Deutsche Börse Group

Response

to the Commission's targeted consultation on market liquidity
in foreign exchange markets

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1. Introduction

We welcome the Communication by the European Commission "Towards a stronger international role of the Euro" and very much appreciate the opportunity to respond to the consultations in that respect.

As a Euro Area based integrated provider of financial market infrastructures and the fourth largest exchange organisation by market capitalisation globally, Deutsche Börse Group (DBG) covers a variety of products from agriculture and energy commodity markets to foreign exchange (FX) and their processing throughout the entire value chain from listing to clearing and settlement. In this context, DBG has followed with great interest the recent European Commission's initiative to further strengthen financial integration and to explore ways to support the role of the euro at the international level.

Strengthening the international role of the single currency may be done through different paths – directly, by increasing the trust and attractiveness of the currency itself; and indirectly, by supporting products and services denominated in euro as well as the Eurozone's financial ecosystem. Given the complexity and potential cross-feeds of such dynamics, we welcome the European Commission's approach to collect and gather feedback from a variety of sectors and actors to better understand the mechanisms at hand.

Against this background, we would like to highlight that DBG contributes to the following consultations and would welcome if the subsequent comments are understood in the general aim of achieving the intended outcome as described above:

- Consultation on the role of the euro in the field of energy
- Consultation on the role of the euro in international trade of agriculture and food commodities
- Consultation on market liquidity in foreign exchange markets

2. Introductory remarks on the consultation on market liquidity in foreign exchange markets

DBG has created an integrated FX market hub encompassing trading and clearing services for both exchange-traded derivatives (ETD) – FX Classic and Rolling Spot Futures tradeable on Eurex – and multiple over-the-counter (OTC) FX instruments that are tradeable via 360T. Moreover, Eurex Clearing will launch an OTC Currency Clearing service for FX Swaps, FX Spots and FX Forwards traded on 360T. That means ETD, cleared OTC and uncleared OTC transactions (through 360T) can be traded side by side enabling the customer to choose the appropriate FX liquidity pool, execution and clearing facility that best meets their needs. Today, 360T provides a link to broad liquidity for FX instruments connecting to more than 200 global and regional liquidity providers offering competitive prices across a broad breadth of currencies. 360T is used not only by most German treasury departments and many German corporates but also by a broad EU and global customer base.

The European Commission in its Communication carefully notes that "*the decision to use a currency is ultimately made by market participants and there are good reasons why economic actors might wish to invest and hedge in different currencies. The objective is not to interfere in commercial freedom or limit choice, but rather to expand the choice for market participants by ensuring that the euro represents a strong and reliable alternative in all relevant ways.*"

We agree with this statement – nevertheless, we believe that the European Union (EU) can play a more vital role in creating the framework required to promote the financial ecosystem in the Euro Area. In this context, we aim to provide some key insights into the dynamics we observe in FX markets.

3. Market dynamics: high liquidity in FX markets

Liquidity is a crucial characteristic for determining if a market is functionally efficient and working well. In that sense, when looking at FX markets it can be observed that they are one of the largest and most liquid financial markets, according to the latest BIS triennial report of 2016[1], with an average global turnover in trading of more than 5 trillion US dollar per day. From DBG perspective, there appear to be no impediments to liquidity in FX markets. There are several factors that determine the high liquidity in FX markets, not only due to a currency itself and the operational factors around trading currencies, but also due to the existence of an efficient infrastructure and ecosystem.

Given that currencies, or exchange rates respectively, are affected by the political and economic environment, one aspect of FX market liquidity might relate to the general confidence and trust of market participants in the underlying financial system of the country the currency originates from, drawing back for instance to the economic and political strength of a country, as well as its stability and legal system.

A second aspect that contributes to the high level of liquidity in FX markets is due to operational factors, such as the fungibility of currencies – i.e. the US dollar can be used anywhere – as well as their convertibility, allowing transactions to be settled/turned into cash within two days only, or the fact that the bilateral markets for trading currencies are open 24 hours a day for 5 days a week allowing market participants to buy and sell currencies without any delay and price fluctuations.

