



EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt, Tuesday 7 July 2015, 14:00-18:00 CET

SUMMARY OF THE DISCUSSION

1. Latest regulatory developments

James Kemp (GFMA) reviewed the recent changes in regulation concerning the FX market. Recently ESMA decided not to enforce a clearing mandate for NDF at this time and discussions with the CFTC suggest no current plans to prioritize NDF clearing in the US. FX option clearing is still dependent on ensuring a safe and sound solution to the physical delivery requirements by a CCP. In February, the Basel Committee on Banking Supervision/IOSCO revised their margin for non-centrally cleared derivatives with a delay in the phase-in arrangement below a certain threshold. Finally, CLS/TriOptima announced in January 2015 plans for the launch of a compression service.

As regards execution and transparency, MiFID will define liquid instruments which will require increased pre- and post-trade transparency and the new regulation is expected to be implemented in January 2017. A final ruling on delineation of FX spot/forward as a MiFID instrument is expected later this year. MiFID Addendum (March 2015) focused on transparency and specifically on defining what is a liquid or illiquid instrument. The recent ESMA paper on the issue has however raised some questions among market participants and GFMA has recommended that ESMA uses more representative data on FX volumes to define liquid instruments. For example, GFMA deems that NDFs, as well as simple and complex options, would generally be classed as illiquid instruments. As regards the Swap Execution Facility (SEF) requirement to obtain all relationships documentation to effect the legal confirmation of a trade, GFMA has discussed execution and reporting with the US regulators and recently provided views on legal confirmation in an effort to solve this challenge. Finally, a review of the recent UK FEMR recommendations was presented.

Discussions took place on possible cost/benefit questions around trade compression, the need to have granular data to assess the liquidity of FX instruments under MiFID, the clarification and possible separation of principal and agency trading and the certification of traders and sales.

2. Liquidity analysis

Petra Wikstrom (BNPP) reported that FX liquidity has decreased since mid-2014, with some currency pairs particularly affected (e.g. Scandinavian currencies and more recently commodity currencies). Even before the SNB removal of the EUR/CHF floor on 15 January 2015, bid-ask spreads had been widening for the major currency pairs - except for the EUR/CHF. Several events contributed to the decrease in FX liquidity and increase in spreads: the surprised expansion of BoJ Qualitative and Quantitative in October 2014, uncertainty about the path of US interest rates and recently developments related to Greece. Contrary to previous episodes of higher volatility regimes, the recent rise in volatility has at most times not occurred with a parallel increase in volumes. Finally, the widening of spreads has been more important for larger tickets, pointing to a lack of depth in the order book. The reduced principal risk-taking by banks has played a role in decreased market depth. Some

members also cautioned that the apparent lack of order book depth could be related to a change in the microstructure of the FX market and new trading behavior with an increase in algorithmic execution. Members also noted that liquidity is also an issue in other markets e.g. fixed income markets.

As regards the impact of the widening to 5 minutes of the fixing window implemented by WM/Reuters on 15 February, the analysis suggests that the volume distribution across the time window is more evenly split on account of increasing algorithmic execution. For the ECB foreign exchange reference rates, the volume distribution has also risen before the setting of the reference rates (14.15 CET), but by a smaller extent compared to the WM fixing time. For both, bid-ask spreads narrow during the setting period pointing to better liquidity. However, some members pointed out that the narrowing of spreads on the WMR may have come at the detriment of volatility, which according to some members has increased since the new methodology was put in place. One member offered to provide further analysis on this. Members also discussed the impact of algorithmic execution on liquidity and volatility during the fixing period and the possibility to open earlier the matching engines for fixing.

3. Common code of conduct for the FX industry

Guy-Charles Marhic debriefed the group on the latest endeavor of the BIS in the field of best market practices in the FX industry¹.

Most members welcomed the BIS announcement to set a working group to work toward establishing a single code of conduct and promoting greater adherence to those standards and principles. Specifically, members reported that a single code would favor a stronger level playing field among market participants. Some members also indicated that a global certification of staff would be useful, while others cautioned that end-users, specifically to be protected by the code, shouldn't be overburdened with adherence rules acting on their role. On the adherence, some members indicated that the web based tool (ELAC) recently launched by the ACI to attest certification of the ACI Model Code could be further expanded to include the Common Code. Discussion took place on the granularity of the future code, with some arguing that the code should be exhaustive and granular in order to provide more clarity in particular in some grey areas (e.g. stop losses, barrier options, pre-hedging), while others were calling for high level principles, leaving room for each jurisdiction and each institution to elaborate on those principles. Members also called for having a procedure in place to regularly update the single code and an entity that would be responsible for this. There were some concerns, though, around the practicality and effectiveness of application of a large and frequently modified document. Some discussions also took place on the need to have regional annexes to the single code, with the example of Know Your Customer rules and the range of application depending on client size and volumes.

4. Market review and discussion

Members discussed recent FX market developments. They indicated that the lack of significant move in currencies and on the euro in particular following Greek developments is related to the limited appetite to establish positions and the belief in central bank action in case of adverse developments. Implied volatility has picked up, but volumes have remained particularly subdued. Positioning is reported to be limited, with reportedly small underweight euro positions. Several members pointed that developments in Greece are purely politically-driven, thus discouraging active trading as they are very difficult to predict. In case of *Grexit*, views diverged on the impact, with some expecting a sharp depreciation of the euro (e.g. below parity) with negative long- term implications for the euro area. Others indicated that the euro move would be limited, as measures would be taken to reinforce the euro area. A

¹ BIS Press release: <http://www.bis.org/press/p150511.htm>

resolution of the Greek case would shift market participants' focus back on trading central bank actions and policy divergence. Some members reported large outflows in the Spanish government bond market, while flows in Italian sovereign market were subdued. Others expressed some concerns about the coming elections in Spain and possible negative market reaction. Several members reported that focus on Greece was extreme and that the developments in Chinese financial markets and the recent price decline in commodities warrant more attention, as implications are of a global nature. Against this backdrop, some members warned that volatility could further pick up into the summer months.