Guy Debelle: The global code of conduct for the foreign exchange market

Speech by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, at the FX Week Europe conference, London, 25 November 2015.

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Thank you for giving me the opportunity to talk to you tonight about two important pieces of work currently occurring in the foreign exchange market. First, I will summarise developments in FX benchmarks. Second, I will talk about the global code of conduct for the foreign exchange market.

But before that, let me step back and ask why is the work going on? The reason, as many of you are painfully aware, is that the foreign exchange industry is suffering from a lack of trust in its functioning. This lack of trust is evident both between participants in the market, but at least as importantly, between the public and the market.

Trust is the lynchpin of all financial market transactions. Without trust, markets do not function well.[1] At an FX Week conference earlier this year,[2] my colleague Simon Potter outlined the important role that the foreign exchange market plays in the global economy. We clearly need the market to be functioning as effectively and efficiently as possible. But for that to happen, we need to restore the trust in the foreign exchange market.

FX benchmarks

I will start by summarising the current state of play in FX benchmarks, reiterating remarks I made in Sydney last week.[3] Roberto Schiavi has talked about this from a European perspective earlier today.

From early 2013, concerns were increasingly raised about the integrity of FX benchmarks, particularly around the potential for market misconduct in the trading around the time of benchmark fixings. Accordingly, the Financial Stability Board (FSB) formed a group co-chaired by Paul Fisher of the Bank of England and me to firstly analyse the structure of the FX market and the incentives that might promote inappropriate trading activity around a fix, and then come up with some potential remedies to address the problems we found.

After talking to participants from all sides of the FX market around the world, in September 2014, we proposed 15 recommendations to reform the FX benchmark process, which were endorsed by the FSB.[4] These recommendations were in four main areas: benchmark methodology; execution of benchmark transactions; market conduct; and guidance on reference rates produced by central banks.

Earlier this year, at the request of the chair of the FSB, Mark Carney, I chaired a group that summarised the progress in implementing the 15 recommendations one year on, drawing on

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1 I spoke at length of this issue of trust in financial markets more broadly a few years ago: "Credo et Fido: Credit and Trust", Deakin University 2012 Richard Searby Oration, Melbourne, 25 September 2012.

2 Potter, S. "Trends in Foreign Exchange Markets and the Challenges Ahead", Remarks at the 2015 FX Week Conference, New York City. Available at <https://www.newyorkfed.org/newsevents/speeches/2015/pot150714>.

3 "Benchmarks", Bloomberg Summit, 18 November 2015.

4 These recommendations were contained in a report published by the FSB that is available at <http://www.financialstabilityboard.org/wp-content/uploads/r_140930.pdf>.

information gathered by the foreign exchange committees (FXCs) and central banks in the major FX centres. We put out a progress report on FX benchmarks just over a month ago.[5]

I will provide a quick summary of what has happened in this space over the past year and briefly highlight some areas where there is still more to be done.

In terms of benchmark methodology, we made a number of recommendations concerning how WM calculate the London 4pm fix. In particular, we recommended widening the fixing window, and as a result, from February 15, WM widened their calculation window from one minute to five minutes.

This widening of the window appears to be helping to achieve the intended outcomes and the progress report contains some data analysis to support this. It is early days yet, with only a few month-ends (where flows through the fixing window are generally the largest), but so far, it would appear, so good. If you are interested, I would recommend reading Section 3 of the report which compares the exchange rate dynamics before and after the change in the window for a number of currency pairs. It is likely that the dynamics will continue to evolve as participants adjust their execution strategies and it will be interesting to see how that goes. There are also a number of propositions in the market in terms of netting of fixing transactions which will also shape these dynamics going forward.

The wider window has helped to highlight the risk transfer involved between the buy side firm initiating the transaction and the sell side firm executing it for them. This in turn was very helpful in the communication of another of our recommendations, which garnered quite a lot of attention, namely that fixing transactions should be charged for. Previously, transactions were often executed for free, at least notionally. The “free” cost of the transaction probably increased the incentive for manipulation as trading desks sought to generate greater profitability to compensate for taking on this risk.

