A review of the work of the London Foreign Exchange Joint Standing Committee in 2002

This note reviews the work undertaken by the London Foreign Exchange Joint Standing Committee during 2002.

Introduction and overview

The Foreign Exchange Joint Standing Committee (FX JSC) was established in 1973, under the auspices of the Bank of England, as a forum for banks and brokers to discuss broad market issues. The membership of the Committee includes senior staff from many of the major banks operating in the foreign exchange market in London and representatives from brokers, corporate users of the foreign exchange market and the Financial Services Authority (FSA). A list of the members of the Committee, as at end-2002, may be found at the end of this review.

The FX JSC met six times during 2002. During the earlier part of the year, the main focus of the Committee's work was on the formation of an Operations subgroup and contingency planning, while in the latter months of the year it was on the issue of undisclosed principal trading.

Formation of an Operations subgroup

In the aftermath of the terrorist attacks in the United States on 11 September 2001, the FX JSC discussed the lessons to be learnt from the impact on the foreign exchange market of those events. The main conclusion drawn by the FX JSC was the key role played in New York by the Operations Managers Working Group (OMWG)(1) in facilitating the continued operation of the foreign exchange market there. The OMWG enabled effective communication and co-operation between market participants to ensure that payment and settlement problems were resolved quickly and efficiently.

The FX JSC noted at its January 2002 meeting that no similar group existed in the London market that could perform such a role, and furthermore that there was no existing group that met regularly to discuss operational issues in detail. The Committee therefore agreed that an Operations subgroup of the FX JSC should be created, and that it should also cover the international money market, given its synergies with the foreign exchange market.

The Operations subgroup first met on 18 April 2002 and met a further two times during 2002. The subgroup comprises individuals active in the operational areas of banks: its members, as at end-2002, are listed in the annex. As well as examining contingency planning(2) the subgroup can also act as a forum for the discussion of technical operational issues, raising with the FX JSC the potential or actual implications of developments in these operational issues for market practice and, where appropriate, suggest action to improve procedures. In 2002 it considered the following:

- Confirmation processing—contrary to guidance in the Non-Investment Products (NIPs) Code,(3) a number of companies were reported not to be confirming all foreign exchange trades. Banks were concerned that this could affect the promptness and accuracy of payment instructions and receipts, and contract enforceability. A particular processing issue was highlighted by losses sustained by Allfirst, a subsidiary of Allied Irish Bank, where it was reported that a contributory factor was a failure to confirm foreign exchange trades.(4) A working group has been formed to

(1) This is a subgroup of the New York Foreign Exchange Committee. The latter has a similar role to the FX JSC in respect of the New York foreign exchange market.
(2) This issue is discussed in the next section of this review.
(3) This is a code of good market conduct for the sterling, foreign exchange and bullion wholesale deposit markets, and the spot and forward foreign exchange and bullion markets. It can be downloaded from: www.bankofengland.co.uk/markets/nipscode.pdf. The FX JSC has responsibility for its maintenance with respect to foreign exchange.
(4) See the 'Ludwig' Report to the Board of Allied Irish Banks Plc concerning currency losses, page 15 E.1. It can be downloaded from www.aibgroup.com ('Press Office' and search for 'Ludwig report').

produce a statement of good practice; it will liaise with other international foreign exchange centres where appropriate.

- Standard Settlement Instructions (SSIs)—there have been discussions about whether to review the current NIPs Code guidance, which is that all SSI changes should be authenticated. At present many firms do not adhere to this guidance, as they notify SSI changes by means of an unauthenticated SWIFT broadcast.

- Continuous Linked Settlement (CLS)(1)—the subgroup agreed to form a working group to look at technical issues relating to good market practice following the launch of Continuous Linked Settlement Bank (CLSB) in September 2002.

For 2003, a priority, in addition to the above, is to enhance liaison and communication with other similar groups. One member of the FX JSC Operations subgroup is also a member of the New York OMWG, while the Chairman of the subgroup is also a member of a similar group that meets under the auspices of the European Central Bank.

Contingency planning

During 2002 the FX JSC particularly focused on the issue of contingency planning. Presentations were made to the FX JSC and the Operations subgroup on the work of the resilience and continuity subgroup of the official sector's tripartite Standing Committee on financial stability(2) and on the Financial Sector Continuity web site.(3)

The Operations subgroup is primarily intended to act as a point of co-ordination in the foreign exchange market on operational matters during times of market distress, enabling speedy resolution of settlement problems and, by its actions, ensuring the market continues to operate as effectively as possible. It has therefore focused mainly on the development of a coherent and robust contingency plan for times of severe market distress. This plan covers two broad areas: first, the process and mechanics of invoking an emergency meeting of the group; and second, the output that would be required once the group had been invoked. The process will involve the holding of regular conference calls, and the establishment of a contingency web site to facilitate information exchange. The Committee agreed to undertake such a test conference call during 2003. The output issue is being considered by a working group set up by the Operations subgroup, which plans to report later in 2003.

