

FROM: [REDACTED]

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STOCK EXCHANGE : ANALYSIS OF MARKET CRASH

The Stock Exchange are publishing their analysis of the market crash this Friday (though the press briefing will be on Wednesday). A copy is attached. (Summary only for copy recipients.) You have already seen a copy of the Bank's paper on the market crash, which is largely descriptive rather than analytic, and the Governor's speech on this subject, both of which will also be published in the next few days.

2. Overall it is a workmanlike effort, with some detailed data, based on minute by minute analysis of market movements. It is perhaps a bit thin compared to the reports being produced in the US, but this is largely because much of the information available in the US, for example on what groups were doing the buying and selling, is not currently collected by the Stock Exchange. They are looking at how to improve the information available to them. But the information the report contains will be helpful in assessing the lessons of the crash.

3. The Stock Exchange will inevitably want to make the point that the UK Stock Exchange performed well throughout the market

crash. But they will stress that the report itself is essentially factual, and does not prejudge the question of what if any policy changes may be needed. That, of course, is a matter for the Council. No doubt they will also point out that the UK market is very different from the US, and thus that the proposals put forward over there are not necessarily appropriate over here. In particular, the Chairman and Deputy Chairman have already made it clear they would not favour circuit breakers of any sort.

Main Points

4. The key points are summarised at the beginning of the report. Apart from statistical information, there is also a robust defence against some of the main criticisms that the Stock Exchange has faced. They argue that:

- The screen - based system held up well during the crash, since prices on the screen were, throughout, very close to those at which transactions were actually taking place.
- Market makers moved their prices in response to selling pressure and were not leading the market down.
- Market visibility - ie being able to see prices fall moment by moment on the screen - did not contribute to the speed or extent of the fall (though the evidence on this point only supports a conclusion of not proven).

There is also a major section on the inter-relationship between the equity market and the futures/options market. The main conclusion here is that the derivative product markets in the UK are too small to exercise an important influence, with programme trading virtually non-existent. They did conclude however that the fact that the futures market traded at a substantial discount to the cash market contributed to market expectations of further price falls.

Recommendations

5. The recommendations for action are limited, since the report is being presented as essentially factual. They are also limited

by the scope of the study; in their own words "it is the efficient way in which business is conducted - that is, the expedient execution and settlement of investors decisions to buy or sell securities - which determines just how good a market is" and this is what the report concentrates on. The report does not therefore look at broader questions, about market structure and international linkages such as those raised in the US. Their recommendations for change, which are summarised on pages 43 and 44, are:

- the London markets should encourage techniques, such as index arbitrage, to ensure the cash and futures/options markets do not get out of step.
- Increased capacity and more rapid execution services are needed, so that the system can cope more easily with very large volumes and difficult trading conditions. (This is particularly necessary in the international equities market).

6. You should also note the reference on page 43 to tax factors as contributing to the slow development of the futures/option markets in the UK. We can no doubt expect lobbying for more favourable tax treatment (we have had regular lobbying in recent years on both the tax treatment of investors in futures and options, and on the tax treatment of market makers in those markets).

Implications for Policy

7. Though the report has clearly been written with US developments very much in mind, some of the major issues raised in the US are not dealt with in the report. There are also some specifically UK issues that are not dealt with in the report. These include:

- The need for increased co-ordination of clearing/settlement arrangements across markets (a priority both for the SEC and the Brady Commission).

- The need for consistent margin requirements across different markets.
- International co-operation on issues of market structure (ie clearing and settlement, circuit breakers, margin requirements).
- The account period - does it lead to a dangerous build up in counterparty risk (this is referred to in the Governor's speech, and both the Bank and the Stock Exchange are looking at the case for shortening it, or possibly moving to rolling settlements).

8. All this material will no doubt be discussed at Lord Young's seminar on 26 February (which the Economic Secretary and [REDACTED] will be attending), and will be on the agenda for one of [REDACTED] regular meetings with DTI and the Bank, probably in late March.

