Financial market developments

- *Bond and equity prices rose slightly in most major financial markets, probably reflecting a market view that the interest rate and inflation outlook in the major economies was more favourable than previously thought.*

- *Issuance and secondary market turnover remained high in bond and equity markets, as did activity in over-the-counter (OTC) and exchange traded derivatives.*

- *Prospects for Stage 3 of EMU remained a major influence on participants in most markets in the third quarter, and there is evidence of a continuation of convergence-related positioning as well as some convergence of European bond yields.*

Background

Yields on government bonds generally fell in the major economies in the third quarter. US ten-year government bond yields fell only marginally (three basis points), but were volatile throughout the quarter. German and Japanese ten-year government bond yields both fell by 34 basis points this quarter; ending September at 6.08% and 2.82% respectively. This slight rally in prices probably reflected, at least in part, a market view that both current and future interest rates were more likely to be favourable to bonds than previously thought. Over the quarter, interest rate expectations implied by market prices fell in both the United States and Germany; at the end of the third quarter, the price of three-month eurodollar futures implied an increase of around 25 basis points in US rates by the turn of the year.

Speculation about the possibility of a substantial fall in the major equity indices—particularly in the United States—was not borne out. In the United States, the S&P 500 rose by 2.5% over the quarter, reaching a record high of 687.3 on the last day of September. In Europe, the FT-SE 100 also recorded an all-time high, and both the French and German equity market indices rose.

Bond issuance remained strong in the third quarter (see Table A) and both issuance and turnover on equity markets remained high. Turnover on derivatives exchanges was also sizable, at least in Europe: for example, on the London International Financial Futures and Options Exchange (LIFFE), July, August and September all set records for those months. Finally, activity in the OTC derivatives markets was reported to be strong, particularly when the traditional summer lull is taken into account.

Trades based on the convergence of European interest rates ahead of Stage 3 of EMU reportedly remained popular in bond and derivatives markets and may be a factor in the longer-term changes in yields on European government bonds. The yield on the French government OAT fell below that of the ten-year Bund in May this year and was 11 basis points below it at the end of the third quarter. Meanwhile, spreads over Bunds for traditionally higher-yielding European sovereign bonds have fallen markedly over the past two years (see Chart 1). But EMU is only part of the story: in France, for example, strong demand from domestic institutional investors for bonds of 8–12 year maturities has also encouraged a convergence in long-term yields with Germany, where domestic demand for similar maturities has been low. In the traditionally higher yielding European countries, investors' apparent preference for bonds

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

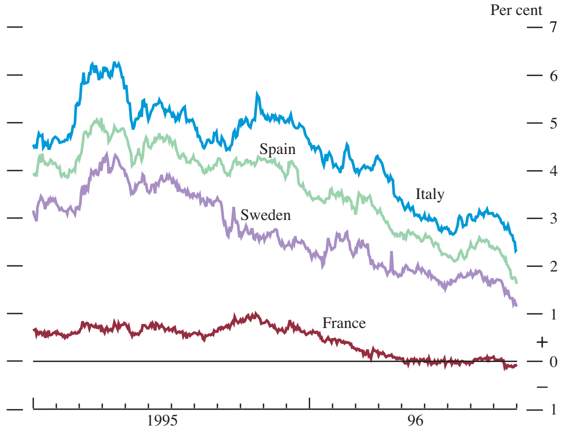
$ billions; by announcement date

	1994	1995			1996		
	Year	Year	Q3	Q4	Q1	Q2	Q3
International bond issues							
Straights	320.2	378.4	100.2	97.7	145.1	123.2	125.0
Equity-related	35.4	24.1	7.7	5.8	12.4	13.3	8.1
of which:							
Warrants	*11.7*	*6.7*	*1.5*	*3.2*	*4.2*	*3.6*	*2.6*
Convertibles	*23.7*	*17.4*	*6.1*	*2.6*	*8.2*	*9.8*	*5.5*
Floating-rate notes	126.4	100.1	30.4	25.2	38.0	44.4	44.6
Total	**482.0**	**502.6**	**138.3**	**128.7**	**195.5**	**180.9**	**177.7**
Credit facilities (announcements)							
Euronote facilities	196.8	293.3	68.8	64.6	100.5	95.2	61.8
of which:							
CP (b)	*36.4*	*50.3*	*6.4*	*18.6*	*23.3*	*30.6*	*16.9*
MTNs	*160.4*	*243.0*	*62.4*	*46.0*	*77.2*	*64.6*	*44.9*
Syndicated credits	548.3	785.0	151.0	220.1	164.8	226.1	167.6
Total	**745.1**	**1,078.3**	**219.5**	**284.7**	**265.3**	**321.3**	**229.4**
Memo: amounts outstanding							
All international							
Bonds (c)	2,020.8	2,224.9	2,199.7	2,224.9	2,230.4	2,251.0	2,305.1
Euronotes (b)	378.7	595.2	555.8	595.2	647.5	710.9	758.2
of which, EMTNs	*259.4*	*461.0*	*426.4*	*461.0*	*504.6*	*555.0*	*607.2*

