Financial services into the year 2000

In this speech,(1) Ian Plenderleith outlines some of the main challenges and opportunities facing the derivatives industry in the next few years, in particular the introduction of the euro, Year 2000 compliance, and a range of issues bearing on the structure of derivatives trading.

I am asked, in this keynote address, to try to identify some of the challenges and opportunities facing financial services in the derivatives industry into the year 2000. There are in fact so many issues that I hardly know where to start. But let me try to offer you an agenda of some of the issues that I hope you will have an opportunity to review over the course of this conference; and if, in debating them, you should happen to stumble on any answers, I would be delighted to have them.

Preparations for the euro

First, however, we have to get to the year 2000, and there are a couple of preliminary hurdles we have to clear on the way—sort of warm-up games before the main contest. They are, of course, our old friends, the single currency and the Millennium bug. Far be it from me to imply that they are in any way similar, but they do at least share the common characteristic of being capable of delivering serious damage to your business activities if you do not prepare for them thoroughly and in good time.

For the euro, since the rather extended meeting of the selection committee at the beginning of May, we now know the names of the players and their starting prices. The United Kingdom will, as you know, not itself be a participant in the first wave, but as a 'pre-in', we intend to remain closely involved in the development of the monetary union. In particular, the UK Government has placed great emphasis on the importance of pushing ahead with the necessary preparatory work, so that the UK business and financial communities will be ready for the euro.

This is most notably evident in the substantial scale of preparatory work that has been undertaken in the past two years in the international financial markets here in London. Since these are international markets, trading all the major world currencies, and since London is the world's pre-eminent international financial centre, there will understandably, and perfectly naturally, be substantial trading activity in the euro in London, just as there is already in the dollar and other internationally traded currencies. My colleague, John Townend, and his team at the Bank of England have therefore been leading a far-reaching exercise to ensure that the necessary market-wide systems and dealing conventions are put in place to trade the euro, and to provide essential information for individual firms to make their own in-house preparations. This comprehensive exercise has extended across the full range of markets—not just foreign exchange, but also money-market instruments, bonds and equities, futures, options, swaps, FRAs and other derivatives, on-exchange and OTC, repo and collateral management, and the full range of payment and settlement systems. To keep everyone who is engaged in this extensive exercise up to date with progress, we have issued a flagship quarterly publication, now in its eighth edition, *Practical Issues*, which is circulated to some 40,000 avid readers, several thousand of them abroad; indeed, the European authorities themselves have described it, gratifyingly, as the bible for euro-preparatory work.

This extensive programme to prepare for the euro has made excellent progress, and the bottom line is that the London markets will be ready, willing and able to trade the euro. So let no one doubt the seriousness of our intention that London will be in a position to offer the full range of trading and payment facilities in euro on an efficient, safe and cost-effective basis. This is not a matter of competition with other centres. It is entirely likely that EMU will generate an expansion of euro activity in the countries joining the monetary union at the outset, because of course the euro will be their domestic currency. But it will also be an international currency, and it is in international trading that London's distinctive strengths lie—for the euro, just as much as for the dollar and other international currencies at present. The important point is that what is involved is a positive-sum game, from which all can gain. The euro represents an opportunity for expanded international business in London, and seizing that opportunity is a very real practical contribution that the London markets can make to the success of the euro. We cannot fix the weather, but we shall be able to do pretty well anything you want with the euro.

Preparations for the year 2000

Having geared up for the euro, it might then seem reasonable to have a short rest, but someone with a twisted sense of humour decided to follow the launch of the euro very rapidly with the year 2000 and its Millennium bug.

(1) Given at the Fifth International Derivatives Conference, organised by the Futures and Options Association and the Futures Industry Association in London on 16 June 1998.

You do not need me to emphasise the need for thorough and painstaking review of all systems to ensure Year 2000 compliance. Certainly, this message is being taken with the utmost seriousness throughout the London markets. Here, too, the Bank of England has been active in helping to co-ordinate and stimulate timely action, and in providing information in another quarterly publication, *Financial Sector Preparations for the Year 2000*.

Issues for the next millennium

Let us now try to look forward beyond these immediate business challenges. If we assume that you succeed in embracing the euro, and avoiding the embrace of the bug, what issues await you in the next millennium? I could draw up quite a long list, but I want to concentrate today on five issues that seem to me to be particularly relevant to your agenda for this conference.

Organised exchanges

The first is what future role there is for organised exchanges to play in the international trading markets. There is no doubt that organised exchanges around the world have undergone enormous changes in recent years, in the type of services they provide, in their use of technology, and in the way they are structured and governed. Some critics have argued that, with advances in IT providing ever more sophisticated systems for electronic trading, including the capability for participation via remote terminals, and with the growth of OTC business, the day of organised exchanges is drawing to a close and that they will have no role, or only a limited role, to play in the future.

