EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt, Thursday 24 October 2013, 14:00-18:00 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 reforms regarding financial benchmarks

Juliane Kinsele (ECB) reviewed the latest developments regarding financial benchmarks. The vulnerabilities and recent scandals related to allegations of manipulation of key interest reference rates have led to a comprehensive review of the benchmark processes to reduce the risk of manipulation and make them more robust, reliable and representative. The presentation described the IOSCO's principles for financial benchmarks and the Financial Stability Board work on the reform of financial benchmarks. It also described the specific initiatives in Europe, including the ESMA-EBA principles for benchmarks, the ECB work with the EURIBOR-EBF to ascertain the feasibility of a transaction-based unsecured money market reference rate for the euro, the EU amendment to the market abuse legislation and the European Commission's draft Regulation on financial benchmarks. The latter requests benchmark providers to be regulated and supervised and the methodologies to be transparent and robust in order to ensure appropriate governance and controls, to manage conflicts of interest and to improve transparency of benchmark-setting process. It covers administration, supervision, contribution and use of benchmarks within the EU. Such draft regulation needs to be adopted by the European Parliament and the Council and is currently expected to be completed in Spring 2014 with the rules coming into effect in 2015.

Members stressed the challenge of finding transaction-based alternatives to the current quote-based reference rates (like Libor and Euribor), given the currently limited liquidity in money markets, while acknowledging the benefits of transaction-based references. The discussion covered also FX reference rates (or fixings), which have been recently under the spotlight. The investigation seems to be focused at this stage on the possible collusion between some banks and on the possible manipulation ahead of FX fixings. However, some members mentioned that the very nature of the FX market and the lack of precise rules on some specific issues, like transacting an order for a customer at the fixing, leave scope for different interpretations as regards "manipulation" or "pre-hedging" of client orders. For instance, FX traders cannot feasibly execute very large orders at the "fixing price" at the precise time of such fixing unless distorting the market, so they would have to start executing the order before and finish after the fixing. Members stressed that the most used FX reference rates like the WM-Reuters rates are already fully transaction-based. They agreed that proper governance and proper behaviour promoting integrity with clear process would improve robustness of FX reference rates. Recommendations to improve the reference rates could also include the widening of the time window for the collection of transactions used for the setting of the reference rates. Also a better understanding of client needs and closer communication with them would be required. For instance, one should incentivise customers to shift their orders over a longer time frame or foster "algorithmic" execution in order to avoid concentrating client orders at one point in time (as is now the case for "orders at the fixing"). However, it was recognised that changing client behaviour is a lengthy process and there is no easy solution, because the better the process the more volumes will concentrate around such fixing. Indeed members stressed that client demand for execution at fixings is still very strong.

2. Regulatory developments in the US and the EU

Françoise Jaulin (ECB) provided an update on the latest regulatory developments in the US and the EU since the last FXCG meeting in June. The European Market Infrastructure Regulation (EMIR) entered into force on 16 August 2012 with the aim to create a new regulatory framework for counterparties to derivative contracts, central clearing counterparties (CCPs) and trade repositories, to

manage counterparty credit risk more effectively and to increase transparency and stability of OTC derivative markets. Options, swaps, forwards and foreign exchange derivatives are covered within the Markets in Financial Instruments Directive (MiFID). EMIR is imposing obligations on central clearing of OTC derivatives through CCP, on implementing risk mitigation techniques for un-cleared OTC trades, and reporting on all derivatives contracts to Trade Repositories.

Members reported that the preparation of clients – except for the very large ones - is lagging and most of them count on banks to help them through the required changes. This poses a big challenge for banks, which for example cannot be always certain to which category the client belongs. Even though central banks of the EU are exempted from these requirements it is not entirely clear to the banks how to separate them in reporting flows. Uncertainty on several other aspects of the regulatory details in the US and Europe remain a major concern and banks are adjusting their IT system on a "just-in-time" basis. As FX spot and forwards are exempted from central clearing, focus was on possible margin requirements for FX options, which could make the instrument less attractive. Finally members noted that some form of regulatory arbitrage is already taking place, with customers shifting away from US banks due to concerns over DFA-related requirements.

3. Market review and discussions

Camilla Sutton (Scotiabank) reviewed the results of the latest BIS triennial FX survey and the recent developments regarding the euro and gold prices. The discussion focused on the euro resilience and the increased share of the emerging market currencies in currency trading, in particular the Chinese renmimbi.

Participants reported that several factors contributed to the recent resilience of the euro (relative economic surprises with stronger-than-expected data in the euro area, the reduction of tail risks in the euro area after the OMT announcement, inflows in euro area equities and bonds) and the US dollar weakness driven by the delay in reducing the pace of asset purchases by the Fed, the US government shutdown and the reserve holders' concerns that could lead to reserve diversification out of USD. Looking forward, some members remain concerned about the euro area growth and inflation outlook, and most remain fundamentally bearish on the euro. However, market participants seem reluctant to open euro short positions after having been often wrong over the past year(s). In fact, some members deem that further euro appreciation may continue in the near term, as some supportive short-term factors remain intact (e.g. equities inflows versus on-going US fiscal uncertainty and possible further delay in reducing the pace of asset purchases by the Fed), and market liquidity normally dries up into year-end, which could support the euro if any short positions remain to be covered. On the Chinese renmimbi, members reckon that the move towards convertibility will still take time, but it is taking place more rapidly than initially expected – in particular in the trade invoicing area. In the view of members, still significant steps remain before the Chinese renmimbi becomes a major reserve currency, in particular the development of a large and liquid domestic capital market.

Stephen Leach (Citibank) talked about the recent selloff in some emerging market currencies, the various responses from central banks and the outlook for emerging market currencies. He linked the selloff during summer to the expectations of a reduction in asset purchases by the Fed and ascribed it to two factors: the re-pricing of risks for currencies with weaker fundamentals and portfolio rebalancings following the increase in US bond yields affecting all emerging market currencies. Since then, most currencies have recovered and portfolio outflows have, at least partly, reversed. Looking forward, some members deem that the delay in Fed tapering has given some breathing room to emerging market currencies, but outflows may resume. Members deemed that market participants increasingly differentiate between countries and currencies: some currencies are gradually shifting away from an emerging market status towards major currencies or even a regional safe haven status (e.g. the Korean won and the Taiwan dollar). Others may, however, come again under pressure due to domestic imbalances and weaker fundamentals (e.g. the Turkish lira). The organisation of banks' FX-trading desks also increasingly reflects this development, with for instance some banks adopting a single trade desk approach for all currencies now including majors and EMs, while others reorganise their emerging market trading desks to include also less liquid currencies (e.g. Nordic currencies).