Reaction PGGM on FSB consultation paper

The Financial Stability Board (FSB) has published a consultation paper on Foreign Exchange benchmarks. The consultation paper makes 15 recommendations and the FSB asks market participants to respond to at least a couple of the recommendations. We set out the findings of PGGM below.

Using fixings

While reading our comments, please note that PGGM uses WM fixings extensively. The WM rates are used for valuation, benchmarking and trading. As highlighted in the paper many benchmark providers apply WM fixings to get to one currency. PGGM uses some of those benchmarks. This leads to demand from those portfolio managers with a tight mandate to request FX execution at WM rates. PGGM trading therefore enables internal trading at WM rates. Furthermore, holdings of PGGM funds or clients denominated in other currencies than euro are converted at the WM rates for valuation purposes.

It is our opinion that the WM processes are among the best within the FX benchmark world. Most likely this is also the reason it has become the most popular FX benchmark. There remains some room for improvement, but applying those improvements will not solve all of the issues.

The deeper problems around fixings are more an effect of flows that are known in advance, traded by people that act both as principal and agent at a price they can influence. This combination of factors has proven to be an environment prone to misbehaviour. PGGM therefore urges to focus on the governance of FX trading. Some of the initiatives to enhance the governance that PGGM supports are:

- Client information cannot be shared with third parties without explicit consent;
- Banks with fixing orders for clients are not allowed to participate in FX trading for their own account;
- The processes of dealing with client and fixing flows have to be redesigned and shared with clients;
- Making bank employees that are involved in FX trading adhere to a moral/ethical code should be considered.

Finally, PGGM sees a responsibility for professional market participants. Smaller clients should be protected but larger clients have their own responsibilities. Such professional clients should invest in their knowledge of FX dealing.

1: Widening fixing window

Widening the time window is one of the solutions that would help to diminish the possibilities for abuse. At the moment a window of approximately 5 minutes would suffice. If the interest in benchmark-related products increases further in the future, the window might have to be increased further as well. However a bigger window will lose significance as a reference rate at a specific point in time (or the close). Transparency might also be an issue.

For benchmarking purposes a single point benchmark is preferred over an average. A single point is easier to verify with other market data and replication is easier as well. Using a benchmark based on a bigger time window might also create a difference between currencies. The benchmark rate for EURGBP might not be equal to EURUSD divided by GBPUSD. In short time windows this difference will be small. This difference can be larger when calculated over a larger time window. This reduces the transparency of the benchmark.

PGGM would support a larger time window of up to ±5 minutes. We do however not consider this to be the ultimate solution but it may decrease the possibilities for abuse.

2: Alternative benchmarks

Using alternative benchmarks in certain situations can help. At the same time the use of a global benchmark like WM for a given point in time is clear and transparent for clients. Alternative benchmarks will most likely be more difficult to explain and other benchmarks would also be likely to have flaws and challenges. Obviously, the alternative benchmarks need to be transparent and have to meet very strict quality criteria.

Assume the suggested 24h average benchmark. Would that require all execution firms to run 24h businesses? How would one deal with new orders that arrive mid-day?

It is PGGM's opinion that the clients pick the benchmark. WM has become popular because of its advantages. A way to break the circle (index providers use WM → clients use WM → more index products based on WM → more clients…) is to ask index providers to calculate their indices using several different FX benchmarks. This will create awareness among the investment community that multiple benchmarks can be used. Making all the local constituents available in local return will allow clients to more easily apply their own FX benchmarks. This will open the market for other participants to come up with their own benchmarks. Although to be able to compare different asset managers the market might force everyone to use the same benchmarks.

PGGM is in favour of releasing constituent data of multi-currency benchmarks more freely/easily. This could spur innovation leading to the creation of alternative FX benchmarks.

3: Fixing on the hour

Although data is rather often released on the hour or at the half hour, the amount of data released at the most important WM fixing (4pm London) is actually very low. Switching to a different time might solve those situations where the current fixing time is not the most ideal. However it will only be a minor improvement on the current situation.

As an additional argument, WM publishes hourly benchmarks 24 hours per day, nevertheless everyone uses the 4pm London fixing. Interest in other hourly fixings is very limited also when news is released around the 4pm London fixing.

