EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Wednesday, 20 March 2019, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. The United Kingdom's intended withdrawal from the European Union – key considerations for the foreign exchange market

Paul Clarke (Refinitiv) reviewed the liquidity developments of the pound sterling currency pairs on its Matching and FXall platforms ahead of the United Kingdom's intended withdrawal from the European Union (EU). The liquidity of pound sterling currency pairs has declined in the dealer-to-dealer market over the last few months, with a widening of bid-ask spreads to get larger volumes done and a thinner order book. In the dealer-to-client market, bid-ask spreads were fairly stable, albeit with a lower turnover. In the discussion, some members linked the lower liquidity to the lack of appetite to take large positions in view of headline risks, the lower capacity of banks to warehouse market risk and clients' reduced reliance on placing orders with market makers. This may lead to reduced shock absorption ability in the event of large price moves. Some members considered that the intended UK withdrawal may impact liquidity further, as EU corporates may increasingly switch trading to banks based in the EU.

Ralf Lierow (Siemens) summarised the current state of operational preparedness for the United Kingdom's intended withdrawal from the EU aimed at ensuring the continuation of the provision of financial services by UK-based banks to EU clients, irrespective of the eventual form of the withdrawal. Many market participants are undertaking a repapering exercise to move coverage (plus existing contracts) to new entities established in the EU by their UK-based counterparties. This process has proved more complicated than expected, which raises uncertainties about the readiness of some UK-based banks to continue servicing their EU clients if no agreement is reached on the terms of the United Kingdom's withdrawal. Some members confirmed that there was a risk that not all of their UK-based bank counterparties would be ready on time, which should however not limit their operations due to existing alternatives. Another issue was that some of the newly established bank entities in the EU do not have the same ratings or levels of capitalisation as their parent entities, which may lead to lower credit limits on the client side and reduce the amount of foreign exchange (FX) trading that could potentially be conducted.

2. FX Outlook: Review of FX market developments and outlook

Chris Freeman (State Street) reviewed recent developments in the main FX markets. A new indicator 'Media Stats' that scans the media articles for the term recession spiked in both Europe and the US at the turn of the year, but has since eased back a little in February and March as recession fears are supplanted by concerns about slowing growth. As regards investor flows, State Street has seen inflows into the euro area sovereign bond and equity markets in the last month, while investors still appear underweight relative to their benchmarks in some assets. These inflows have not lead to the appreciation of the euro, as most of them seem to be currency hedged while the euro has acted as a funding currency in a general context of low financial market volatility.

The Group also discussed the causes and dynamics underlying the flash event in the FX market affecting the Japanese yen in early January. Members pointed to a combination of triggers during the early Asian hours and agreed on the difficulty of predicting the timing and occurrence of such events. While flash events have generally proved short-lived, they have the potential to undermine trust and confidence in the market. Therefore the Group agreed that it is important to continue developing a deeper understanding of the rapidly evolving FX market structure and its associated vulnerabilities.

3. FX Global Code and Global Foreign Exchange Committee

Roswitha Hutter (ECB) informed the Group of the key initiatives of the Global Foreign Exchange Committee (GFXC) and of its working groups as regards the implementation of and adherence to the FX Global Code. As a follow-up to the information paper published in February by the GFXC, the Cover and Deal working group is working on developing examples related to cover and deal trading arrangements. The Disclosure and Transparency working group also published an information paper and is continuing to explore issues related to anonymous trading platforms. The Embedding working group is exploring three avenues in its work: designing the 2019 survey; reviewing the use of the Statement of Commitment; and assessing whether GFXC should have a role in education and training relating to the FX Global Code. Lastly, the Buy-side Outreach working group, which is led by the ECB, has produced an information package for use by all local foreign exchange committees to raise awareness and encourage adherence among the buy-side community. The working group is also considering various tools that could facilitate the adoption of the Code by buy-side participants.

4. Update on euro interest rate benchmark reforms

Yasmina Santalla (ECB, Secretariat to the working group on euro risk-free rates), gave an update on the work done by the working group on euro risk-free rates, highlighting possible implications for market participants.

She referred to the key milestones achieved by the working group so far: (1) the selection of the euro short-term rate (€STR) as the new risk-free rate and replacement for the euro overnight index average (EONIA); (2) the recommendation of a transition path from EONIA to the €STR; (3) the recommendation of the overnight index swap (OIS) tradable quotes-based methodology as the forward-looking methodology to be considered when calculating a term structure based on the €STR as a fall-back for the euro interbank offered rate (EURIBOR), relying on several market assumptions and subject to further analysis; and (4) the publication of some guiding principles for fall-back provisions in new contracts for euro-denominated cash products that will be followed by more detailed fall-back language for new and legacy contracts. Please find more information here.

5. Any other business

Torsti Silvonen (Chair of the FX Contact Group) raised the attention of the Group to the Tokyo Foreign Exchange Committee's communication, regarding the settlement dates of existing trades falling between 30 April 2019 to 2 May 2019, as no settlement for FX trades executed in Japanese yen will take place between Saturday, 27 April 2019 and Monday, 6 May 2019.