The widening of the window in February served as a focal point for sell side firms to start charging for these services. Most sell side respondents to the FXCs’ surveys report that they are now charging for fixing transactions, particularly those linked to the London 4pm fixes and especially the most liquid currency pairs. That said, some respondents, who tended to be smaller banks less active in the fix, reported they were still reviewing their pricing structure for benchmark orders.

Moreover, while there had been good progress in terms of the London fix, there was much less progress for other fixes. However, the scope for benchmark manipulation is there for all fixes, not just the London 4pm fixes, and hence it is important to reiterate that the recommendations of our report are intended to apply to *all* FX benchmarks.

So how are fixes being charged for? A mix of pricing strategies is being used. Some are applying a bid-offer spread, some a fixed fee, where the fee is based on an assessment of the risk transfer involved. Others are pursuing a strategy which could be called “rent my algo”, where a firm provides access for a fee to an algorithmic trading tool to directly execute their fixing transaction in the fixing window.

This in turn, leads me to another of the recommendations of the report, namely that banks should establish separate processes for handling and executing their fixing orders from other orders. This recommendation was designed to address potential conflicts of interest arising from managing customer flow. A sizeable number of banks have implemented this recommendation by shifting the execution of fixing orders from the spot voice FX trading desk to electronic trading desks that execute them with algorithms.

[5] The progress report is available at http://www.financialstabilityboard.org/wp-content/uploads/FX-Benchmarks-progress-report.pdf.

As a result, the share of fixing orders executed by algorithm has increased substantially, as we document in the progress report. There is also considerably enhanced internal scrutiny from senior management around fixing transactions. Some firms have physically separated their fixing desk from other desks. This segregation of trading functions has involved some cost. Other participants regarded the cost of implementing this recommendation as being too high, given the size of their business, and have not implemented it to date. Others have decided to cease offering this service directly, in some cases offering customers a portal to other fixing services instead.

Again, I would like to emphasise that the intention of our recommendations was that it was to apply to all participants, with appropriate consideration to the size and structure of the market.

In the case of smaller, less actively traded currencies, separation of business is clearly more complicated than for large actively traded currencies, but in these cases participants should still be able to demonstrate to their customers that appropriate processes are in place, in keeping with the fundamental motivation of the recommendation to reduce the scope for benchmark manipulation.

In terms of market conduct, we made a number of recommendations around appropriate sharing of information, including around trading positions (beyond that necessary for a transaction) and particularly customer information. As Roberto talked about earlier, these were picked up in a statement of *Shared Global Principles* that was published following the Global FXC meeting in Tokyo earlier this year.[6] Many market participants have reflected these principles in their internal policies and codes of conduct, as well as revised policies around benchmark execution consistent with our recommendations.

FX code of conduct

More broadly in terms of improving market conduct, in May this year, the BIS Governors commissioned a working group of the Markets Committee of the BIS to facilitate the establishment of a single global code of conduct for the FX market and to come up with mechanisms to promote greater adherence to the code.[7]

There are two important points I want to highlight: first, it's a single code for the whole industry and second, it's a global code. It's intended to cover the whole gamut of the industry. This is not a code of conduct for the sell side. It is there for the sell side, the buy side, non-bank participants, the platforms; its breadth is both across the globe and across the whole structure of the industry.

I am chairing this work, with Simon Potter of the New York Fed leading the work on developing the code and Chris Salmon of the Bank of England leading the adherence work. Our group comprises representatives of the central banks of all the major FX centres.[8] To repeat, it is very much a global effort reflecting the global nature of the foreign exchange market.

This work is also very much a public sector-private sector partnership. In that regard, we are being supported in this work by a group of market participants, chaired by David Puth of CLS. The group contains people from all around the world on both the buy side, including corporates, and the sell side, along with trading platforms and non-bank participants, drawing from the various FXCs and beyond. Hence all parts of the market are being involved in the drafting of the code to make sure all perspectives are heard and appropriately reflected.

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6 These principles are available at: http://www.rba.gov.au/afxc/about-us/pdf/global-preamble.pdf.

7 <http://www.bis.org/press/p150511.htm>

8 <http://www.bis.org/about/factmktc/fxwg.htm>

The work in drafting the text of the code is well and truly underway. There are two aspects to this. First is harmonisation of the existing regional codes. There is a lot of good material in them and there is no point in reinventing the wheel there.

