Simon M Potter: Trends in foreign exchange markets and the challenges ahead

Remarks by Mr Simon M Potter, Executive Vice President of the Markets Group of the Federal Reserve Bank of New York, at the 2015 FX Week Conference, New York City, 14 July 2015.

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Good morning. It's a pleasure to be here. Let me extend my thanks to *FX Week* for the invitation to speak at this conference. Before I begin, I would like to note that my comments today reflect my own views and not necessarily those of the Federal Reserve Bank of New York.

The ability of households, corporations, and sovereigns across the world to safely and efficiently exchange assets denominated in one currency for assets denominated in another is essential to a healthy and robust global economy. These transactions can occur for myriad reasons – to support the flow of goods, services, and investment across national boundaries, to diversify the savings of retirees, or to hedge risks associated with manufacturing a particular type of product. These transactions all rely on a foreign exchange market that functions with integrity – that is, one that allows a diverse set of buyers and sellers, supported by robust infrastructure, to confidently and effectively transact at prices that reflect available market information and in a manner that conforms to acceptable standards of behavior.

In my remarks today, I would like to expand on the essential role that the foreign exchange market plays and examine some of the ways the market's structure has changed in recent years. Then, amid the backdrop of a number of recent negative developments – specifically, evidence of unethical and illegal behavior by some market participants – I will discuss the critical role that implementation of and adherence to strong global industry standards, including best practices, can play in restoring and maintaining the integrity of the foreign exchange market. In doing so, I will highlight recent and ongoing efforts to help strengthen these standards through the Financial Stability Board and collaborative efforts by major central banks and market participants working within and across jurisdictions, often through local foreign exchange committees. I will conclude by setting an expectation for all market participants in foreign exchange to help support this work in order to reinforce the integrity of, and the public's trust in, this important market.

The importance of the foreign exchange market

The foreign exchange market is perhaps the largest, most globally integrated, and most active financial market in the world. The transactions that take place there are the lifeblood of a global economy that comprises many different national currencies. By enabling the transfer of funds and purchasing power from one currency to another, the foreign exchange market offers an important means for price discovery that facilitates international trade and investment activity.

The relative value of a currency, expressed in exchange rates, both drives and is driven by the costs of goods, services, and investment opportunities in each economy. Understanding relative prices helps businesses make decisions about the competitiveness of their goods and services, which is important for consumption and production choices. For example, the current and future value of an exchange rate can be an important factor for a corporation when deciding where to locate a new factory or where to source parts, or even where they want to sell their finished products. These decisions ground the composition of activity within an economy, and have a bearing on the distribution of jobs, investment, and growth across the global economy. This is a particularly important function given trade's increasing contribution to global growth. Indeed, between 2003 and 2013, the share of trade in global GDP increased by about 11 percentage points, to just over 59 percent.[1]

The FX market is a large and growing market. According to the latest Triennial Central Bank Survey of foreign exchange and derivatives market activity conducted by the Bank for International Settlements (BIS) in April 2013, total global average daily turnover across over-the-counter foreign exchange instruments – including spot, forward, swap, and option transactions – was estimated to be more than $5 trillion, an increase of nearly 60 percent since 2007.[2] This trading volume dwarfs the U.S. fixed income market, where average daily turnover at the end of 2013 was about $815 billion.[3]

Within this large market, a broad range of foreign exchange products is traded each day by a diverse set of market participants for a wide variety of reasons. Derivatives are the largest component of global trading in the FX market, accounting for about 60 percent of turnover in 2013. They play an important role in helping transfer a wide variety of risks from entities that cannot or do not want to bear it to those that can and do – including risks associated with hedging cross-border exposures or positions in other markets, such as fixed income – or to provide a source of funding to help meet liquidity needs. The most actively traded derivative product, foreign-exchange swaps, accounted for about 40 percent of all trading activity in the global FX market in 2013, serving as a critically important cross-currency funding tool for a wide variety of market participants. For example, banks may have domestic currency liabilities but foreign currency assets, and thus may use the FX swap market to source foreign exchange. The spot market, which accounted for about 40 percent of trading activity in 2013, is used by private nonfinancial entities to trade goods and services or to invest in foreign businesses, while banks may use it to engage in cross-border lending and asset managers may use it to purchase financial assets or take positions based on their economic and financial market outlook.

