European Fund and Asset Management Association

EFAMA Response to the FSB Consultative Document on Foreign Exchange Benchmarks

A. General Remarks

The European Fund and Asset Management Association[1], EFAMA, welcomes the FSB consultative document and its proposed course of actions to address incentives towards trading activities that can create price manipulation opportunities and increase volatility to the detriment of the end-investors. Asset managers represent an important group of benchmarks' users - both in the case of passively managed funds and exchange traded funds (ETFs) - where benchmarks are used as a target for index linked funds - and in the case of actively managed funds. This makes clear that asset managers need to rely upon credible, transparent and robust benchmarks and foreign exchange benchmarks in particular.

The FSB report makes reference to different uses of FX benchmarks by asset managers, either by replicating the WMR fix prices in the case of passively managed funds or by taking into consideration the competition of quotes for orders in the case of actively managed funds. Due to the white pool of liquidity it offers and the possibilities to easily replicate the benchmark or to aggregate orders and use netting opportunities, trading at the WMR fix is considered one of the most convenient and efficient methods asset managers use to evaluate their assets. At the same time, we agree with the FSB analysis on the necessary improvements as to the calculation methods and data input from a broader range of sources, as well as on the need for a central trading utility.

Asset managers are already subject to extensive requirements and conditions as to the use of financial indices, either through regulatory standards or by existing industry practice around robust index selection. It is therefore in their own interest to work upon more transparent and cost efficient model that will allow them even more to perform along their high fiduciary standards.

[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 62 corporate members almost EUR 17 trillion in assets under management of which EUR 10.2 trillion managed by 55,000 investment funds at end March 2014. Just over 35,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org

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B. Comments on the draft Recommendations

Recommendation 1: The group recommends the fixing window be widened from its current width of one minute. It seeks feedback from market participants as to the appropriate width of the calculation window.

EFAMA agrees that the current width may be too narrow to meet aggregate demand of orders and ensure sufficient available data to fix the rate. At the same time, an extensive width may also entail important risks, as it will be difficult to achieve an easily replicable market price at a specific time. For that reason, the estimation on the width should target a balance between sufficient time/volume available and capacity to generate a replicable market price. The discussed lengthening of the fixing period does not change the underlying principle that the fixing is still based on the averaged (median of) trades during the period. On the other hand follow on processes which rely on the current fixing time frames may have to change because, for example, the valuation of the fund holdings will be delayed which may have negative knock on effects on the sales and redemption process of funds.

For the same reason, we would not recommend to change the time of the fixing on the hour (Recommendation 3). Alternative benchmarks as suggested in Recommendation 2 are only acceptable if they are tradable in practice because otherwise the buy side would lose the ability to trade at the fix.

EFAMA would also like to stress that the methodology on the calculation of the benchmark is closely related to the development of a global/central utility for order matching as foreseen in the draft Recommendation 6. In order to avoid price manipulations and influences by unusual price movements, the width of the window is not the only element but the mechanism to trade is the other key component. A utility for order matching and execution or auction in the market during a given fixing window – as described in Recommendation 6 – gives no room for arbitrage as the determination of the market price will be based upon demand and supply. In that way conflicts of interest are adequately addressed and the fixing price can be determined upon a balanced fixing window and transparent trading rules.

Recommendation 4: The group proposes that WM investigate the feasibility of receiving price feeds and transactions data from a broader range of sources to further increase its coverage of the FX market during the fixing window, and should regularly assess its coverage as market structure continues to evolve. In that regard the group also proposes that in the short term, WM develop its methodology to utilise the transactional and quote information from both Thomson Reuters Matching and EBS, wherever both are available.

EFAMA agrees with the proposal for additional sources of data as this would enhance the liquidity for the calculation purposes and would therefore reflect in a more realistic way the underlying activity the WMR seeks to capture. However, not all courses are of equal quality. In order to insure "real" prices which are not skewed by credit, settlement or other operational risk (e.g. duplicated prices from request driven venues), only venues/sources with prices offered solely by regulated financial service providers should be considered.

Recommendation 6: The group supports the development of industry-led initiatives to create independent netting and execution facilities. However, it also is interested in seeking feedback from market participants on the development of a global/central utility for order-matching to facilitate fixing orders from any market participants.

As mentioned in our comments on Recommendation 1, we fully agree with the development of a global/central utility for order matching to facilitate fixing orders for any market participants. Such a trading utility can ensure that the fixing price is determined by demand/supply orders and will prevent move market prices from going beyond what is determined by liquidity providing orders.

Independent netting and execution facilities supported by industry-led initiatives are also welcome, but less effective to mitigate conflicts of interest and provide a transparent regime compared to a central utility for order matching. An "equity trading venue" type of approach seems to be useful to consider. To avoid conflicts of interest and manipulation (e.g. front running) the aggregation of trade orders should be performed by a body which is separate from the body matching the orders e.g. through an auction. Moving from a bank driven OTC market, in which customarily all orders for fix are filled at the risk of the banks, to a regulated trading/matching venue entails – like in equity auction markets –entails the risk that not all orders can be filled at the (expected) fixing.

Recommendation 7: The group recommends that fixing transactions be priced in a manner that is transparent and is consistent with the risk borne in accepting such transactions. This may occur via applying a bid-offer spread, as is typical in FX transactions, or through a clearly communicated and documented fee structure such as a direct fee or contractually agreed price.

The principle of a transparent fee structure is of course welcome. However, transparency on the pricing of the fixing transactions will not eliminate the risks as to the manipulation of fixing prices and conflicts of interest. If these risks are not dealt with, then transparency on fees could mean that a well-defined fee is put on top of non-transparent profits gained by the dealer through different ways of trading maximizing his profits. EFAMA would, therefore, support the creation of a transparent trading mechanism/utility which could then be complemented by a transparent fee structure.

Recommendation 15: The group recommends that asset managers, including those passively tracking an index, should conduct appropriate due diligence around their foreign exchange execution and be able to demonstrate that to their own clients if requested. Asset managers should also reflect the importance of selecting a reference rate that is consistent with the relevant use of that rate as they conduct such due diligence.

As already mentioned in our general remarks, asset managers already have important due diligence duties concerning the use of financial benchmarks deriving either from regulatory requirements or via existing industry practice around robust index selection.

EFAMA, therefore, supports this Recommendation as it is consistent with the high fiduciary standards asset managers are already implementing vis a vis their clients.

At the same time, we would like to stress that it would be to the benefit of the end-investor to be fully informed on both models, the one based on a transparent fee structure and the one on fully replicating an FX benchmark with no tracking error but involving potential and implicit benefits for the dealer and the benefits and inefficiencies both models carry, in order to be in the position to choose the model that fits best his investment needs.

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