EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt, Friday 17 October 2014, 13:00-17:00 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

Stéphane Malrait (Chair of ACI FXC/Société Générale) reviewed the **latest regulatory developments**. Due to the specificities of the foreign exchange market, participants to a FX transaction often reside in different jurisdictions, which can pose challenges in case of conflicting regulations to the same trade. After different initial starting points, the US and EU seem now to be moving forward on the same timetable, which is easing some concerns from market participants.

In the meantime, market liquidity for the most actively traded Non-Deliverable-Forwards in currencies such as the Chinese renmimbi, the Indian rupee, and the Korean won prevails or grows mainly in Asia, while the U.S. and European customers account for less than a third of the global NDF market activity. Regulators were therefore asked to avoid taking actions that might disrupt US and EU access to liquidity pools in Asia.

Discussions focused on the difficulty of defining FX liquidity as it may evolve over time and on the challenges of pre- and post-trade transparency. Finally, members also discussed the opportunity to have a central repository aggregating positions across jurisdictions.

2. Corporate approach to hedging (Airbus)

Jean-Baptiste Pons reviewed his company's approach to FX markets and in particular to hedging. FX levels are one of the major drivers of the competitiveness of the Airbus group, as aircrafts as sales are mostly invoiced in US dollar. Since the banking crisis, another key issue is counterparty credit risk and therefore Airbus has enlarged the number of eligible counterparties to diversify its exposure and to access more liquidity.

The group typically hedges half of its commercial FX exposure in EUR/USD up to a maximum of 8 years, mostly via FX forwards on a hedge accounting basis. The hedge implementation is spread over time to benefit from a cost averaging effect. In principle everything is hedged fully up to the first three years, beyond then only partially. Regarding derivatives, the group has been reluctant to engage into collateralisation of its FX forwards, as its portfolio is so large that it may imply very large margin requirements. Similar to most corporates, Airbus does not hold a wide range of assets accepted as collateral and has mostly cash and cash equivalents.

Members discussed the necessity and opportunity cost to hedge for corporates. The concentrated exposure to a limited set of currencies, the monitoring by rating agencies and the shareholder pressure, however, require from Airbus a well-established hedging strategy. Some members noted that the reporting and other regulatory requirements are manageable for a large corporate, but may be a major issue for smaller corporates. Finally, it was mentioned that the Financial Transaction Tax (FTT) may become a major issue if implemented in FX and money market instruments.

3. FXBG final report on FX benchmarks

Guy-Charles Marhic provided **a summary of the Foreign Exchange Benchmark Group (FXBG) final report.** The Financial Stability Board (FSB) mandated this working group to focus on FX benchmarks and undertake analysis of the FX market structure and incentives that may promote particular types of trading activity around the benchmark fixings. The FXBG was also tasked to propose possible remedies to address these adverse incentives as well as to examine whether there is a need and scope to improve the construction of the benchmarks themselves. The FXBG membership included central banks, regulators, the IOSCO and the FSB Secretariat and it engaged to discussions with asset and money managers, non-financial corporates, benchmark providers, FX trading platforms and banks to conduct its task.

Market participants provided a broad range of comments to the interim report published on 30 July 2014 before the final report was published on 30 September. While the report reviewed a broad range of FX benchmarks, it essentially focused on the WMR benchmark in its analysis. Its data analysis indicates a large spike in volumes at the time of the WMR fixing but does not point to a parallel increase in volatility.

The FXBG report put forward 15 recommendations, which include the widening of the fixing window, the incorporation of broader price feeds, the creation of a user group for WMR and the support to the IOSCO review of WMR fixing. Some other recommendations were related to the dealer behavior, e.g. setup of internal guidelines and procedures, sharing of information with other traders and clients, establishment of internal systems and controls. The report also required index providers to review the use of FX benchmarks and assess if they are fit for purpose. Finally, asset managers are requested to conduct appropriate due diligence around their foreign exchange execution.

Regarding the report, some members indicated that the issue of agency versus principal in client orders' execution is not solved by the report. Members also noted that many market participants had wrongly inferred that the FXBG requests to set up a one-size-fits-all 5 minutes time window although the report explicitly requests WMR to carry its own due diligence on the proper time window. Finally, they noted the request for asset managers to carry proper due diligence on their use of FX benchmarks.

4. Market review and discussion

John Hydeskov (Nordea) provided **a review of the FX market development**. After the first part of the year characterized by low FX volatility, recent months have been characterized by a pickup in volatility driven by the divergence in monetary policy across the Atlantic. While carry strategies have continued to perform poorly, trend following strategies have provided better returns of late. The prevailing low volatility may have been driven by the forward guidance and quantitative easing policies pursued by some central banks but also the lower commercial and speculative market activity.

Some members were of the view that the expected divergence in central bank stance should continue to drive FX volatility higher. The recent sharp moves in FX were told to be mostly related to position unwinding (e.g. long US dollar positions, short euro and Japanese yen), while there was no substantial changes in the economic outlook which should grant a continuation of the prevailing moves. Some members noticed that following the introduction of negative rates by the ECB, the cross currency basis has moved more negative. A pickup in FX-volumes following the increase in volatility and related hedging activity by corporates was also mentioned. Many market participants were told to have focused on the implementation of new regulation at the beginning of the year, thus limiting market activity. As regards the euro outlook, some members noted that the euro was still supported by strong current account surplus and that up to date there were limited portfolio outflows. Finally, concerns were expressed over the possible market impact of Ebola.