Frankfurt am Main
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FSB Consultation: Foreign Exchange Benchmarks

The German fund industry represented by BVI[1] welcomes the FSB consultative document and its proposed course of actions to address incentives towards specific FX trading activities that can create price manipulation opportunities and increase volatility to the detriment of the end investors.

Asset managers represent an important group of benchmarks' users - both in the case of passively managed funds and exchange traded funds (ETFs) - where benchmarks are used as a target for index linked funds - and in the case of actively managed funds. Asset managers rely upon credible, transparent and robust benchmarks and foreign exchange benchmarks in particular.

The FSB report makes reference to different uses of FX benchmarks by asset managers with which we broadly agree. Due to the wide pool of liquidity it offers and the possibilities to easily replicate the benchmark or to aggregate orders and use netting opportunities, trading at the WMR fix is considered one of the most convenient and efficient methods. Therefore asset managers also use the fixing to value their assets. At the same time, we agree with the FSB analysis on the necessary improvements in particular the need for a central trading and netting venue.

Asset managers themselves are already subject to extensive requirements and conditions as to the use of financial indices, either through regulatory standards or by existing industry practice around robust index selection. It is therefore in their own interest to support a more transparent and cost efficient FX trading model that will allow them even more to perform along their high fiduciary standards.

BVI-Comments on the FSB draft recommendations

We would like to comment on the recommendations as follows:

1. The group recommends the fixing window be widened from its current width of one minute. It seeks feedback from market participants as to the appropriate width of the calculation window.

BVI agrees to explore whether the current width of the fixing window may be too narrow to meet aggregate demand of orders and ensure sufficient available data to fix the rate. At the same time, a substantially expanded width may also entail important risks, as it will be difficult to achieve an easily replicable and tradable market price at a specific time. Any lengthening of the fixing period does not change the underlying principle that the fixing is still based on the average/median number of trades during the period, which does not improve pricing per se. On the other hand follow on processes which rely on the current fixing time frames may have to change because, for example, the valuation of investment fund holdings will need to be delayed by the new fixing procedure which may have negative knock-on effects on the settlement of redemption proceeds of the funds. Also the simple trading of the

[1] BVI represents the interests of the German investment fund and asset management industry. Its 82 members currently handle assets of EUR 2.2 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. (BVI's ID number in the EU register of interest representatives is 96816064173-47). For more information, please visit www.bvi.de.

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fix by allocating equally distributed number of trades to the time segment of the window (e.g. by the second) will lead to more trades and costs only.

2. The group seeks feedback from market participants as to whether there is a need for alternative benchmark calculations (such as a volume weighted or time weighted benchmark price) calculated over longer time periods of up to and including 24 hours.

Alternative benchmarks as suggested are acceptable only if they are tradable in practice because otherwise the buyside would lose the ability to trade at the fix.

3. The group also seeks feedback from market participants as to whether the fixing windows should continue to be centered exactly on the hour (half hour) or whether the fixing window should close or start on the hour. Market participants should consider whether this view changes depending on the size of the window.

For the same reasons as mentioned in our answer to recommendation 1 we would not suggest to change the time of the fixing on the hour.

4. The group proposes that WM investigate the feasibility of receiving price feeds and transactions data from a broader range of sources to further increase its coverage of the FX market during the fixing window, and should regularly assess its coverage as market structure continues to evolve. In that regard the group also proposes that in the short term, WM develop its methodology to utilise the transactional and quote information from both Thomson Reuters Matching and EBS, wherever both are available.

BVI agrees with the proposal for additional sources of data as this would enhance the liquidity for the calculation purposes and would therefore reflect in a more realistic way the underlying activity the WMR seeks to capture. However, not all price sources are of equal quality. In order to insure “real” prices which are not skewed by credit, settlement or other operational risk (e.g. duplicated prices from different request driven venues), only such venues/sources should be considered which accept only regulated financial service providers as traders.