I would not agree. I would argue, instead, that organised exchanges will continue to have an important contribution to make to the structure of our trading markets, in providing liquid, fair, and safe trading facilities for the international financial community. To see why this is likely, I think one needs to go back to fundamentals and see what it is that organised exchanges provide, at the most fundamental level. What they provide is at least two essential features of any efficient market: first, a trading system so that buyers and sellers can find each other and deal on the basis of a known set of trading and execution conventions, which each can rely on the other observing; and second, trade-supporting services—principally clearing and settlement, which may be administered by the exchange itself or provided by an outside supplier, and frequently also trade-reporting, price display, and related market-information services. The way in which these facilities are provided has changed over the years, and will continue to change. But however they are structured and delivered, they are necessary ingredients for a healthy market, and providing them is a role that exchanges can usefully fulfil for years to come. Interestingly, as the OTC derivative markets have developed increased volume in recent years, the same desire for the same two features—to standardise trading practices, and to provide safe clearing arrangements, has begun to emerge, and the lack of any exchange to organise these facilities for OTC business sometimes makes it harder to achieve agreed market-wide procedures.

Organised exchanges have therefore, in my view, a continuing and important future role to play. But one can nonetheless expect big changes in the landscape, as indeed is already happening. As integration of the world financial system deepens, we can expect to see a process of coalescence and consolidation of individual national exchanges. Just as we have seen, within a single country, regional and local exchanges consolidate into one or more integrated national exchanges, so now at the international level we may see national exchanges progressively consolidate into fewer, wider-ranging exchanges covering large areas of a particular time zone. Two current developments may particularly accelerate this process—the increased capability of exchanges in providing remote trading access, for participants not physically present in the local market; and the introduction of the euro as the single currency for eleven European national markets.

The process of consolidation may take some time, and I would expect it to advance incrementally, by a process of progressive identification of areas of co-operation and joint venture, rather than instant merger. There may, for example, be scope for exchanges to come together to co-operate in joint marketing of particular products or services, or to promote reciprocal membership, or to develop a common trading platform while still remaining independently responsible for functions such as membership and marketing. But whatever the model, the general direction seems to me clear: we shall still see exchanges playing a role in providing facilities for liquid, fair and safe markets, but we are likely to see greater cross-border integration and, in the end, fewer exchanges. The important challenge facing exchanges will be to identify the areas where co-operation among them can maximise the value of the services markets need them to provide; and the prizes will go, as they should, to those with the clearest foresight.

Trading systems: open-outcry or electronic?

A second issue that I would suggest for your agenda is what form of trading system, or systems, exchanges should be providing. In the securities markets, the debate in this area has been long-running, as the competing merits of quote-driven, market-making systems, as compared with trade-driven, order-matching systems, have been debated endlessly. In the futures industry, the debate has in recent years been about the respective merits of open-outcry floor trading or electronic trading.

In all these debates, the answer always seems to me very straightforward—in principle. The choice is not something to be resolved by academics debating the intrinsic merit of one approach or another, though academic research can certainly produce illuminating insights, and has done so. Equally, sadly, the debate is not a cultural one: coloured blazers and vivid manual gesticulation may be a lot more fun than horn-rimmed computer nerds hunched over electronic terminals, and we all know what makes a better sight for the tourists and the TV cameras, but that is not how the debate should be resolved. Nor should it hang on regulatory convenience, since both systems are capable of proper regulatory oversight; nor solely on the financial interests of the market intermediaries, since it is their customers and clients—the end-users—who ultimately pay.

What it seems to me will always ultimately determine the choice of trading system is, quite simply, revealed preference—which system market-users actually prefer to use in executing their business. The problem, of course, is that this is fine as a criterion in principle, but revealed preference is often hard to determine in practice, and certainly hard to divine far enough in advance for the necessary systems to be put in place.

In the securities markets, interestingly, the debate between quote-driven and order-matching has for the moment ended in a draw. Both types of trading system are wanted and the London Stock Exchange has, I believe, put itself in a strong competitive position—much stronger than is sometimes recognised—by equipping itself with both. In the futures markets, the answer may be different. Electronic trading plainly offers many advantages—lower costs, possibly quicker product innovation if new products can be brought to a screen more promptly than a new pit can be allocated, better audit trails, and maybe wider distribution through the potential for remote access and round-the-clock trading. Equally, electronic trading has limitations, at any rate with the current state of screen technology: there may be capacity problems; the liquidity of screen-trading can suffer in volatile markets; and spread trading can be difficult without execution risk. Here again, the best guiding principle seems to be the revealed preference of market-users—particularly the end-users, without whose business there would be no market. Looking down the road, it seems very likely that advances in technology will increase the relative advantages of electronic trading over time, and perhaps quite quickly. The key challenge for exchanges is to keep up with the pace of change, and to equip themselves with the technology that best provides liquid, fair and safe trading for the users of their markets.

