EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Tuesday, 20 March 2018, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Taking stock of the first weeks of operations under MiFID II and MiFIR

Tony Botting (Crédit Agricole), Darryl Hooker (NEX Group) and Jean-Baptiste Pons (Airbus) provided a review of the functioning of the FX market following implementation of MiFID II and MiFIR on 3 January 2018.

Members generally agreed that the implementation had proceeded more smoothly than initially anticipated, given that no disruptions to FX market functioning in early January had been reported. Some members confirmed that FX market volumes had been above historical averages in December 2017 due to pre-positioning by certain market participants. Cautious activity had been observed in the first week of 2018, with a pickup in volumes later in January. Views among members differed as to whether the largest increase in e-trading had been seen in the fixed income market or in the FX market, but it was generally felt that electronic FX trading had increased substantially in January and February compared with previously, and that algorithmic execution stood at record levels.

Several members noted that some market participants had used the inception of MiFID II/MiFIR as an opportunity to push for a reduction in the number of counterparties. The main motivations appeared to be onerous documentation, lack of price competitiveness and low quality of service. Somewhat surprisingly, banks operating in the Asia/Pacific region seemed to benefit most from changes in counterparties. Some members highlighted that work is ongoing to obtain outstanding Legal Entity Identifiers (LEIs) from some Asian market participants.

Concerning the more extensive reporting requirements, qualitative feedback from members pointed to a greater level of unease than had been shown in the results of Crédit Agricole's client survey. Buy-side institutions were vocal on the issues of late communication by banks and substantial increases in legal costs, resources required and operational risks stemming from counterparties' amended terms of business. Some members were of the view that the small proportion of market participants so far intending to use the data available from MiFID II called into question its overall benefit, while at the same time creating a considerable administrative workload. The change involving the unbundling of research was viewed as causing only minor issues. Members were surprised by the responses of many of the market participants surveyed who indicated that they had not experienced confusion or lack of clarity with the new rules. There was general agreement that re-running the survey later in the year and including reference to some of the delayed measures would be useful.

2. Introduction to Jump Trading and an analysis of FX cash and futures markets

Mark Bruce (Jump Trading) gave an overview of Jump Trading and provided an analysis of the FX cash market against the FX futures market. The analysis of the FX cash (EBS and Reuters) and FX futures (CME) markets generally showed that the relative volumes traded on the FX futures market have grown, in comparison with cash trading. It also showed that relative volumes and price discovery for the USD/JPY and AUD/USD currency pairs shifted over the course of a business day – cash market trading dominated in the Asian markets trading hours, whereas futures market trading led as the New York market opened. The EUR/USD and GBP/USD pairs provided a broadly similar picture of relative volumes in the cash and futures markets over the course of the business day. In terms of absolute volumes, the futures market tended to dominate the primary cash market, particularly in the case of the GBP/USD pair. In terms of market depth as measured by VWAP spreads, for smaller trade ticket sizes the FX futures market had generally displayed tighter pricing than the cash market, but as ticket sizes increased, the depth of the FX futures market diminished.

3. FX Global Code – the way forward

Roswitha Hutter (ECB) presented recent developments related to the FX Global Code (the Code). Members participating in key work streams of the Global FX Committee (GFXC) also provided an update on their work. The level of market awareness and expectations of the Code were discussed and members generally noted that there was market interest in the Code, but that the momentum, in particular in relation to the new Statements of Commitment, had stalled somewhat in recent months. Awareness was high among banks, although it could be improved in certain other segments of the market, particularly in the asset management and hedge fund communities. Bank representatives reported that in recent months most questions from clients had focused on issues related to MiFID II, but there were some encouraging signs that further questions on the Code could be expected.

Some members were of the view that a renewed push to bolster awareness and adherence would be assisted by encouragement communicated by central banks, by promotion via articles in financial magazines and by participation in conferences. A proposal for a Global Index with links to all public registers was currently being assessed by the GFXC and was viewed by all members as highly desirable. The Chair reminded members to demonstrate their adherence to the Code by signing the Statement of Commitment by 25 May 2018 in order to remain eligible for membership of the Foreign Exchange Contact Group (as at the date of the meeting, 52% of members had signed). The Chair also emphasised that 22 ESCB central banks had already signed up to the Code and that the remaining seven would do so by the end of May.

4. FX Outlook: Review of FX market developments and outlook

Tobias Helmersson and Dimitrios Rakitzis (both ECB) reviewed trends in the FX market and the FX swap market. The members viewed US policies (monetary, trade and fiscal) as important drivers and risks going forward; it was felt that these factors could provide a temporary boost to the US dollar but then fade and become US dollar negative. In this regard, most members anticipated substantial demand – particularly from largely under-hedged corporates – for EUR/USD as soon as the exchange rate declined to around 1.22.

One member expressed surprise with the progress of Brexit negotiations and considered that this could provide a boost to the British pound. Another highlighted Italy as a medium-term risk to the euro, to be monitored closely. The volatile period in the equity markets in January was seen as a warning amid generally elevated asset prices.

Regarding the FX swap market, it was generally agreed that US domestic factors and regulation were exerting similar effects on all major currency pairs when viewed in terms of US dollar funding metrics and availability of liquidity. Some members acknowledged that volatility in the FX swap market on balance sheet reporting dates was triggered primarily by regulation, and that this effect was not likely to disappear in the short term due to regulatory differences.

Members also agreed that the current USD LIBOR-OIS spread widening was different from previous episodes and did not appear to reflect US dollar market funding stress. It was considered to be primarily driven by the accelerated T-bill issuance in the United States which had put pressure on US dollar availability, although the repatriation of tax-related earnings by US corporates could have been another contributing factor. However, this latter development had not yet materialised to the extent originally anticipated by markets.

Concerning the Eurosystem's US dollar liquidity-providing operations, one member remarked that it was not attractive for banks to take part due to supervisory scrutiny, while another member mentioned that such operations were not available to non-banks with large USD requirements.