Source: IFR, Euroclear, BIS.

(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. Bond total includes issues from MTN programmes.
(b) Euroclear figures.
(c) BIS-adjusted figures, including currency adjustment. Includes issues of fixed-rate bonds and floating-rate notes.

Chart 1
Spread of ten-year government bonds over Bunds



with a higher nominal yield in a time of generally low interest rates in the major economies, and a relatively sustained period of political stability and low inflation, will have had the same effect.

Bonds

International issues

Gross issuance of international bonds, at $177.7 billion ($191.2 billion on a seasonally adjusted basis), was still very high in the third quarter but did not reach the record of the first quarter this year. This may be because some borrowers had found the conditions earlier in the year sufficiently attractive to accommodate their planned borrowing. After the strength of the last two quarters, redemptions, at $71.9 billion, fell back towards the average for the last two years.

The average maturity of international bond issues, at 6.0 years, was little changed from the second quarter and so remains significantly lower than in the first quarter (6.6 years). The share taken by floating-rate notes (FRNs), at 30%, was also little changed and remains historically high. But equity-related bond issuance fell back to $8.1 billion in the third quarter—about the same as in the third quarter of 1995—after high issuance in the first half of this year.

Table B
Industry classifications of international bond issues

Per cent

Industry	1994 Year	1995 Year	1995 Q3	1995 Q4	1996 Q1	1996 Q2	1996 Q3
Banks	39.1	36.8	37.2	33.6	40.5	37.1	37.7
International and commercial companies	24.0	29.0	28.7	33.3	27.4	33.4	27.0
Central governments	14.1	12.0	10.6	10.3	11.2	10.0	14.8
International agencies	6.5	7.7	7.4	7.1	8.4	6.8	7.4
Other	16.3	14.5	16.1	15.7	12.5	12.7	13.1
Total (US $ billions)	**482.0**	**502.6**	**138.3**	**128.7**	**195.5**	**180.9**	**177.7**

Source: IFR Omnibase.

Asset-backed securities(1)

International issuance of asset-backed securities continued on the upward trend that started at the beginning of 1995, with $22.3 billion issued in the third quarter. While the market remains dominated by US issuers (which accounted for 90% of issues in the third quarter), European participation has grown. For example, the third quarter saw the first fixed-rate Deutsche Mark-denominated international asset-backed security; and NatWest securitised $5 billion (£3.2 billion) of corporate loans, the first example of this type of transaction in the United Kingdom.

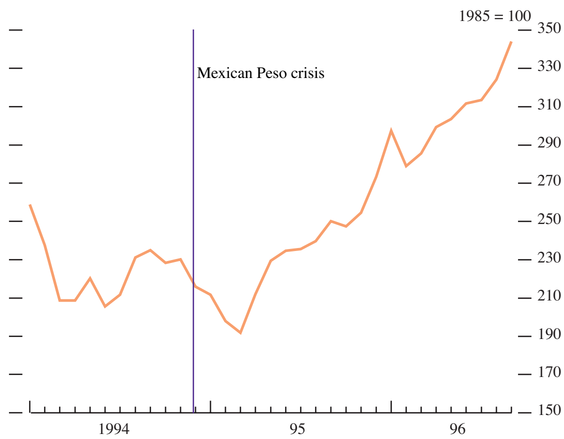
Samurai market(2)

Samurai issuance in the third quarter, at $10.3 billion, was strong and slightly above that in the second quarter. Retail investors' demand for higher yielding assets continued to encourage emerging market borrowers to issue Samurai bonds. However, changes to the regulation of yen-denominated eurobonds—in particular, the almost total removal of lock-up periods(3) and the possible removal of the withholding tax exemption on them—mean that they may become closer substitutes for Samurai bonds; that may affect issuance patterns.

