**Mr. Davies looks at the tasks of the UK's new Securities and Investments Board and how it will affect the business community** Speech by the Deputy Governor of the Bank of England, Mr. Howard Davies, at the Futures and Options Association International Derivatives Week Conference in London on 4/6/97.

Thank you for your invitation. And, particularly, thank you for not withdrawing it when you discovered that, rather than having on your platform a benign, soft-centred Deputy Governor of the Bank of England, you found yourself face to face with the all-seeing, all-regulating head of super-SIB. This may have come as a surprise to you - but nothing like as big a surprise as it was to me, I can assure you.

And I have to say that, in spite of the way I have been presented in some of the newspapers, muscles rippling beneath a Superman T-shirt, I still feel rather more like Clark Kent in his thick specs, stumbling myopically around the office. I haven't yet found a phonebox in which to get changed.

I do not plan, this morning, to talk at length about my new responsibilities, partly for the very good reason that I have not had the time to prepare a coherent plan of campaign. But I might just say a word or two about the new SIB, and the way it will affect your business.

I have been quite encouraged, so far, by the market reaction to the proposed new structure. Warning notes have been sounded, of course, about the need to avoid a lumbering, slow-moving bureaucracy, and the need to ensure that regulation is appropriate for the type of market. I understand those points and, particularly as far as you are concerned, the need to distinguish between professional wholesale markets and the retail sector. There are some interesting developments in that direction in the US at present, which we shall certainly look carefully at as we decide our own new structures.

But, overall, I sense that we begin the task with some goodwill in the marketplace. I was particularly interested to see the summary of the views of members of your Association on regulation in the Price Waterhouse report published late last year. That is a helpful document which we will take into account. I was struck by the importance you attached to a clear but flexible regulatory environment, which scored highly as a success factor as far as the London market was concerned. And I took the strong point made about the need for cost control, on the one hand, and to provide a framework which facilitates innovation.

When it came to structure, your views were divided. But I was encouraged that the option of an enlarged SIB incorporating the SROs was the one which received the strongest favourable response. There was also quite a bit of support for taking banking supervision out of the Bank of England. Unfortunately, I cannot readily assess the level of support for the particular option which the Government have now chosen, since the researchers did not ask you to assess it - which is certainly a tribute to the new Government's ability to surprise the market.

But in these surveys I am always fascinated by the outlying views - the small minorities who express a contrary opinion. For example, when asked about the most appropriate regulatory structure 2 per cent of those asked said they thought the best option would be to abandon the SIB and the SROs, and the Bank of England, and that regulation should be carried out directly by the Treasury. I would be very grateful if that 2 per cent of you could stay behind afterwards, assuming they have not been institutionalised since the study was conducted.

The strongest message to emerge, though, was the need for regulators to consult the market effectively on both structures and on rules. I am certainly prepared to undertake here and now that we shall do so. We are charged by the Government to produce an over-arching framework pretty quickly, so our discussions with the market will need to start now. But, thereafter, we will consult intensively on the way in which the new structure will affect day to day regulation. I give you my firm undertaking on that point.

But, as I said, today I am not speaking to you as the Chairman of the SIB. And you have asked me, particularly, as Deputy Governor of the Bank to talk about Economic and Monetary Union, and the way it will impact on your business. Let us, therefore, move quickly on to that point.

Whenever I have accepted an invitation to speak about EMU over the last couple of years, I have done so with the hope that when the day came to speak, the clouds of uncertainty surrounding the project would have cleared - both in terms of developments among the countries committed to going ahead, and in terms of the UK's position. But my hopes have so far been confounded, and indeed the events of the last couple of weeks have complicated matters even further.

This is not the time or place to talk in detail about the Bundesbank's little local difficulty with Herr Waigel. And it is too early to assess the consequences for the project of the results of the French election. But it is clear that new elements of uncertainty have entered the scene, making it harder than ever to forecast the outcome next year.

Looking at the markets' own assessment, our interpretation of movements in the forward FX markets since the autumn is that the markets have become more persuaded that the euro will begin, but that it will be a broader, and possibly weaker euro. Until last summer the assumption appeared to be that only seven or eight countries would make up the hard core. In the last few months the expected future correlation of the deutsche mark/dollar and lira/dollar rates has strengthened, suggesting a stronger market expectation of those currencies being part of the first wave. Very recently, a few doubts seem to have emerged about the project itself, though it would seem that, according to the market, the most likely outcome remains that a euro of some sort would start on time.

I recognise that this is a difficult background against which businesses need to plan. Our own advice, which we have maintained for some time now, is that it is prudent to plan on the basis that the euro will begin on 1 January 1999, as set out in the Treaty. As far as the position of the UK is concerned, the option remains open, the policy remains what the French call 'le wait and see'. But the new Chancellor, like the old, has acknowledged that there are considerable difficulties to overcome if the UK is to be a first wave member. This is not a tidy position to be in, perhaps, but against the uncertain background, it nonetheless has a certain practical appeal.

