The London Foreign Exchange Joint Standing Committee: a review of 2000

This article gives an overview of the role of the London Foreign Exchange Joint Standing Committee, and reviews the work undertaken by the Committee during 2000.

Introduction and overview

The London Foreign Exchange Joint Standing Committee was established in 1973 under the auspices of the Bank of England, largely as a forum for the different participants in the foreign exchange market to discuss issues of common concern.

The Committee met seven times in 2000. The Committee's key focus during the year was 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. There have also been discussions on other issues such as e-commerce, liquidity and the Continuous Linked Settlement Bank.

At the start of the year, the Committee's membership increased from 8 to 20, partly reflecting its new responsibilities in relation to the London Code. The Committee now includes senior staff from 11 of the major banks that operate in the foreign exchange market, as well as voice and electronic-brokers and the Financial Services Authority (FSA). In addition, the Committee strengthened its already close ties with the British Bankers' Association and the Wholesale Market Brokers' Association by including representatives of these associations as members. A representative from the Association of Corporate Treasurers is also now a member, reflecting the importance of corporates in the foreign exchange market. 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 Committee was responsible for maintaining the London Code of Conduct, which provides guidelines on good practice in the foreign exchange market. Changes introduced as a result of the Financial Services Act 1986 meant that responsibility for maintenance of the Code shifted to the Bank of England and, more recently, to the FSA. However, 'non-investment products' (NIPs)—ie 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 when the Financial Services and Markets Act comes into force towards the end of 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 separate code of conduct for NIPs, along much the same lines as the London Code but produced by the market as a guide to good practice.

The Bank of England agreed to facilitate the production of the new code, working with individuals with experience in the relevant markets. Much of the Committee's work in 2000 therefore related to producing the code, in conjunction with the management committee of the London Bullion Market Association and the Bank of England Money Market Liaison Group, representing the bullion and sterling deposit markets respectively. The Committee also considered enhancements to the code suggested by other groups, both in the United Kingdom and overseas, to reflect market developments.

At the end of November 2000 a draft of the code was published for public consultation, available both in hard copy and on the Bank of England's web site.(1) The consultation period ended on 22 December 2000, and the Committee has spent the early months of 2001 finalising the code in the light of comments received.

(1) At www.bankofengland.co.uk/markets/nips.htm

E-commerce

Developments in e-commerce and their potential impact on the foreign exchange market were another major part 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 of the 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 FSA's perspective, the key challenge posed by electronic trading platforms, as a component of the market's infrastructure, was how far they should be regulated, and whether entities that provided similar functions and services in the same market or products (eg exchanges and brokers) should be regulated in significantly different ways. Both the FSA and other regulatory bodies abroad were working hard to resolve this issue. 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 partly 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. In addition, recent initiatives had largely been aimed at the wholesale markets, which raised different regulatory issues compared with systems that admitted retail participation.

Use of the Internet as a foreign exchange trading platform

In discussions early in the year, the Committee identified trading via the Internet as a possible driver of structural change in the foreign exchange (FX) industry. Subsequently, consortia that included many of the largest global FX market players announced the development of two large multilateral FX trading platforms for customers, FXall and Atriax. The Committee suggested that the main business driver of trading with customers on the Internet was cost reduction: both for banks in providing FX prices to corporates, and to corporates in executing their FX 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, the technology might mean that a bank would not necessarily have to be a major market player 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 exchange market had changed markedly over the past decade. However, opinions differed as to whether recent sharp market movements were a reflection of those changes, or were examples of the volatility that 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 Committee members thought 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. While 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, liquidity often varied depending on the timing of the transaction, the currency pair being traded, and the currency product being traded.

Settlement of spot foreign exchange on T+1

The Committee discussed this topic at its meetings in February and March, on the latter occasion reviewing a paper produced by one of its sub-committees. The discussions were prompted by the statement in late 1999 by the Securities and Exchange Commission that US securities settlement systems 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 for 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 foreign exchange dealing. 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 and the Australian and New Zealand dollars, time-zone differences mean that these would be more difficult. Moreover, banks could currently trade for T+1 settlement 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

The Committee had several discussions during the year on the impact on front offices of the forthcoming introduction of continuous linked settlement (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 that 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 temporarily. (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 temporarily if these swaps were used as part of the transition to more effective intra-day liquidity provision.

Looking ahead: 2001

The focus of the Committee's work in the first half of 2001 is likely to remain the London Code of Conduct for non-investment products. The FSA has published the Inter-Professionals Conduct Chapter of its Handbook, and the Committee will deal with any issues arising on the interaction between this and the NIPs code. The code will become operational once the Financial Services and Markets Act comes into force towards the end of 2001.

The Committee will continue to monitor Internet-based trading platforms, changing patterns of liquidity, CLS, and any other challenges and issues in the foreign exchange market that arise in 2001.

In recent years, representatives of the Committee have attended meetings of the foreign exchange committees run by the Federal Reserve Bank of New York and the European Central Bank (ECB), and visitors from the ECB and the Bank of Japan have attended the Committee's meetings; the Chairman and the Secretary have also met their opposite numbers from several other committees. The Secretary 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.