A Review of 2000 by The London Foreign Exchange Joint Standing Committee

Introduction and overview

The Foreign Exchange Joint Standing Committee (FX JSC) was established in 1973 under the auspices of the Bank of England, in the main part as a forum for banks and brokers to discuss broad market issues. The focus of the Committee's regular work remains issues of common concern to the different participants in the foreign exchange market.

The FX JSC met seven times in 2000. In addition to discussions on a number of topics, including e-commerce, liquidity and Continuous Linked Settlement Bank (CLSB), perhaps the key focus of the Committee's work this year has been its work on the London Code of Conduct for Non-Investment Products, in conjunction with its sister committees in the London gold and sterling deposit markets.

At the start of the year, the FX JSC increased in size from eight to 20 members, partly reflecting its new responsibilities in relation to the London Code of Conduct for Non-Investment Products. The Committee now includes senior staff from 11 of the major banks in the foreign exchange market, as well as voice- and electronic-brokers, corporate users of the foreign exchange market and the FSA. In addition, the Committee has strengthened its already close relationships with the British Bankers' Association and the Wholesale Market Brokers' Association by including representatives of these associations as members of the JSC. Reflecting the importance of corporates in the foreign exchange market, the JSC also now includes a representative from the Association of Corporate Treasurers. The Bank of England continues to provide the Committee's Chairman and Secretary.

The Committee's work in 2000

Code of Conduct for Non-Investment Products

Until 1987, the FX JSC was responsible for maintaining the London Code of Conduct, which provided guidelines on good practice in the foreign exchange market. Changes introduced as a result of the Financial Services Act meant that responsibility for maintenance of the Code shifted to the Bank of England and, more recently, to the Financial Services Authority (FSA). However, 'non-investment products' (NIPs) – that is transactions conducted in the sterling, foreign exchange and bullion wholesale

deposit markets, and in the spot and forward foreign exchange and bullion markets – will fall outside the FSA's regulatory coverage once the Financial Services and Markets Act comes into force in 2001. The FSA's market consultation on the future regulation of inter-professional business in October 1999 found that there was broad support for the development of a code of conduct for 'non-investment products'. There was strong market support for a Code drafted along much the same lines as the London Code, but produced as a guide to good practice by the market.

The Bank of England agreed to facilitate the production of the Code, working with individuals with experience in the relevant markets. Much of the JSC's work in 2000 has therefore related to the production of this Code, in conjunction with the Management Committee of the London Market Bullion Association and the Bank of England Money Market Liaison Group, representing the bullion and sterling deposit markets respectively. The Committee is also involved in considering developments to the Code of Conduct suggested by other groups, both in the UK and overseas, to reflect market developments.

At the end of November 2000 a draft of the Code was published for public consultation, both in hard copy and on the Bank of England website at www.bankofengland.co.uk/markets/nips.htm. The consultation period ended on the 22 December 2000, and the Committee will spend the early months of the New Year finalising the Code in the light of comments received.

E-commerce

Developments in e-commerce, and their potential impact on the foreign exchange market, have been one of the other major themes of the Committee's work in 2000. The Committee discussed two main aspects of e-commerce: the implications for regulation and the development of internet-based trading platforms.

The effects of e-commerce on regulation

David Strachan (FSA) was invited as a special guest to a Committee meeting to discuss the effects of e-commerce (particularly new trading platforms) on regulation. From the perspective of the FSA, the key challenge posed by electronic trading platforms as a component of the market's infrastructure was how far such entities

should be regulated, and whether entities that provided similar functions and services in the same market or products (e.g. exchanges and brokers) should be regulated in significantly different ways. Much work was taking place to resolve this issue, both at the FSA and in other regulatory bodies abroad. There were a number of related issues, including whether any switch in trading to the new platforms would require greater transparency or market monitoring. This depended in part on whether the trading platforms obtained a significant market share such that the transparency of the market was undermined, and whether they might represent a threat to the stability of the financial system. It was relevant in this context that spot and forward FX was not an investment product. In addition recent initiatives had been aimed very much at the wholesale markets, which raised different regulatory issues compared with systems which admitted retail participation.