The second part of the work addresses those aspects of the foreign exchange market not adequately covered in the existing codes. We need to fill those gaps; for instance, in providing more detail around various aspects of order-handling and execution. We are also addressing mark-up and last look. We are aiming to provide language around what it means to participate in the market as principal rather than agent. In these areas we intend to describe what is good practice as well as what is not good practice.

While the content of these regional codes is pretty good, it is very evident that they were often ignored, wilfully or otherwise. Hence the critical need to come up with mechanisms to achieve greater attention and adherence to the global code. We will have more to say on this later as our work in this area proceeds.

At this stage, it is worth reiterating a point I made at an FX Week Conference in Sydney earlier this year in the context of the FX benchmark work:[9] "if these recommendations were not acted on, authorities could conclude that a regulatory response was necessary to generate the desired improvement in market structure and conduct." Mark Carney made a similar point in his Mansion House speech in June,[10] as did Simon Potter in July.[11] I think the message should be pretty obvious. This process of establishing a global code of conduct for the FX market provides an opportunity for the industry to work with the public sector to improve the FX market and restore confidence in it, rather than having a (possibly sub-optimal) solution imposed on it.

That said, an overall aim of the code is for it to be principles-based rather than rules-based. There are a number of reasons why we intending to proceed in this manner, but from my point of view, an important reason is that the more prescriptive it becomes the easier it is to get around. Rules are easier to arbitrage than principles. If it's not expressly prohibited or explicitly discouraged, then it must be ok seems to be the historical experience. The more prescriptive and the more precise the code is, the less people will think about what they are doing. If it's principles-based and less prescriptive, then market participants will have to *think* about whether their actions are consistent with the principles of the code.

The intention is to have this work of developing a single code to replace the various regional industry codes completed by May 2017, with a new framework for adherence completed at the same time. However, we intend to put out some parts of the global code, including drafts of material on order handling and execution, by May 2016. We recognise that there is a need for greater clarity around some of these issues sooner rather later.

We will be providing this draft material to the various FXCs and other market participants for their input in the first quarter of next year. At the end of the process, for the code to be effective and for it to achieve what we want it to achieve, it will need to be accepted and endorsed by the FXCs and market participants more generally. That said, the process does not really end, because as the foreign exchange market continues to evolve, the code will need to evolve with it.

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9 "FX Benchmarks", Address to the FX Week Australia Conference, Sydney, 12 February 2015.

10 Carney, M, "Building real markets for the good of the people", Mansion House speech, 10 June 2015. Available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech821.pdf>.

11 Potter, S. "Trends in Foreign Exchange Markets and the Challenges Ahead", Remarks at the 2015 FX Week Conference, New York City, 14 July 2015. Available at <https://www.newyorkfed.org/newsevents/speeches-/2015/pot150714>.

Conclusion

As market participants, regardless of which side of the market you are on, it is important that you are aware of the changes that have occurred, and are still underway, in the foreign exchange market.

If you are on the sell side, I am sure that you are well aware of these changes and hopefully, I have provided you with some of the background and motivation for them. In terms of benchmarks, there is a fuller articulation of this in the FSB benchmark report.

If you are in the asset management business, you may not have paid so much attention to the details of the FX aspect of your business. But it is important that you also understand the context for the changes that are occurring. Some practices and services that you were accustomed to in the past, or maybe were unaware of, may no longer be available, and you cannot expect your counterparty to provide them.

The motivation for the changes to the foreign exchange benchmarks is to reduce the incentive and opportunity for improper behaviour by market participants around benchmark fixes. The implementation of the recommendations in the FSB benchmark report, together with the enhanced scrutiny externally and within organisations on fixing transactions, appears to have moved the market in a favourable direction.

As we develop the single code of conduct for the FX market, the intention is that the market will move further to a more favourable and desirable location and allow participants to have much greater confidence that the market is functioning appropriately. We need this to occur, as it very much in all our interests to have a well-functioning foreign exchange market. As Roberto said earlier, we central banks care as much about this as anyone.

As it is in all our interests for trust to be restored to the FX market, I very much trust that you, as market participants, will work with us constructively in this important endeavour.