The Translation Layer In FX

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Sponsored content – David Holcombe, Product Lead for FX Futures and Clearing at 360T discusses breaking down the remaining barriers between OTC and Listed FX markets

Recently there have been some well-publicised attempts by exchange groups to bridge the gap between OTC and Listed FX trading, however, these efforts have been lacking something crucial: a 'translation layer' – but what exactly is this?

Different market participants with varying levels of access to the fragmented FX market will describe this translation layer differently, but essentially it boils down to this: a setup where 'the market' that they face includes OTC and Listed FX liquidity, allowing them to Make or Take simultaneously across both while facing every counterpart they should, to ensure they get the right trade done.

Talking to a broad swathe of these market participants in recent months we've observed different factors driving this demand for a translation layer.

Two Sides of the Same Coin

Some OTC-only firms tell us that they'd like futures liquidity to be brought into the OTC market. Indeed, a shift from FOMO (Fear of Missing Out) to the ROMO (Risk of Missing Out) of accessing firm, credit-neutral liquidity for the majors in the futures market has prompted more buy side firms to set up to access Listed FX alongside their OTC trading.

Yet while many of these buy side firms have still not developed access to Listed FX products, we already see the sell side evidencing the benefits of operating both the Listed and OTC FX markets. Banks today are monetising feeds of futures liquidity from the exchange by stripping out the basis to offer as spot liquidity to their clients, then hedging back into the futures.

On the other side of this 'access' coin are the futures-only firms, who tell us that they would love the mountain of liquidity that exists in the OTC FX markets to be made available to them in the futures markets. Again, access is the key, but here the FOMO and ROMO focuses entirely on finding a route to access deeper electronic FX liquidity at times when it can be a bit thin on exchanges, or there is a need to trade in size electronically, without the need to specifically set up bilateral lines and relationships.

Routing spot liquidity into the futures market to address this has proven difficult for many providers so far, given the need to manage the spot to IMM basis, then quoting as firm liquidity into the exchange central limit orderbook. Subsequently, the 'depth of futures liquidity' has remained a challenge to solve.

An Evolving Ecosystem

As an established OTC FX platform that now includes FX futures, 360T has clearly spent some time digging into all of this with our clients, and as a result we have established solid futures technology foundations that present many distinct opportunities for liquidity providers and takers, however, this is just the start and that's because what is really significant about this desire for a translation layer between OTC and Listed FX markets is that it is indicative of how the FX market will ultimately evolve into a single accessible pool of FX liquidity. Or, put another way, we will increasingly see an FX ecosystem where all of the participants within it – regardless of the different business models they operate and goals that they are pursuing, will be able to interact with one another.

Let's get more specific and look at the different factors driving us in this direction.

1. Access, Access, Access

It is fair to say that access and settlement remain the fundamental constraints that every FX market participant faces today. Some firms will continue to have access to futures but not OTC, others will have OTC access but not futures, and others still will ultimately have broad access to both.

Because of the cost burden associated with direct memberships and associated infrastructure for every liquidity pool though, it is clear there will always be a distinct opportunity for access providers to take a fee for providing access to relevant liquidity for their clients. We will, however, see the current landscape of archaic transaction and service fees repriced, as the edges between listed and OTC increasingly blur, and providers increasingly realise and start to pass on some of the value from clearing that can reduce their capital costs, as well as the impact of holding and servicing client portfolios.

2. Pioneers Bridging Between OTC and Listed Market

With many firms not wanting, or maybe unable to change their existing level of access to the FX market, we already see firms looking at bridging between OTC and Listed markets as means of making a land grab, delivering OTC liquidity into Listed markets or futures liquidity into bilateral OTC streams.

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This is not a new activity, many banks and other firms have done this implicitly via their hedging for years, but now providers are looking for easy routes to expand their offering and presence. As a result, we already have several parties looking at how the 360T Market Maker Cockpit gives them a toolset for price formation, basis setting or stripping, quoting, and auto hedging. By deploying these tools firms can offer spot streams using underlying futures markets, or they can quote into Futures based on existing spot baskets, while maintaining a market risk neutral position and separately managing their basis risk.

The Electronification of Off-Exchange Liquidity

That bridge to shift liquidity between OTC and Listed markets is only one piece of the 'translation layer' puzzle. Over the next two years we will see seismic shifts in the electronification of the off-exchange futures market to round this out.

When you consider which trading models still reign supreme in FX, from bilateral price enquiry for risk transference and trading in size, to streaming disclosed or undisclosed offerings that permeate throughout the spot market, you see how the FX market naturally wants to transact.

So while there is nothing implicitly lacking in on-exchange execution – in fact, there is definitely a case to be made that many trading scenarios can benefit from accessing firm all-to-all liquidity in a central limit orderbook – the benefit of being able to execute Futures off-exchange electronically, means that firms can replicate the bilateral execution models of the OTC market whilst still being able to face counterparties without the need for bilateral credit.

As well as solving the 'depth of futures liquidity' challenge with streams of outright buys/sells (block futures transactions), this bilateral streaming off-exchange FX market completes the FX translation layer with a transaction built exactly for this purpose; the EFP.

These two types of off-exchange activities will develop in parallel. We are already seeing spot focused liquidity providers setting up to make and take streaming outright 'block' pricing of the Eurex Rolling Spot Futures in 360T as their first steps into futures without the need to manage a quarterly basis (typically with an "it's just cleared spot" at the aha! moment). And we are working with our buy side clients and their banks to ensure our forthcoming streaming EFP market provides a bilateral translation layer in which clients can face their LP panel to switch between bilateral, cleared, futures positions at will (stay tuned, there will be more to come on this shortly!)

It's always been in our DNA at 360T to provide routes for our clients to access the right liquidity at the right time. This has already evolved so our makers and taker clients can use FX futures within those pools too, not only to maximise their access to the right counterparts and liquidity, but also so they can maximise the portfolio effect of holding their positions in the right place once traded. These are the foundations for what everybody needs, a single FX market where a diverse ecosystem of FX participants can openly interact.