The foreign exchange market is a truly global market and one of the few markets that trades around the clock. This gives it the unique ability to provide signals as to how market participants are interpreting or responding to developments taking place in other markets or in the real economy. During the global financial crisis, the foreign exchange market often was the first to reveal how market sentiment was evolving in response to significant events that occurred outside of trading hours in other markets. Such signals can be very useful to policymakers and market participants, particularly during periods of market stress.

Of course, the foreign exchange market's ability to support price discovery and to enable the international flow of goods and capital requires a marketplace that is founded on integrity and capable of ensuring smooth and efficient interaction among market participants. This remains especially important as the structure of the market continues to evolve and adapts to new technologies and financial flows.

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1 *World Bank Development Indicators*; http://data.worldbank.org/data-catalog/world-development-indicators.

2 *BIS 2013 Triennial Central Bank Survey*. The Triennial Survey is coordinated by the BIS under the auspices of the Markets Committee (for the foreign exchange part) and the Committee on the Global Financial System (for the interest rate derivatives part). The latest survey of turnover took place in April 2013. Central banks and other authorities in fifty-three jurisdictions participated in the 2013 survey. They collected data from about 1,300 banks and other dealers in their jurisdictions and reported national aggregates to the BIS, which then calculated global aggregates. The survey, among other things, provides data on turnover, instruments, counterparties, and currencies, which are referenced in this speech; http://www.bis.org/publ/rpfx13fx.pdf.

3 *SIFMA US Bond Market Trading Volume*; http://www.sifma.org/research/statistics.aspx.

Changes to market structure

The foreign exchange market is a dynamic market with a long history of change and innovation. Today, I would like to focus on two of the more significant recent changes in the market's structure: first, the broadening of participation, and second, how execution is taking place within the market.

Participation in the FX market

The broadening of participation in the foreign exchange market is one reason why growth in FX trading volumes has far outpaced growth in global trade. The BIS Triennial Survey on foreign exchange market activity provides evidence of the degree to which this expanded participation is taking place.[4] Traditionally, volumes in the foreign exchange market were dominated by what is known as the inter-dealer market – trading between dealers. However, in the 2010 survey, the largest share of volume reported by dealer respondents was for transactions with "other financial institutions" – a category that includes nonreporting banks;[5] other financial institutions such as institutional investors, hedge funds, and proprietary trading firms; and official sector institutions. This shift continued through the 2013 survey, when "other financial institutions" accounted for just over half of reported volume, reinforcing evidence of a broadening in foreign exchange trading, with nondealers playing a greater role in the market.

The 2013 survey broke out the "other financial institutions" category for the first time. The data showed that nonreporting banks accounted for about 45 percent of the category's trading volume while institutional investors and hedge funds/proprietary trading firms each accounted for about 20 percent. In a market where daily trading volume exceeds $5 trillion, this represents significant activity and is consistent with a general theme of increased participation by nondealers in the FX market.