Emerging markets(4)

The Salomon Brothers Brady Bond Index (see Chart 2) reached a new high in the third quarter, 36% higher than a year earlier. The prices of other types of emerging market

Chart 2
Salomon Brothers Brady Bond Index



Source: Bloomberg.

bonds also rose, continuing the upward trend established soon after the Mexican peso crisis. The secondary market in emerging market debt recovered quickly and strongly from that crisis because of demand from investors for bonds with high nominal yields, against the background of low interest rates in the major economies.

Strong issuance accompanied this rise in price although, following the Mexican peso crisis, investors appear to have

(1) Asset-backed securities referred to here do not include mortgage-backed securities.
(2) A Samurai bond is a yen-denominated bond issued in the Japanese domestic market by a foreign issuer.
(3) A lock-up period follows the issue of a security; during it certain investors cannot buy that security.
(4) 'Emerging markets' are the World Bank's middle and low-income countries, excluding Gibraltar, Greece, the Isle of Man, Malta and Portugal.

been making greater distinctions between countries in Latin America, resulting in—for example—a differentiation of Mexico, Argentina and Brazil in terms of yield.

The development of central and east European markets—noted in previous *Financial market development* articles—continued, with the first two Slovakian koruna-denominated international bonds, issued by the EBRD and the IFC. The first Lithuanian litas-denominated international bond was also issued, by the Republic of Lithuania.

Table C
Currency composition of international bond issues

Per cent

Currency denomination	1994 Year	1995 Year	Q3	Q4	1996 Q1	Q2	Q3
US dollar	38.4	39.2	40.8	42.2	39.3	48.0	45.9
Yen	17.2	18.4	19.1	17.2	12.1	13.7	15.6
Deutsche Mark	10.9	13.9	11.7	15.0	16.1	8.6	11.0
Sterling	6.5	4.3	3.5	4.3	7.6	6.1	4.5
French franc	5.4	2.7	1.7	2.3	5.5	6.4	4.4
Swiss franc	4.5	6.1	6.8	5.3	4.5	3.3	4.2
Italian lira	3.6	2.4	1.5	1.7	2.8	4.5	3.4
Ecu	1.6	1.8	2.7	0.2	0.8	0.2	1.0
Other	11.9	11.2	12.2	11.8	11.3	9.4	10.0
Total (US $ billions)	**482.0**	**502.6**	**138.3**	**128.7**	**195.5**	**180.9**	**177.7**

Source: IFR Omnibase.

Among Asian countries, the benchmarking process discussed in the August 1996 *Financial market developments* continued, with the Indonesian central bank issuing a Yankee bond(1) to aid the pricing of future Yankee bonds issued by Indonesian private sector borrowers.

In addition, the re-packaging of Brady bond debt continued in the third quarter: after Mexico's successful re-packaging in the previous quarter, Venezuela securitised some of their Brady bonds to create a DM 150 million international asset. The institutional investor base of the Brady bond market is reported to be broadening beyond dedicated emerging market funds; how permanent that change is will be clearer when the 'search for yield'—investors' apparent preference for bonds with a higher nominal yield at a time of low interest rates in the major economies—becomes less of a factor. If there has been a permanent increase in demand for emerging market securities, investors in emerging markets will eventually need to widen their demand to include instruments other than just Brady bonds because once a country's Brady bonds mature it cannot issue any more.

Sterling issues

Total fixed-rate issuance in the third quarter was £4.0 billion, of which £2.0 billion was short-dated, £1.0 billion was medium-dated, and £1.1 billion was longer-dated, including a perpetual issue of £30 million. All the fixed-rate issuance was in Eurosterling form, with no domestic debenture issues.

There was a broad range of fixed-rate issuers, almost half of which were from overseas. Overseas borrowing was mainly short-dated paper issued by European financial institutions, but there were also two sovereign issuers (Argentina and Sweden). UK corporations seeking to build longer-term capital structures issued £1.1 billion in medium and longer-dated fixed-rate debt; these included recently privatised industrial companies (National Power, Hyder and Railtrack) and City Greenwich Lewisham Rail Link, the consortium which is to build the Lewisham extension to the Docklands Light Railway under the Private Finance Initiative.

UK financial institutions issued £1.2 billion of fixed-rate debt. About a half of that was in longer maturities as part of various capital restructurings, notably by building societies: Woolwich launched a £200 million 25-year subordinated issue ahead of its flotation; Northern Rock issued a £150 million 25-year bond in preparation for its conversion to a bank; and Britannia launched a £100 million 15-year structured issue to boost its regulatory capital. Lloyd's TSB issued a £150 million 15-year bond to top up its capital base ahead of its acquisition of the remaining stake in Lloyd's Abbey Life.