But taking my prudent assumption - that EMU will go ahead - what can we say about the impact on the London market in general, and on the futures and options business in particular? I note with interest that your own assessment is that the best option for the futures and options business in London would be for EMU to go ahead and for the UK to participate in the first wave. It is a moot point as to whether the impact on the profits and bonuses of derivatives traders will be the number one criterion in the minds of Labour MPs when they come to reach a view on EMU, but I will certainly draw it to their attention if you would like me to do so.

By contrast, you are slightly, though not exaggeratedly pessimistic about business opportunities in London if EMU goes ahead with the UK a ‘slow track’ country. I regard this as a pessimistic assessment, and will attempt this morning to persuade you that you are wrong.

My first point, and perhaps the strongest, is that uncertainty about UK participation in EMU has persisted now for a considerable number of years - perhaps indeed since the late 1970s when the UK government’s response to the original EMU plan was distinctly lukewarm. And certainly no British Prime Minister has given an enthusiastic endorsement of the most recent Delors Plan for EMU, at any stage. Yet at the same time, London has remained the dominant futures and options market in Europe, and indeed it has strengthened its position in many markets during that time so that, as far as on-exchange business is concerned, London is by far the largest centre in Europe and second only to Chicago. And the central bank survey of OTC derivatives markets in 1995 demonstrated London’s position as the premier centre for the trading and booking of OTC derivatives with 27 per cent of average daily turnover, pushing New York into second place.

I do not propose to follow the traditional gambit of Ministerial speakers at trade conferences, reciting figures far better known to the audience than to the speaker, but the growth of LIFFE, the LME, the IPE and OMLX in recent years has been striking, and the most recent development is that LIFFE overtook the Chicago Mercantile Exchange to become the world’s second largest exchange in the first quarter of this year. So if, as I was taught at Stanford Business School, markets are efficient in the sense that they react in advance of events, in the light of an assessment of probabilities, then they appear not to have been particularly distressed by the prospect that EMU may start without the UK in the first wave. Certainly we have not seen an anticipatory flow of business away from London and towards Continental European markets.

We have recently asked ourselves why it is that LIFFE has retained its position in the three-month euromark contract and the ten-year Bund contract - Europe’s most active longer-term interest rate contract. And for those of you who like to go home with a reading list, there is an interesting article on the subject of what makes for successful futures contacts in our latest Quarterly Bulletin. (I am sure the restaurants and the bars of the West End will be empty tonight as you sit in your hotel rooms poring over it.) Frankfurt has recently started making inroads into LIFFE’s share of Bund futures business - but the level of activity on LIFFE nonetheless continues to increase.

Our assessment is that, in these markets, there is a considerable and long-term advantage inherent in being the first mover. That helped LIFFE to achieve a very broad and international membership, with only 27 per cent of members being UK-based. It has meant that London has an established skill base and good support functions in law and accountancy. Also a good telecommunications system - though fewer of those old telephone boxes, which may be a problem for me at super-SIB. London also has a strong clearing function and we should not forget the advantage of the English language, which is increasingly the lingua franca of the European Union, and I believe that even some Americans can now speak a kind of pidgin version which allows them to be understood.

But EMU will create change. This raises three interesting questions. What will be traded in an EMU environment? How much will be traded? And where will the new instruments be traded? Let me take these points in turn.

What will be traded when the euro makes its debut?

Looking first at on-exchange markets, it seems likely that, in EMU, there will be room for only one three-month euro short-term interest rate futures contract, although the greater depth of the new euro market may allow other products at the short end of the yield curve, such as a one-month euro contract, to co-exist with the three-month benchmark product.

In the bond markets, one - and perhaps the most likely outcome - is that a particular government’s bonds will become the benchmark for the new euro bond market. We may all speculate idly on which that country might be. These issues would then anchor the euro yield curve and futures contracts would follow naturally. The greater depth of the new euro bond market may well mean that it can support a greater range of futures contracts further along its yield curve, as is the case now in the US. Five and two-year contracts, which do already exist in the Bund market, may develop further. The exchanges themselves recognise this point and are seeking to fill in the yield curve in their various markets before the start of EMU.

Other national bond markets will be keen to run alongside the main market and futures contracts on those markets may also exist. But their number will depend on the basket of deliverables of the futures contracts and how those baskets are defined. The alternative would be for a group of different countries’ bonds to be traded interchangeably, but that seems an unlikely outcome.

On the OTC markets, the last 18 months has seen the proliferation of trades based on changing perceptions of the likelihood of convergence for the traditionally high-yielding countries and trades based on the differential yields of French and German government bonds.

If I might embark on a regulatory diversion here, just for one moment, we at the Bank expect those banks involved in convergence trading to undertake rigorous stress testing of their portfolios to assess the market risk they are running on open positions. That testing should also shed light on the potential for changes in their credit risk - for example if an OTC contract is moving further in the money due to a market movement, the bank would become more exposed to its counter-party. We believe that the credit exposure implications of stress testing should be taken seriously too and are encouraging banks as best practice to do that. In our view not enough institutions do so yet.