Execution in the FX market

One factor contributing to the expansion in participation by nondealers in the foreign exchange market has been the increased ease of entry into the market, attributable to an expansion in the number of execution platforms and services. In part, this has been supported by technological advancements, which, in some cases, have reduced trading costs, increased the speed with which transactions take place, and improved transparency. Electronic trading activity in foreign exchange markets, as well as in other markets, has played a growing role, and some reports suggest it may represent as much as 70 percent of daily turnover in the foreign exchange market, up from roughly 30 percent a decade ago.[6]

In addition to expanding entry to the market, technology is also changing how participants engage the market, through both single- and multi-dealer platforms. In the past, institutional customers could engage the market only by calling their dealing bank, but the marriage of technology and prime brokerage – the bundling of investor services, such as trade execution, settlement, financing, and custody – has enabled direct access to the interdealer market in ways not seen previously. Prime brokerage services have enabled an expansion in potential trading partners, allowing customers to trade in the name, and on the credit, of their prime broker. Altogether, this has served to transform what was once a two-tiered market –

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[4] *BIS 2013 Triennial Central Bank Survey*; http://www.bis.org/publ/rpfx13fx.pdf.

[5] *The anatomy of the Global FX Market through the lens of the 2013 Triennial Survey*. A significant fraction of dealers' transactions with nondealer financial customers is with lower-tier banks. While these "nonreporting banks" tend to trade smaller amounts and/or only sporadically, in aggregate they account for roughly one quarter of global FX volumes. http://www.bis.org/publ/qtrpdf/r_qt1312e.pdf.

[6] *Euromoney*, December 2013, Rise of electronic FX trading won't silence voice brokers. http://www.euromoney.com/Article/3286064/Rise-of-electronic-FX-trading-wont-silence-voice-brokers.html.

interdealer and dealer-to-client – into a market with much broader access. Moreover, as new trading platforms have come online, the profile of FX market participants, and thus the way FX is traded, has changed. New participants, such as retail and smaller institutions – that are often engaged in high-frequency or high-speed trading – could begin executing on their home or office computers, or could connect their trading algorithms directly to the platforms.

The expansion of both the universe of market participants and the infrastructure to support execution has brought many positive benefits to the market and global economy, but we should also be mindful of potential costs that might arise. In particular, it is important to consider the implications for the overall integrity of the market, which, as I noted earlier, relies on the ability of market participants to confidently and effectively transact at prices that reflect available market information.

Technology has helped ease entry to the market, but the capital investments needed to keep up have also increased. Indeed, operating in fractions of milliseconds has become an important component toward achieving faster execution. Will this hinder the entrance of new participants in the future, particularly those who may not have the extensive resources required to keep up?

In addition, while many market participants note the positive influence that technological changes have had on market functioning, including narrower bid-ask spreads.[7] it is unclear how these changes may affect the broader price discovery process or liquidity of markets overall. Technology allows market participants to better connect across potentially fragmented execution options, but has the central price discovery mechanism emerged stronger, and is liquidity as resilient?

Further, dealers increasingly are internalizing customer flows—that is, matching their clients' buy and sell orders in-house rather than executing them through the open market. But what does this do to the quality of pricing in the open market? And does reduction in potential open market trading have negative consequences for market functioning?

Moving toward more robust practices in the FX market

These changes in market structure and their potential implications for the functioning of the market are important to monitor, but market integrity does not rest solely on the ability to transact. It also requires that parties in the market behave in accordance with appropriate standards of behavior – standards that help to ensure that parties treat each other fairly. This is an area where further work is clearly required to support, and in fact to rebuild, the integrity of the market. As this audience is well aware, the foreign exchange market has recently been rocked by broad, unethical misconduct, which is unacceptable, and this has shaken the public's trust and faith in the market.

A recent series of investigations in the United States and abroad established that serious misconduct and collusion had occurred in the spot foreign exchange market. The investigations led to a string of regulatory actions and fines against some of the largest banks active in this market, and criminal pleas across multiple jurisdictions. These developments