Undisclosed principal trading

Undisclosed (or unnamed) principal trading is when a fund manager acts as an agent for clients who do not want their identity disclosed to a third party (usually a bank) with whom the fund manager is trading on their behalf.

In late 2001 a number of banks became concerned about the extent of their exposure to unknown counterparties and so the credit officers from 14 UK banks formed a working group to investigate undisclosed principal trading and to see what action could be taken to end it. They saw it as inherently risky because the third party is unable to quantify accurately the counterparty credit, legal and operational risks in undertaking the trade. In addition, there is the possibility that money-laundering regulations could be contravened.

There are references to undisclosed principal trading in the NIPs Code (section 91), but it does not currently state that trading on this basis is inconsistent with good market practice. Therefore the banks' working group proposed a change to the NIPs Code that would discourage undisclosed principal trading. Under the proposed revised wording, the fund manager would notify the credit and compliance function of the bank counterparty as to the identity of the principal for which it was acting. The front office would be unaware of the principal's identity (a 'Chinese wall' would operate) and this would avoid any market-sensitive information being released.

At its September meeting the Committee concluded that it should undertake a wider consultation exercise with market participants (both banks and fund managers), the Investment Management Association (the fund managers' representative body), and those organisations

(1) CLS is a payment-versus-payment settlement system for foreign exchange transactions.
(2) The tripartite Standing Committee on financial stability was set up in 1997 in the Memorandum of Understanding drawn up between the Bank of England, HM Treasury and the FSA.
(3) See www.financialsectorcontinuity.gov.uk

that endorse the NIPs Code[1] to ascertain their views on the proposal. Among the issues raised in the responses were:

- The impact of the proposed rewording on the wholesale deposit market. Such deposits are covered by the NIPs Code, but the risk issues are different: the counterparty credit risk applies only to the undisclosed depositor (rather than the bank accepting the deposit); and the fund manager is obliged, under anti-money laundering regulations, to have carried out the necessary 'know your customer' checks. Hence there was no desire on the part of banks to seek disclosure of the identity of the undisclosed depositor. Therefore the FX JSC felt that the proposed change to the NIPs Code, if approved, should exclude wholesale deposits.

- The interaction of the NIPs Code with FSA regulations. The FSA reported that, in its view, the current concerns regarding undisclosed principal trading in foreign exchange markets were not replicated in other markets. Therefore FSA-regulated investment products were distinct and separate from foreign exchange products and the NIPs Code was the correct vehicle to implement the proposed change. The NIPs Code links to FSA regulations through the Threshold Conditions for Authorisation, which state that non-compliance with a relevant code of practice may raise issues regarding a firm's integrity and/or competence.

There is an international dimension to the issue because undisclosed trading also occurs in the United States. The New York Foreign Exchange Committee (FXC) sent a letter, signed by all its members, to New York market participants, encouraging the ending of undisclosed trading in New York.[2] Undisclosed trading does not appear to occur in the rest of Europe (except Ireland), because the codified nature of these countries' legal systems effectively prevents the practice, since the fund manager would automatically become the principal in the deal.

The next stage will involve a round table meeting with interested parties to address the technical issues raised. Subject to this ongoing consultation process, it is hoped that the proposed change to the NIPs Code's wording could be implemented by the end of 2003.

E-commerce

During 2002 the Committee discussed developments in e-commerce and their potential impact on the foreign exchange market. The development of internet-based trading platforms had been identified as a driver of continued structural change in the foreign exchange industry. In 2001 the Committee set up a subgroup to undertake a detailed review of e-commerce developments and their effect, if any, on market practice. This group reported at the April 2002 meeting.

- There had been an increase in the number of customers transacting via the multi-bank portals. These are electronic trading platforms, which offer customers foreign currency trade execution with a number of banks providing liquidity, and in many cases straight-through processing of transactions. However, the average deal size remained smaller than in the voice market, reflecting customers' desire to have larger deals managed in a more hands-on fashion. The group noted that e-commerce systems are better positioned to handle smaller, operationally based foreign exchange transactions such as day-to-day cash management or flows relating to trade in goods or services.

- Banks have been able to increase the automation of their internal foreign exchange businesses (and generate operating cost savings) through their participation in multi-bank portals. Automated foreign exchange trading also offers benefits to banks' customers as the costs of trading support are lowered, audit trails improved and operational errors reduced.

- Pricing transparency was already very high in the foreign exchange market and on-line trading continued to improve this, again to the benefit of customers.

(1) The Money Market Liaison Group (MMLG) and the London Bullion Market Association (LBMA) co-ordinate the NIPs Code in their relevant markets, jointly with the FX JSC. The Association of Corporate Treasurers (ACT), the British Bankers' Association (BBA), the Building Societies Association (BSA), the Chartered Institute of Public Finance and Accountancy (CIPFA), the London Investment Banking Association (LIBA), and the Wholesale Markets Brokers' Association (WMBA) also endorse the code.
(2) This letter can be downloaded from: www.newyorkfed.org/fxc/2003/fxc030131.pdf

- Finally, larger banks were already offering white-labelled[1] e-trading packages to smaller banks, which is likely to concentrate further the majority of foreign exchange activity into the hands of a small number of global players.

