



EUROPEAN CENTRAL BANK
EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Tuesday, 18 June 2019, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Best execution and transaction cost analysis

Nico Weinert (Deutsche Bank) and Christoph Hock (Union Investment) gave presentations on best execution and transaction cost analysis in the foreign exchange (FX) markets.

Deutsche Bank's functional data analysis on their concept of "price signatures" (the volume-weighted average price movement after an FX transaction) suggests that a client can improve the quality of its FX execution by reducing the number of counterparties with which it trades. It was explained that choosing fewer liquidity providers or a single liquidity provider with exclusive flow alleviates adverse selection issues and the anticipated leakage of information (compared with aggregating many liquidity providers in competition, especially if these providers use mixed hedging strategies). The analysis shows that this approach could offer liquidity consumers tighter bid-ask spreads, reduce response times and the market impact, and simplify workflows.

Following the presentation the Group discussed factors that may determine the optimal number and type of FX trading partners. These factors included liquidity providers' absorption capacity, internalisation rate and hedging style, as well as the overall trading conditions, volatility, timing of trade and selected currency pair. Members were of the view that liquidity consumers' awareness of issues concerning market impact and execution quality is generally increasing, even though a few members considered that some clients tend to use too many liquidity providers in competition. A concern raised in the discussion was that some liquidity providers may engage in transactions not with the intention of winning the trade, but of extracting information from the planned FX flow.

Christoph Hock (Union Investment) argued in his presentation that best execution should be seen as a process of ensuring that each FX transaction is carried out using the right modality and accounting for anticipated liquidity, volatility and market impact, with the aim of minimising transaction costs, information leakage and market impact. This involves actively evaluating transactions with pre-trade and post-trade analysis, maintaining a dialogue with counterparties and having an in-depth understanding of the variously available liquidity pools and algorithmic functionalities. The Group discussed investment firms' typical workflow between portfolio management and trading desks, as well as the role that automation, electronification and human decision-making play in firms' FX activities.

2. Anonymous FX platforms – trading practices and engagement

Simon Brunner (Credit Suisse) and Richard Anthony (HSBC) reviewed the trading practices of and engagement in the anonymous FX platform landscape. Anonymous electronic communications networks (ECNs) are typically characterised by streaming liquidity, prime brokerage intermediation, last look capability and live market data. ECNs enable market participants to connect with multiple liquidity providers and form bespoke liquidity pools via a single connectivity network.

Members agreed that ECNs form an important part of the FX market landscape and discussed a few of the challenges surrounding their use. Dispute resolution was identified as a key issue owing to the

nature of anonymous trading. This arises because the ability to identify counterparties and the process of doing so are complicated and may be further inhibited when intermediated by prime brokers. A few members considered that the ECNs should assume more responsibility for resolving disputes on their platforms and prime brokers should monitor their client activity more closely. Members also raised the issues of asymmetrical information flow in connection with unique identifiers, and challenges concerning high and low prices in connection with FX orders. These features may exacerbate dispute resolutions.

Despite these challenges, members confirmed that there was continued demand from market participants to engage on ECNs for a variety of reasons, including obtaining more competitive pricing, reducing market impact and accessing additional sources of liquidity. The migration of activity to anonymous ECNs, which some members thought featured a more aggressive trading style than disclosed venues, has typically been led by more sophisticated market players and facilitated by an increase in algorithmic trading.

3. FX Global Code and Global Foreign Exchange Committee

Members discussed the Global Foreign Exchange Committee's activities and exchanged views on the different priorities.

The Committee had agreed to publish one additional example of cover and deal type trading arrangements in the FX Global Code and the FXCG members agreed that it was important to continue raising awareness of this topic in the FX market.

The Committee's Disclosures Working Group will continue its work with the aim of finalising a report by December, which will highlight the key topics and map the flow of information on anonymous platforms so that market participants can use them more easily.

The Buy-side Outreach Working Group has continued its efforts to raise awareness of the FX Global Code in the market using a decentralised approach. It has also produced a number of tools that will be made available to the market to help market participants to adhere to the FX Global Code.

The Committee has begun planning for next year's three-year review of the FX Global Code in accordance with its Terms of Reference. It intends to solicit feedback from local FX committees and a wide range of market participants in preparation for the review.

4. FX Outlook – review of FX market developments and outlook

Members discussed the comparatively low implied volatility of the FX market versus other asset classes in the light of the elevated uncertainty concerning the global growth outlook. According to some members, given the low realised volatility over the past few months, a considerable number of market participants have been selling implied volatility consistently to earn additional income in their investment portfolios. Other views pointed to an anticipation of central banks' monetary policy outlooks moving in a parallel fashion. While this would make it challenging for investors to take directional views on currencies, bond and equity markets were considered more set for directional movements.

A few members also observed that FX flow dynamics and activity had been muted overall in recent months, while recent investor flows into the euro area were said to be constructive. It was pointed out that the longer a low volatility environment lasts, the higher the potential risks become for substantial adverse price movements in markets, even though the currently low leverage should mitigate contagion across asset classes in such a scenario. Some members highlighted the recent tensions in the Middle East as constituting large risks to financial markets which are, in their views, currently underpriced.