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[7] Not only is liquidity both challenging to define and measure, but the impact of technological change on liquidity is difficult to isolate. On a number of dimensions, technological change appears to have improved both the efficiency of price formation and the ability to transact in size without significantly affecting market prices. But recent "flash" events in various markets – including rapid round-trips in prices on March 18, 2015, in the euro-dollar currency pair and on October 15, 2014, in the U.S. Treasury cash and futures markets – have suggested the possibility that advancements in automated trading and changes in market structure may have improved liquidity in normal times but left markets prone to more frequent bouts of illiquidity during which price formation appears disconnected from fundamental information. Structural developments and the connection to liquidity and price discovery across markets warrant further study. See also recent comments by Lael Brainard, member of the Federal Reserve Board of Governors. Recent Changes in the *Resilience of Market Liquidity*. http://www.federalreserve.gov/newsevents/speech/brainard20150701a.htm.

have resulted in damage to the integrity of the global FX market – damage that will not easily be undone. The behaviors that triggered these criminal and regulatory actions illustrate that, for many, self-interest and the lure of near-term gains were put above the preservation of the market's integrity and long-term sustainability.[8] The resulting loss of the public's faith and trust in this critical market comes with a cost: Let's recall that it is ultimately the public that stands to lose from an FX market unable to play its vital role in the global economy.

The FX market is considered by many to be relatively lightly regulated, particularly in the FX spot market. Regulatory treatment across jurisdictions varies.[9] Regardless of who regulates in a given region, in the absence of a single centralized and comprehensive global regulator of this highly global market, collaborative efforts between the private and official sectors play an important role. These efforts help us to better understand the roots of the misconduct and the misalignment of incentives that contributed to weaknesses in trading structures and encouraged unethical and illegal activities. And they can also play an important role in elevating best practices in order to promote a sound, effective FX market going forward. In the remainder of my remarks, I'll discuss three examples of such work. First, the recommendations of the Financial Stability Board's Foreign Exchange Benchmarks Group. Second, the work of the various foreign exchange committees, including the New York Fed-sponsored Foreign Exchange Committee (FXC), to provide more detailed, globally harmonized guidance through an expanded Global Preamble to the existing regional codes of conduct. And third, the expansion of that work into the current international effort to develop and implement a single global code of conduct for the foreign exchange market and to enhance adherence to that code among all market participants.

Work of the Financial Stability Board's Foreign Exchange Benchmarks Group (FXBG)

Given the global nature of the FX market, as well as the number of jurisdictions in which wrongdoing has been uncovered, efforts to strengthen the market must be global in nature as well. Recognizing this imperative, the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system, established the Foreign Exchange Benchmarks Group (FXBG) in early 2014. The purpose of the FXBG was to review FX benchmarks and associated market practices, including potential misaligned incentives, and make recommendations for change. The FXBG, which consisted of representatives from more than twenty countries, engaged with a range of market participants to analyze the market structures and incentives as they related to trading around benchmark fixings. The group produced a series of recommendations to enhance the structures and behaviors around FX benchmark trading. I would like to focus on two particular aspects of these recommendations – first, changes to the WM/Reuters calculation[10] and second, changes aimed at strengthening market conduct.

The FXBG report highlighted the dominant use of the WM/Reuters (WMR) 4 p.m. London fixings by many different sets of market participants, including some not otherwise active in the foreign exchange market. The fixings, provided across many different currency pairs, were used in many different ways – including for multicurrency portfolio valuation and for the valuation of key financial market indexes. In regard to the WMR 4 p.m. London fixings, the group identified important changes to strengthen the construction methodology and reduce the scope of potential manipulation. Specifically, it recommended that the length of time over

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8 See the U.K.'s Fair and Effective Markets Review Final Report for related insightful discussion on fixed income, currency and commodities (FICC) markets. Available at: http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf.

9 In the United States, the CFTC has regulatory responsibility for most FX products.

10 The WMR London fixing is now subject to regulatory oversight by the Financial Conduct Authority (FCA) in the U.K., in addition to the FSB initiatives. See the FCA's report *Bringing additional benchmarks into the regulatory and supervisory regime*, https://www.fca.org.uk/news/ps15–06-additional-benchmarks.

which the fixing was calculated be extended. In addition, it recommended that this fixing incorporate price feeds and transaction data from a broader range of sources. These recommendations resulted in changes to the WMR calculation methodology, which were implemented in mid-February of this year.

