and higher spreads and fees on syndicated credits may also have choked off some potential demand. Deals announced for the air transport and energy sectors continued to form a large

Chart 4
International syndicated credits



Source: Bank of England ICMS database.

proportion of the syndicated credit market. For example, the value of loans arranged for energy companies in the first quarter exceeded \$5.5 billion, around one fifth of the total. Some such loans to the UK oil sector were heavily oversubscribed, suggesting that banks continue to be ready to provide funds to well regarded borrowers, provided that loan prices reflect the level of risk.

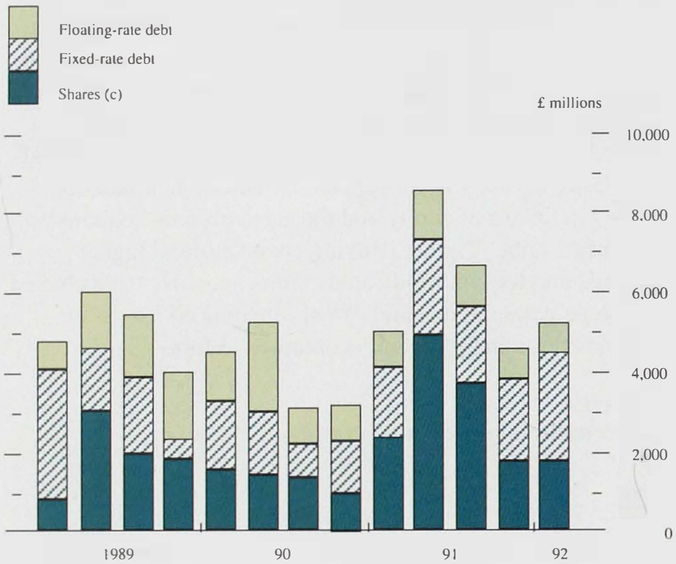
Domestic markets

New issues and turnover

Sterling new issues remained at high levels despite difficult market conditions

Total new issues of sterling debt and equity announced during the first quarter totalled £5.9 billion, up from £5.1 billion in the fourth quarter, despite the fall in bond and equity prices in the wake of the Budget and the announcement of the election. Immediately after the election, several new issues were brought to the market. Announcements of debt issues by domestic financial institutions, particularly building societies, accounted for much of the rise in issuance (Charts 5 and 6). There were

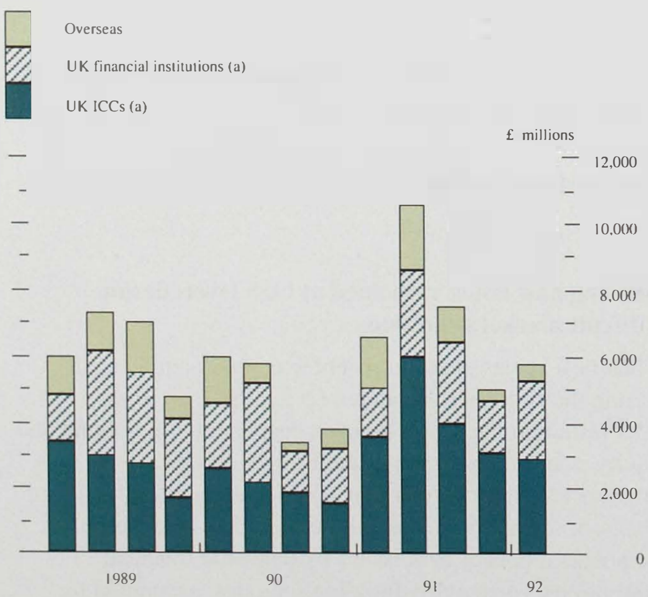
Chart 5
Sterling capital issues announced (a) by UK borrowers; (b) by instrument



(a) Further details can be found in the Bank's monthly Capital Issues Press Notice.
(b) Including issues by overseas subsidiaries of UK companies.
(c) Shares comprise ordinary shares and preference shares including convertible preference shares. Only those issues which raise new money for the issuer are included: therefore sales of shares by the Government (eg the electricity privatisations) are excluded.

two further issues of permanent interest-bearing shares (PIBS) by building societies and two issues convertible into PIBS. There was also a spate of new (PEP-related) investment trusts, ahead of the Budget and the end of the financial year. The value of announcements by domestic industrial and commercial companies (ICCs) was little changed from the fourth quarter. The largest was Thorn EMI's one-for-four rights issue for the acquisition of the Virgin Music Group. Overall, the proportion of new equity raised by rights issues was lower than in 1991, reflecting market uncertainties.