FRN issuance in the third quarter was £1.4 billion; roughly 60% was issued by building societies, with all five issues by such entities at a maturity of five years. Lloyd's TSB issued a £100 million ten-year FRN to accompany its fixed-rate issue. In addition there were two asset-backed FRNs: a seven-year FRN backed by car hire purchase receivables; and a ten-year FRN backed by consumer loans.

Spreads on sterling issues widened at the start of the period due to the increase in supply but narrowed again for two possible reasons: first, as a result of the pause in issuance in August; and second, because of further demand from continental investors for sterling assets. Despite renewed issuance in September, the benign credit outlook and strong institutional appetite for sterling paper has led to spreads tightening further.

Total outstanding sterling commercial paper (CP) fell to £6.5 billion by the end of the third quarter, £200 million lower than at end-June. Outstanding sterling medium-term notes rose by £1 billion to £19.4 billion at end-September.

Other developments

There were a number of structural changes in the G3 domestic bond markets—which together account for almost three quarters of the world's total outstanding bonds(2)—in the third quarter. First, the German authorities started to issue short-term government debt on a regular basis. The Second Financial Reform Bill of 1994 set up a legal framework for money-market funds, which are expected to be major investors in this type of instrument (a perceived lack of potential investor demand had previously been an obstacle to creating a liquid money market). Separately, the German authorities plan to introduce the capacity to

(1) A Yankee bond is a US dollar-denominated bond issued in the US domestic market by a foreign issuer.
(2) Salomon Brothers 'International Bond Market Analysis'.

strip some ten-year and 30-year Bunds during the course of 1997.

Second, the US Treasury announced that it will auction ten-year inflation-indexed notes, starting in January 1997. Both interest and principal on the notes will be adjusted for changes in the consumer price index. As well as potentially lowering the government's financing costs, the Treasury's move will provide a new means for measuring the market's inflation expectations.

Third, the practice of Japanese government bonds (JGBs) settling only on so-called *gotobi* days (those numbered days of the month that are divisible by five) has ended. Since 1 October, JGBs settle on a T+7 basis and there are plans to reduce this down to T+3 in spring 1998, which would make the settlement of JGBs comparable to bonds settled on Euroclear and Cedel.

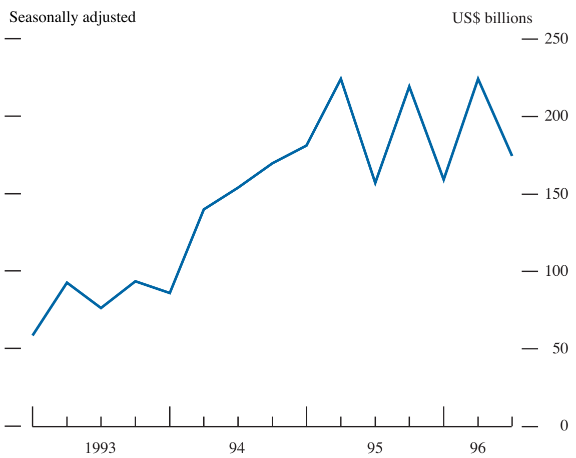
Note markets

The third quarter was the least active quarter for some time in euromedium-term note (EMTN) markets, with announcements totalling only $44.9 billion, down 29% on the same period last year. The growth of total announcements of commercial paper (CP) over the last two quarters stalled somewhat in the third quarter, with announcements of $16.9 billion. This is, however, still considerably higher than the same period in 1995 ($6.4 billion); announcements of CP in the first three quarters of 1996 have totalled $70.8 billion, compared with $50.3 billion in the whole of 1995 and $36.4 billion in 1994.

International syndicated credits

Syndicated credit announcements continued to follow the saw-tooth pattern established in the first quarter of 1995, as Chart 3 shows. The third quarter's borrowing was 26% down on the second quarter's, but 11% higher than the third quarter of 1995. Spreads on syndicated loans continued to remain low, probably because many banks being relatively cash and (regulatory) capital rich, wish to increase the size

Chart 3
International syndicated loan announcements



Source: IFR Omnibase.

of their balance sheets and are more comfortable investing in loans than securities.

