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The Future(s) of FX Trading

Are FX Futures a "One Size Fits All" Solution? What is Driving the Buy-Side Demand for FX Futures?

What is Driving the Buy-Side Demand for FX Futures?

Joshua Hurley, FX Sales and Business Development at Eurex, quizzes Chris Callander, Head of FX Futures Sales & Trading/Client Facilitation London at Societe Generale, on the extent to which FX Futures can replicate the flexibility of an OTC market, the key drivers pushing buy-side firms towards these products and why there is growing demand for them regionally in Europe.

Joshua: Can FX Futures really offer a viable alternative to the OTC market, which offers a range of different execution models?

Chris: That's a question that we hear a lot, but actually it is possible to trade FX Futures whilst still maintaining the flexibility of execution that clients are used to in the OTC market.

In fact, on the principal Futures trading desk at Societe Generale (SG) we aim to effectively treat listed Futures and OTC Forwards as the same product, meaning that instead of two counterparties executing anonymously on the exchange, a client can discuss, negotiate, and execute a trade directly with a known counterparty or set of counterparties, just like in OTC.

This enables the client to trade "OTC-style" with their selected liquidity provider, but then results in them holding listed contracts cleared via their Futures Commission Merchant (FCM) with a highly rated clearing house. To a large extent, this provides the "best of both worlds" where the client can trade with a chosen counterparty to access principal OTC liquidity, but ends up with the exchange as their counterparty to the resulting positions. There are two specific mechanisms that allow for this: Exchange for Related Physical (EFRPs) and FX Futures Blocks.

Joshua: What exactly are EFRPs and what benefits do they offer?

Chris: EFRPs enable customers to transition risk from the OTC marketplace into equivalent-listed positions, and as such, the customer needs to be enabled to trade and hold both OTC and listed transactions.

Typically, the client will initiate their FX position by trading either a spot FX or forward trade and will then subsequently work with a partner like Societe Generale to Exchange for Related Position (EFRP) the OTC position onto the exchange by agreeing to the basis differential.

The end-result of this is that the client no longer holds an OTC position but instead holds the equivalent position in listed FX Futures.

One of the main benefits of this is that initiating the trade in the OTC market increases the depth of liquidity and range of tools available. In addition, using a single relationship, multiple bilateral lines or a prime brokerage agreement can provide even greater spot liquidity along with a wider range of algorithms and care orders such as stops and limits.

It's also worth pointing out that EFRPs can work in the opposing direction if needed. Should clients require additional spot liquidity but are restricted to a certain number of counterparties, they can initiate the trade in listed FX Futures, and then use a reverse EFRP to close out the listed positions and open the equivalent positions in Spot FX – or to whichever forward date they need.

Joshua: And FX Futures Blocks?

Chris: FX Futures Blocks are an immediate risk transfer between two known counterparties. These are similar to an EFRP in that the client needs to have a direct relationship with the chosen counterparty, but in a Block trade there is no OTC element or position at any stage. The process for a Block trade is very simple, all the client needs to do is negotiate the price with their chosen counterparty, who will then post the relevant buy- and sell-sides to the exchange creating the Futures Block.

We have many customers who can only trade Futures but at times require more liquidity than is available by directly accessing the CLOB.

While some clients will choose to work these large orders over a period of time in the order book, others will call our desk to facilitate a Block trade as an efficient mechanism for them to transact in significant size, reduce spread cost, and to reduce market impact.

Joshua: If Off-Exchange FX Futures are actually relationship trading, then do clients still need an ISDA/CSA with each of their counterparts?

Chris: No, you do not need an ISDA or a CSA to trade Futures. Over the years we've partnered with a variety of asset managers, pension funds, CTAs, other banks, corporates and central banks. Obviously across these client groups we cater to a diverse range of requirements when it comes to Futures execution, with some more focused on holding costs, others on transparency and many firms looking at cross margining. However, we see that the decision making across all these different groups is primarily driven by the underlying mandates from customers who are unwilling to go down the ISDA and CSA route in the bilateral environment.

