



EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt, Wednesday 29 November 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. Is FX Volatility Dead?

Monica Fan, RBC, addressed the question of the decline in FX volatility since the 1990's. She went through the main factors behind the decline in volatility for the major currency pairs. The global convergence in interest rates was cited as the predominant cyclical factor, while three main structural factors were identified. The increased central bank credibility has reduced the long term risk premia required by market participants. The globalisation of trade and financial markets was also mentioned. Finally the growth of central bank reserves, particularly in Asia, is also viewed as having a dampening effect on volatility. However, a deeper than expected US slowdown, the unwinding of carry trade or the reduction in the number of liquidity providers could be the catalysts for a temporary spike in FX volatility.

3. How important is prime brokerage?

Roger Hawes, RBS presented an overview of the Prime Brokerage (PB) business. PB revenues are expected to grow at a double digit rate from USD 9 billion in 2005 to USD 15 billion in 2010 across all asset classes. PB has offered clients the opportunity to trade in markets previously inaccessible at a relatively low cost. In a recent FX survey, 52% of Prime Brokerage clients expect FX trading volumes to increase in the next 12 months and 62% of those surveyed had monthly FX trading volumes in excess of USD 10 billion. Prime Brokerage clients account for roughly 18% of total daily volumes on one platform and, over the past twelve months, it has seen an increase of approximately 30% in clients, but an increase of over 100% in traded volumes.

PB clients have the benefit to face a single bank that covers all counterparty risk, manages those risks and any margin requirements. Typically PB also offers additional services to support their clients business and increase operational efficiency, such as cash/Collateral management, service, risk analysis tools with adequate reporting, thus allowing clients to focus on their core business.

The operational infrastructure is characterised by a high level of automation and operational efficiency, real-time credit checking, early warning solutions, fast matching processes and quality reporting capabilities.

However, reputational risk of banks offering PB services to clients is paramount, particularly when clients transact anonymously under the PB name. Banks have a responsibility to control and ensure that the quality of clients' trading on platforms is at the standard required. Therefore clients should be thoroughly checked to support the integrity of the inter-bank community. The key drivers of PB used to be a client willingness to outsource back-office functionality, reporting and risk management. More recently the growth seems to stem more from the algorithmic trading segment that seeks access to new markets.

4. Other business

- a.) Work programme for 2007. The Chairman expressed his gratitude for the members' contributions in 2006 and wished for 2007 a balanced allocation of the workload through an equal commitment of members. Many ideas have been proposed by members. 8 topics could

be considered for the agenda of the meetings in 2007. The interest of the group was high to work on issues related to the new joint venture between Reuters and the CME called FX MarketSpace, i.e. on the implications of the initiative, new business models, settlement issues,...). A presentation by FX MarketSpace was deemed useful to understand the current developments and should be scheduled for the first meeting of the year on 6 February 2007. Further work connected to algorithmic trading was also approved by the group. A presentation by another electronic platform is also under consideration. Moreover, a broad consensus was reached to look into the following issues:

- Retail FX margin trading and the consequences of market transparency could be considered together.
 - Update on CLS and alternative settlement solutions.
 - Review of the FX options market in general and the outlook for electronic trading in particular.
 - Currency risk management in emerging markets
 - Development of cooperation with other FX committees worldwide.
- b.) The Chairman reported about the FX committees meeting hosted by the Federal Reserve Bank of New York for which a brief summary was circulated shortly after the event. A formal summary has been drafted by the hosting committee and is currently in the process of being finalised. It will be circulated upon finalisation.
- c.) The secretary provided some facts on the recent contingency exercise. Out of 20 members, 14 participated to the exercise including 2 banks that called in teleconference themselves. 12 members accessed the restricted website successfully. The result of the similar exercise that was carried out by the Money Market Contact Group was also shared with the FXCG members (see link to the MMCG webpage <http://www.ecb.int/paym/groups/mmccg/html/index.en.html>). Members gave their feedback and the lessons from this exercise were drawn. In particular, the possibility that members design their own password will be investigated. The idea of having two phone numbers called into the teleconference for each member (including possibly a mobile phone) will also be looked into. The sending of an email/SMS could also be envisaged to ask members to join a teleconference. The FXCG, MMCG and OMG will propose a consistent approach.
- d.) ECB euro foreign exchange reference rates: the group was informed that from 1 January 2007 the Slovenian tolar (SIT) will be deleted from the reference rate list, as Slovenia adopts the euro. Moreover, from the start of 2007, the position of the Bulgarian lev (BGN) and Romanian leu (RON) in the ECB publication pages will be changed and both currencies will join the sub-group of the European Union currencies, as Bulgaria and Romania become members of the Union. The group gave general feedback about the ECB's foreign exchange reference rates and discussed the recent initiative of the Bank of England's to discontinue the setting of exchange rates.
- e.) The Operations Managers Group (OMG) secretary reported about the last OMG meeting on 7 November 2006. The summary of the meeting can be found under <http://www.ecb.int/paym/groups/omg/html/index.en.html>
- f.) The calendar of the meeting in 2007 was distributed. The next meeting will take place on 6 February 2007 at the ECB premises.

Annex 1**LIST OF PARTICIPANTS**

Participant's organization	Name of participant
ABN AMRO	Mr Peter Frank
Bank of Tokyo-Mitsubishi UFJ	Mr Kazuki Fukunaga
BBVA	Mr José Sanchez
BHF-Bank	Mr Joerg Isselmann
BNP Paribas	Mr Henri Foch
CECA	Mr José Manuel Villaverde
Citigroup	Mr Bernard Sinniah
Credit Suisse	Mr Joe Prendergast
Deutsche Bank AG	Mr Stefan Bender
Dexia-Bil	Mr Joseph Hensen
Dresdner Kleinwort Wasserstein	Mr Alex Finos
JP Morgan	Mr Adam Burke
Morgan Stanley	Mr Paul Blain
Nordea AB	Mr Mick Ankjaer
RBC Capital Markets	Mr Marshall Bailey
Royal Bank of Scotland	Mr Roger Hawes
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 Panagiotis Pliatsikas
Banco de España	Ms Jose Luis Jimenez
Banque de France	Mr Philippe Mongars
Central Bank and Financial Services Authority of Ireland	Mr Robert O'Hara
Banca d'Italia	Mr Antonio Marras
Banque centrale du Luxembourg	Ms Sandra Leches
De Nederlandsche Bank	Mr Jaap Teerhuis
Oesterreichische Nationalbank	Mr Reinhold Wanka
Banco de Portugal	Mr Jorge Alves
Suomen Pankki	Ms Päivi Heinäaro-Ehgartner
Guest speaker	Ms Monica Fan (RBC)