PGGM is not opposed to adjusting the timing of WM fixings to an alternative time. However it does not see the current fixing time as a concern.

6: Netting and Execution facilities

The ability to net fixing flows used to be a role for banks. However sharing client information has come to be seen in a different light. Platforms that create the ability to show interests in order to find partners to net with are a logical next step. Several firms are working on such a platform. The big question remains what will happen with the net interest.

The news of last year has shown that client information has been misused. Especially in the situation where banks shared information to figure out the net directional fixing flow. It is therefore of great importance that the net flow is processed in a correct and confidential manner where a netting vehicle is used.

As mentioned in the paper the volume spikes are especially associated with month ends. Given that these flows are very often related to rebalancing it is not unlikely that these are directional. Hence, after netting, there is still a large buy or sell order. If this flow is executed in a predictable manner, the market will know there is a large directional transaction going through, which might create an adverse effect. The impact of the flow could be even bigger as there now is clarity around the net flow. Currently, people looking for a skew in the flows always need to take into account the possibility of other flows going through. When the netting institution becomes a success the amount of other flow around that time will be reduced. The value of knowing the final flow from the netting vehicle will then be large. In the situation of a central netting vehicle the value this value is maximized. A proper solution for handling this net flow is a prerequisite for a successful netting vehicle.

PGGM supports innovation that could lead to efficient and effective netting and execution of FX (fixing) flows. A central netting vehicle only makes sense if there is for the net flow that has to be executed. Otherwise the net flow might create an even bigger impact.

8: Executing fixing orders

PGGM supports improved guidelines for fixing orders but more as a part of a larger improvement of the guidelines regarding how banks deal with client flows. (see also point 11)

11: Controls at banks

More clarity about the way the banks execution desks operate is welcome. Clients must be able to know:

- How does a bank handle fixing flows;
- Does a bank have processes to deal with conflicting client interests and conflicting interests between clients and the bank itself
- How does a bank deal with the bank's own interests;
- Does the bank also act as principal and if they do so, how are these activities separated from the client business;
- How does the bank treat client information;
- What are the incentives of the bank's sales/trading staff;
- Which educational and ethical standards do the bank's sales/trading staff have;

PGGM thinks that clients should be more aware of the practices at their counterparty. Professional counterparties will be more aware of these practices and therefore smaller clients should be better protected. However, it remains the responsibility of the banks to inform their clients and to explain how they handle client information. They should improve their processes and guidelines and share those with clients.

PGGM supports better controls and processes at the banks. New processes and controls for dealing with conflicting interests and client information should have priority. These processes have to be shared with the clients of the bank.

12 & 13: Codes of conduct and education

As a move to professionalize the largely unregulated FX markets it would be good to increase the level of knowledge of the market participants. A first step is to agree on and introduce a general code of conduct. This code will raise the ethical standards and will clarify how parties should act in certain situations. Currently the ACI is finalizing such a code. Professional market participants must demonstrate knowledge of this code and guidelines should be incorporated in processes.

A first priority would be to make sure all banks' trading and sales people adhere to such a code. An even stricter regime should apply to employees dealing with non-professional clients.

At the same time the clients must also follow such a code and they need to be aware of their duties and responsibilities. Professional clients must demonstrate knowledge of the FX market in the same way as people working for a bank.

PGGM supports the introduction of a general code of conduct to increase market knowledge and ethical standards for all market participants, both banks and clients. The level of education on these topics need to be increased.

15: FX execution at asset managers

As a professional counterparty PGGM already has a separate FX trading and execution mandate. This mandate has extensive controls and is monitored by independent risk departments. This is not a feasible solution for every asset manager. However in general PGGM also supports the raising of the level of knowledge at client level.

In order to be able to act as a professional counterparty within the FX markets parties should be able to demonstrate their competence. This requirement of being able to show its competence as professional counterparty should be included in any relevant conduct code.

Further to point 2, more freely available index benchmarks in local currencies could help clients to choose their own FX benchmark. Nowadays parties could feel forced to use WM fixings.

It is of PGGM's opinion that clients have their own responsibilities when acting in financial markets. Especially towards their end-clients an asset manager should be able to demonstrate that they have the knowledge and controls in place to act as a professional asset manager.