

“Trends in Global Futures Markets”
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Let me begin by thanking you for inviting me to this distinguished conference. The derivatives business is going through a period of extremely rapid change and growth, and I am looking forward to sharing some thoughts and observations on the main trends that we are seeing.

Before we start talking about the overall state of the industry, let me first tell you something about the Futures Industry Association. We are a non-profit organization. Membership is voluntary. Our funding comes from our members and from the revenues we earn from conferences and other activities. Although we are based in Washington, we are not backed by the government and we have no regulatory powers. Our purpose is to provide the futures and options industry with a forum to discuss industry issues and to work together on common problems.

You might be interested to know that many of our members come from the Asia-Pacific region. I won't name all the names, but just to give you an idea, our membership includes exchanges and brokerage firms from Australia, China, Hong Kong, Korea, Singapore, and of course Taiwan. And of course, many of our members in the U.S. and Europe are keenly interested in becoming more active in your markets. I understand that several foreign firms have already become members of Taifex, and several more are actively seeking membership. Globalization is not a new trend by any means, but it is certainly getting stronger and stronger every day.

To put the rest of our discussion into context, I would like to cite a few statistics from the FIA volume reports. In the first nine months of this year, a grand total of 7.28 billion futures and options contracts were traded on derivatives exchanges around the world. Remarkably, some of the fastest growing exchanges in the world were in the U.S., arguably the most mature market for futures and options. Looking again at that same nine-month period, January to September, we calculate that 2.57 billion contracts were traded on U.S. futures and options exchanges, up about 25% from the same period in 2004. Looking just at the month of September, the year-over-year growth rate at the U.S. exchanges was nearly 40%.

That is an incredible number, and in a few minutes I will talk about some of the factors driving that growth. But let's talk first about Asia's share of the global business. I am sure you all know about the extraordinary success of the Kospi index options contract in Korea. That contract is by far the single most actively traded derivative in the world, and it has helped keep the Korea Exchange at the top of our volume lists for a number of years.

The Korea Exchange is not alone, however. Looking again at the volume statistics for January to September of this year, we calculate that four out of the top 10 exchanges outside of the U.S. are based in Asia. In addition to the Korea Exchange, they are the National Stock Exchange of India, the Dalian Commodity Exchange, and--you will be pleased to hear this--the Taiwan Futures Exchange.

Volume isn't everything of course. The depth and liquidity of a market are also critically important, as are the number of participants and the quality of market supervision. But I think these volume statistics tell an important story about the spread of futures trading around the world, and the importance of the Asia-Pacific region to any futures firm with global ambitions.

If we look back over the last several decades, we can see four major waves in the evolution of futures markets. The first great breakthrough came in the 1970s, when the Chicago exchanges began to apply the concept of a futures market to interest rates and foreign exchange. The next wave came during the 1980s when we saw financial futures spreading abroad to places like London, Paris and Sydney. That was also the decade when we launched stock index futures in the U.S. The third wave came in the 1990s, when electronic trading swept across the industry, starting with the DTB in Germany. That wave is still in motion, but I think all of us can see the next big wave coming in our direction. I am speaking, of course, of the growth of new markets in Asia.

Futures have been traded in Asia for many, many years, so futures are not new to this audience. What has changed is the scale of the opportunity. Today we are seeing the emergence of new markets with huge potential, most notably China and India. At the same time, we are seeing the rapid expansion of existing markets, such as Korea, Singapore and of course Taiwan. Last year, roughly 30% of all futures and options trading worldwide came out of exchanges in the Asia-Pacific region, and clearly there is plenty of room for growth.

As I am sure you can imagine, the FIA is very interested in the development of derivatives markets in Asia. In a moment, I will talk about our Asia strategy, and in particular the potential for a new organization for Asian members. I would be remiss, however, if I did not take this opportunity to give you an update on the global trends affecting our business.

Trying to predict the future is always a risky business. So I won't offer you any predictions on where the leading markets will be 25 years from now, or what the global volume figures will look like. But I can point to several factors that are driving volume upwards and that are likely to continue for some time to come. These factors may not be present in your market today. They may not be present tomorrow. But they will be, and soon.

First, this business is becoming significantly more efficient, mainly because of the advances in technology. When I became president of the FIA in 1982, we used the open outcry system. Each order had to be executed by an individual trader standing in the pit.

It might take hours to fill an order. Now, with electronic trading, it is possible to send an order to an exchange and get a message back confirming the trade in less than one second. In fact, some of my members would be outraged if it took that long. They want the order out and back in less than 100 milliseconds.