The Use of the Internet as a Foreign Exchange Trading Platform

In discussions early in the year, the FX JSC identified trading using the internet as a possible driver of structural change in the foreign exchange industry. Subsequently, the development of two large multilateral FX trading platforms for customers was announced by consortia which included many of the largest global FX market players. In its discussions, the Committee suggested that the main business driver of trading with customers on the internet was cost reduction: both for banks in providing foreign exchange prices to corporates, and to corporates in executing their foreign exchange business. Looking further forward, the growth of trading with customers on the internet was thought likely to lead to further globalisation of the market: increasingly, transparent prices would be available instantaneously to customers across the world. It was difficult to tell whether internet-based trading would reduce or increase market concentration. At one level, technology might mean that banks did not necessarily have to be one of the major market players in order to obtain business. On the other hand, it was possible that the major banks could deliver, individually or collectively, internet-based services that met customers' requirements, in which case market concentration could increase.

Liquidity in the foreign exchange market

The Committee discussed this topic at a number of meetings in 2000. There was general agreement that the structure of the foreign market had changed markedly over the last decade. However, opinions differed as to whether recent sharp market movements were a reflection of those changes, or examples of the volatility which had always existed in foreign exchange markets. There had been a number of changes to the structure of the market, including the greater influence of options-related trading on price formation, as well as concentration of liquidity and reduced market making. The majority of members of the committee felt that these changes meant that the likelihood of other extended price movements would increase in future. However, it remained difficult to generalise about levels of liquidity in the foreign exchange markets, which had become more volatile: at times, it was surprisingly easy to transact a large order with very little effect on the price. Whilst the fall in liquidity might be partially explained by the reduction in hedge fund activity, and a reduction in risk appetite more generally with fewer firms acting as market makers, in general liquidity often varied depending on the time at which the transaction is done, the currency pair being traded and the currency product being traded.

Settlement of spot foreign exchange on T+1

The FX JSC discussed this topic at its meetings in February and March, on the latter occasion reviewing a paper produced by a JSC subcommittee. The discussions were prompted by the statement in late 1999 by the Securities and Exchanges Commission (SEC) that securities settlement systems in the US should reduce settlement cycles to T+1 by 2002. This led some to question whether the foreign exchange market could and should alter the convention for spot fx trades to T+1 (from T+2 currently).

Settling spot foreign exchange would reduce the length of time in which firms were exposed to counterparty credit risk. However, the consensus of the Committee was that shorter deadlines for confirming and matching trades would increase firms' operational risk, possibly increasing the overall risk to which they were exposed through dealing foreign exchange. Most large banks could reduce settlement for spot to T+1 relatively easily for most currency pairs; however, for transactions involving currencies such as the yen, Australian and New Zealand dollars time-zone differences

meant they might still need to be settled on T+2. Moreover, banks could currently trade for settlement on T+1 on demand from customers: it was possible that demand for T+1 settlement would increase if the settlement cycle for equities was reduced to T+1, but that this could be accommodated without altering the settlement convention. Given this, any change in the convention for spot was likely to be led by the market: if the majority of foreign exchange trades were settled on T+1, rather than on T+2, the market would call trading for settlement on T+1 'spot'.

Continuous Linked Settlement (CLS)

The FX JSC had several discussions over the course of the year on the impact on front-offices of the forthcoming introduction of CLS. The Committee assessed the cost-benefit aspects of CLS and related initiatives, including the impact on settlement risks and systems issues. The main issue identified was the management of liquidity required to meet the deadlines imposed by the CLS system, and the possible ways this could be achieved. By the end of the year it became clearer that "inside-outside swaps" would be used by CLS members as their liquidity management tool, at least on a temporary basis. (This involves CLS settlement members undertaking intra-day FX swaps between themselves to allow members to swap currencies they are short of in CLS for currencies in which they are long). This implied the reintroduction of a small amount of settlement risk, although perhaps only on a temporary basis if these swaps were used as part of the transition to more effective intra-day liquidity provision.

<u>2001</u>

Looking to 2001, the focus of the FX JSC's work is likely to remain on the London Code of Conduct for Non-Investment Products, at least in the early part of the year. The FSA will be publishing a final version of its Handbook chapter on Inter-Professional Conduct, and the JSC will deal with any issues arising on the interaction between this and the NIPs Code.

The JSC will continue to monitor internet based trading platforms, including their introduction in the first half of this year, changing patterns of liquidity, CLS and the other challenges and issues in the foreign exchange market that arise in 2001.

In recent years, representatives from the FX JSC have attended meetings of the foreign exchange committees run by the Federal Reserve Bank of New York and the European Central Bank, and received visitors from the ECB and the Bank of Japan at its meetings; the Chairman and the Secretary have also met their opposite numbers from a number of other committees. The Secretary of the JSC circulates 'Key Points' from each meeting to the counterpart committees overseas, and debriefs the Committee on developments in these counterpart committees. The Committee is keen to maintain and strengthen its links abroad in 2001.

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