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OTC and Exchange

Thinking Big


Carlo Koelzer

Carlo Koelzer, CEO of 360T Group and global head of FX at Deutsche Börse Group, talks to Galen Stops about the importance of building critical mass amidst the changing landscape of the FX market.

Galen Stops: It's now about one year on from Deutsche Börse's acquisition of 360T. Can you shed some light about why you agreed to the deal?
Carlo Koelzer: Prior to this deal we were a big trading platform in the market, but a small organisation in comparison to our competitors. When you look at the larger platforms in the market they're backed by firms like Icap, Thomson Reuters, Bloomberg and State Street, all of whom had larger balance sheets than us.
At the same time we observed some multi-dimensional changes that were beginning to impact the FX industry. Firstly, there are all the regulatory requirements such as Dodd-Frank, the Volcker Rule, SEF rules, EMIR and MiFID coming into play. We saw that these, in addition to new capital requirements and Basel III, were creating a lot of changes at the micro level about how trading occurs.
Secondly, there are changing technology requirements around providing greater transparency and an effective audit trail.
Thirdly, there is the potential for completely new underlying technologies to become adopted and change market behaviour. One example of this is the potential for blockchain to alter the current T+2 settlement cycle.
With all of these changes in front of us, we felt that we needed to place some bets for the various possible eventualities of each and we didn't have the capital to do so. That's why we were looking for a partner that was highly capitalised, highly regulated and technology-focused. And Deutsche Börse filled all of these criteria.

GS: So what's the next step in terms of combining the two businesses?
CK: Right now we're working on a concept that we're calling "FX 2.0", which refers to the width and depth of our offering.
In terms of width, we want to provide market participants with a place where they can use any existing trading style to execute any type of FX product. The aim is to offer everything from liquid to illiquid products that can be traded via RFQ on executable streams, via a central limit order book (CLOB), via futures or, bridging between those markets, by exchange for physicals (EFPs). This will enable liquidity to float from the listed market into the OTC market and *vice versa*.
In terms of the offering depth, the aim is to provide credit mitigation to market participants, which we're now able to do via Deutsche Börse's clearing house. Initially our focus was on spot forwards and cross currency swaps because of how these products sit on balance sheet compared to spot.
But the contraction of the prime brokerage (PB) capacity in the FX market over the past 12 months has led to more interest amongst market participants for spot FX clearing as a possible alternative to using a PB for these trades.

GS: OK, so what do you have in place already and what still needs building?
CK: We have the full OTC suite already, apart from the CLOB, which we are building and aim to have live in Q1 next year. Deutsche Börse has futures and options on futures via Eurex, but they are not very liquid right now and so we've just re-launched these products. The EFPs are already available to trade and then we'll be launching a rolling spot future in Q2 next year. Then while we have clearing for futures in place, we still need to develop OTC clearing, which will probably take about another year.
But there are also other ways that we feel that our FX 2.0 concept differentiates us from what's already in the market.

GS: Which are……?
CK: At this point the pure platform that we operate has become a commodity, FXall has it, Bloomberg has it. What we're looking to do is differentiate our offering on two levels, a micro level and a macro level.
The macro level is about firms wanting to work with an organisation that is a one-stop shop, that is highly regulated, highly credited, has scale, is transparent and has a high degree of technological competence.
The micro level is about workflow integration and analytics. Firms don't just want a platform with a GUI any more, they want pre- and post-trade workflows and they want to be integrated. That's why we offer full EMS for corporates, asset managers and banks, we have white label systems that we offer to banks with compliance tools about who can trade with who and what margin is required for trades. We offer the ability to integrate to infrastructure providers like Traiana and then provide trade analytics around where, when and why firms should be trading in a certain way.
So FX 2.0 isn't about accessing 2 million in EUR/USD through the pipe, it's about smart order routing, finding the right liquidity and providing the necessary analytics.

GS: There's been talk of FX moving to an exchange model for some time, but now we're beginning to see exchange groups acquiring OTC platforms. Is this admission that actually FX is never going to move to an exchange model?
CK: FX is a very different animal to the listed markets, not least because exchanges work through exchange members whereas OTC platforms have direct end customers. The two models are just different and the magic formula is to combine the services of each in one place. That's what we think makes our offering unique: we're the only company in the world at the moment that has a full fledged OTC platform and a listed offering.

GS: You talk about re-launching FX futures. Eurex already tried this once, it has to be said, without much success. Why didn't they get any traction the first time?
CK: There are a few reasons. One is simply that there was no FX DNA within the Deutsche Börse Group. There was no franchise, no existing FX customer base, it was a global product

only trading during German hours and, ultimately, there was an alternative product available and there wasn't enough justification for another similar contract.

