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TO:

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Brussels

March 29, 2019

Re: Market Liquidity in Foreign Exchange Markets

Dear Benjamin, Lourdes, Anna and Nicolas

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) welcomes the opportunity to comment on behalf of its members (consisting of 25[1] global foreign exchange (FX) market participants, collectively representing approximately 80% of the FX inter-dealer market) on the European Commission's consultation on the euro and market liquidity in foreign exchange markets, launched on the 25 January 2019.

The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). We and our members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

The FX market is the world's largest financial market, and effective and efficient exchange of currencies underpins the global financial system. Sovereign entities, central banks and other government

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds Bank, Mizuho, Morgan Stanley, MUFG Bank, Natwest Markets, Nomura, Royal Bank of Canada, Scotiabank, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

sponsored entities rely on the FX market to be well-functioning and liquid, and corporations and investors regularly participate in the market for important operational needs: to reduce risk by hedging currency exposures; to convert their returns from international investments into domestic currencies; and to make cross-border investments and raise funding outside home markets.

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

GFXD Response: Foreign exchange markets are typically highly liquid

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

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The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. The FX market forms the basis of the global payments system and as such both the number and diversity of market participants and the volume of transactions are high.

Whilst we note in our response to Question 1 that the FX market is typically highly liquid, there are many factors that could and do impact the wider availability of liquidity. These include:

Financial Services Regulations and Data

- Financial Services Regulations: The predictability of those regulations impacting capital markets and their consistent application across jurisdictions and market participants will impact the ability/desire of market participants to provide liquidity and make markets
- Market data announcements: the frequent release of market-related data (e.g. economic data/indicators) usually provides a stimulus for activity in the FX markets, impacting the liquidity in currency pairs
- Stress factors: Certain events, such as geo-political events, can cause the markets to be directional in nature i.e. a predominance in selling or buying. Such events can create challenges for market participants in providing liquidity
- Central Bank activity: Central Banks directly impact the liquidity of the FX markets, typically through their own intervention through trading i.e. buying and selling large positions

Market structure

- The time and location at which trades are executed: The availability of liquidity generally matches the main market hours of the main FX trading centers, with liquidity generally being reduced outside of these hours
- Instrument and Currency pair traded: Different FX instruments and different currency pairs are understood to have differing levels of liquidity. More vanilla instruments, such as FX spot, are generally more liquid than exotic products, such as complex FX options. Similarly, with currency pairs, emerging market currency pairs are deemed to be less liquid than developed market currency pairs
- Counterparties to the trade: Depending on numerous factors, some market participants will act as liquidity providers and some liquidity takers
- Electronification of the FX markets: the FX markets have evolved highly electronic methods of execution, confirmation and settlement over the last 20 years, enabling the high volumes that are seen today to be traded. This ease of trading and high velocity, with increased transparency, enables quicker risk-based decisions to be made, thus allowing the higher volumes to be traded
- Venue access: Given the cross-border nature of FX, it is critical for access to be harmonized, especially when considering access to trading venues. If access is not harmonized, then liquidity in some jurisdictions may not be available for those in other jurisdictions to access

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

A stated in our response to Question 1, we generally believe that the FX markets are typically highly liquid.

However, there are certain general policy considerations which can impede the availability of liquidity, and in this context, we consider policy being synonymous with financial services regulation.

FX is by definition a cross border, global market which operates 24 hours a day for 5.5 days a week; it is also the world's largest financial market. Trading activity is driven by market participants who execute FX to pay for goods and services, fund investments or hedge currency exposures. Market participants therefore require the ability to trade in any currency pairs or FX instruments. Any impediments to trading will impact the ability of market participants to perform these activities, in the worst case rendering them illegal or too expensive to execute.

For instance, we do not believe that the provision of euro liquidity should be limited to either specific market participants or to specific jurisdictions. Wholesale market liquidity is provided to meet the needs of client business and is not location specific. The FX market is global in nature and any restrictions, due to specific regulation/policy is likely to (negatively) impact the provision of liquidity to end-users, be that for corporate or investment purposes.

Feedback from our members suggests the following:

1. Corporate flow will largely be based on the currency pairs in which there is a specific requirement (e.g. EURCHF), and not necessarily triangulated against another currency, such as the USD
2. Activity in certain sectors may warrant trading against the USD, such as the Air sector, where debt is usually USD denominated. Banks will therefore meet the requirements of their clients and in this example offer USD crosses

However, when the bank providing the liquidity looks to consolidate and hedge any positions, the hedging activity will be determined at the portfolio level. A portfolio will comprise many individual trades in multiple currencies and will be hedged according to the strategy of the individual in any number of currencies and/or products.

Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and the GFXD wishes to emphasize the desire of our members for globally coordinated regulation which we believe will be of benefit to both regulators and market participants alike.

Whilst the 2009 G20 Pittsburgh Agreement promoted such a harmonized approach, in reality the regulatory implementation of the G20 Agreement has not been fully harmonized across the main FX trading centers.

Such differences include:

1. Unharmonized regulations: If each participant to a trade has duplicative or different regulatory obligations then the likely impacts will include: 1) the legal inability for one participant to provide liquidity to clients within certain jurisdictions, and 2) changing costs of doing business, in that compliance with two separate regulations may actually mean that either participant to the trade may actually choose not to execute due to prohibitive costs.

   If we consider an eligible FX trade executed between the US and the EU, we can see that the main regulatory obligations on each party will differ.

   i) Trade Reporting

   MiFIR requires market participants to i) use EU specific reporting vehicles (Approved Reporting Mechanism/Approved Publication Arrangement), ii) comply with specific reporting thresholds based on EU-only liquidity determinations, iii) use a raft of new EU-only processes and architectures, such as FIRDS and ANNA-DSB for ISIN generation, and iv) perform EU-specific reporting such as those required to monitor best execution.

