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Hong Kong

Banks have a place in futures markets

Banks are finding their niche in the futures markets with the rapid growth of trading in financial instruments. A panel of bankers and financial executives told the International Monetary Conference in Hong Kong in June of the need for banks to use financial futures in transferring risk.

"The role played by futures is a very important one," Credit Suisse Chairman **Rainer Gut** said, while his fellow panelist, Morgan Guaranty Trust Company executive **Dennis Weatherstone**, added, "I think we do need interest rate futures. It's a question of lessening our credit exposure."

Bankers have not always waxed enthusiastic about futures trading. Until the advent of financial futures about ten years ago, the banking community generally ignored commodity futures markets. In 1972, the 12 agriculturally-based US exchanges recorded a volume of 18 million contracts. A dozen years later, the volume had swelled to 159 million contracts — over 70% of them in financial instruments, and many traded by banks.

Leo Melamed, another IMC panelist and special counsel to the Chicago Mercantile Exchange, believes that bank participation in the futures markets will increase. "Banks are in a position to know their clients' special financing needs, and they are in a position to adapt the highly liquid but specialized futures and options markets to fit those needs," he told the IMC. "Banks will stand between the futures and options markets and their clients. For providing this service, I am confident they will be rewarded handsomely."

Melamed: Need for speculation

Concern over speculation

In an interview with *Asian Finance* following the conference, Melamed conceded that some banks were still concerned about "excessive speculation" in the markets.

"But markets without a sufficient flow of speculative activity become distorted," he said. "The most vicious price swings can occur when volume is too thin. Speculative activity often has a stabilizing, rather than a destabilizing effect."

Melamed cited a New York Federal Reserve report as evidence that, despite their reservations, banks are using the futures markets. The report estimated that as much as 10% of the foreign exchange transactions performed by New York banks were done in futures rather than the forward markets.

The ability of the banks to prosper in today's highly competitive environment will depend on how well they can hedge their risks and arrange relatively exotic financial packages for their clients, Melamed said. Banks cannot cl im full-service status unless they can provide futures and options expertise, he added.

Asian banks, in particular, must develop this expertise because "the next decade of meaningful new futures and options business will come from Southeast Asia," Melamed told *Asian Finance*. Anticipating this, CME began as early as 1980 to investigate possible links with the Asian business community.

"Hong Kong as a vibrant economic centre was clearly a leading candidate," he recalled. "But what attracted us to go with Singapore was the ability to start from scratch. Hong Kong had an existing market that was not designed exactly as we might have preferred."

With help from CME, Singapore established SIMEX, the Singapore International Monetary Exchange, to trade 3-month Eurodollars, yen, Deutschemarks and gold. Later this year, SIMEX will list a contract based on the widely-known Nikkei stock index published by Japan's leading economic newspaper.

Challenge to Hong Kong

Asked whether this will preempt Hong Kong's long-awaited Hang Seng index futures contract, Melamed declined to comment directly. But he said: "The American experience leads one to believe that once a contract takes root, and becomes viable, no other similar market can succeed in that time zone. If that experience holds true in Asia, then, Hong Kong will be hard pressed to succeed once SIMEX begins trading stock indices and the Tokyo market begins trading bond futures."

Nevertheless, Melamed believes other US exchanges will follow CME's lead in establishing links with their Asian counterparts. The Commodity Exchange

(COMEX) in New York and the Sydney Futures Exchange have already announced plans to set up a computerized gold futures trading link, and the Hong Kong Futures Exchange has discussed a link-up with the Philadelphia Options Exchange to trade foreign currency options.

"Cost efficiency is of unquestionable importance for business flows," Melamed said. Rather than taking positions on two different exchanges, a trader can offset his position on one exchange with an opposite position on the partner exchange.

"The model we created with the CME-SIMEX link will be adopted by others because it works," Melamed predicted.