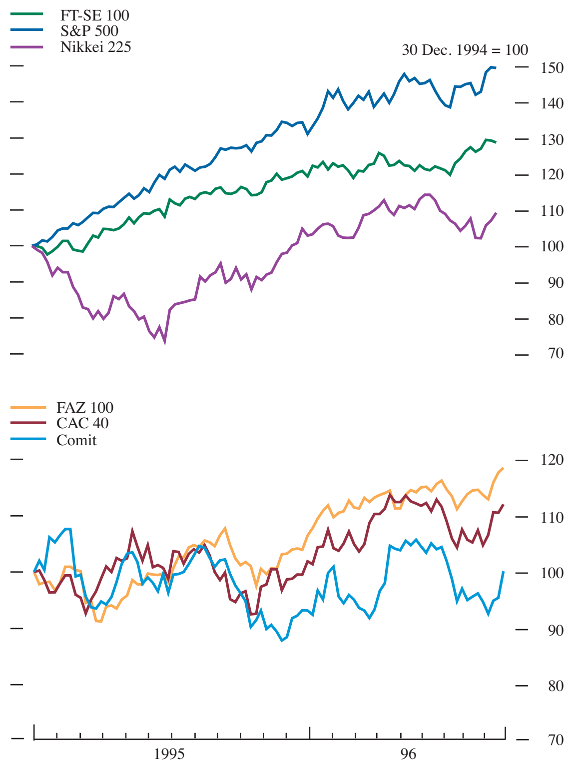
The international syndicated loans market has now provided easier access to capital for lower credit-rated borrowers than the bond markets for several quarters; among issuers this quarter were several Turkish banks, for example. Many emerging market borrowers find that the syndicated credits market is their only available source of international capital and its popularity is helped by the fact that many firms, from both emerging markets and developed countries, are more familiar with loan financing than securities financing. Some borrowers use the syndicated credits market to gain name recognition with investors prior to issuing bonds.

Equity markets

Prices

The US equity market, as measured by the S&P 500 index, rose 2.5% during the third quarter, bringing its rise in the first three quarters of the year to 11.6% (see Chart 4). The NASDAQ index, which is more heavily weighted towards the technology sector, rose 3.5% (16.6% in the first three quarters of the year). The early part of the quarter saw

Chart 4
Equity indices(a)



Source: Individual exchanges.

(a) End-week prices; data to 27 September 1996.

prices decline amid two major concerns: first, that inflationary economic growth would necessitate a rise in interest rates; and second, that company earnings would not grow as quickly as earlier projections had suggested. However, in the latter part of the quarter, economic data and company results allayed both these fears, at least in the short term, resulting in the S&P closing at an all-time high of 687.3 on the last day of the quarter.

Japanese equity prices failed to retain the momentum they achieved in the first half of the year, and fell 4.3% over the third quarter. Sentiment was fragile, with the slowness of the country's economic recovery disappointing investors. In addition, the prospect of a strengthening dollar, which would decrease dollar returns on Japanese equities, discouraged foreign investment.

After its relatively weak performance in the first half of the year, the UK equity market, as measured by the FT-SE 100 index, rose sharply in the third quarter, recording a gain of 6.6% (7.2% so far this year) and reaching a then record high of 3,977.2 on 16 September (before rising above 4,000 in October). The rising US market underpinned sentiment in the United Kingdom, but equity market analysts' view that a rise in interest rates is unlikely before the next election was reportedly another important factor.

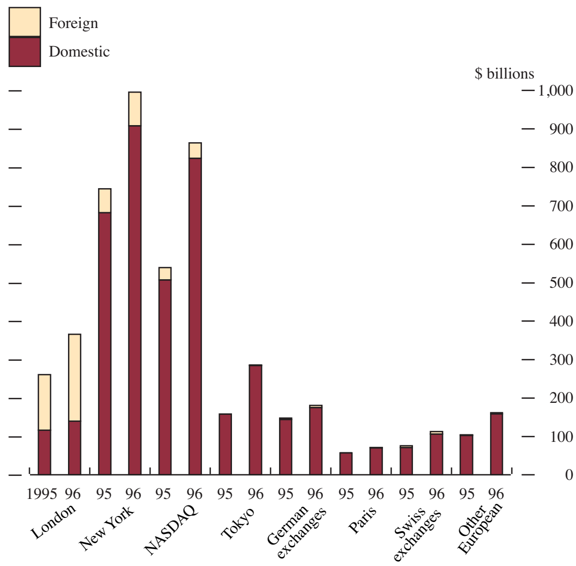
Most continental European equity markets were less buoyant than the United Kingdom during the third quarter, but strong nonetheless. The German equity market, measured by the FAZ index, rose 2.2% over the quarter, with the repo rate cut in late August seen as positive for both economic growth and exporting companies. The cut also helped French equities, which were weak until the end of August, but closed September 0.4% up on the quarter. The Italian equity market was the weakest in Europe, falling 3.3% over the quarter, while Scandinavian markets were strong over the quarter: Finnish equities rose 8.2%; and Swedish equities 5.5%. Throughout continental Europe, equity market analysts have become preoccupied with the likelihood of the various countries meeting the Maastricht criteria.

