Foreign Exchange Contact Group

Frankfurt, Thursday 31 January 2013, 13:00-16:00 CET

S U M M A R Y   O F   T H E   D I S C U S S I O N

1. ECB and Foreign exchange

Roberto Schiavi updated the group on foreign exchange issues directly related to the ECB: the size and split of the ECB and Eurosystem FX reserves; the recent renewal of the global central bank FX swap arrangements; the declining usage of the ECB swap lines with the Fed; the latest G7 and G20 communiqué on exchange rates; the high public demand for ECB reference rates.

The Chairman noted that the ECB foreign exchange reserves were small compared to those of many other central banks. Some members asked about the composition of ECB reserves and the role of diversification objectives. It was clarified that the currency composition of the ECB foreign exchange reserves reflected possible intervention needs and no other consideration (although the USD – JPY composition also took into account diversification aspects).

2. Regulatory developments in the US and the EU as regards derivatives clearing

Sophie Bening, Legal Counsel at the ECB, gave an update on the latest regulatory developments in the US and the EU as regards derivatives clearing and reporting.

As regards European regulation (EMIR), 6 regulatory and 3 implementing technical standards were adopted by the Commission including on CCPs requirements, data reporting and trade repository (TR) registrations. Effective deadline for the reporting requirements for credit derivatives and interest rates derivatives is 1 July 2013 and for other derivatives (including FX) 1 January 2014. Data to be reported includes information on counterparty and product data on a daily basis. MiFIR is still under way and a general approach has to be defined at the level of the Council before negotiations can start with the European Parliament and the Commission to agree on a final text.

In the US, the Treasury issued its final determination that FX swaps and forwards, as defined in the Commodity Exchange Act (CEA), should not be regulated as swaps under the CEA. The Commodity Future Trading Commission (CFTC) issued on 28 November the first clearing determination for certain CDS and IRS. The CFTC approved an exemptive order for non-U.S persons and foreign branches of U.S. persons providing time-limited relief from certain cross-border applications of the Dodd-Frank Act (DFA), including exemption of non-US persons from certain entity-level requirements and transaction-level requirements. In 2012, the CFTC issued 65 no-action letters, most of them to delay compliance with certain rules.

Members discussed the intended and unintended impact of the different regulations. One member warned that the TR requirement as regards FX instruments may have some negative impact on liquidity in some foreign exchange market with lesser liquidity (e.g. some emerging markets) and in turn negatively impact domestic capital markets as foreign investors may be reluctant to invest on a non-hedged basis. Another member warned about the risk that some end-users will not be able to fully match their risks as the CFTC rules lead to a shift of trading from over the counter to futures markets.

3. Effects of QE on foreign exchange

Johannes Gräb, Economist at the ECB provided an overview on recent work in the ECB on the implications of the Federal Reserve quantitative easing measures (QE) on the exchange rate. Work focused on quantifying the impact of QE announcements and actual operations on exchange rates across regions and analysing if different types of interventions have different impact on foreign exchange rates. The announcement of “QE1” led to significant US dollar movements against all currencies, while the announcement of “QE2” had only a slight US dollar impact.

4. What thwarted yen weakness and what’s changed now?

Derek Halpenny, European Head of Global Market Research at BTMU, discussed what factors thwarted yen weakness and what has changed now.

Official capital flow data only partially explains the yen movements, as a significant part of investments are hedged. Large external surplus and valuation prevented the Japanese yen to depreciate for a long period. In addition, domestic investors had a strong domestic home bias on the back of high domestic real yields, low inflation expectations, stable demography and concerns over the financial crisis, which led to a sharp reduction in foreign asset exposure. Those factors also provided broad support to the JGB market. However, the landmark victory of the LDP in the Lower House election on 16 December and the subsequent expectations for more BoJ monetary policy easing and for fiscal and tax reform, as well as structural changes in external surpluses, the easing euro area crisis and the brightening US macro-outlook, have resulted in a broad depreciation of the yen against the major currencies since late last year.

The group discussed items 3 and 4 jointly. On QE, Members noted the difficulty to identify the no-anticipated elements in the official announcements and a number of other methodological challenges. Members also discussed the recent developments in FX market in particular as regards the yen weakness and expectations for further BoJ easing. Some mentioned the difference between the BoJ and the Fed action as regards the maturities of the BoJ purchases which are focused on the short-end of the curve and the scope for the BoJ to extend its purchases on longer maturities.

5. EBS and market ecology changes

Jeff Ward presented an update on the recent developments regarding EBS. He recalled the guiding principles of EBS: rewarding genuine liquidity from all market participants, taking steps to ensure a level playing field where “ultra speed” does not deliver an advantage, innovating and working collaboratively with the market. FX markets have remained deep and robust. They have experienced significant changes in particular over the past 10 years with the introduction of high frequency trading, which has also led to some frustration from some market participants. Over the past months, EBS has worked closely with leading banks and non-banks to bring some major changes: introduction of some new dealing rules (e.g. new policies on fill ratio), system changes (e.g. data distribution randomisation), price granularity (move away from decimalisation to half and full pips) and increased surveillance (e.g. creation of a cross functional surveillance team, identification and elimination of key areas of disruption). Since then, material improvement has taken place as regards the depth of the order book, the quality of liquidity, the mix of counterparties and the client satisfaction. EBS is working with the market on the introduction of further material change in 2013. EBS is also introducing a new platform, EBS Direct, a relationship-based trading proposition delivered through the existing EBS network. As regards FX volumes, they have declined markedly during the sovereign debt crisis, but have picked up markedly since the beginning of the year. Volumes of “algorithmic trading” on EBS platform have in the meantime declined somewhat. Members discussed the difficulty of assessing the market share of various trading platforms due to the lack of timely data on foreign exchange market.”

6. Concentration of trading in single bank platform on some FX products

Richard Oliver raised the issue of the concentration risk in particular for foreign exchange OTC instruments not covered by the Dodd-Frank Act (e.g. FX swaps and forwards). Trading of foreign exchange options, swaps and forwards is increasingly concentrated within a few banks due to the elevated fixed costs in particular in technology. He raised some concerns over the potential risks of such concentration and the risks of payment failure if for instance one trading platform is suddenly unavailable. Another member however deemed that competition between foreign exchange platforms was limiting such a risk.

During the discussion, some members also expressed some concerns related to the compulsory trade reporting of foreign exchange swaps and forwards, which in their view may impair liquidity in foreign exchange markets which are not very liquid (e.g. emerging markets).

7. Other Business

- Meeting agenda for next FXCG meeting on 13 June.
- The Global FXCG will be hosted by the HKMA in Hong Kong on 15 March and will discuss in particular recent regulatory reform, the draft preamble of the codes of best practice and shared global principles, and the code of conduct for quote contribution for benchmark.