The FXBG also identified a series of recommendations to strengthen market conduct and reduce the scope for manipulation and mistreatment of customer flow and information. For example, the recommendations encouraged greater clarity around fixing transactions through transparent pricing for such transactions and by establishing a clearer separation of fixing transactions from other types of activity. Further, the recommendations sought to strengthen the framework for the protection of information by providing greater detail around certain types of information that are not to be shared. Finally, the recommendations encouraged more detailed guidance within the various codes of conduct in the FX market as well as demonstration of greater compliance with such codes.

In February of this year, the co-chair of the FXBG, Guy Debelle, spoke at the *FX Week* Australia Conference about this work and addressed the status of implementation of the recommendations. He noted that while there had been some areas of progress, questions remained about the implementation in other areas – for example, with regard to the recommendations related to more transparent and risk-appropriate pricing of fixing transactions.[11] The FSB has since requested an update this summer on the status of implementation of the FXBG recommendations, and the various foreign exchange committees are working together, and with others, to assist in this effort.

Foreign Exchange Committee

Additional work to support the implementation of the FXBG recommendations has been an area of focus for the FXC. The FXC is a private sector group, made up of market professionals and sponsored by the New York Fed since 1978, that is intended to help provide guidance and leadership to the global FX market. In its earlier years, the Committee worked closely with comparable committees sponsored by central banks in other major jurisdictions, as well as with the Financial Markets Lawyers Group here in the United States, to improve standardization in the market, including through developing standardized documentation in the FX market, such as master agreements. Over the years, the Committee has evolved as the market has changed. For example, as entry to the FX market has expanded and as nondealer firms have come to play important roles in the market, the FXC expanded to include buy-side representatives. I believe that this has strengthened the FXC's ability to contribute on FX market issues, including the work now required to help strengthen the best practices landscape on a global basis. Before turning to these global efforts, I would like to briefly highlight a couple of recent changes to the Committee's Charter, which I believe will further support the FXC's ability to contribute in particular to this global work.[12]

First, the revised Charter language places a more direct emphasis on the role of Committee members to help promote the efficiency and integrity of the market through, for example, the development and implementation of best practices. Second, the revised Charter better highlights the importance of incorporating an even broader set of perspectives and expertise directly on the FXC. Engaging a broader set of perspectives across operations, legal, and compliance professionals – as well as individuals across buy-side, sell-side, and various market infrastructure firms – will help the Committee to apply this more comprehensive perspective to its work on best practices. It will take some time for these changes to be fully

[11] See http://www.bis.org/review/r150213c.htm.

[12] See http://www.newyorkfed.org/fxc/FXC_Charter_2015.pdf.

implemented, but it is expected that the various steps that move us in this direction will also help us to engage even more effectively in the important work ahead.

Global best practices efforts

The FXC has been engaged in two global efforts with its counterparts abroad: development of the Global Preamble and work, now under way, to extend the Global Preamble into a single global code of best practices in the FX market.

The Global Preamble ("Preamble") is a document that was developed collaboratively by the eight central-bank-sponsored foreign exchange committees to provide a common basis from which our individual codes of conduct for the FX market follow. The Preamble lays out key, shared principles that underpin our respective codes. The publication of a revised Global Preamble earlier this year was an important development that built upon a tradition of increasing engagement across the committees. The initial Global Preamble was published in 2013 and marked the first time the committees had come together to provide a single voice around best practices. For example, the document noted that market participants are expected to have systems and controls in place to:

- develop and promote a strong culture of ethical behavior and standards of conduct;
- promote awareness and use of general dealing practices, procedures, and conventions;
- ensure accurate and timely pre-trade preparation and trade capture;
- support robust and efficient back office operations including confirmation, netting, payment, and settlement; and
- mitigate risk in FX transactions from the point of initial discussion regarding a potential transaction to settlement.

