EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt, Thursday 29 January 2015, 13:00-18:00 CET

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

1. Latest regulatory development: The clearing obligation and OTC FX derivatives

Emmanuel Boyer (ESMA) **reviewed the clearing obligation and OTC FX derivatives**. The European Markets Infrastructure Regulation (EMIR) provides authority to ESMA to implement the clearing obligation. Two different processes have been established. First, a bottom up approach under which CCPs have first to be recognised (third country CCP) or authorised (EU CCP), before the classes of derivatives they clear can be analysed. Under this process, 16 CCPs have been authorised and have led to 3 consultations so far. Second, a top-down approach starting with the products that could be added to the clearing obligation but that are not offered for clearing, however this has not been used so far. Taking into account standardisation, liquidity and pricing criteria, ESMA has proposed that non-deliverable forwards (NDF) for 11 currencies would be cleared and launched a consultation with the industry. Answers were mixed as regards the timing of the obligation. The majority of respondents agree that the maximum maturity for an NDF mandated to be cleared should be one year or less. Most also request a long phase-in and international coordination.
Discussions focused on the precise implementation timeline for NDF clearing. The date of implementation has not yet been decided but ESMA will communicate on this soon. Members also wondered about the international cooperation with US as well as Asian authorities – as most of the NDF currencies required to be cleared are Asian currencies. It was noted that ESMA has established closed contact and coordination with the US CFTC as well as relationships with relevant officials in multiple Asian jurisdictions. A few members showed some concerns about the capacity of the market to support the clearing obligation due to possible higher capital requirements and its impact on the leverage ratio. However, a phase-in process could mitigate some of these concerns.

2. WM/Reuters FX Benchmarks

Shirley Barrow (WM/Reuters) presented the changes impacting **the WM/Reuters (WM) FX Benchmarks**. WM is an exchange rate service which provides Spot, Forward and NDF rates at fixed trading hours throughout the day. The WM rates are independently set using data from highly liquid sources for each currency, following a transparent calculation methodology, and are reliable and resilient. In view of the regulatory changes regarding benchmarks, WM issued on 25 July 2014 a compliance statement relating to the "IOSCO Principles for Financial Benchmarks", introducing several changes (e.g. oversight charter). Following the FSB's Foreign Exchange Benchmark Group (FXBG) recommendations published in its report on 30 September 2014, WM has implemented one of them, while the 3 others are in progress. WM is also engaged with ongoing consultations (UK Fair and Effective Market Review, FCA Consultation Paper). WM has introduced on 15 February 2015 methodology changes for the spot rates, consisting of enlarging the time window for the calculation process (from 1 minute for "Trade currencies" or two minutes for "Non-Trade Currencies" to 5 minutes for all currencies), broadening the data sources and pooling data from all these data sources. No change is currently planned for forward rates.
Members enquired about the possible publication delay following the change in methodology, possible changes to the forward rate methodology and a broader consultation with end-users. Regarding FX benchmark execution, members noted that banks have changed

markedly the way they collect and execute FX benchmark orders, e.g. with some introducing a strict separation for trading those orders. Several members also noted that the wider time window implies higher uncertainty for execution and requires algorithmic execution, making it challenging for smaller banks to cope with the related higher cost. Discussion also focused on the introduction of fees for fixing execution, as contemplated by the FXBG report. Some members noted that some end-users were shifting and ready to accept fees, while others indicated that some institutions have operational issues with charging a fee or are unlikely to accept fees and seek alternatives. Several members expected volumes at fixing to decrease and shift to algorithmic execution. The group also discussed the possibility to set up a central utility to process fixing orders. However, members agree that such solution would not address the concerns regarding the residual fixing orders. Finally, members enquired about the WM consultation process. WM clarified that the consultation process was being reviewed and welcomed banks and market participants to liaise with WM to ensure being added on the consultation list.

3. Codes of Best Market Practice and Shared Global Principles

Guy-Charles Marhic (ECB) **provided an overview of the ongoing work to further enhance the existing joint statement on "Codes of Best Market Practice and Shared Global Principles"** which was issued after the meeting of the Global Foreign Exchange Committee (FXC) in 2013. Each year, the Global FXC meeting brings together the representatives from the major foreign exchange committees to discuss market developments and coordinate their work. The various Committees have held bi-weekly or weekly teleconferences to produce an enhanced draft, which was sent to the individual FX Committees in December 2014 for comments. A high number of comments and suggestions were received with a general appreciation of the "new" preamble. The amended draft will be circulated to the members for comments.

4. Market review and discussion

Derek Halpenny (MUFG) provided **a review of the recent FX market developments**. Several themes have been driving the FX markets. First, the crude oil price drop: it should benefit particularly the US, China and India with the large reduction in the US energy deficit providing support to the US dollar. In the meantime, currencies of large oil exporting countries have depreciated markedly, led by the Russian ruble. Second, the central bank's actions: countries or area with the lowest inflation rates have seen their currencies depreciating the most against the US dollar (e.g. Swedish krone, euro) while the recent removal of the floor by the Swiss National Bank (SNB) has also been a key driver of FX. Third, the US wage growth and the expected lift-off of the target fed funds rate by the Fed will be instrumental in driving the US dollar. Fourth, political developments in Europe (Greece, Spain and UK) may also be key for the euro. As regards Japan, "Abenomics" has not yet triggered large capital outflows and important reforms still need to be implemented (e.g. social security). Some members expressed concerns that Abenomics may be questioned as well as the capacity of Bank of Japan to achieve its inflation target. Fifth, the improvement in emerging markets fundamentals since the *"taper tantrum"* would mitigate any negative impact from the interest rate lift-off by the Fed.

Members also discussed the recent ECB announcements, with some noting that the impact on the euro area fixed income market was relatively muted as they were well anticipated. The euro may be increasingly used as a funding currency due to its highly liquid characteristics. Members also touched upon FX market positioning with large long US dollar and short euro and Japanese yen positions being reported. Some saw a risk of unwinding of these long US dollar positions in case the first rate hike by the Fed would be further delayed. It was also noted that the liquidity in the FX market has been deteriorating, as illustrated by the outsized moves following the SNB decision, possibly on the back of increased regulation and lower risk appetite from banks.