5. The group considers that, where central banks publish reference rates, it is the responsibility of each to set internal procedures. Central banks should at least take note of guidance from the IOSCO principles. However, where central bank reference rates are intended for transaction purposes, the group encourages compliance with the relevant IOSCO principles.

We support in full and note that the transparency of Central Bank FX fixings could be improved. Even in your report the description of the ECB fixing is much less detailed than the description of the WMR fixing.

6. The group supports the development of industry-led initiatives to create independent netting and execution facilities. However, it also is interested in seeking feedback from market participants on the development of a global/central utility for order-matching to facilitate fixing orders from any market participants.

We support the exploration of an option to move the current OTC FX markets to a regulated trading and netting venue. Independent netting and execution facilities supported by industry-led initiatives are welcome, but less effective to mitigate conflicts of interest and provide a transparent regime compared to a central utility for order matching. An “equity trading venue” type of approach seems to be useful to consider. To avoid conflicts of interest and manipulation (e.g. front running) the aggregation of trade orders should be performed by a body which is separate from the body matching the orders e.g. through an auction. Such a trading utility can ensure that the fixing price is determined by demand/supply orders and will prevent move market prices from going beyond what is determined by liquidity providing orders. A utility for order matching and execution or auction in the market during a given fixing window gives no room for arbitrage as the determination of the market price will be based upon demand and supply. In that way conflicts of interest are adequately addressed and the fixing price can be determined upon a balanced fixing window and transparent trading rules. Moving from a bank driven OTC market in which customarily all orders for fix are filled at the risk of the trading banks to a regulated trading/matching venue entails – like in equity auction markets – the risk that not all orders can be filled at the (expected) fixing (for example similar to auction based equity trading venues).

7. The group recommends that fixing transactions be priced in a manner that is transparent and is consistent with the risk borne in accepting such transactions. This may occur via applying a bid-offer spread, as is typical in FX transactions, or through a clearly communicated and documented fee structure such as a direct fee or contractually agreed price.

The principle of a transparent fee structure is of course welcome. However, transparency on the pricing of the fixing transactions will not eliminate the risks as to the manipulation of fixing prices and conflicts of interest. If these risks are not dealt with, transparency on fees could mean that a well-defined fee is put on top of non-transparent profits gained by the dealer through different ways of trading maximizing his profits. We therefore support the creation of a transparent trading mechanism/utility which could then be complemented by a transparent fee structure.

8. The group recommends that banks establish and enforce their internal guidelines and procedures for collecting and executing fixing orders including separate processes for handling such orders.

The principle is of course welcome.

9. Market-makers should not share information with each other about their trading positions beyond that necessary for a transaction. This covers both individual trades, and their aggregate positions.

The principle is of course welcome. In case of “novation” trades an exception should apply.

10. Market-makers should not pass on private information to clients or other counterparties that might enable those counterparties to anticipate the flows of other clients or counterparties, including around the fix.

The principle is of course welcome.

11. More broadly, the group recommends that banks establish and enforce their internal systems and controls to address potential conflicts of interest arising from managing customer flow.

The principle is of course welcome.

12. Codes of conduct that describe best practices for trading foreign exchange should detail more precisely and explicitly the extent to which information sharing between market-makers is or is not allowed. They also should, where appropriate, incorporate specific provisions on the execution of foreign exchange transactions including fixing orders.

The principle is of course welcome.

13. The group recommends stronger demonstration by market participants of compliance with the codes of the various foreign exchange committees, as well as their internal codes of conduct.

The principle is of course welcome.

14. The group recommends that index providers should review whether the foreign exchange fixes used in their calculation of indexes are fit for purpose.

The principle is of course welcome.

15. The group recommends that asset managers, including those passively tracking an index, should conduct appropriate due diligence around their foreign exchange execution and be able to demonstrate that to their own clients if requested. Asset managers should also reflect the importance of selecting a reference rate that is consistent with the relevant use of that rate as they conduct such due diligence.

As already mentioned in our general remarks, asset managers already have important due diligence duties concerning the use of financial benchmarks deriving either from regulatory requirements or via existing industry practice around robust index selection.