Deutsches Aktieninstitut

ECB Fixings for the FX Markets: Remaining Concerns of Non-Financial Companies

Position Paper of Deutsches Aktieninstitut, 29 April 2016

Background

This short position paper summarizes the concerns relating to the changes in the ECB fixings for the FX market which become effective as of the 1 July 2016. The paper is based on the feedback Deutsches Aktieninstitut received from German non-financial companies (NFCs) organized in the working committee on treasury and corporate finance.

We would most appreciate if the ECB would take into account our remaining concerns in the ongoing process and stay ready at your disposal in case of further questions.

The use of reference rates among non-financial companies

Reference rates for the FX markets in general and the ECB fixing are used for the following purposes within NFCs:

- For information purposes they are used in order to convert accounts, contractual obligations (e.g. currency clauses in supply agreements), or internal financial relations from a foreign currency into EUR. It is our understanding that the ECB's change in the publication schedule does not aim at reducing or even prohibiting the use of the ECB fixings for these purposes. However, if the ECB fixing was published even later than 4pm (as it is currently envisaged) even the use of FX fixings for information purposes would become problematic due to internal processes (cut-off times).

- For execution purposes the ECB fixing has long been used as the main reference in derivative markets. For example, the ECB fixing determines the EUR leg in Non-Deliverable Forwards which are used for transactions with countries without a freely convertible currency. The ECB fixing is, however, also used in other occasions (such as determining the trigger reference in FX option) or to determine the conversion rate of future payments resulting from contractual obligations based on a different currency (e.g. contract is based on EUR, customer will pay in GBP). As NFCs need to be able to hedge accordingly, the ECB fixing has frequently been used as a reference.

  Until the decision of the ECB's policies relating the EBC fixing, the NFCs had access to a freely available, independent, market-neutral and reliable benchmark that had also been accepted by banks so that NFCs companies had been able to get a sufficient number of competitive bids for a certain hedging demand. To accomodate this demand from NFCs, counterparty banks needed to be able to execute trades close to the fixing in order to hedge against risks resulting from FX orders of their clients. It is our understanding that the ECB is concerned about the concentrations of trading activity around the fix that resulted from this inherent economic logic (and attempts to manipulate the fixing) and, thus, would like to reinforce the original "reference only" purpose of the ECB fixing by changing the schedule of publication and increasing pressure not to use ECB fixings for execution purposes.

Concerns of NFCs

Though we fully agree with the ECB that the manipulation of reference rates needs to be addressed in an appropriate manner and NFCs in general encourage more transparency in the FX market we still do not understand the ECB's move to discourage the use of the ECB fixing.

From our point of view the (potential) problem of a manipulation of fixings by market participants will not be addressed with that and actually be shifted to an area where prepositioning of market participants might be easier to achieve. Generally, we rather expect that attempts to manipulate the market will just concentrate on other reference rates than the ECB fixing. We furthermore doubt that private benchmark providers (such as WM Reuters and Bloomberg) are less prone to the risk of manipulation. Rather the opposite may be true, because if the trading around the ECB fixing is discouraged the FX trading will concentrate on the remaining alternatives where it is in contrast to the ECB fixing not yet ensured that these fixings are supervised by an independent body. In addition, current data around the London 4 pm WMR fixing already indicates that the fix tends to be either at the high or the low of the trading day.

For NFCs the consequences of the change of market structure are far from clear because there is limited information available on liquidity and other trading patterns in a number of FX segments so that the risk of getting unattractive conditions will rather increase for NFCs. In contrast, until the decision of the ECB market participants could rely on that at least some liquidity was available around the fixing which made it easier to get competitive bids for an existing hedging demand/FX order.

In addition to that the ECB fixing is available for free so that NFCs, including smaller ones, currently have access to a transparent public benchmark. Though it is our understanding that the ECB urges private benchmark providers to reformulate fee policies it is far from clear whether these final policies will meet the needs of NFCs. As a consequence, it is likely that NFCs will face significant additional costs.

Furthermore, the change of the ECB fixing policy forces all market participants to change existing processes and practices in the FX market. Though we acknowledge that "legacy positions" will not be in scope of the changes, there is still a high level of uncertainty in the market which concrete “solution” could be used to substitute the well-proven ECB fixing. We have even been reported by our members that some banks already try to change the basis for legacy positions which rather reinforces the legal and practical uncertainty for NFCs and their customers.

The feedback we have received so far clearly shows that most of the NFCs still do not have a substitute for the changes in the ECB fixings nor is it clear how banks will adopt to the policy changes and whether NFC’s and banks’ preferences can be matched.

A short survey following the call with the ECB in April reinforced this picture based on roughly 20 comments from NFCs. It is also worth to note that there is an enormous time pressure for NFCs and other market participants which rather strengthens the position of private benchmark providers and increases the risk of suboptimal solutions and processes. Furthermore, it undermines the negotiating position of NFCs vis-a-via the banking sector to find an acceptable solution for all parties.

Conclusion

Against the background of the concerns above, NFCs would still prefer if the ECB reverted its decision.

At least, the ECB should reduce the time pressure for market participants by rescheduling the date when the changes in the ECB fixing will become effective until new market practices will be developed.

From our point of view this should also be in the interest of the ECB in order not to create market fractions.

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