

Comments on Foreign Exchange Benchmark Group (FXBG) Consultation Paper

Reply by Simon Wilson-Taylor, President & CEO, Molten Markets, Inc

I submit the following comments in response to your excellent Consultative Document on Foreign Exchange Benchmarks of 15th July 2014.

I am somewhat expert on this subject, having been an EVP at State Street for many years responsible for several businesses and trading products serving asset managers, including direct management of the WM Reuters benchmarking business itself. My current company, Molten Markets, provides FX trading platforms to large asset managers, and we have undertaken several consulting projects from fund managers and banks focused on addressing these and similar issues. I have studied the questions raised in your document over a period of many years and therefore have deep insight. My comments are, of course, my own and may or may not reflect the views of my company.

I address your recommendations individually by your recommendation number, as follows:

1. Time window: I see no particular utility in extending the data window from one minute. In fact, it may even have a negative effect - giving traders more time to “game” the market. An interesting characteristic of the WM calculation methodology is the fact that it is a “median” rate. Mathematically, this means that after the first 31 (of 61) one second rate observations you know that the final rate cannot be outside the range of those 31 observations. This means that someone trying to “beat” the rate wants to get their positions on early in the time window to establish that range (and the direction). Manual traders may struggle to get that many button presses done in 15 seconds....so widening the window does give them more time...but is this really a benefit? Hard to say, so why change something with an uncertain outcome?

2. VWAP. WM already calculates fixes every hour/half hour for 22 hours a day and therefore it would be trivial for WM to create some kind of VWAP or TWAP [time weighted average price] – it is a simple calculation based on data that the company already has. However, this creates two enormous and probably insurmountable problems:

1. Valuation problems and lack of internal consistency of the data. The principal purpose of the WMR benchmark is as a VALUATION tool for creation of multi-currency indices across asset classes. A key tenet of the process is that all rates should be internally consistent...so that a triangulation of say EURUSD and USDJPY would produce exactly the same rate as an observed EURJPY. This is required so that fund managers who manage funds in multiple base currencies can operate, and so that performance across funds and fund managers can be compared on an accurate and objective basis. Taking local market time-zone TWAPs (where liquidity for each currency is at its greatest) destroys this internal data consistency and makes the benchmark virtually useless for its primary purpose. Creating a 24 hour TWAP might solve the data consistency issue, but a VWAP would not. However, a 24 hour TWAP would create significant liquidity issues for people replicating the

benchmark due to the thinness of markets throughout end of day US and the Asia time-zone

2. Greater hedging problems for Banks. Fund managers calculate their trading requirements throughout the day, and place WMR orders in a relatively short time window prior to 4 pm London. As this is a consequence of other trading and hedging processes, fund managers are highly unlikely to be able to submit orders any earlier. But the TWAP/VWAP calculation process starts its clock much earlier in the day. So banks will be completely unable to hedge the risk as they not only do not know the rate they will be filled at, but they also do not know the amount or the direction!. The only possible solution is that fund managers execute their FX the day AFTER their exposure arises, which is a severe retrograde step and introduces a permanent one day slippage and consequent performance tracking error. In addition, the one day lag in execution produces an even bigger opportunity for information leakage and inappropriate behavior by those with that information.
3. Seems trivial, as there is no real history of news events being a problem around 4pm London.
4. There are a number of very important issues relating to combining data, which have not been commented on in your document.
 1. Weighting of data. Today, WMR do combine data for certain currencies, where Currenex is perceived to have enough depth to be relevant. The method for weighting is not referred to in the methodology document, but I did call the WM Company to investigate this. It turns out that, because they are not provided with volume data (the equivalent of Time and Sales in exchange traded markets) they are unable to volume weight the inputs. Therefore they simply EQUALLY weight the traded rates captured from EBS or Thomson Reuters and Currenex. As Currenex supports a lot of retail volume their average trade size is probably very much smaller than the average trade size of the other two platforms. This provides an opportunity for aggressive small-size trading on any platform with a smaller average trade size to influence the benchmark rate. Introducing CME data to the mix, or other ECNs presents exactly the same problem...
 2. Quality and relevance of data. It is of some concern that the volumes on EBS and Reuters now represent such a small part of the total volume traded in the market today. Internalization by the larger FX banks has been a huge factor in this. Arguably, the top 6 FX banks have much better data on actual market executions than any single external trading venue.
 3. RECOMMENDATION: That the top X Banks be required to submit actual "Time and Sales" data to WM for the construction of the WMR rates for G10 currencies (and perhaps beyond). The data should exclude trades done for the banks own account against its internal liquidity. This data should then be combined on a volume weighted basis. This would provide the best possible benchmark (broadest data set/actual executions), with the least opportunity for gaming.

5. I believe that anyone setting a benchmark should be required to use a robust, documented and transparent process. The central banks do not appear to have set a high enough bar for themselves in this area, leaving themselves open to potential for criticism.

6. Not a good idea.... As is observed in the paper, the principal users of trading at the WMR are passive (Index) fund managers. By definition, their positions are all the same way round, so submitting orders to a matching engine is highly unlikely to find an even balance of supply and demand. Currently, there is an imbalance between buying and selling in any currency, and a much bigger imbalance, as shown in the report, is seen at month and quarter ends. That is the consequence of fund managers rebalancing their portfolios and redoing their hedges. At the moment, the market does a good job of absorbing that imbalance, (even though the banks may complain about market "indigestion" at 4pm). However, if you take that risk position and require it to be transparent and executed like an exchange model by matching demand and supply, we are going to see increased volatility in the markets, which the report shows is not there at the moment. We should learn from the example of the equity markets, where there is a more even balance of supply and demand, yet a typical matching facility matches only 16%, leaving an 84% tail. The position in FX is likely to be even more imbalanced, creating the potential for extreme volatility as the tail is "transparently" executed.

7. In OTC markets, spreads are determined by the market. There is a wide range of pricing offered to clients for the WMR, including spread and fee options. The WMR itself calculates a bid and ask and yet the FX market has already determined that the spread for WMR trades is as little as zero. Are we now going to mandate minimum spreads for our "free" markets? This seems highly problematic. How do we know what the minimum spread should be for any given currency and size? If we simply require that Banks should not take a position at a loss we have a degree of market driven pricing, but we could still end up with a bank asserting that do do not make a loss even when pricing at the mid-rate.

8. 8-15...no specific comment.

I may be contacted as below for discussion or expansion of any of these points.