Turnover

Turnover in equities was strong in the second quarter of 1996 (the most recent data available). As Chart 5 shows, all major exchanges recorded a rise of at least 25% compared with the same quarter in 1995. Tokyo saw the strongest rise, after comparatively low turnover last year; trade in domestic equities almost doubled. Volumes of US equities traded continued to rise with NASDAQ volumes 65% higher and New York Stock Exchange volumes 40% higher. Despite the increased volumes in European markets, the number and proportion of foreign equity trades on the London Stock Exchange continued to rise: 62% of equity turnover in the United Kingdom was for non-UK equities, compared with 57% in the second quarter.

Tradepoint—the computerised order-driven market in UK equities which started operation a year ago—recorded its highest quarterly turnover to date in the third quarter, with £102 million of shares traded, compared with £64 million in the second quarter. Despite this, Tradepoint's share of the UK equity market remains low, at under 0.5%.

Chart 5
Turnover of domestic and foreign equities on major stock exchanges(a)



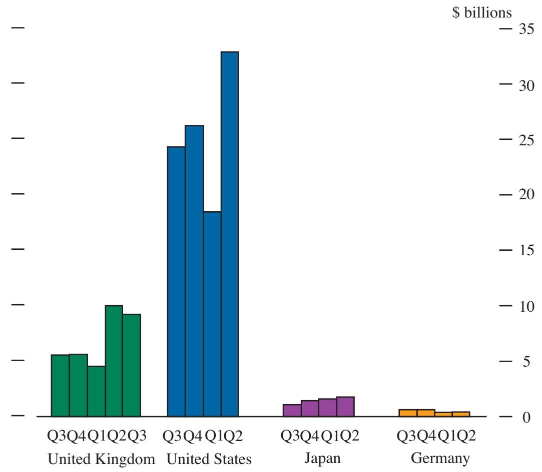
Source: Individual exchanges.

(a) Turnover in the second quarter of year indicated.

Equity issuance

Equity issuance outside the United Kingdom rose significantly in the second quarter (the most recent data available) compared with the first (see Chart 6). Issues of new equity in the United States totalled $33 billion, a third of which was in the form of initial public offers. Issuance picked up slightly in Japan, with $1.8 billion of new equity raised in the second quarter, over 90% of which was by companies already listed on the Tokyo Stock Exchange. Issuance in Germany continued to be subdued, at $0.4 billion; one possible reason for that was the planned DM 15 billion Deutsche Telekom flotation which is to be launched on 18 November and which might have been crowding out other prospective issuers.

Chart 6
Equity capital raised in major stock exchanges



Source: Individual exchanges.

Issuance in the United Kingdom in the third quarter of 1996 was very strong, with £3.2 billion raised during the quarter, compared with £3.0 billion for the whole of 1995, despite the third quarter being traditionally the quietest of the year. The total for new issues has already reached £8.5 billion this year. The issuance figures for 1996 have been boosted by two large privatisation issues—Railtrack (£1.9 billion) in May and British Energy (£1.4 billion) in July—but, even without these issues, 1996 issuance has already comfortably exceeded that of 1995. Similarly, buoyant issuance is evident on the alternative investment market (AIM), with new issues of £314 million in the first nine months of 1996, compared with £76 million for the whole of 1995.

Other developments

The London Stock Exchange's new electronic trading platform—Sequence 6—went on-line at the end of August. That had two immediate effects. First, it introduced an electronic link for trade reporting; second, it led to a large increase in Exchange members with access to the extended Stock Exchange Automated Trading system (SEATS plus), the electronic order book for stocks on AIM and stocks with fewer than two market-makers. In due course, the Sequence 6 platform will also be the basis for an order book for FT-SE 100 shares, which is likely to be introduced towards the end of 1997.

