EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

FINANCIAL SURVEILLANCE AND CRISIS MANAGEMENT

CONSULTATION DOCUMENT

TARGETED CONSULTATION ON MARKET LIQUIDITY IN FOREIGN EXCHANGE MARKETS

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudge the final decision that the Commission may take.

The views reflected on this consultation paper provide an indication on the approach the Commission services may take but do not constitute a final policy position or a formal proposal by the European Commission.

The responses to this consultation paper will provide important guidance to the Commission when preparing, if considered appropriate, a formal Commission proposal.

Commission européenne/Europese Commissie, 1049 Bruxelles/Brussel, BELGIQUE/BELGIË - Tel. +32 22991111
https://ec.europa.eu/info/business-economy-euro_en

You are invited to reply **by 31 March 2019** at the latest to the **online questionnaire** available on the following webpage:
https://ec.europa.eu/info/consultations/finance-2019-euro-foreign-exchange_en

Please note that in order to ensure a fair and transparent consultation process **only responses received through the online questionnaire will be taken into account and included in the report summarising the responses**.

This consultation follows the normal rules of the European Commission for targeted consultations. Responses will be published unless respondents indicate otherwise in the online questionnaire.

Responses authorised for publication will be published on the following webpage: https://ec.europa.eu/info/consultations/finance-2019-euro-foreign-exchange_en#contributions

CONTENT OF THE CONSULTATION DOCUMENT

About this consultation

This targeted consultation is aimed at financial institutions and other key stakeholders with an in-depth understanding of foreign exchange markets. Its main aim is to assess the role of the euro in these markets, notably in comparison with other major currencies, and to determine whether trading the euro is conducted efficiently and on the basis of adequate market liquidity. It will also assess the role that euro area banks play in foreign exchange market making.

NB: This survey seeks your views on the functioning of foreign exchange markets in general (i.e. the spot market, outright forwards, futures, etc.). Should you wish to comment on aspects relating to particular instruments or contracts, please do so in the space provided at the end. Please skip any questions which are not relevant for you.

Background

At the beginning of December 2018, the Commission adopted the Communication "Towards a stronger international role of the euro". The Euro Summit took note of the communication of and encouraged work to be taken forward to this end.

The Communication outlined the need to continue deepening the Economic and Monetary Union, in particular by completing the capital markets union and the banking union. Additional measures were proposed in the domains of financial services, and the international financial sector. Moreover, the Commission proposed actions in key strategic sectors; i.e. energy, raw materials, food commodities, and transport sector manufacturers, including targeted consultations of stakeholders. In the energy sector, the Commission issued a Recommendation on the greater use of the euro at the same time as the Communication.

The targeted public consultations are now launched in a coordinated way for different sectors: the financial sector, energy, transport manufacturing, food commodities and raw materials. The main objective is to further explore with stakeholders, how to increase the role of the euro in their respective areas. These consultations will be open for two months from end-January until end-March 2019.

In addition to the consultations, the Commission will also open discussions on the increased international role of the euro in different public fora. The Commission will report on progress by summer 2019.

Introduction

BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's more than 100 members manage assets of some 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22% in the EU Germany represents the largest fund market as well as the second fastest growing market in the EU. (BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en)

We support the initiative started by the EU Commission to strengthen the role of the Euro within the Capital Market Union. A generalization of direct currency quotes against the EUR, as it is done for the dollar should be also implemented thereby strengthening the euro as a pivot currency role similar to the current one of the dollar. We welcome the opportunity to respond to the European Commission's targeted consultation on market liquidity in foreign exchange markets.

Key questions

We have marked our answers in yellow.

Foreign exchange markets in general

1. In your view, how liquid are foreign exchange markets, in general?

   - **Foreign exchange markets are typically highly liquid**
   - Foreign exchange markets are typically quite liquid
   - Foreign exchange markets often have less than adequate market liquidity
   - Don't know / no opinion / not relevant

2. In your view, what are the main factors that determine the degree of market liquidity in foreign exchange markets?

   - Access to various pools of liquidity such as bank, non-bank, corporate, buy side to buy side and exchange traded FX (Futures markets), Existence of a variety of market participants

3. What policy measures, if any, do you think would be necessary to address any impediments to market liquidity in foreign exchange markets?

