EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group
Frankfurt, Monday 3 September 2012

SUMMARY OF THE DISCUSSION

1. Latest regulatory developments as regards the central clearing of OTC derivatives

Sophie Bening, Legal Counsel at the ECB, made an update on the latest developments in the US and the EU concerning the rules on derivatives central clearing and reporting.

As regards US regulation, the CFTC/SEC have published final rules with respect to the definition of "swap" in August 2013. Subject to the adoption of the Secretary's determination, FX swaps and forwards will no longer be considered swaps. They will nevertheless be subject to certain reporting requirements. As regards FX spots, the CFTC clarified that they are not swaps and also gave guidance as to which transactions qualify as FX spots, and are therefore excluded from the provisions of the Dodd-Frank Act. Furthermore, on 30 July 2012, the CFTC also published a rule establishing a schedule for compliance with the mandatory clearing requirement for swaps, and on the same date, proposed a first determination of classes of swaps that will be subject to mandatory clearing (IRS and index-linked CDS, to be mandatorily cleared by end January 2013).

The schedule for the implementation of the EU regulation lags behind the US. EMIR was published in the Official Journal of the EU on 27 July 2012. European Supervisory Authorities (ESMA and EBA) are due to submit draft regulatory standards by 30 September 2012, followed by an adoption by the Commission expected by end 2012. There is no ex-ante exemption for FX derivatives in EMIR, but the regulation acknowledges in its preambles that FX swaps do not raise major concerns in terms of systemic risk and that infrastructure aiming at reducing settlement risk already exists. In view of this, it is expected that some FX derivatives will be excluded from mandatory central clearing, like in the US. FX spots are excluded from the definition of financial instruments in MiFID and are therefore excluded from the application of EMIR and MiFIR.

2. Impact of the Volcker rule on the FX market

Ulrich Leuchtmann, Head of FX Research at Commerzbank, made a presentation on the impact of the Volcker rule on the FX market.

The Volcker rule foresees a prohibition for banks to engage in proprietary trading. This prohibition will apply only for FX options, forwards and swaps, but not for spot. Only US banks and US activities of foreign banks will be affected.

The regulators have proposed a number of criteria to differentiate between prop trading and market making. It will nevertheless be difficult to differentiate the two. According to Mr. Leuchtmann, an effective implementation of the rule could increase market separation between spot and forward markets and increase bid-offer spreads and US banks would likely lose market share.

3. Review of recent market developments

The members of the Group exchanged views on recent financial market developments and the outlook, introduced by Steven Saywell, Head of FX Strategy Europe at BNP.

4. Sovereign debt crisis and its impact on the FX market

Hans Redeker, Global Head of FX Strategy at Morgan Stanley, made a presentation on the sovereign debt crisis and its impact on the FX market. On aggregate, the euro area runs a balanced current account and hence has no external funding issue. However, Mr. Redeker regards internal EMU current account imbalances in conjunction with core countries not willing recycling its surpluses back into “peripheral” countries as the main reason why intra euro area sovereign spreads have widened. Once sovereign bonds were regarded as safe assets supporting bank balance sheets. Widening bond spreads and rising bond volatilities have reduced if not eliminated this safe haven asset status. Banks balance sheets have become uncertain reducing bank lending and subsequently economic growth.

According to Mr. Redeker, ECB has understood this problem and aims at restoring the monetary transition mechanism. The ECB targets reducing intra euro area bonds spreads, which will work in favour of EUR denominated assets, supporting the EUR now.

However, Mr. Redeker does not see the ECB hiking rates any time soon and predicts euro area interest rates staying below US rates. In 2014, the EUR is expected to loose its asset status becoming a funding currency. Hence, the current EURUSD rally can be expected to run out of steam by the end of this year.

5. Other Business

- Global FX committees’ meeting.
- FXCG work programme for 2013.
- The next FXCG meeting will take place on 31 January 2013 from 13:00 to 16:00 at the ECB premises.