The revised and expanded Global Preamble, published this past March, features even more substantive and detailed guidance on topics such as personal conduct, confidentiality and market conduct, and policies for execution practices.[13] The Global Preamble provided an important opportunity to integrate the recommendations from the FSB FXBG report into best practices at a global level. For example, it includes language related to protection of information and confidentiality, as well as the enforcement of internal systems and controls involving both certain types of transactions and information.

The publication of the Global Preamble was a very important step in helping to provide a more globally harmonized and consistent framework for national codes of conduct and in integrating the FXBG recommendations, but it is not the final step. It is clear that further work is required both to strengthen best practices at a global level and to promote greater adherence to those practices. Recent developments indicate that market participants have either not been aware of existing best practices guidance or have made the conscious decision to violate such guidance in the hopes of making a short-term gain. The cost of these short-term gains has come at all of our expense and we must all be engaged to ensure that this does not happen again. Moving toward more globally harmonized guidance – and consistent adherence to such guidance – is an important step forward in maintaining the integrity of the market.

In recognition of the importance of this work, a new working group of the BIS Markets Committee has been formed to facilitate the establishment of a single global code of conduct and principles and to promote greater adherence to such guidance.[14] This newly formed

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[13] See http://www.ny.frb.org/fxc/2015/Global%20Preamble%20March30.pdf.

[14] See: http://www.bis.org/press/p150511.htm.

structure will deepen and broaden the already initiated public-private partnership and will engage an even wider set of financial centers in order to effectively move this work on best practices forward. The work will occur on a global scale and will engage a wide variety of market infrastructures and participants, including both the buy side and sell side. It will likely draw upon a variety of efforts, including the important work done in the U.K. under the Fair and Effective Markets Review. The FXC will be actively engaged in this effort along with its counterparts abroad, at the direction of the BIS Markets Committee FX Working Group.

The development of a single global code for the FX market is a significant effort, but developing a code is not enough. Codes of conduct and associated best practices are an important complement to regulation. They can support the integrity and function of the market by underpinning the smooth operation of the market and instill confidence that participants will treat each other fairly. But this is not possible, or sufficient, if best practices do not evolve as the market evolves, if they are not implemented effectively, or if they are not adhered to by market participants actively engaged in the market. Development of dynamic best practices is critical, as is the market's adherence.

Recent headlines and events paint a picture of an FX market that does not always serve the public well. But you all have an opportunity to change this picture – to support the work to strengthen the market. I encourage you all to make the most of this opportunity. As Guy Debelle noted in his speech in February, the failure to act on the FXBG recommendations may prompt authorities to conclude that further regulation is the only way to strengthen the integrity of the market.[15] Similarly, the Governor of the Bank of England, Mark Carney, emphasized in his recent Mansion House speech that a failure to establish effective common standards that are adhered to would likely result in more restrictive regulation.[16] Consider this message reiterated here today as well. I encourage you all to be engaged both at the individual and the firm level – to share your perspective and contribute to the process to help strengthen best practices, and to support adherence to such standards in this critically important market.

Conclusion

To sum up, the foreign exchange market is one of the most vital markets in the world. Individuals, institutions, and the global financial system as a whole rely upon the ongoing effective functioning of this market. The market is constantly evolving, and it remains imperative that the industry work to strengthen the foundation of the market, and help to ensure that its integrity is upheld. Particularly in the wake of recent scandals, there is a role for industry participants to restore and maintain market integrity through support and development of best practices.

You all have a shared stake in this. As you move forward, always bear in mind the critical role that the FX market plays and think about whether your choices enhance or weaken the integrity of the market.

I appreciate the work of those around the room to do so, as well as publications such as *FX Week* and others, for sharing their perspectives and providing continued coverage of these and other issues relevant to the market. Thank you.

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15 See http://www.bis.org/review/r150213c.htm.

16 See http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech821.pdf.