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*Dear David*

BIG BANG: MEETING ON 5 JUNE

I enclose the note on preparations for the Big Bang requested in your letter of 14 April, and prepared against the meeting now rescheduled for 5 June.

I am sending copies of this letter and enclosure to Tony Kuczys (HMT) and John Mogg (Department of Trade and Industry).

J R E Footman  
Private Secretary  
to the Governor

*Yours* *WR*

*John*

## PREPARATIONS FOR BIG BANG - MARKET OPERATIONS

Note by the Bank of England

This note assesses the preparedness of the markets for Big Bang, which is due to take place on 27 October this year. It distinguishes between, on the one hand, the infrastructure of trading, settlement and monitoring arrangements provided by the Stock Exchange and the Bank of England, and on the other, the trading arrangements of individual firms.

### SUMMARY

\* Big Bang reforms require major changes to the Stock Exchange's market support and surveillance systems, to service dual capacity trading, to provide new forms of investor protection and to supervise new-style SE members;

\* the Stock Exchange is responding by building upon and enhancing existing systems for price and trade dissemination, settlement and surveillance. In the gilts market, new settlement and supervisory systems are being constructed by the Stock Exchange and the Bank of England;

\* the Stock Exchange and their external monitors have expressed confidence that their essential market systems will be operational on 27 October but there is very little slack in the timetable;

\* takeovers/mergers involving SE members are only now being completed. New managements are grappling with complex corporate reorganisations while attempting to plan ahead and modify existing systems or instal the new systems needed for Big Bang;

\* the state of preparedness of SE firms appears mixed. Participants in the new gilt-edged market are for the most part likely to be ready in time. Among other securities firms, some are well advanced, both as to management systems and technology, but for a few it will be a close run thing;

\* if a few firms, however important, cannot meet the timetable, this should not affect the efficiency of market operations, although the firms themselves will obviously sustain commercial losses.

## THE MARKET INFRASTRUCTURE

1 To implement the Big Bang reforms, the Stock Exchange has to introduce new computer systems to support dual capacity trading and new techniques of investor protection, both to replace those provided by single capacity, and also to anticipate its obligations under the Financial Services legislation. The participation of financial conglomerates as members will place new demands on the Exchange's financial supervisors. In the gilt-edged market, two projects will mainly involve the Bank of England; the settlement of transactions and the prudential supervision of gilt-edged market makers.

2 The Exchange is adopting what it considers to be a relatively low risk strategy by building upon its existing systems, rather than attempting a clean sweep on Big Bang day. The cost will nonetheless be high; over the past two years, the Exchange has incurred capital and development expenditure of £42 mn, and will spend a further £38 mn in the next twelve months. Even these changes are only steps in a wider process of modernisation of the Exchange's facilities especially in the direction of trading support and information systems, automated execution of transactions and computerised surveillance techniques.

3 The Stock Exchange's programme falls under three main headings: trading support (the display of quotes and last trade reports on SEAQ); clearing and settlement (TALISMAN); and surveillance (of markets and firms, with data being fed from SEAQ and TALISMAN). The Exchange have hired an external consultancy firm to monitor progress in relation to quality of work, budgets, and timetables. Regular reports are given on this subject to the DTI and the Bank at the SE Monitoring Group.

4 The Exchange, supported by their consultants, remain confident that the Big Bang timetable for its own projects will be met, although there is still a great deal of work to be done. The SEAQ project is reported to be close to plan: the aim is to begin user trials in July. The system has to go fully live on 27 October without fail. The TALISMAN settlement system was

slightly behind its August schedule, but this now appears to have been made up. The surveillance project has been split into three phases: essential monitoring facilities will be in place on 27 October, though not all computerised. Computerisation of less vital facilities will follow.

5 This fairly reassuring picture does not, of course, rule out accidents or system failures. In the past two months there have been failures of electronics systems which caused part of the Exchange's market facilities to be out of operation for a period. Inevitably there may be other failures and teething problems when the new systems come on stream. Nevertheless on balance, the Exchange are more concerned about the state of readiness of their members' technical systems than about their own.

6 The Stock Exchange is also co-operating with the Bank in setting up and running a service for the book entry settlement of gilt-edged transactions, through the Central Gilts Office (CGO). Phase 1, which came into operation on schedule at the beginning of 1986, largely replaces clerical systems, and allows stock to be transferred in book entry form between jobbers and other participants at the centre of the market. A second phase aims to introduce a system of "assured payments" through settlement banks nominated by members of the CGO service. This will be important for the smooth functioning of the new gilt-edged market, and is to be implemented by 27 October. Development of the project is running broadly to schedule; trialling with members is due to take place in July and August. There are, however, some difficult negotiations in train with the banks on the legal basis for assured payments, and these have yet to be concluded.

7 In its role as prudential supervisor of the market makers in the new gilt-edged market, the Bank of England is constructing a computer system which will collect and process daily returns from them. The volume and regularity of these reports mean that computerisation is the most effective way of handling the data. This project is running to schedule: trialling is due to take place in July and August, and the system will be ready in good time for October.