   BVI sees the following impediment to market liquidity in FX markets:

   - The capital requirements imposed on banks: The capital requirements applicable to banks are leading to a recurrent reduction of liquidity in the FX market at the end of each year and for several years.

   Our suggestions are therefore to:

- Consider re-calibration of relevant regulation to address unintended consequences of fragmenting and dampening liquidity. The EU should consider a “regulatory pause” that would allow to assess the cumulative impact of the different financial legislations from a liquidity perspective.

- Price provision with Last Look transparency: Liquidity providers need to inform each client with a clear internal definition of last look and process of use. They should inform clients when Last Look is applied on a trade, and explain why the trade has been rejected.

- Common acceptance of the FX Global code**:** We welcome and strongly support the FX Global Code for the foreign exchange (FX) market. This initiative will strengthen the integrity and effectiveness of the FX market. We support adherence to the Code by the FX Buy Side community.

4. a) In your view, how does the cost of currency hedging in euros compare to US dollars?

   - About the same
   - Typically higher in euros
   - **Typically lower in euros**
   - Don’t know / no opinion / not relevant

   Basis Effect = preference of USD vs EUR (long term effect)

   We would like to separate the following two points:

   1. Hedging cost due to interest rate/monetary policy differentials: depending on the business cycle (currently lower cost in EUR, but that might change in the long run)

   2. More important: Deviations from Covered Interest Rate Parity (i.e. non-negative cross currency basis) partially due to different bank regulation (e.g. year-end reduction of off balance sheet positions at US banks => demand for $-liquidity => extreme negative cross currency-basis)

   b) In your view, how does the cost of currency hedging in euros compare to Japanese yens?

   - About the same
   - **Typically higher in euros**
   - Typically lower in euros
   - Don’t know / no opinion / not relevant

   Basis Effect = preference of JPY vs EUR (long term effect)

c) In your view, how does the cost of currency hedging in euros compare to British pounds?

- About the same
- Typically higher in euros
- **Typically lower in euros**
- Don't know / no opinion / not relevant
- **Basis Effect = preference of EUR vs GBP (long term effect)**

d) In your view, how does the cost of currency hedging in euros compare to Swiss francs?

- About the same
- **Typically higher in euros**
- Typically lower in euros

Basis Effect = preference of CHF vs EUR (long term effect)

Don’t know / no opinion / not relevant

5. For the relevant instruments, are you satisfied that exchanges and/or market makers are listing sufficient euro currency pairs, and, if not, which currency pairs would you like to see listed?

- **Yes**
- No
- Don’t know / no opinion / not relevant

Our members are generally satisfied with the current state of Euro currency pairs as all banks quote EUR-crosses.

6. a) For the relevant instruments, are you satisfied that exchanges and/or market makers are efficiently promoting euro currency pairs versus major currencies?

- **Yes**
- No
- Don’t know / no opinion / not relevant

Generally speaking, we are satisfied with the way the markets are promoting the use of euro, as long as you can get a pairing of two currencies.

However, we also see numerous situations when you cannot get a direct currency pair between the euro and another currency.

In those instances, you have to pass through the dollar through “triangulations” – and making the dollar the pivot of the triangle.

Consequently, prices are calculated against the US Dollar (USD) and applied in to currencies of the transactions, leading to important cost increase due to a double spread against the euro (EUR).

Beside the spread impact, we consider that triangulation increases operational and counterparty risks in the absence of central clearing.

The negative effects of “Triangulation” can be avoided by the use of Algos.

b) For the relevant instruments, are you satisfied that exchanges and/or market makers are efficiently promoting euro currency pairs versus exotic currencies?

- Yes
- **No**
- Don’t know / no opinion / not relevant

As expressed in our reply to question 6.a, all prices given for these currencies are calculated according to the dollar (USD). This situation is creating a double spread against the euro, which causes cost increases.

Role of the euro in foreign exchange markets

7. In your view, to what extent does the euro play a role in foreign exchange markets that is commensurate with the size of the euro area in the global economy?

- It plays a role that is commensurate with the size of the euro area economy
- **It plays a role that is less than would be expected given the size of the euro area economy**
- It plays a role that is more than would be expected given the size of the euro area economy
- Don’t know / no opinion / not relevant

Given the size of the European economy, the euro should play a bigger role in foreign exchange markets. It was recently reflected in the BIS Annual Report.

