

EUROPEAN CENTRAL BANK

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Foreign Exchange Contact Group

Dublin, Thursday 7 September 2006

SUMMARY OF THE DISCUSSION

1. Review of market developments

As usual, the Group reviewed and discussed the latest trends in financial markets, particularly in foreign exchange markets.

2. Effects and influences of the opening up to the buy side of EBS and Reuters

Marshall Bailey, RBC, elaborated on the possible effects and influences of the opening up to the buy side of EBS and Reuters. Through the search for efficiency and cost savings, technology has driven the structural changes in the FX markets towards less intermediaries. Electronic tools have enabled an increase in high frequency trading that was mainly stemming from the buy-side. The higher liquidity is a benefit for the FX markets with faster execution, increased transparency. However, FX markets are multi-faceted. The borderline is blurred between the inter-dealer market and the dealer-to-client side with many single bank platforms. Many market participants are pursuing the aim of linking platforms together that represent overall an important pool of liquidity. The various channels for providing liquidity and the fierce competition around them are challenging the perception that EBS and Reuters might be in a dominant position. The trend towards central clearing also raises the question of the possible emergence of a commission-based and “exchange” type of FX markets.

3. The impact of Hedge Funds on the global FX markets: overview, implications and trends

The presentation of this topic is the result of a joint work between the Deutsche Bank, BHF Bank and the Deutsche Bundesbank. Peter Griep (Bundesbank) shed some light on the hedge funds’ impact on market dynamics. The difficulty to have a global view was highlighted due to the lack of coverage of the database available. There seem to be no clear empirical evidence of hedge funds’ impact on volatility. Increasing technical trading might amplify price movements while speculation could also stabilise prices. Hedge fund’s popular carry trades might contribute to prolong currency trends, moreover crowded trades make them vulnerable to adverse market dynamics. Jörg Isselmann (BHF) concentrated on hedge funds’ performance, leverage and risk. The correlation between hedge funds’ return has risen since 2004 suggesting a herding behaviour and returns appear to trend lower. The leverage also seems to have been relatively stable during the same period. The less aggressive trading strategies tend to converge towards the investment styles of traditional asset managers, which may decrease the appeal of the “asset class” of hedge funds. Stefan Bender (Deutsche Bank) addressed the benefits for clients to diversify hedge fund investments and presented some new products. He explained the process to select funds out of a given universe and described the art of designing a tailor made portfolio in a combination of hedge funds according to clients’ desired level of risk and targeted return.

4. Other business

- a.) The FXCG received information on the ECB's contact group webpages since they started on the ECB website in July 2006. The number of visits so far indicates a good start.
- b.) Paul Dillon, Chairman of Operations Managers Group (OMG) provided information on the Global Conference hosted by the ECB on 23 and 24 April 2007 in Frankfurt. He presented the draft agenda and urged the involvement of the FXCG, in particular for the item on electronic trading.
- c.) The next meeting shall take place on 29 November at the ECB premises at 13:00, a buffet lunch will be served from 12:00. The Chairman reminded that there was some room in the agenda to cover some of the topics left in the work programme. The secretary will coordinate with members for finalising the agenda.
- d.) The tentative calendar for 2007 will be submitted soon to the members for comments. The process to set the work programme for 2007 shall also be initiated soon and to this purpose the secretary of the group will gather the members' suggestions that would be discussed at the last meeting of the year.
- e.) The Chairman informed the group about the meeting of representatives of global foreign exchange committees organised by the FED NY on 26 October 2006 in New York. The ECB answered positively to the invitation. Although the agenda of the meeting has not been circulated, the invitation letter states the purpose of the meeting to *facilitate communication and understanding between the respective committees in order promote the smooth and efficient functioning of the global foreign exchange market.*
- f.) A contingency exercise shall be organised in October to test the teleconference system that would be triggered in case of a crisis. The exercise is to check how operational it is, the number of members reached,...and is expected to last no more than 15 minutes.
The FXCG will be informed on due time about the details of the exercise (timing, contingency webpage, password to access,...).

Annex 1**LIST OF PARTICIPANTS**

| Participant's organization | Name of participant |
|---|---------------------------------|
| Bank of Tokyo-Mitsubishi | Mr Kazuki Fukunaga |
| BBVA | Mr José Sanchez |
| BHF-Bank | Mr Joerg Isselmann |
| BNP Paribas | Mr Patrick Mauberqué |
| CECA | Mr José Manuel Villaverde |
| Citigroup | Mr Holger Achnitz |
| Credit Suisse | Mr Toby Cole |
| Deutsche Bank AG | Mr Stefan Bender |
| Dexia-Bil | Mr Joseph Hensen |
| Dresdner Kleinwort Wasserstein | Mr Alex Finos |
| Fortis Bank | Mr Yves Van Landeghem |
| JP Morgan | Mr Adam Burke |
| Nordea AB | Mr Morten Tysnes |
| RBC Capital Markets | Mr Marshall Bailey |
| Royal Bank of Scotland | Mr Roger Hawes |
| Société Générale | Mr Lars Hakanson |
| State Street Global Markets | Mr Michael Kahn |
| The Bank of Nova Scotia | Mr Barry Wainstein |
| European Central Bank | Mr Francesco Papadia - Chairman |
| European Central Bank | Mr Werner Studener |
| European Central Bank | Mr Etienne Port - Secretary |
| Deutsche Bundesbank | Mr Peter Griep |
| Bank of Greece | Mr Efthymios Gatzonas |
| Banco de España | Ms Marta Sáinz |
| Central Bank and Financial Services Authority of Ireland | Mr Robert O'Hara |
| Banca d'Italia | Mr Antonio Marras |
| Banque centrale du Luxembourg | Mr François Zenner |
| De Nederlandsche Bank | Mr Jaap Teerhuis |
| Oesterreichische Nationalbank | Mr Reinhold Wanka |
| Suomen Pankki | Ms Päivi Heinäaro-Ehgartner |

ECB FOREIGN EXCHANGE CONTACT GROUP**WORK PROGRAMME 2006****Remaining items**

1. How important is prime brokerage? Is the market comfortable that the operational infrastructure surrounding prime brokerage is robust? If not, what is being done and is it enough?

The long term future of the FX market and the market model.

2. Will banks continue to act as intermediaries in FX? Could a major ECN¹ merge with a clearing house and develop an exchange model? What is the role of CLS in this scenario? What would be the implications of this for the industry?
3. As margins narrow, is the market moving towards more commission based foreign exchange trades? What impact would this have on the market environment?
4. How will these factors impact on the profitability of the different players (global banks, regional banks, non-bank trading counterparties, non-bank hedging counterparties)?
5. What will happen to price transparency and liquidity?
6. There are now a growing number of model traders in the market whose only activity is to trade anomalies in price between different ECNs and bank proprietary eCommerce systems. Is this good or bad for the market? Will the FX market follow the development of the cash equity market where algorithmic trading takes a large percentage of market share and the traditional market makers become secondary players?

¹ Electronic Communications Network.