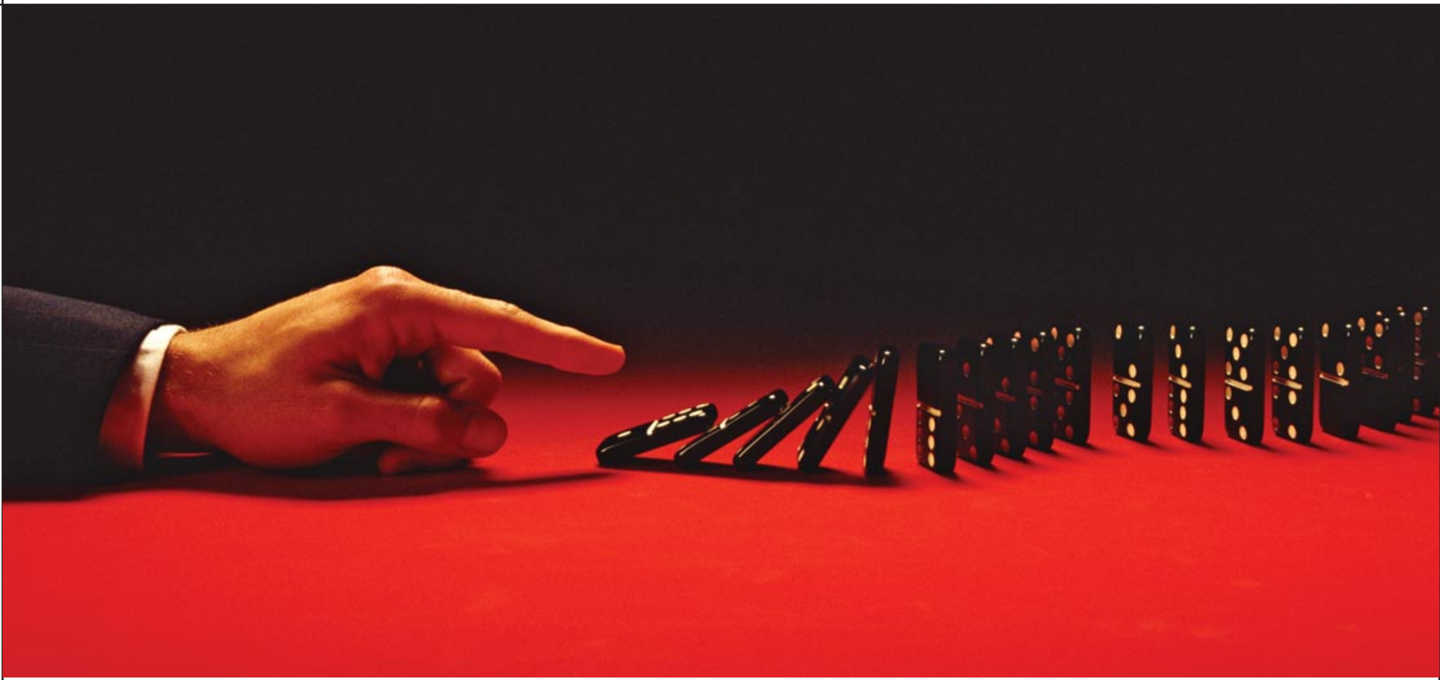

2017 to be Tipping Point for FX Clearing

We are now nearly seven years into the three-year market reformation project kicked off by the G20 in Pittsburgh 2009, but we are still some way from our end-state. The structural, foundational, and utterly disruptive changes to the good old days of FX are still playing out, and the pure economics of trading FX are changing. But 2017 will be the tipping point for a major structural evolution that will free the market from many of its current constraints, marking a new generation of FX.

MiFID's regulation of the execution landscape will dramatically reshape single dealer offerings beyond spot products, simultaneously fragmenting many participants' modus operandi and blurring the lines between taking single dealer liquidity and having agent access to multiple liquidity pools. The foundations of being a largely electronic market will facilitate this shift towards being able to use the right product, in the right venue, at the right time.

While the SNB event last year accelerated structural changes for how credit is made available to smaller firms, the dependency on bank Prime credit - either direct or via prime of prime - still exists, and the cost of credit is still being bundled alongside the provision of access to liquidity. From both prime and agency perspectives, there is still credit concentration at banks; and as we already see, banks facing increased calls to justify the return on capital and credit at a more granular level are determining which areas of FX business they are going to support, and which clients they will retain. It is difficult to imagine the situation that will increase the availability of bank credit at this point.

The forthcoming un-cleared margin rules are introducing significant costs and focus on counterpart post-trade; the cost of both margining positions against multiple counterparts without any netting or offsets, and building operational capacity to handle multiple intraday margin calls and collateral movements is teeing up CCP clearing as the catalyst to the new world of FX. In fact, we already see astute market participants of all types stating they would exploit the benefits that CCP clearing could bring to their FX business, if only CCPs offered the right products, and priced their service in such a way that benefits could be realised.

Considering the stifled emergence of FX clearing from regulators pushing back clearing mandates for NDFs, and the complex settlement risk introduced by CCPs clearing deliverable FX, it is easy to see why this hasn't arrived yet. But the liquidity challenges are addressable given appetite for the benefits offered by a new credit model for the FX market – and the un-cleared margin rules are accelerating us to the tipping point that will cause 2017 to become the year deliverable FX clearing becomes a reality.

Looking beyond its reduced capital costs, the multi-lateral netting offered by regulatory-qualified CCPs simplifies the operational processing of margin against one CCP rather than multiple counterparts, and allows for massive optimisation within a portfolio of cleared trades regardless of the original counterpart. Arguably this netting and optimisation is the same role that a PB takes for its clients, albeit the CCP does it in a much more tightly-regulated operational framework.

All of this takes big infrastructure investment. Last year's FX M&A activity suggests that the major exchange groups have all seriously considered how to gain FX market share. While it's unlikely that any group thinks the market can move to a single exchange product, breaking away from that position is obviously easier for some than for others. We will see much activity and many products in the exchange group space, so given the structural shift ongoing in the market, the one that gets the breadth and depth of its FX value proposition right - not constraining its offering to preserve a franchise, but allowing participants to choose the right OTC or LISTED FX product and style of execution they need - has the proposition most suitable for those wishing to thrive in the next generation of the FX market.

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