EUROPEAN CENTRAL BANK

EUROSYSTEM

# Foreign Exchange Contact Group

Frankfurt, Thursday 13 June 2013, 13:00-16:00 CET

***SUMMARY OF THE DISCUSSION***

## 1. Regulatory developments in the US and the EU

Sophie Bening (ECB) provided an update on the latest regulatory developments in the US and the EU as regards derivatives clearing and reporting. About European regulations (EMIR), the first technical standards came into effect on 15 March 2013 and include clearing thresholds for non-financial counterparties, an exemption for pension schemes and intragroup exemptions from clearing and margin requirements. The effective date for reporting remains unclear, with the 23 September 2013 at the earliest. Reporting of CDS and Interest Rate Swaps (IRS) will start 90 days after the first trade repository has been registered with ESMA (which will probably occur in August 2013). Reporting of other asset classes of swaps (including FX) will start by 1 January 2014 if the trade repository is registered before 1 October 2013 (and by 1 July 2015 at the latest). EMIR requires both counterparties to fulfil the reporting obligation, with the possibility to delegate the reporting process. Non EU entities are not subject to reporting obligation.

In the US, the Commodity Futures Trading Commission (CFTC) published in December 2012 an exemptive order providing time-limited relief from certain cross-border application of the Dodd-Franck Act (DFA), with the consequence that non-US persons are exempted from several provisions of the DFA, incl. External Business Conduct Rules. Effective 5 August 2013, any swap required to be cleared must be traded on a Swap Execution Facility (SEF).

Florian Walch (ECB) gave an overview of the financial transaction tax (FTT), reviewing the existing financial taxes in the EU, the key features of the proposed FTT and the timeline of the Commission proposal. The FTT applies to a financial transaction if at least one party is established in a participating Member State and if a financial institution is established in a participating Member State. A financial institution is deemed to be established in a participating Member State according to the residence and issuance principle. Taxable transactions include financial transactions in a large set of financial instruments, but with some exemptions (e.g. primary issuance, FX spot, transactions with the ECB and national central banks). The initial timeline for the introduction of the FTT was 1 January 2014.

Members enquired about the level of cooperation between the US and EU authorities and lamented the lack of a harmonised framework, but which also reflects the different domestic frameworks. On the FTT, some members questioned the Commission's tax receipts estimates. Others expressed concerns as regards the introduction of a competitive disadvantage for banks located in participating Member States, the potential detrimental impact on market liquidity and saw some risks of reduced hedging activity by corporates or investors, thus increasing the overall level of risk among end-users. Some members raised the risk of relocation for financial instruments without issuance principle, which is the case for FX instruments. Members listed proposals to improve the tax definition: among others, the exemption for some products like FX swaps, of market making and of hedging activity.

## 2. HFT and the evolution of the FX spot market landscape & Latest development regarding Reuters and the FX

Dave Fotheringhame (Barclays) reviewed the changes in the FX market landscape focusing on some of the challenges related to high-frequency trading (HFT). HFT now represents a growing share of the FX market turnover drawing on parallel developments in the equity market. Banks and trading platforms have adopted some counter measures to curb the impact of some of the disruptive practices

of HFT. In the meantime, the race for latency by HFT has led to further investment in technology and evolving relationships with exchanges. The longer term responses to HFT include so-called dark pools, algorithmic trading and outsourcing execution function. The growing share of HFT has also resulted in higher market fragmentation of trading venues with increased diversity of platforms and several launches over the previous months.

Paul Clarke (Thomson Reuters) presented an overview of Thomson Reuters interaction with FX market participants resulting of the changing FX market, as well as the preparation to the recent changes in Swap Exchange Facility (SEF) rules. Evolving in a variety of market, Thomson Reuters is tailoring each market to its participants: e.g. onshore market (mostly manual), emerging markets (primary manual with some electronic price support, wider spreads) or developed markets (high trade volumes). The rulebooks for Thomson Reuters FX venues are currently being updated jointly with clients and include a review of instrument-specific granularity, market data delivery, platform transparency, market abuse behaviour and surveillance activity.

Some members voiced their concerns at the adverse impact and the elevated cost of HFT on FX market, while others reckon that HFT is inherent to financial market innovation. Market participants including electronic platforms have to regularly review their rules and practices to avoid disruptive behaviour. Members remind the importance of the Code of Conducts and Best Practices which should be applicable to all market participants. In this respect, the Chairman recalled the recent adoption by major FX Committees of a Global Preamble.[1]

Members also briefly discussed FX reference rates and fixings. Most members reported that a key feature of FX fixing is that they are transaction-based and that their methodology is transparent and recognised by market participants. Members said that most banks propose the execution of transactions at fixing rates as a pure service to customers with limited immediate benefits.

## 3. Market review and discussions

Michael Metcalfe (State Street) discussed recent market developments. He highlighted that market participants were overly pessimistic in 2012 and that the perception of risk has normalised in the past year. Tail risks are now seen as less likely, volatility is rising back to normality and correlation across markets is also normalising. Investment flows have generally been supportive of equities and emerging markets. Investors have gradually shifted positions from underweight to overweight European equities and Italian bonds.

Johannes Gräb (ECB) presented a study on the impact of recent policy changes in Japan on international asset prices and capital flows. The event study analysis was carried on (a) the announcement by the BoJ of quantitative easing and (b) the dissolution of the Lower House in Japan. The study indicates that (a) had a large impact on the Nikkei, bond yields and foreign exchange rate and that (b) had more limited impact on equities but some impact on European peripheral bonds. In term of capital flows, (b) led to large repatriation flows by Japanese investors and some shift out of bonds into equities.

Most of the discussion focused on Japan and the recent volatility in Japanese financial markets. Members attributed the recent increase in volatility to the surprise and bold BoJ action and the related change in expectations. Moves in currency markets were also attributed to some profit taking activity, as some investors are sceptical about the new policies led by the BoJ and the Japanese government, in particular as regards the capacity of the government to pursue structural reforms. Some members expect Japanese financial markets to remain somewhat volatile and some moderate increase in yields on the back of the increase in inflation expectations.

---

[1] The Global Preamble was posted on the ECB FXCG website:
http://www.ecb.europa.eu/paym/groups/fxcg/html/index.en.html