Joshua: Has the advent of UMR been a driver for an increased interest in listed Futures?

Chris: Over the last 6 years we have seen a steady increase of growth in listed Futures. But since the UMR rules began to come into place we really have seen an exponential growth of interest from the asset management community for a variety of different reasons, not least the cost of onboarding new sub-funds needing CSA/ISDAs and the additional liquidity an anonymous liquidity pool can offer.

To this point, we're increasingly seeing clients conducting more sophisticated cost analysis around their execution which takes into account the total cost of holding the positions they have on their books. And as a result, more firms are realising that in many cases it is more effective to push at least some of their trading activity towards a listed environment rather than trading bilaterally. To help with this we offer portfolio cost analysis as a service, as do most exchanges.

Ultimately, whether they're trading bilaterally or via a prime broker, clients are going to encounter direct or implied RWA, CSA, and Independent Amount costs. Even the cost of repapering ISDAs for underlying customers is being taken into account.

As I mentioned earlier, a good part of our flow is from customers who do not have an ISDA, as they can trade FX Futures on (CLOB) or off (Block/EFRP) the exchange without the additional paperwork. These factors are driving the sudden uptick in interest in FX Futures that we've observed the past few years.

Joshua: What type of clients do you see using FX Futures, and are there common drivers for use of Block trades and EFRPs?

Chris: Block trades and EFRPs tend to only be used by the larger and more sophisticated accounts. There's little value in doing a one- or ten-lot on the near-dated expiry as an off-exchange Block trade, but there is certainly a benefit of doing larger clips. We've seen G10 outright Block trade sizes range from 150 lots to numbering in the thousands. Clients should also consider that this process may be even more beneficial if they are looking at emerging market currencies. In those markets, even doing a 50 lot could be a significant cost saving by executing off-exchange as a Block trade.

Joshua: Do you get more price requests during the quarterly roll period?

Chris: The two weeks prior to the expiry of the quarterly rolls are our busiest period. Customers compare the CLOB liquidity to our principal price and then decide to trade on whichever is best for them.

Usually we see most of our customers start with emerging market currencies at the beginning of the roll month and then spread the G10 over the following week. Mid-week, prior to the roll, is when we see the most flow.

On the subject of pricing, it's worth noting that one of the big benefits of the Futures market is price transparency. Customers can easily compare the exchange price to our own, and in fact we encourage them to do exactly this, so that they can be certain that they are executing on the best price available.

Joshua: You mentioned that there is growing interest in FX Futures. Do you see this translating into more demand for a European FX Futures trading venue?

Chris: Yes, I think there's a lot of room for growth when it comes to FX Futures trading.

Historically, most of the FX Futures trading activity has been executed on U.S. exchanges, such as the CME and Intercontinental Exchange (ICE), with the listed market forming a small but very integral part of the overall FX marketplace there. Then in other regions we have seen the growth of other exchanges offering FX Futures trading, such as B3 in Brazil, SGX in Singapore and Moex in Russia.

These exchange offerings have benefitted the FX Futures markets in their respective regions and, as the interest in these products continues to grow and become more sophisticated, I believe that the European market would similarly benefit from the development of an exchange traded FX Futures offering.

There is no "one size fits all" answer when it comes to servicing our clients on this subject. They increasingly need a service that can offer tailored, impartial advice, and I genuinely believe that Societe Generale can help as we cover all aspects of this product: from OTC bilateral FX trading, Clearing, Prime Brokerage all the way through to agency and principal Futures desks.

Further information

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Please do not hesitate to contact your local account manager for more information or contact us at info@360t.com · www.360T.com

Europe
Frankfurt
Tel: +49 69 900 289 0

Americas
New York
Tel: +1 212 776 2900

Asia Pacific
Singapore
Tel: +65 6597 1770

Middle East
Dubai
Tel: +971 4 458 7440

South Asia
Mumbai
Tel: +91 22 4077 1437