   Delving a little deeper into trade reporting, an eligible trade executed between the US and the EU will be reported up to 12 times across the US and EU (MiFIR/EMIR), this number increasing if there is also an Asian nexus. The same information will largely be required for each report yet will require tailoring for each report due to the report specific obligations, such as seen in the EU-only use of ISINs. Each report will therefore not only incur increased costs to produce and submit but will also result in increased operational risk management processes to ensure that the data is accurate and is reported on time.

ii) Capital

Additionally, the global minimum standards for capital requirements under the G20 mandated Basel Committee for Banking Supervision (BCBS) include the Fundamental Review of the Trading Book (FRTB). Whilst the FRTB rules have been accepted at the BCBS level, they are yet to be transposed and implemented at the national level.

Within the EU the application of the FRTB requirements are via the Capital Requirements Regulation and Directive (CRR/CRD). The CRR/CRD may include options and discretions, pending on the Commission's delegated act and the technical standards the EBA shall develop. The standards developed in the EU and in other jurisdictions may lead to inconsistent application and increased costs and further fragmentation of liquidity offerings.

iii) Uncleared Margin

Inconsistencies between the EU implementation of variation margin requirements for certain FX products and that of other jurisdictions have raised fragmentation concerns from banks and FX end-users, although we note the recent positive action taken through EMIR REFIT to achieve closer harmonization with the rest of the world.

2. Trading venue access: Policies which restrict the trading of FX to venues within a specific jurisdiction will invariably fragment the availability of liquidity to the wider market. Whilst there are currently no mandatory trading obligations for FX, there are requirements on multilateral trading through venues. EU venues have now registered as MTF/OTFs and as such are required to comply with those obligations as defined under MiFID II; this action has impacted the desire of non-EU participants (especially Asian) to trade on EU venues (i.e. provide/take liquidity) as they too would be required to comply with MiFID.

3. 3rd country equivalence: Any regulations which impact the ability to trade FX between jurisdictions will invariably impact the choice of provider and availability of liquidity. We have seen through the implementation of the G20 Pittsburgh Agreement that the application of regulation across jurisdictions has not been harmonized, with each jurisdiction largely taking its own view on how to implement the G20 Agreement. The granting of equivalence for 3rd countries greatly reduces the likelihood of differing regulatory obligations applying to each of the counterparties to a trade.

The GFXD strongly supports that any further regulatory considerations should promote further harmonisation across jurisdictions and remove any barriers to participants accessing the global FX markets, whilst allowing supervisors the best opportunity to oversee trading practices and market transparency.

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

GFXD Response: About the same

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

GFXD Response: Typically lower in euros

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

GFXD Response: Typically lower in euros

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

GFXD Response: Typically lower in euros

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?

GFXD Response: Yes

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

GFXD Response: Yes

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

GFXD Response: Yes

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?

GFXD Response: It plays a role that is commensurate with the size of the euro area economy

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

GFXD Response: It is not relevant

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

GFXD Response: It is typically the same

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)?

GFXD Response: 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

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

We largely support those points previously made by the Commission in their 12 December 2018 publication 'Towards a stronger international role of the euro'.

Increased investment will be driven by less fragmented markets within Europe, and the Capital Markets Union and Banking Union should aim at providing such a framework once they are successfully completed. Both of these efforts aim to increase the stability and predictability of both the EU markets and EU market participants, itself increasing the safety, attractiveness and ease of doing business in Europe. We are a strong supporter of the completion of the EU Banking Union and Capital Markets Union.

As confidence increases, we believe that the levels of national and international corporate investment will grow, funded through an increase in the issuance of euro denominated assets such as bonds, themselves being funded in euros – the net result being an expected increase in the use of the euro.

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?

GFXD Response: Triangulation involving the euro is used about the same compared to other major currencies

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

GFXD Response: Triangulation does not really raise costs for affected companies

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

GFXD Response: Yes

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?

GFXD Response: Yes

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?

In our response to Question 2 we introduced the importance of regulatory harmonization across jurisdictions to the global FX markets. As FX forms the basis of the global payment systems, the number of participants and volumes traded are extremely high and any barriers to trading will impact the ability for participants to trade FX to pay for goods and services, fund investments or hedge currency exposures.

We drew particular attention to the harmonisation of the regulations concerning trade reporting, capital, margin and trading venue access. Using trade reporting as an example we described how a trade executed between the US and the EU could be reported up to 12 times, duplicating processes, introducing increased operational risk and costs.

There are also EU specific regulations and policies which are likely to impact the availability of liquidity to the FX markets within Europe.

The EU Benchmark Regulation is expected to impact the availability of FX liquidity within the EU. Specifically, at the end of the current transition period, 1 January 2020 (noting that the EU authorities have recently agreed an extension, but only for an additional two years), there are currently eight currencies which may not be able to be traded within the EU, as the daily benchmarks within those currencies will be unlikely to be deemed compliant. These currencies include Korean won, Indian rupee and Taiwan dollar. The impact being that EU market participants (such as an importer/exporter to Korea) may not be able to effectively hedge any currency risk incurred through daily business activity which may prohibit their ability to execute within such markets.

We note the ongoing debates on taxation, most notably with the financial transaction tax and the recent digital services tax. The additional potential cost if either of these are applied to the FX markets could be considerable and would likely result in impacts to the provision of liquidity.

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We greatly appreciate the opportunity to share our views on the Proposal. Please do not hesitate to contact Andrew Harvey on 44 203 828 2694, email aharvey@gfma.org, should you wish to discuss the above.

Yours sincerely,

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