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The Future of FX

Will the FX market move on-exchange? A question often asked to panels at FX conferences, seemingly with the expectation of a binary answer. It's a strange one though, as either a yes or no answer would have to ignore all of the individual drivers for the FX activity in question as well as the types of participants involved.

On-exchange / Listed FX is not new. While the FIA's latest open interest report shows nearly 30 exchanges with some currency derivatives listed, a reasonable question is why is Listed FX still only a single digit percentage of the overall average daily volume in the FX market? Putting aside domestically focused exchanges that are arguably achieving what they have set out to do, it is fair to say the international offerings have seen limited uptake from critical mass FX participants because of the distance between Listed FX's rigidly standardized products and operation, and the immediate accessibity of liquidity and credit in the OTC market, plus the flexibility in terms of the products that has enabled it to evolve to where it is today.

Credit in the OTC FX market has become more expensive and scarce, with SNB accelerating a trend regulation had already kicked off, for trading businesses to really quantify the value of their trading counterparts or clients in terms of revenue, risk, and return on capital. We have seen PB credit providers for OTC markets re-price from an unsustainable discounted rate to numbers that now make business sense, and set the bar higher in terms of who can be and who can remain a client of the Prime, and Prime of Primes emerging to facilitate access to liquidity further down the curve.

On the OTC liquidity side there are pressures too. With banks being driven by regulation to constrain their risk taking trading activity, nonbank liquidity providers have increased their presence and significance in markets, moving from typical position of backup liquidity to banks to now participating directly and materially in markets, albeit with the constraint of their PB determining who they can face. While banks do remain focused on serving their clients well, it is only natural that we are already seeing clients wanting to find ways to interact with more providers and new types of liquidity provider for certain areas of their activity.

So a more specific question to lead with would be what is the impact of this structural change in terms of market participants, credit models, accessibility and liquidity and some drive for more transparency, and what role do exchange groups have to play in that.

Within the Deutsche Boerse Group which includes 360T, a market-leading OTC FX venue, and also the Eurex Exchange and Clearing House, we know that the catalyst for a lot of changes in FX will be FX Clearing – both OTC FX clearing, where the execution is conducted bilaterally then given up to the CCP to clear, and Listed FX Clearing, where the product is exchange-listed and is designed to clear.

This isn't on the back of expectations of when a major jurisdiction will mandate NDFs to clear, it is entirely driven by firms already planning to exploit the economic benefits of using a CCP to mitigate credit risk, increase their pool of trading counterparts to everyone participating in the cleared product in question, and using the multilateral netting benefits for margin and other optimisations on a portfolio basis to maximise their revenue and return on capital.

One of the strengths of the FX market is the diversity of participant types and trading rationale, and the 360T client base is a great example of this. So we have assembled new tools in our platform that let our users access new market models including the use of cleared products, and also new participants, at their own pace and in a robust and safe way.

In addition to the ECN in 360T that increases access to OTC FX liquidity for our clients, on the cleared side we have an OTC FX clearing proposition for spot, forwards and swaps (that merits an entire article of its own), and 360T users have also access to the entire family of Eurex FX Futures products – including the new Rolling Spot Futures as well as the Classic Futures contracts.

With Listed FX alongside existing OTC FX in 360T, users have the access to place orders direct into the exchange orderbook, and also to face Block and EFP liquidity providers – this flow proving to be of great interest to OTC participants stepping into the use of Listed FX given the familiarity of the execution model.

So to answer the opening "Will the FX market move on-exchange", it is clear that exchange groups will have a material role to play in FX. A new ecosystem is forming around each individual thread of exchange group offerings such as ours, with client intent to use a combination of OTC and exchange execution, new and innovative market models and products, and CCP clearing alongside bilateral credit, as part of a new operating model that lets them survive and thrive in the new FX landscape.

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