## THE MARKET PARTICIPANTS

8 Since agreement was reached on Stock Exchange reforms, there has been a succession of anticipatory mergers, takeovers and corporate restructurings in the UK financial sector. Where existing Stock Exchange member firms were involved, these corporate moves could only begin to be consummated after 1 March 1986, when SE rules to permit outside ownership of member firms and corporate membership came into effect. (Up to that date, stakes in SE member firms were limited to 29.9%.) Many mergers cannot, however, be fully completed before 27 October because jobbing and broking activities will have to remain separate until then - even when conducted within the same firm. As a result, the managerial and corporate reorganisations needed are only now being implemented.

9 Newly-created managements face the physical task of integrating, housing and equipping their various activities, and the cultural problems of bringing together units which have functioned and have been managed independently hitherto. These changes are taking place against a background in which the shape of markets after October 1986 is difficult to predict; the switch from single to dual capacity in the Stock Exchange cannot be phased in gradually. Dual capacity experience is limited mainly to firms which have traded off-market in domestic and international securities, or which have US connections. In constructing their internal systems for monitoring risk and performance, some managements may have been waiting until the SIB's prudential and business guidelines have become clearer, but member firms are by now aware of the Stock Exchange's draft rulebook and financial guidelines, which are being brought in line with provisional SIB rules.

10 It is difficult to generalise about the preparedness of Stock Exchange member firms, in large part because of their diverse circumstances. Prior to 1 March, there were a little over 200 member firms, most of them stockbrokers. Over 20 firms are now in the process of being taken over by UK clearing and merchant banks, a further 13 by US commercial and investment banks, and

nearly 40 by a mixture of UK and foreign firms covering a wide range of financial (and occasionally non-financial) activities. This leaves rather more than one hundred SE firms which remain independent. Finally, there will be a number of firms, mainly large international securities houses, which will be entering the Exchange either in their own right or by creating new firms (Lloyds Bank will also enter through this latter route).

11 Since most firms are already members of the Stock Exchange, they will be familiar with the Exchange's present financial reporting requirements, and will have internal reporting and audit systems to match. These will have to be remoulded, however, to fit in with extensive changes being made in the Exchange's financial regulations; and firms' internal systems will have to reflect their new corporate structures. On the technology front, firms need to be geared up to receive the SEAQ display, and to have on-line links to the Exchange for inputting market makers' quotes and trade reports. The more ambitious firms are in the process of integrating these links with their own in-house computer systems. On the settlement side, firms will not be linked on-line to the Exchange, but will be expected to provide computer readable records of all bargains struck. A large number of firms are computerising their "back-office" activities, either by means of custom-made systems, or through bought-in systems. Some are joining bureaux or pooling resources with other firms.

12 The Bank is well placed to see these preparations in the case of participants in the gilt edged market, through its involvement in planning the new market. Firms which wished to become committed market makers were invited to outline their plans to the Bank about a year ago. Our policy was not to restrict numbers, but rather to accept all those who could demonstrate adequate financial and managerial capacity to perform the various market functions. As a result there are to be 28 gilt-edged market makers, compared with eight jobbers at present.

13 The firms in the gilt-edged market come from a wide variety of backgrounds, and they consequently face many of the organisational problems described above. Unlike the firms specialising in

equities, however, those in the gilt-edged market were given an early and clear picture of the market structure and of their obligations to the supervisors. A year ago, following wide consultations with prospective participants, and study of the US government securities market, we published a paper setting out in detail the nature of the dealing and supervisory relationship that we expect to have with the market makers and other central participants in the gilt-edged market. Some firms are well advanced with their plans. Others are not as well advanced - eg, on computer systems - but expect to be ready in time for Big Bang, even if with partly manual systems. It is impossible to be certain that they will all in fact be ready, but we retain the option of refusing to begin dealing on Big Bang day with any whose preparations seem to us to be seriously deficient. There is no particular group of prospective participants which at this stage stands out as being particularly well (or badly) prepared.

14 Outside the gilt market, Stock Exchange firms led by banks have now sorted out the broad organisational structure of their securities operations, although in terms of designing their overall control systems for these activities, the position is more patchy. Arrangements for internal audit are inevitably rather less advanced than other organisational changes: it is not feasible to audit a system until it is fully designed and operational. However, most banks already have well established internal audit functions, and there seems no difficulty in principle in extending their ambit.

15 The large international houses (some of which also intend to seek banking licences in due course) have considerable dual capacity experience; their computer and risk management systems are likely to be highly advanced and commensurate with their range and level of financial activities. Such firms will, of course, need to make their systems compatible with those of the Exchange, but there is no reason to doubt that they will in general be ready for Big Bang. Where SE firms have been taken over by non-banks the picture is much less clear, although in the majority of cases it is likely that they will continue to function fairly independently (eg where the new parent is a fund manager)..

Consequently the adjustment problems facing this group pre-Big Bang will be fairly simple. The operations of these firms, and also of those remaining totally independent are likely to remain relatively straightforward (very few will become market makers, for example). In addition, they are tending to rely mainly on technology approved or installed by the Exchange.

16 Overall, therefore, the preparedness of Stock Exchange member firms for Big Bang is rather mixed. Notwithstanding action by the Stock Exchange to spur the laggards, some firms may still find themselves unready to operate the new systems on 27 October. This is more likely to be among the larger firms which have opted for ambitious systems. Nevertheless it does not seem at all likely that this will be on a scale to prejudice the overall market operations following Big Bang.



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