Furthermore, the regulatory framework for any market needs to set appropriate requirements and incentives for market participants and service providers encouraging them to provide liquidity. Finally yet importantly, any market needs efficient infrastructures as well as a balanced ecosystem of liquidity providers (market makers) and liquidity takers (market takers) – for FX markets that includes for instance central banks, commercial and investment banks, multi-national corporations, hedge funds, foreign investment managers, high frequency traders but also retails brokers, traders and investors.

The high liquidity in FX markets is thus to a large extent determined by the huge number of market participants active in trading and the volume they are generating, making transactions flow more easily and reducing the costs of transactions. That said, it is noteworthy that activity in the FX market is relatively concentrated regionally on a few centres in the UK, US, Singapore and Japan, accounting for 77% of FX trading volumes. The UK hub holds the biggest market share with 37% followed by US with 19% and Singapore with 8%. Germany as the biggest continental European market place in this ranking accounts for 2% market share.[2] Although FX markets are rather decentralised, usually CLS – a specialised US FX operator – is chosen for settlement of FX transactions in order to mitigate settlement

[1] Bank for International Settlements, Triennial Central Bank Survey – Foreign exchange turnover in April 2016: https://www.bis.org/publ/rpfx16fx.pdf

[2] Ibid.

risks. Further, the FX market is per se mostly a bilateral market with inter-dealer contracts accounting for about 44% of notional traded (referred to as the interbank FX market), while contracts with other financial counterparties account for the other half.[3] The primary liquidity providers are from commercial and investment banks, mostly US or UK-based,with the Top 10 accounting for approximately 60% of trading, according to the Euromoney Foreign Exchange Survey 2018.[4] One could conclude that Euro Area banks acting as liquidity providers and promoting specific currencies as well as Euro Area based market infrastructures might currently be underrepresented in this picture, though new players and offerings are emerging. As of 2018, there are six non-bank liquidity providers in the top 50, in particular propriety traders which are increasing their market share[5]. The FX clearing market is evolving with market operators about to introduce or having already introduced dedicated offerings for FX instruments, e.g. Eurex Clearing for FX OTC instruments (FX Spots, FX Forwards, FX Swaps) and Cross Currency Swaps as well as LCHForex Clear for Non Deliverable Forwards (NDFs). Trading strategies are also evolving with the emergence of new instruments such as the FX Strategy, which is a type of swap comprised of two forward legs (instead of a spot leg and a forward leg as for FX swaps).

When looking in particular at liquidity for specific currencies or currency pairs respectively, it can be observed that the US dollar provides the market standard, being the most traded currency with a daily average turnover of 4,438 billion followed by the euro with a 1,591 billion daily average. Contracts against the US dollar accounted for 90% of the notional outstanding in 2016, followed by the euro (~30%), and in the second rank Japanese Yen and British Pound (please note the double count of both legs of an FX transaction). As the most traded currency pairs, EUR/USD and USD/JPY account for approximately 41% of all FX trades annually.[6] In general, the currency pairs offered by service providers and promoted by liquidity providers go back to the demand of market participants and transaction costs. Cost of currency hedging in euro is higher compared to the US dollar while it is typically lower compared to other currencies like the British Pound, Japanese Yen or Swiss Franc.

In sum, the euro has a healthy position in FX markets and indeed this can be seen in the recent increase in EUR/CNH trading. Though the US dollar dominates since as the reserve currency of choice it is paired with other currencies and backs commodities, etc. Overall, since its introduction in 1999, the euro has become the second most used currency in FX markets and the euro is still young!