In July, the Chancellor of the Exchequer announced changes to the stamp duty relief on share transactions. The existing exemption for market-makers and broker dealers will no longer be practicable when the order book trading begins and market making (as a defined activity) comes to an end. The changes will be introduced during the 1997/98 financial year and the exemption will in future apply to intermediaries on any UK recognised investment exchange or European Economic Area regulated market. As a result, the London Stock Exchange's earlier proposal for the creation of Registered Principal Traders to support order book trading and who would receive exemption in return for various obligations, has been withdrawn. The Exchange is now considering the functioning of the order book itself and has formulated detailed proposals on this issue in the light of responses of market participants to a consultation document issued in May.

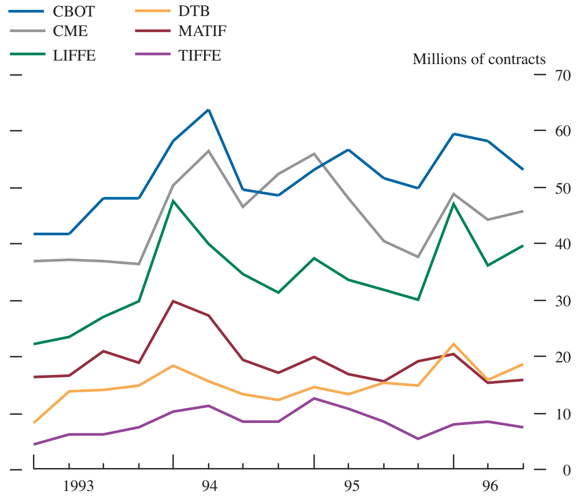
EASDAQ, a new pan-European market for the securities of smaller companies, opened in late September. The market is based on a quote-driven system modelled on NASDAQ, with share prices advertised on screens and traded by intermediaries using telephones. EASDAQ will operate alongside the domestic small company markets set up elsewhere in Europe, including AIM in the United Kingdom and the Nouveau Marché in France. Separately, AIM—the London Stock Exchange's market for smaller companies—is conducting a review of nominated advisors to its traded companies as it moves into its second year of operation.

Derivatives exchanges

Volumes

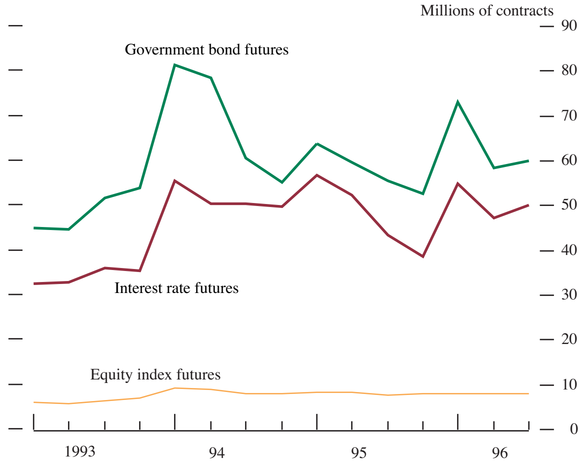
Turnover on the major European derivatives exchanges in the third quarter of 1996 was higher than in the second quarter (see Chart 7). However, volumes were lower on a number of exchanges outside Europe; nevertheless, worldwide turnover was higher than in both the previous quarter and the equivalent period last year. Turnover in interest rate futures contracts showed a bigger increase over the third quarter than turnover in government bond futures (see Chart 8). The stronger growth in the former probably reflected hedging business from the OTC markets, in particular the hedging of trades based around EMU convergence; that also probably encouraged the growth in volumes on European exchanges.

Chart 7
Quarterly turnover on major derivatives exchanges



Sources: FIA, individual exchanges.

Chart 8
Quarterly turnover of futures by type(a)



Sources: FIA, individual exchanges.

(a) Turnover in the major futures contracts listed on the CME, CBOT, LIFFE, DTB, MATIF and TIFFE.

Total volumes on LIFFE[1] increased by 9% from the second quarter to the third, and by 25% on a year-on-year basis, mainly because of the performance of its interest rate contracts. July, August and September all saw record volumes for those months and open interest on the exchange increased by 9% from end-June 1996 to end-September.

