EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt, Thursday 18 February 2016, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. BIS's FX Working Group on Single Code and adherence

Guy-Charles Marhic reviewed the ongoing work to establish global principles for good practice in the FX market ("Single Code") and to promote and incentivise adherence to the Code under the auspices of the BIS FX Working Group (FXWG) [*for more background information see also FXCG summary dated 12 November 2015*]. The first work stream of the FXWG, which develops the Single Code in two phases, received comments from the central banks within the FXWG, as well as the Market Participants Group (MPG), as part of the first review of the draft for the Single Code. In a second review, comments were received from the FXCG, the ECB's Operations Managers Contact Group (OMCG) and Eurosystem central banks. Guy-Charles reviewed the main comments and informed the FXCG group that the draft had been shared for comments in parallel with the other seven Global FX Committees. Orazio Mastroeni (Secretary of the ECB OMCG) summarised comments received from the review of the draft Single Code within his group. Adrian Bohler, member of the MPG, updated the group on the ongoing work of the MPG. The MPG is working on draft language and defining high level principles on topics including mark-ups, pre-hedging and market colour. Comments will be compiled by the MPG and FXWG. A revised draft will be circulated for another round of comments from 10 to 23 March 2016. Overall, despite the tight deadlines, work is progressing well with one FXWG meeting held earlier this year and two upcoming meetings on 26 February and 2 April 2016. The objective is to release an interim publication on some parts of the Single Code (phase 1 material) and a public update on adherence in May 2016.

Members strongly support the initiative to establish global principles for good practice in the FX market and welcomed the information provided on the ongoing work. At the same time some members note that it is challenging to comment on the Single Code at this stage without knowing the adherence mechanisms. Members were informed that the phase 2 material of the Single Code will include electronic trading among other topics. It was confirmed that the composition of the MPG has evolved to have a more diverse representation of FX market participants on board.

2. ECB reference rates

Christophe Beuve recalled the changes in the publication schedule of the ECB euro foreign exchange reference rates (ECBRR), which were announced on 7 December 2015 following a ECB FXCG consultation on 12 November 2015[1]. More specifically he recalled that the ECB Governing Council decided that, effective 1 July 2016, the new daily publication schedule for the ECBRR should be 16:00 CET/CEST, as applicable. He highlighted that the ECBRR are intended for information purposes only and not for transaction purposes. While the methodology for setting the ECBRR will remain unchanged, the ECB has enhanced transparency by releasing information on the governance and methodology. He summarised the outcome of a survey conducted

[1] See: http://www.ecb.europa.eu/paym/groups/pdf/fxcg/2015/1211/summary_Nov_2015.pdf

among FXCG members on the changes to the framework of the ECBRR. Comments received indicated that the implementation is progressing smoothly and that there is a broad awareness of the announced changes to the framework of the ECBRR.

Members understand the emphasis made by the ECB solely on the information/reference purposes of the ECBRR as opposed to a usage within a trading context. It was, however noted that the ECB could not enact a legal prohibition. Several institutions indicated that they have stopped or will stop offering execution at ECBRR. There are, however, two challenges in particular for European corporates, as many had been using the ECBRR in some of their contracts. There is first the issue of legacy contracts, which will come into play when most major banks announce that they will stop offering trading at the ECBRR at the latest on 1 July 2016. Second, there is the fact that some alternative fixings are relatively costly. While it is understood that the adjustment of internal processes is time demanding and/or changes of some legacy contracts are difficult to implement, the pro-activeness in finding alternatives to the ECBRR is encouraging. Some members also noticed that certain fixings are also offered free of charge and asked the ECB for guidance in finding some alternative fixings to the ECBRR.

3. Last look

Ankur Pruthi presented the findings of an NBIM issue paper released in December 2015: "*The role of Last Look in the foreign exchange market*"[2]. Last look enables market-makers to reject trades within a certain timeframe to protect them from sudden price moves and latency arbitrage. However, some liquidity providers have recently been accused of deliberately turning the feature into an unfair advantage.

NBIM used their own execution data across global FX pairs and studied the impact on the liquidity taker over time. NBIM evaluated Last Look comparing it to an option (call) that the liquidity taker sells to the liquidity provider with a knock in when the threshold is hit. There are two key issues with last look: the symmetry (or asymmetry) of the threshold and the trading information about the flow direction that the liquidity provider can obtain. NBIM found out that the rejection of trades was not a function of the size of the trade of the underlying currency, that risk management considerations were not driving last look and that there was an adverse skewness.

The paper advocated greater transparency in the application of Last Look (e.g. with usage of time stamp) and a greater disclosure in particular in case of asymmetry of the threshold. It also highlighted that the monitoring of liquidity provider's behavior will be a crucial element.

Some members questioned the role of some electronic platforms as some platforms may have their interests aligned to the ones of the liquidity providers due to the fee structure when only the liquidity provider is charged for execution. Some electronic platforms may also amend protocols to include specific reasons for rejections and police liquidity providers. Members noted that there has been an increased transparency of liquidity providers over the past months on their implementation and usage of Last Look. Finally, members also highlighted the need for clearer definitions and high level principles in particular in the upcoming Single Code. Those principles could include full disclosure, a symmetry of pricing unless differently specified and the possibility to switch off the feature.

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[2] See: http://www.nbim.no/contentassets/bab2624ad58c4aa4aca65d19bfff2152/nbim_asset-managerperspective_3-15.pdf

4. Market review and discussion

Roswitha Hutter (ECB) provided a brief review of the recent market developments, focusing on some of the drivers of the euro and US dollar exchange rate, the sharp increase in risk aversion since the beginning of the year and the risks going forward.

Members discussed recent FX market developments and indicated that the style and focus of trading changed significantly away from central bank policy to other matters including oil, China and emerging markets. Political developments and risks are also a renewed focus for market participants (e.g. Brexit, US elections). Certain members noted that there is some scepticism among some market participants on the effectiveness of the introduction of negative rates or further moves into negative territory as illustrated by the market reaction to the recent policy announcements by the BoJ and the Riksbank. The Japanese yen and the Swedish krona, after some initial weakening, are now trading at stronger levels against the US dollar and the euro, respectively. In the meantime, others note that the recent increase in risk aversion had a muted impact on the Swiss franc. As regards the US, views were mixed: some members pointed to the strength of the domestic economy and expect the Fed to hike rates most probably in the second part of the year, while others deem that US policy rates may remain unchanged over the foreseeable future due to external developments and an expected slowdown in the US economy. Finally, some members noted that implied volatility has picked up, but volumes have remained particularly subdued. While overall members expect some stabilization or correction of the risk-off sentiment, positioning is reported to be limited, reflecting the uncertainty in the market. Positions on the euro were assessed as limited or underweight.