Chart 6
Sterling capital issues announced; by type of issuer



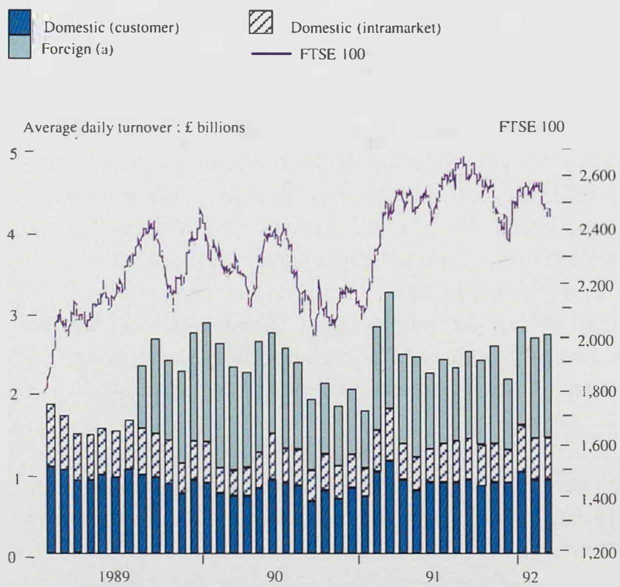
(a) Includes issues by overseas subsidiaries of UK companies.

The amount of sterling commercial paper outstanding at the end of March recovered to £4.4 billion from its seasonal low at the end of the fourth quarter. The Bank was notified of five new programmes, of which three were sterling options within multi-currency programmes. The Bank was also notified of seven new MTN programmes during the quarter.

Turnover increased in the first quarter . . .

Daily turnover of domestic equities on the London Stock Exchange averaged £1.5 billion during the first quarter, 12% higher than in the previous quarter (Chart 7). Over the same period, average daily trading of foreign equities in London by Exchange member firms rose by 18% to £1.2 billion. Within this figure, turnover of US stocks nearly doubled and turnover of European stocks increased by 29%, more than offsetting a fall of 16% in the turnover of Japanese equities in London (which shadowed an even more pronounced fall in domestic turnover in Japan).

Chart 7
Equity prices and turnover on the London Stock Exchange



(a) Complete foreign equity turnover data were not available until late 1989 when the London Stock Exchange introduced SEQUAL, its trade matching and reporting service for non-UK equities.

. . . although equity prices ended the quarter lower

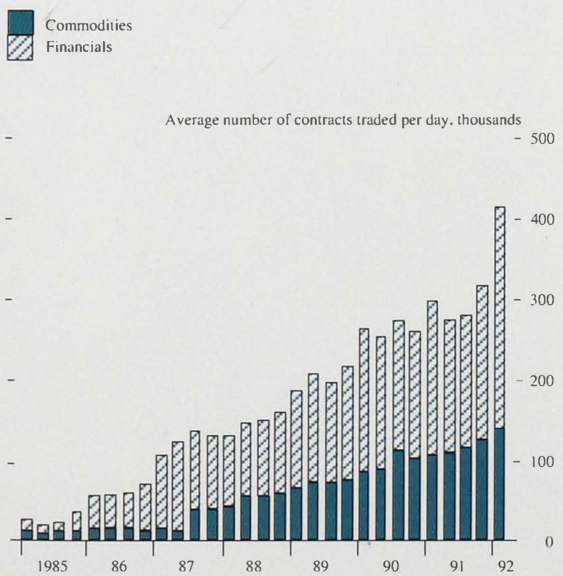
The FTSE 100 index rose cautiously in January and February, held back by uncertainty in the run-up to the election and continuing unease about the prospects for domestic and international economic recovery. The index reached a peak of 2,574.8, but promptly lost 52 points on 11 March after the announcement of the election and continued on a downward path until the end of the quarter to reach a low of 2,440.1 at the end of March. The Eurotrack 100 index (which covers the leading non-UK European stocks) rose by 6.5 % during the first quarter, partly reflecting the impact of the US dollar on companies' overseas earnings and exports.

The average touch on the FTSE 100 stocks (the difference between the best bid and offer prices, measured as a proportion of the mid-price) narrowed slightly to 1.2% over the first quarter of 1992, from almost 1.25% in the previous quarter. The touch for second line stocks widened marginally, averaging 6.9% over the quarter, and that for third line stocks widened more significantly to 10.7%, from 9.7% in the previous quarter.

Turnover in the gilt-edged market rose to average £5.1 billion per day in the first quarter, up from £4.7 billion in the previous quarter. The number of bargains averaged some 2,800 per day in March, the highest since January 1991, reflecting volatility following the Budget, when prices fell sharply, and during the period of political uncertainty before the election.

The issue of £200 million each of put and call options on the 10-year benchmark 9¾% Treasury 2002 was announced, amid increased volatility in the gilt-edged market ahead of the Budget. As a result, the nominal amount of call warrants exercisable into gilt-edged stocks outstanding rose to £300 million and of put warrants to £200 million. £30 million call and put option contracts expired during the quarter.

Chart 8
Aggregate turnover on the London derivative exchanges



Sources: LCH./GAFTA./LOCH.