OTC trading

A third issue that I would suggest for your agenda is what role, alongside the trading systems provided by exchanges, there is for OTC trading. The scale of OTC activity has grown rapidly in recent years. At the beginning of 1994, OTC outstandings were about the same as exchange-traded outstandings. On the latest data, OTC outstandings were more than double those of exchange-traded contracts. This rapid growth no doubt reflects the greater flexibility OTC products can offer on contract size, maturity, underlying instrument, etc, ie greater customisation. The growth has been facilitated by improvements in credit risk management, with the greater use of collateral freeing up credit lines, and by greater regulatory acceptance of netting in the calculation of regulatory capital requirements. What is interesting is that, as the scale of trading increases, greater attention is being directed towards developing a standardised trading framework and structured clearing arrangements, for at least the more plain-vanilla products such as swaps and FRAs. OTC activity thus begins to take on some of the characteristics of exchange-traded business, which is one reason why I argued earlier that exchanges, in a modern form, will continue to have a contribution to make to the market.

But in the OTC area, it seems to me that we are not looking at a mutually-exclusive phenomenon, in which exchange trading competes with OTC. Exchange trading can provide greater depth of liquidity for standardised products. OTC trading offers greater scope for customisation, but often needs the depth of exchange-based trading in standard products to provide the necessary hedge. So both are needed, and indeed complement each other. I buy my suits off the peg, as it happens, being a modestly-paid central banker; you no doubt have your blazers bespoke-tailored; but in the market as a whole, there is a need for both services—and so too in the futures markets.

Product innovation

A fourth issue I would like to suggest for your agenda flows very cogently from the OTC markets, and that is product innovation. The derivatives markets have been marked by rapid growth in recent years. Can this continue? All the evidence, looking forward into the next millennium, suggests that derivatives will continue to display rapid expansion—in overall activity, but most especially in diversity of products. Customer needs for specific financial packages seem likely to grow, as control of financial risk becomes more advanced. The process of global integration will add to this demand. Continuing advances in IT will make the derivatives industry more able to meet the demand for customised products. And demand is likely to be fed at the wholesale level by the widening circle of countries that reach economic maturity on the basis of market-based economic systems, notwithstanding the present setbacks in Asia; and at the retail level, by the increase in personal wealth and by the greater responsibility individuals have to take for managing their own savings.

We are likely therefore to see increased appetite for customised financial products, and an increased demand for product innovation. This seems to me a further reason to be confident of the role of London, because a great strength of the London financial markets, and an important reason for London's pre-eminence as an international financial centre, has been its immense capacity for innovation and its rapid responsiveness in developing new products for new needs. I expect this to continue, and it is one reason that I am confident that London will retain its international lead in financial services.

LIFFE

This brings me to the fifth and final issue on which I want to touch—the future development of London's international futures and options exchange—LIFFE.

It is worth reminding ourselves that LIFFE has a track record of outstandingly strong performance in a highly competitive arena, and that its present market position, notwithstanding recent movements, remains extremely powerful. It remains the dominant futures exchange in the European time zone, looking across the product range as a whole; in volume, it matches the major American exchanges; and its business continues to expand—volume in its short-term interest-rate contracts has risen by 57% in the first five months of this year.

Quite undue attention has recently been paid to shifts in the trading pattern of just one of LIFFE's contracts, the ten-year Bund contract—attention, in my view, out of all proportion to the importance of what is happening. It hardly seems very surprising that trading in the German government's own bond should move to the home country if the local exchange there can offer adequate facilities in its local centre, just as trading in the dollar bond contracts is centred in the domestic US exchanges. What is actually extraordinary is that so much trading of the German Bund contract should for so long have been concentrated outside Germany, in London. What matters for London, and for the international markets based here, is that London, and LIFFE, should continue to provide competitive facilities for internationally based trading activity, and for this, the depth and diversity of the unrivalled range of markets that London provides remains the great strength.

Nonetheless, the needs of these markets do not stand still, and it is therefore a very positive development, and much to be welcomed, that LIFFE is currently addressing significant changes in the structure of its trading systems and in its governance arrangements. These changes, and the virtually unanimous support they commanded at last week's EGM, are encouraging evidence of the vigour and the capacity for change of the LIFFE markets. They reflect LIFFE's determination to remain at the cutting edge of international futures and options trading, and they will place LIFFE in a strong position to capitalise on the trends I have tried to outline earlier in this speech. Futures trading originated in the United States, and I think those two great American wordsmiths had it right—Mark Twain, when he said, 'Rumours of my demise are greatly exaggerated'; and Ronald Reagan when he said, 'You ain't seen nothing yet'.

Conclusion

I have tried in these introductory remarks to suggest some of the issues that you may want to address in the next few days. No doubt there are others. The challenges are great, but so too are the opportunities. I have every confidence that the derivatives industry has an immense contribution to make to the future development of the international trading markets, and hence to the wider aims we all share for worldwide economic advancement.