Speed is not the only way in which technology has made our markets more efficient. Electronic trading, and technology in general, has given our markets much greater capacity. Traders can participate in the market from anywhere in the globe. We can see this in the expansion plans of the CBOT and the CME. Both exchanges have installed telecommunications hubs in Singapore, and I am sure they are looking at other locations as well.

Technology also has changed the nature of trading. We are beginning to see in the business markets the development of automated trading systems, sometimes called “black box” trading systems, that identify and execute trading strategies without needing any human intervention. The typical trader of today doesn’t need a big body and a strong voice. Today’s traders are coming from MIT, CalTech and Stanford with advanced degrees in mathematics, physics and mechanical engineering. They are building computer programs that seek out tiny anomalies in pricing across a host of markets, faster than the human eye can react.

With greater efficiency comes lower cost, of course, and that leads directly to the second major factor that I believe is driving higher volume. The last two decades have been boom years for the swaps business, but I think we are beginning to see some recognition among users of that market of the advantages of using exchange-traded derivatives. A number of observers have commented on a migration of trading from over-the-counter markets to exchanges, partly because of cost, and partly because of the credit risk advantages of the clearing process.

We are also seeing a migration from the cash markets into derivatives. Investors have become more sophisticated. They have become more willing to use derivatives, and more willing to put their money into hedge funds and CTAs that are major users of derivatives. The amount of assets currently invested in hedge funds is estimated at \$1 trillion, and this is forecast to grow at 15-16% per year for the next four years. This is going to be a huge tailwind for all our markets for many years to come.

We are also seeing greater sophistication in the use of derivatives for risk management. You may have read about Southwest Airlines and its jet fuel hedges, which have contributed immensely to its ability to remain profitable amid tremendous energy price volatility. I would not be surprised if corporate treasury officers and chief financial officers all over the globe are scrambling to include derivatives in their risk management programs.

Volatility is a major factor in the use of derivatives, but I believe that most of the volume growth that we are seeing comes from structural changes in the business, rather than cyclical price movements. It is interesting to see that in the U.S., equity futures and

options volume has been rising quite rapidly in recent years, even though volatility has been trending downwards and in some respects has hit record lows. It will be very interesting to see what happens to our trading volumes when equity market volatility returns to normal levels.

Let me turn now to another trend, the remarkable change in the ownership structure of the exchanges. Just this year, three of the leading exchanges in the U.S. have gone public. The Chicago Board of Trade, our second largest futures exchange, the International Securities Exchange, our second largest options exchange, and the Intercontinental Exchange, a leading energy exchange, all listed their shares on the New York Stock Exchange this year. The Chicago Mercantile Exchange went public some time ago, as many of you know, and next year we could see several more exchanges take this road, including the New York Mercantile Exchange and the Chicago Board Options Exchange.

This trend did not begin in the U.S., as you know. The major European exchanges went public several years ago, and several Asian exchanges several years before that. So the U.S. may be the last to join this trend, but we are certainly not the least. Just look at how investors have responded. Based on current share prices, CME has a market capitalization of \$12.5 billion, about the same as General Motors. The CBOT has a market capitalization of \$4.8 billion, even though it does not own its technology or its clearinghouse.

What these numbers tell us is that investors see futures exchanges as profitable companies with high rates of growth. And they are not the only ones. You may have heard that the New York Stock Exchange would like to get into the derivatives business. The NYSE knows that derivatives trading is growing much faster than cash equities trading. Our volumes have been growing at 15% a year over the last 20 years, and the rate of growth has been accelerating since 2000. Wall Street used to think of futures as a commodity business. They used to think of us as a bunch of guys trading pork bellies and soybeans. Not any more. They are now recognizing that in a modern economy, with a modern financial system, futures and options have a central role as cost-effective instruments for price discovery and risk management.

In a few minutes I would like to talk about the FIA's Asia strategy, but first I feel I must say a few words about the recent collapse of Refco. Refco was one of the largest futures brokers in the U.S. and, I might add, one of the leaders in seeking out new markets in Asia. To see such a large and well-established firm collapse in just a matter of days was a real shock to everyone in our business.

It is too early to draw final conclusions, but I offer three observations. First, I think it is clear to everyone that the origin of the collapse was not in the futures side of Refco. Judging by what I read in the press, the problems seem to have been in the accounting at the group level. Once these problems emerged, however, there was a loss of confidence in the firm as a whole. The unregulated side of Refco was forced to shut down, and on the regulated side, customers panicked, even though their money was

protected by the segregated funds rules. Customer funds in the futures part of Refco went from \$7.5 billion to \$3.4 billion in just two weeks.

This highlights the importance of risk management at the clearinghouse level. The CME clearinghouse and other clearinghouses quickly installed their own auditors at Refco to monitor the movement of customer funds and Refco's own capital. They shared information on a daily basis, and they worked together to put an orderly process in place for winding down the business and transferring customer assets to other firms. In the event, that was not necessary, but they were ready.