Futures and options

Turnover was very strong in the first quarter

Trading volume on London's futures and options exchanges expanded by 26% in the first quarter of 1992 (Chart 8), reflecting significant price movements in underlying markets, domestic political uncertainty and increasing user familiarity.

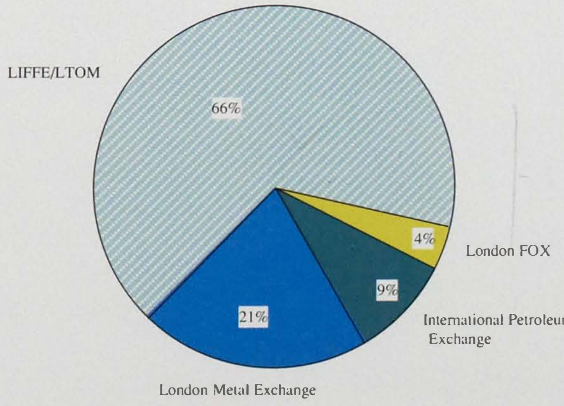
In the quarter which saw the formal merger of LIFFE and LTOM, turnover of LIFFE contracts rose by 25% and was 55% higher than a year earlier. Trading on most financial futures exchanges abroad also rose sharply in the quarter. However, growth at LIFFE continued to outpace that of its larger US counterparts: the Chicago Board of Trade (CBOT), 22% up on the comparative quarter of 1991 after a 10% fall during the year, and the Chicago Mercantile Exchange, where volume rose by 30%.

March was the most active month in the quarter. Record exchange turnover was driven by the domestic (UK) contracts which now typically account for around 40% of trading. Election uncertainty produced new monthly turnover peaks for short sterling futures and options, long gilt futures and options and the FTSE 100 future. The previous long gilt record dated back to February 1988. LIFFE's Italian government bond contracts responded to differing election information by reaching new trading records. The future has matured in six months' trading and by end-March open interest had risen to almost 41,000 contracts (compared with 56,000 for the long gilt future).

Trading in the exchange's most liquid contract, the German Bund future, rose by 49%. LIFFE accounted for almost three-quarters of the total market, split in late 1990 when Frankfurt's Deutsche Terminborse (DTB) introduced an imitative contract. This partly reversed the fall in share which accompanied the introduction of a controversial trading quota system for DTB market-makers in November 1991.

The merger of LIFFE and LTOM was completed on 22 March, seven weeks after the equity option market moved from the Stock Exchange to share LIFFE's new trading facilities at Cannon Bridge. The full title of the merged exchange is the London International Financial Futures and Options Exchange; LIFFE is retained as the shortened form. The merger makes LIFFE the third largest futures exchange in the world in terms of contracts traded, accounting for two thirds of turnover in London (Chart 9). The London Clearing House has assumed full responsibility for clearing and guaranteeing equity options, further extending the scope of its services to the London exchanges. The merger promises significant cost savings to member firms and a boost to stock index and equity option trading. It follows

Chart 9
Composition of London derivatives turnover by exchange: Q1 1992



Source: LCH./LOCH.

one year after the regulatory merger of the TSA and AFBD to form the SFA. In most other major markets, financial futures and equity option trading continues on separate exchanges. For example, in the United States the Chicago Board Options Exchange, trading equity options and regulated by the SEC, is separate from the CBOT, trading financial futures and regulated by the CFTC. In France equity options are traded on the MONEP and financial futures on the MATIF.

Turnover on the London Metal Exchange again grew strongly, by 19% in the quarter and by 57% in comparison with the same period in 1991. Volume on the International Petroleum Exchange fell by 11%, reflecting reduced volatility in energy prices. Trading was nevertheless 8% above that of the first quarter of 1991 when activity was boosted by the sharp fall in oil prices as Operation Desert Storm began. London FOX turnover grew by 20%, with higher volumes in all the staple soft commodity contracts.

Regulation

The SIB has published a report commissioned from Sir Kenneth Clucas on the future structure of retail regulation. The key proposal is that FIMBRA and LAUTRO should merge to form a new self-regulating organisation, which would also take over regulation of some other aspects of FSA retail business.

The SIB has also published revised proposals for future rules on disclosure of investment product details, commission structures and the status of advisers. The revisions are intended to underpin the main thrust of the proposals, which is to ensure clear and timely presentation of relevant information to investors.

The Legal Risk Review Committee, which was established in April 1991 to investigate the problems of legal uncertainty as it affects the UK financial markets, has published its initial findings in the form of a consultation paper. The paper documents the wide range of submissions received and, more importantly, makes proposals for new machinery to tackle uncertainty in the future. Responses to the consultation paper are now being analysed and will be used in drawing up the Committee's firm recommendations. These will form part of a final report to the Governor of the Bank of England later in 1992.

Settlement

Bilateral limits on banks' intra-day exposure were introduced within CHAPS at the end of April.