4. Supporting the financial ecosystem of the Euro Area

Rather than simply seeking to increase the liquidity of FX markets, the question of how to make the euro itself more attractive might be more important to help achieve the goals of this initiative. Increasing trust in the euro would constitute the preferred way forward, while fostering political and financial integration and stability in the EU should be seen as pre-requisites. DBG sees two important dimensions

[3] Ibid.
[4] Euromoney Foreign Exchange Survey 2018: https://www.euromoney.com/article/b18bzd2g51lqkn/fx-survey-2018-overall-results
[5] Ibid.
[6] Bank for International Settlements, Triennial Central Bank Survey – Foreign exchange turnover in April 2016: https://www.bis.org/publ/rpfx16fx.pdf

to these efforts: deepening the EU financial integration to increase resilience and attractiveness of the currency, and promoting the financial ecosystem of the Euro Area.

Any market needs a balanced ecosystem of liquidity providers (market makers) and liquidity takers (market takers). As mentioned above, the high liquidity in FX markets is to a large extent driven by the huge numbers of market participants active in trading and the volume they are generating, ensuring efficient and liquid transaction flows whilst reducing transaction costs. European markets and the Euro Area's financial ecosystem would benefit from Euro Area banks acting as liquidity providers and promoting specific currencies as well as Euro Area based market infrastructures. With efficient EU27 market infrastructures and competitive Euro Area banks prioritising euro denominated products, there is no reason why in the long term the costs of using the euro could not be reduced, thus driving further liquidity and use.

However, this will first and foremost require reforming the Eurozone. DBG appreciates the reinforced efforts of the European Commission outlined in its Communication to further deepen the Economic Monetary Union (EMU) as well as the efforts of the EU Ministers of Finance to strengthen the Banking Union. Completing the Banking Union is an important and necessary step in order for competitive Euro Area banks to provide liquidity for EU markets and products. A fiscal stabilisation tool will also ultimately be necessary for a finalisation of the Banking Union. The Franco-German declaration of Meseberg is a welcome development in this context. In that respect, building sufficient trust in a currency would especially benefit from the creation of a Euro Area Treasury that combines the fiscal and political leg of a currency. DBG believes that the Capital Markets Union (CMU) can also play an important role in promoting convergence and resilience in the Eurozone as integrated capital markets can provide a buffer against systemic shocks in the financial sector and strengthen private sector risk-sharing across countries. Real ambitious next steps will come through progress on the taxation and insolvency issues. The bigger and more trusted the EU economy becomes, the more its currency may be relied upon and subsequently be traded.

Another aspect that should be taken into account when thinking of ways to strengthen the role of the euro in FX markets relates to market demand and a favourable regulatory environment. There are no obvious obstacles in extending the role of the euro in these areas, though well-functioning market standards cannot be easily implemented without respective commitment or incentives for the market participants' end. Rather, too much regulatory interference in FX markets could even curb liquidity. In that respect, any policy measure should consider market specifics and needs to set appropriate requirements and incentives for market participants and service providers encouraging them to provide liquidity. For example, there are European market incumbents who are using the euro currency for variation margin (VM) exchange rather than the US dollar, and are supportive of the idea to further promote the usage of the euro for FX related VM exchange in Europe. Furthermore, Eurex has successfully launched an on-exchange FX offering composed of deliverable FX Futures and Options and cash-settled Rolling Spot Future instruments in 2018.[7] Liquidity has been gaining pace ever since meeting global customer demand for a distinct European ETD FX liquidity in coexistence to the US.

[7] For product details please visit https://www.eurexchange.com/exchange-en/products/fx

5. Conclusion

To conclude, DBG and its entities would like to welcome once again the European Commission's approach to collect and gather feedback from a variety of sectors and actors to better understand the mechanisms which underpin the use of the single currency. DBG very much hopes that this response will serve as first step to provide a holistic understanding of the various factors at play in the field of FX markets.

DBG and its entities will continue to follow with great interest the European Commission's initiative to support the role of the euro at the international level going forward. We stand ready to further support the European Commission's objectives to strengthen European markets and Europe's financial ecosystem, including the promotion of competitive FX markets, and remain at the disposal of the European Commission for any questions and additional feedback.