

Foreign Exchange Contact Group

Frankfurt am Main, Thursday, 18 June 2020, 10:30-12:30

Summary of the discussion

Guy Debelle (Deputy Governor of the Reserve Bank of Australia and Chair of the Global Foreign Exchange Committee – GFXC) joined the meeting as a guest and outlined the main issues for discussion at the forthcoming GFXC meeting.

1. Update on trading conditions in the foreign exchange market

Roswitha Hutter (ECB) summarised the feedback that Group members had submitted prior to the meeting on the general trading conditions in the foreign exchange (FX) market. FX liquidity conditions had deteriorated considerably during the worst part of the financial market crisis in March 2020, but overall the functioning of the FX market seemed to have remained impressively resilient. Risk appetite had declined and bid-ask spreads had widened amid spikes in volatility, but no outages or severe disruptions in the market's technical infrastructure had been reported and systems and venues had been able to facilitate trading. Swift and decisive central bank actions had been critical to containing FX market volatility and supporting a gradual return to normal functioning.

In the Group discussion, members agreed that the FX market had been performing well, considering the high level of volatility. On some occasions FX flows had become one-sided, which had caused difficulties for some market-makers seeking to warehouse risk and had on occasion led to lower internalisation ratios and higher rejection rates than under normal market conditions. Liquidity conditions were seen as particularly challenging for emerging market and Scandinavian currencies. However, despite some concerns among market participants, the FX market had functioned in an orderly manner for the March and April month-end fixings, amid elevated volumes. In general, trading seemed to have been concentrated more around fixing times and less in the early hours of the European trading session (e.g. for Scandinavian currencies).

Members had observed a substantial increase in trading on primary market platforms relative to secondary market platforms, as volatility increased. While some customer activity had moved to risk transfer¹ and voice-based trading, many investors had increased their use of execution algorithms. The desire to avoid the cost of risk transfer amid wider bid-ask spreads, algorithms' embedded transaction cost analysis, which enables investors to assess execution performance, and a reluctance to rely on execution at a single point in time were cited as important reasons to use algorithm execution during the crisis. In that context, passive algorithms, requiring more time to transact and entailing less aggressive trading in smaller sizes, as well as algorithms geared towards primary market platforms and trading in the major currency pairs, tended to be used the most and perform the best.

As regards the market outlook, members discussed the potential key drivers for the remainder of the year. Some members expressed positive views on the euro area, as its healthcare systems were considered well equipped to handle an environment characterised by prolonged effects of the coronavirus (COVID-19), and the European Commission's proposal for an EU Recovery Fund was seen as supportive for the euro. Some others felt that the current market narrative seemed optimistic

¹ When market participants execute a "risk transfer", they request a price from their liquidity provider (a request-for-quote, RFQ, or request-for-stream, RFS) and trade the full size at the price received from their counterpart.

and that some of the announced pan-European measures could take longer to implement than was generally thought. In any case, market demand for the US dollar during the COVID-19 crisis period had been efficiently catered for by central banks' US dollar liquidity-providing operations. A few members felt that demand for the US dollar could fall, considering the recent fall in US Treasury yields, a potential increase in US corporate defaults and the uncertainties related to the results of the forthcoming US presidential election. It was highlighted that the euro could also experience volatility caused by the Brexit trade negotiations and potential corporate defaults.

2. Operational resilience in the context of COVID-19

Roswitha Hutter (ECB) presented members' feedback, based on their written submissions, on the FX market's operational resilience during the COVID-19 stress episode and the related working from home arrangements across institutions. Members were generally of the view that the arrangements had surpassed expectations and had had little effect on liquidity conditions in the FX market.

In the discussion, it was highlighted that FX markets had also performed well in comparison with markets for other asset classes, potentially owing to the already high degree of electrification and long experience with managing electronic trading systems in periods of elevated volatility. However, most participants reported that they had focused on running and maintaining their IT systems while putting on hold major updates and system development projects. Institutions differed in terms of the degree to which they had kept staff working in offices. This had tended to depend on the type of business operation and level of technical sophistication involved, but a policy of full teleworking seemed to be more common to buy-side than sell-side institutions. Members had differing impressions of the effectiveness of working from home for a prolonged period of time and it was uncertain how some parts of human resources, compliance functions and support services could be fully adapted to these arrangements over the longer term. While most members felt that the teleworking environment had brought many unexpected benefits and was well-suited to certain types of task, there was a need to examine more closely the long-term implications and lessons learned from the home working arrangements. Product development was mentioned by one member as an example of an area where close interaction was deemed an important prerequisite.

Members agreed that the FX Global Code had been very beneficial in preparing the FX market for the COVID-19 episode. When adopting the Code, market participants had undertaken a thorough review of their systems, processes and procedures and had strengthened their business continuity plans in order to ensure adherence to the Code. It was considered worthwhile to review the Code's principles in the light of the lessons learned from the home working arrangements, but in general members did not expect any considerable changes to be necessary.