Turnover on the Deutsche Terminborse (DTB) increased strongly, by 19% compared with the previous quarter, and by 23% year on year, mainly because of growing volume in the Bobl contract. Quarterly volumes on the DTB have exceeded those on the Marché à Terme International de France (MATIF) since the start of this year. In the third quarter, turnover on MATIF increased by 5% on the previous quarter and by 3% compared with the same time last year. Volumes in the PIBOR contract grew by 28% over the third quarter, boosted by particularly strong activity in August.

In the United States, volumes on the Chicago Mercantile Exchange (CME) increased by 3% on the previous quarter and by 13% compared with the same period last year. The CME's Eurodollar contract, the world's most actively-traded futures contract, saw volume growth of 8% over the third quarter and 13% over the equivalent period last year. Turnover on the Chicago Board of Trade (CBOT) declined by 8% compared with the second quarter, but increased by 4% year on year. Turnover on the Tokyo International Financial Futures Exchange (TIFFE) declined by 12% both on a quarterly basis and compared with the same time last year.

Other developments

The members of the London Clearing House (LCH) endorsed the new ownership and guarantee proposals, by which the LCH's ownership transferred on 10 October from six UK clearing banks to the clearing house's clearing members and the three derivatives exchanges—LIFFE, the London Metal Exchange (LME) and the International Petroleum Exchange (IPE)—for which it clears. Share capital has been increased from £15 million to £50 million; the £150 million back-up provided by the shareholder banks has been replaced by a £150 million Member Default Fund as well as an additional insurance tranche for £100 million, which is initially in place for three years.

Links between derivatives exchanges were strengthened in the third quarter. First, LIFFE's merger with the London Commodity Exchange (LCE) took effect on 16 September, consolidating London's exchange traded derivatives business (though former LCE contracts will continue to be traded on the existing site, separate from the other LIFFE contracts, for the present).

Second, MATIF has confirmed that it is in talks with the Singapore International Monetary Exchange (SIMEX) and the CME over plans to establish joint trading links to rival the link agreement between LIFFE and the CBOT. The proposal also reflects exchanges' increasing efforts to maximise their prospects for capturing Euro business after Stage 3 of EMU. This follows the termination of MATIF's trading link agreement with Germany's DTB.

Third, the Board of Trade Clearing Corporation (BOTCC)—the clearing arm of CBOT—and the CME have signed a letter of intent to pursue a common banking initiative. Common banking will enable clearing firms that do business on both exchanges to settle their trades with a single transaction through a common account at a bank, reducing firms' expenses. The CME and the New York Mercantile Exchange (NYMEX) have already signed a similar letter of intent to provide common banking.

Separately, as part of its review of the LME and the metals markets following problems associated with trading losses at Sumitomo Corporation (see the August 1996 *Financial market developments*), the Securities and Investments Board (SIB) published a consultation document in August and is currently assessing responses. The purpose of the paper was to seek views on issues relating to the rules and trading practices of the LME in the context of the wider global metals markets. A final report is expected to be published at the end of this year.

OTC derivatives markets

Recent statistics on the OTC derivatives markets are scarce, but indications are that volumes remained high in the third quarter, particularly given the traditional seasonal lull. In particular, trades motivated by the likelihood of Stage 3 of EMU occurring—and therefore on the likelihood of interest rates, especially those in Germany and France, converging—are reported to have remained popular. Participation in these markets may also be changing: some smaller users have reportedly left the market, but there are indications that asset managers are making more use of derivatives to enhance yields against the background of low interest rates in the major economies.

According to supervisory data,[2] UK banks'[3] notional principal amounts in OTC derivative contracts held as part of their trading activities totalled £6.1 trillion at the end of the second quarter (the most recent data available), an increase of 16% on the end of the first quarter. Replacement cost—a measure of the amounts at risk from counterparty default—was £78.2 billion (only 1.3% of notional principal amounts), an increase of 2% on the first quarter.

Of the total notional principal amount, 72% was in interest rate contracts and 27% in foreign exchange contracts. Of all contracts, 57% of the total notional principal amounts was in contracts with a residual maturity of under or equal to one year, 34% in contracts with a residual maturity of between one and five years and 9% in contracts with a residual maturity of over five years.

(1) Excludes commodity figures.
(2) Aggregated from individual Capital Adequacy Returns (Trading Book), otherwise known as Forms CAD1. These forms are completed by UK incorporated institutions authorised under the Banking Act 1987. These data are not directly comparable with previously published supervisory data—because the basis of reporting has changed—or with the results of the 1995 central bank survey of OTC derivatives markets.
(3) UK incorporated institutions authorised under the Banking Act 1987.