Third, the collapse of Refco highlights the importance of communication among exchanges and regulators. Refco was an international firm, and it had very sizeable customer business at exchanges in London, New York and Chicago. As our industry continues to globalize, it is absolutely essential for all the exchanges and clearinghouses to have good lines of communication with each other. I have seen quite a number of MOUs signed in recent months between Asian exchanges and their counterparts in Europe and North America. That is a great step forward, but these agreements have to become more than just pieces of paper. We have to be ready to share information, not when the next crisis hits, but now, long before the problem sits our doorstep.

One of the proudest achievements in the FIA's 50 year history was the international best practice recommendations that we issued 1995, shortly after the collapse of Barings. Those recommendations were drafted by a consortium of firms, exchanges and clearinghouses, working in coordination with the FIA. They recognized that events taking place on one marketplace can have a profound influence on markets around the world, and that all market participants need to meet the highest standards for risk management and customer protection. Those best practices are as relevant today as they were when they were issued.

The need becomes even more critical as we see more cross-border trading in Asia, as I am certain we shall. We must not allow competition among markets to stand in the way of communication among markets, or else the next crisis could prove far more damaging.

Let me now turn to my final theme for today, the FIA's strategy in Asia. From my perspective as the head of the FIA, it is more than obvious that our members are eager to participate in your markets. There is very strong interest in Chinese futures markets, which are just beginning to reopen. India also looks attractive. It has huge potential, and in some respects it is more open than China. Japan has revolutionized its commodity futures business, and it has become much more attractive to foreign participation than ever before. I have already mentioned that several FIA member firms have joined Taifex, and more are in the pipeline. Everywhere one looks around Asia, there are tremendous opportunities.

Where does the FIA fit into this picture? As I look across Asia, I see a great deal of economic integration. But I do not see much financial integration, at least not yet. By

and large, each market is developing on its own, in line with local needs and national economic goals. The progress achieved so far has been tremendous, but I fear that the regional differences in business practices and exchange rules could create an obstacle to cross-border trading. That could deprive your markets of a very important ingredient for success.

The FIA believes that foreign participation in Asia-Pacific markets can make a positive contribution to economic development. Foreign firms bring trading expertise and advanced technology. Some will bring more customers to your markets. Some will want to participate as market makers and liquidity providers. And some will want to invest in local firms. The end result is more efficient price discovery and more efficient tools for risk management, with all the economic benefits that we know so well.

So how can we increase foreign participation? Part of the answer is in standardization and harmonization of business practices. It is a lot more efficient to have a common approach to standard operational issues than to have 15 different exchanges with 15 different solutions to the problem. That was one of the reasons why the FIA was created 50 years ago, and the same need is still there today.

There is no magic solution here. What works on one exchange may not work on another. Our markets thrive when each market is free to innovate, when each market can find its own approach to building liquidity and settling disputes. But we can all benefit by sharing our experiences and developing common solutions to industry-wide issues.

Let me give you one example. Omnibus accounts. This type of account is used very widely in the developed markets as a way to handle customer business. They are not allowed, however, in many emerging markets, and this has been a major obstacle for foreign brokerage firms. I am very pleased to see that Taiwan has adopted this business practice, and I hope we will see similar changes in other markets in this region.

More broadly, there may be an advantage for the first Asian exchange to “go global”, as it were. Foreign firms are dealing with many different markets in Asia and many different rules and regulations. The global brokers will have to establish connections to all of these markets, but other types of market participants are free to pick and choose. They will go anywhere in the world to find the best trading opportunity. So the key to success for an exchange is to look at the total trading experience. It is not just about having the right products. An exchange also must provide the most efficient marketplace. This means looking at taxes, technology and access rules, and seeing how they compare with international standards.

A few months ago, we held a conference in Beijing. We invited people to participate from all over the Asia-Pacific region. We were a little nervous leading up to the event, because we weren't sure how many people would show up. Well, as it turned out, there was no reason to worry. The turnout was fantastic, and the dialogue was quite extraordinary. And I am looking forward to another pan-Asian conference next year to build on this success.

I came away from the Beijing conference with the impression that the Asian futures and options community needs an organization much like the FIA to support communication and cooperation. We think we can help establish such an organization, and we have contacted a number of potential members in the region for their views on what the goals and objectives of such an organization should be.

We don't know exactly what FIA Asia will look like, but I expect that it will be based in Asia and that it will be run by its members. Its primary purpose will be to give exchanges, clearinghouses, brokerage firms and service providers a way to share ideas and information. We are moving forward on this project one step at a time, testing the waters as we go. I welcome your support and participation.