After EMU, one would expect to see the elimination of exchange rate risk narrowing yield differentials in the bond markets. With exchange rate risk removed and a single monetary policy in operation, national bond yields will differ principally because of differential default risks and differences in market liquidity. That should leave default risk more readily monitorable and more efficiently priced. We should therefore see an enhancement of banks’ and investment houses’ credit analysis functions and more trading of credit differentials.

My second question was how much will be traded in a post-EMU world?

This is not an easy question to answer. Volumes are difficult to predict. On the one hand, EMU may bring about a more stable interest rate environment, as well as eliminating national interest rates and exchange rates, reducing the need for hedging mediums and hence for derivative products. On the other hand, increased liquidity in the euro bond markets could encourage business and we could well see new participants entering the capital and derivative markets. My hunch is that the latter possibility is more likely. And that the market for carefully constructed derivatives contracts, properly sold to customers with a genuine need for them, will continue to expand.

That brings me to my third question, where will the trading be done?

I do not think that there is a determinist answer to this question. Nor, certainly, should it be a matter of decision by politicians, central bankers or financial regulators. Certainly, our predisposition is to think that competition will and should determine where business is done and the outcome will depend on the imagination and effort of the managers and controllers of the different markets. There will be lively competition between LIFFE, the DTB and Matif, I am quite sure. And LIFFE do not need me to argue their case for them. I see from the programme that they are sponsoring the coffee and the tea at this conference. As a regulator it will of course be quite impossible for me to accept such lavish and unreasonable hospitality, but the rest of you are welcome to do so.

For the moment, LIFFE has a dominant position in short-term interest rate futures and is the leading contender to capitalise on that position, whether or not the UK elects to join EMU in the first wave. It has already amended its contract specifications and from March 1999 onwards these contracts will settle against the three-month interest rate for euros, a move which has been widely welcomed in the industry.

The new euro bond market is likely to support a range of futures contracts, as I have said, and it is not impossible that more than one identical contract will continue to exist post-EMU, due to arbitrage opportunities, as happens now between the LIFFE's and the DTB's Bund contract. That will be an interesting competitive arena to watch.

As far as OTC derivatives are concerned, there is little reason why London should lose its pre-eminent position as a result of EMU. OTC markets by definition have no centralised trading platform and their location will depend on, for example, the regulatory environment, the availability of staff of sufficient quality and in sufficient numbers and the other success factors I described earlier.

It is also worth noting that other changes are under way in the markets as well as EMU. The most notable is the advances in technology which have enabled electronic trading to start to challenge traditional open outcry. In response, open outcry exchanges are looking to automate and streamline their trading through technology to reduce costs. And it would seem that the exchange-traded futures industry is coming under some pressure from the OTC derivatives market, which appears to be expanding at a more rapid pace. All of these changes will run in parallel with the introduction of the euro, and as far as competition is concerned, success in those areas may well dominate the euro factor.

But I said earlier that the outcome of these competitive skirmishes cannot be simply determined in advance by an analysis of existing competitive advantages. It will depend on the efforts of the different players and on the extent to which they are well prepared in advance.

Here I found your own survey rather depressing. The assessment was that relatively few market participants in London had made serious preparations for EMU, and seemed unsure of how to proceed. Only 6 per cent of brokers and own account traders had made contingency plans for the introduction of EMU. But this survey was undertaken in April of last year, and I am confident that the responses would be different today.

Certainly, a lot of work has been done in the London market, co-ordinated and steered by a team in the Bank, to ensure that London is as well prepared as other European centres for EMU. And our assessment now, which I believe is shared by the EMI and the Commission, is that London is as well prepared as most if not all European centres.

I can assure you that the Bank of England itself will be ready for EMU on 1 January 1999, whether or not the UK is a member. We will be able to offer euro accounts and euro settlement facilities. We have taken the lead in work on market conventions across Europe. EMU is likely to bring harmonisation of conventions such as day count and frequency of coupon payments among Europe’s bond markets, and the London market is ready to do that.

We have been in regular discussion with ISDA which is taking a leading role in co-ordinating preparations of those involved with swaps and other OTC derivatives. And a recent working group chaired by the Bank has examined the adaptations that may be needed in the gilt market, covering re-denomination of gilts into euro, whether to quote in decimals or fractions, the frequency of coupon payments, etc. There seems a reasonable chance that the dramatic move to abandon 30 seconds as the basis for gilt pricing may come about before too long. This could be the only unambiguously, incontestably good thing to come out of Economic and Monetary Union.

We have also conducted some really exciting discussions on the issue of rounding - a subject which I find can cause great excitement among accountants and lawyers. And anything which brings excitement to their sad lives should clearly be welcomed by us all.

My general conclusion - and I will end here, you will be pleased to know - is that while EMU will significantly affect your markets, it does not negate the usual rules of competition and success. EMU changes the raw material which you work with to generate your exotic, and sometimes dangerous products. But it does not change the rules of economics, nor does it alter the dynamics of competition. It closes down some aspects of current financial market business, but opens up a big set of new opportunities at the same time. Those who seize those opportunities will be the most innovative, most cost effective, and most fast moving. At the moment, on this side of the Atlantic, most of those people are found in London. I see no reason why they should move.