GS: So why do you think it will be different now?
CK: A lot has changed. Deutsche Börse now has 220 people within the group that are FX specialists. They now have a franchise of 2,000 customers that could be potentially interested in the futures and options.
In addition to this, firms are now looking for a European FX futures contract because regulations have caused liquidity pools in the US and Europe to separate from each other. European corporates and asset managers increasingly prefer to trade with a European entity rather than a US one so that they don't tap into another regulatory environment. This is why I think that when we fully re-launch the FX futures products over the next five to six months that we'll see much more trading in these contracts.

GS: And looking at the CLOB build out, how do you plan to build up activity there? CLOBs are notorious for being something of a chicken and egg problem when it comes to liquidity…
CK: We had the same problem when we first started 360T. We didn't have customers and we didn't even have technology, it was three guys and a laptop. So how did we do it? By creating a value proposition, in that case for the corporates.
The liquidity in the CLOB will come from the same firms that we have as customers today. The orders that we have already on 360T will route to the CLOB and it will operate as a segregated liquidity pool, as well as an all-to-all liquidity book at the top of it. So it will be like a cascade system, the top of which is an all-to-all book.
By the way, when we talk about a CLOB for FX, there's only one real CLOB in the market at the moment, and that's offered by LMAX. The other platforms all offer segregated liquidity pools.

GS: But if there's really demand for CLOB trading in FX, and LMAX is the only game in town on this front, why haven't we seen a larger shift in trading activity toward that CLOB?
CK: LMAX didn't have the fortune of having 180 liquidity providers and a franchise of over 2,000 customers on the other side when they launched their CLOB.
The FX market is already very fragmented and so for banks and other market participants being asked to invest resources into connecting to another platform, the benefits are marginal.
But we're already integrated to these liquidity pools and these market participants and so the CLOB becomes just another pipe. Firms will only use a CLOB if it adds value, and we think ours will have value because we have customers that already use 360T but they trade their spot products somewhere else because we don't offer a CLOB, even though they would prefer a one-stop shop.
Then once we have the OTC, listed and clearing pieces in place there's an additional reason to favour a one-stop shop, because they will be able to net off their margins. These netting benefits become more important at a time when PB businesses are contracting and market participants are looking for alternative ways to access the FX market.
It's always challenging to get a CLOB liquid but, given that we will be the first firm to have OTC trading and central clearing in one place, if we can't make it work then I don't know who can.

GS: Barring one or two short-lived spikes in volatility, 2016 has been a year of muted trading volumes. As a trading platform, how do you counter this?
CK: If you look at our volumes over a 12-month period starting in August last year, we have increased volumes by about 4% year-on-year. Now over that same period of time the firms that make up 75% of our business, our incumbent customers, traded 6% less than the year before.
The reason why this happened was that we added 120 new customers over that time period, while some of the ones added the year before continued to ramp up their activity on our platform. So a lot of our success at the moment comes not from the legacy book but via the acquisition of new customers.

GS: Given the decline of FX trading volumes in recent years, do you expect to see further consolidation in the platform space?
CK: I think that the landscape in FX is changing a lot at the moment. With the capital requirements and regulatory tightness, the cost of doing business for PBs has risen. As a result, the number of firms providing credit has reduced and the overall PB capacity is still reducing. So there is consolidation there. Then in terms of real market risk absorption, the universe is also reducing to fewer players. Ultimately, I think the same will be valid for infrastructure providers because the cost of doing business is going up with regulatory changes and capital requirements. If these providers want to operate in the US they need a SEF and have to put capital down for that. To operate in certain areas in Asia, we have to put capital down. It's a money question, it's a resource question.
As a result I assume that you'll have further consolidation in the trading area, and already there is a pattern emerging with Deutsche Börse acquiring us and CBOE buying Bats, including Hotspot.

GS: But haven't market participants been predicting consolidation amongst FX platforms for some time and yet the environment has largely resisted this? Don't you think that there's room for more niche platforms targeting a specific segment of the market?
CK: I know our cost base and I consider us to be pretty cost efficient, especially considering that our main offices are in Frankfurt where development, rent and labour costs are significantly cheaper than London or New York. But even then we thought that we needed more critical mass behind us.
So I'm wondering how, at a time when the cost of doing business is going up and the overall market volumes are going down, firms can continue to play in this market if they don't have critical mass?
I think that if trading is below a certain threshold of billions per day on a platform it will become very difficult for them to continue operating in this market, which is why I think we'll see some consolidation.

GS: Another thing that has been predicted for some time but never really taken off in FX is OTC clearing. Why do you think that we're actually going to see more firms gravitate towards this now?
CK: A few years ago people thought that more FX would get cleared because of a regulatory mandate for the central clearing of options and NDFs. But then this never materialised and commercially central clearing couldn't compete with bilateral trading because no one was accurately pricing credit risk into the market.
Since then, with Basel III rules, added CVA charges and post-SNB the commercials of the market have changed. PB prices have gone up and this means that central clearing is a more competitive credit mitigation method. The fact that central clearing is a valid alternative, and for some people perhaps the only valid alternative, for credit mitigation is a major change for the FX market.