The Committee found the report of interest in outlining a number of new developments, and it agreed that the subgroup would reconvene in 2003, to re-examine any new developments in the e-commerce field. It also agreed that this group would become a standing subgroup of the main Committee.

Continuous Linked Settlement (CLS)

The Continuous Linked Settlement Bank (CLSB) began live operations on 9 September, settling foreign exchange transactions in seven major currencies. The intraday principal exposures entailed in foreign exchange settlement were first highlighted in 1974 by the failure of Bankhaus Herstatt. In a 1996 report prepared by the G10 Committee on Payment and Settlement Systems,[2] central banks set out a remedial strategy, a key component of which was that private-sector groups should provide risk-reducing multi-currency settlement services.

CLSB is the main industry response. It is designed to eliminate foreign exchange settlement risk by settling bought and sold currencies on a 'payment-versus-payment' basis. Settlement members, ie direct shareholders of CLSB, pay in, for each currency, the net amount they owe, according to a fixed timescale. CLSB then settles each foreign exchange transaction on a gross basis during a five-hour window, through accounts held with the respective central banks.

The Committee felt it was difficult at such an early stage to assess what impact CLSB will have on the broad structure of the foreign exchange market. Some members noted a reluctance among third parties[3] to access CLSB at the outset, although their participation was expected to increase. The Committee also felt that the main issues for the foreign exchange market associated with the introduction of CLSB were operational—such as changes to market practice related to making time-specific payments to CLSB—and these could possibly require changes to the NIPs Code. It therefore asked the Operations subgroup to consider these issues, leading the latter to form a working group to do so.

Other issues discussed in 2002

The Committee discussed a number of other issues during the year, including the Bank for International Settlements triennial survey of foreign exchange and over-the-counter derivatives market turnover, and presentations were made on a diverse range of topics, including the work of the Financial Markets Law Committee and 'volatility in the foreign exchange market'.[4]

Looking forward to 2003

Looking ahead to the Committee's work in 2003, most of the themes discussed during 2002 will continue to be active issues in the coming year, most notably the work on undisclosed principal trading and contingency planning. The Committee will aim to progress the development of the Operations, e-commerce and CLS groups and seek to improve liaison with foreign exchange market committees in other international centres.

(1) White labelling is where a bank provides a trading platform to its client banks. These client banks then provide the platform, branded with their own company identity, to their customers. The customers trade on it, potentially unaware that the client bank is, in fact, channelling liquidity back to the trading-platform owner through a separate trade.
(2) See www.bis.org/publ/cpss17.htm
(3) These third parties are customers of CLSB settlement members. The third party submits its foreign exchange trades to the settlement member, who then settles these trades for it, all through CLSB.

Members of the London Foreign Exchange Joint Standing Committee as at December 2002

Name	Firm/Organisation
Mike Beales	Wholesale Markets Brokers' Association
Michael Brown	Tullett & Tokyo Liberty Plc
Jim Cameron	Banco Popolare di Lodi
Alan Collins	Bank of America
Darren Coote	UBS
Jeff Feig	Citibank
Brian Gracey	Chair, Operations subgroup
Geoff Grant	Goldman Sachs
David Hacon	Financial Services Authority
John Herbert	ICAP Plc
Simon Hills	British Bankers' Association
Jack Jeffery	EBS
Michael Kahn	State Street
Adam Kreysar	Merrill Lynch
Rob Loewy	HSBC Bank Plc
Peter Murray	Morgan Stanley
Peter Nielsen	Royal Bank of Scotland
Ivan Ritossa	Barclays
Jon Simmonds	Credit Agricole Indosuez
Matt Spicer	CSFB
Robert Standing	JPMorgan
Gordon Wallace	Deutsche Bank AG
Brian Welch	The Association of Corporate Treasurers
Paul Fisher (Chairman)*	Bank of England
Andrew Grice (Secretary)	Bank of England

*Clifford Smout was Chairman of the FX JSC until the April 2002 meeting.

Members of the FX JSC Operations subgroup as at December 2002

Name	Firm/Organisation
Paul Brock	Morgan Stanley
Andrew Brown	CSFB
Michael Douglas	Bank of America
John Godfrey	Goldman Sachs
Robert Hadley	ABN Amro
Barry Holland	Barclays
Elaine Kelly	Deutsche Bank AG
Brian Leddy	Mellon Bank
Chris Mann	Bank of England
Leigh Meyer	Citibank
Mike Neale	JPMorganChase
Colin Perry	ICAP Plc
Steve Portway	UBS
Stephen Smit	State Street
Richard White	Royal Bank of Scotland
Brian Gracey (Chairman)	HSBC Bank Plc
Simon Hills (Vice-chairman)	British Bankers' Association
Andrew Grice (Secretary)	Bank of England