8. What influence does the relevance of euro area banks in foreign exchange trading have on the liquidity of euro foreign exchange markets?

- It is not relevant
- It is relevant and euro area banks play a sufficiently strong role
- **It is relevant and euro area banks do not play a sufficiently strong role**
- Don’t know / no opinion / not relevant

9. a) How does the market liquidity of particular currency pairs involving the euro compare with currency pairs involving the US dollar?

- It is typically the same
- The market liquidity of most currency pairs involving the euro is typically higher in comparison with currency pairs involving the US dollar
- **The market liquidity of most currency pairs involving the euro is typically lower in comparison with currency pairs involving the US dollar**
- Don't know / no opinion / not relevant

b) How does the market liquidity of particular currency pairs involving the euro compare with currency pairs involving the major currencies other than the US dollar (i.e. JPY, GBP, CHF)?

- It is typically the same
- The market liquidity of most currency pairs involving the euro is typically higher in comparison with currency pairs involving major currencies other than the US dollar
- The market liquidity of most currency pairs involving the euro is typically lower in comparison with currency pairs involving major currencies other than the US dollar
- Don't know / no opinion / not relevant

10. Which factors do you consider to be important in order for the euro to play a greater role in foreign exchange markets?

- Considering (i) the impacts of "triangulation through USD" and its double spread effect against EUR (impacting liquidity and prices) and (ii) the higher liquidity of cross-dollar due to its prominent role in FX markets, we consider that the European Commission could reinforce the role of the Euro by providing direct / automatic quotes against the euro. The euro would consequently become a "pivot" currency, similarly to the USD. Another factor to be considered would be to create an incentive for central banks to enhance their reserves in euro currency e.g. by accepting cash deposit as collateral on behalf of funds on participants' account.

- Commitment of Liquidity Providers to run larger books against EUR.

- Change of ECBs low interest rate policy

- General promotion for attractive EUR investments.

- Another factor that should be taken into consideration is to create an incentive for central banks to enhance their reserves in euro currency (Larger Central Bank holdings).

Triangulation on foreign exchange markets

11. In your view, what is the extent of "triangulation" (trading via the US dollar) in the trading of particular currency pairs involving the euro, and how does this compare

with currency pairs involving other major currencies?

- **Triangulation involving the euro is used more compared to other major currencies**
- Triangulation involving the euro is used about the same compared to other major currencies
- Triangulation involving the euro is used less than for other major currencies
- Don't know / no opinion / not relevant

12. In your view, how are major companies in the euro area affected by triangulation (does it raise costs for them)?

Whether:

- **Triangulation does significantly raise costs for affected companies; or**
- Triangulation only raises costs modestly for affected companies, depending on currencies
- Triangulation does not really raise costs for affected companies

As explained in our reply to question 6, the situation depends on the currency.

- Don’t know / no opinion / not relevant

13. In your view, do major companies in the euro area have easy access to exchange rate prices for converting to and from euros? Please explain your answer

- **Yes**
- No

Larger and globally operating companies have access to a broader pool of liquidity, market penetration, coverage and sophistication.

14. In your view, do major companies in the euro area have adequate access to hedging instruments to cover their currency and interest rate risks?

- **Yes**
- No
- Don’t know / no opinion / not relevant

Please explain your answer.

- Larger and globally operating companies have access to a broader pool of liquidity, market penetration, coverage and sophistication
- For commercial reasons, the size of the company enables it to have an easier access to hedging instruments than SMEs.

15. Are there any other factors that you consider to be important in relation to the euro and foreign exchange markets, or do you wish to comment about particular foreign exchange instruments/contracts?

Our suggestions include:

1. A generalization of direct currency quotes against the EUR, as it is done for the dollar should be also implemented thereby strengthening the euro as a pivot currency role similar to the current one of the dollar.

2. SME in the euro area should not be disadvantaged by having less direct access than large companies to exchange rate prices and to hedging instruments.

3. The setting of capital requirements of European banks that do not excessively reduce market liquidity, in particular in the last quarter of the years.

4. European Banks, Corporates and Investors should not be required to apply more FX specific market and produc regulation than Non FX-European market participants.
5. The fostering of the Eurozone integration and possible future expansion to deepen the pool of available liquidity.