FX Client Clearing is dead ... so long live the EFP

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There is something really exciting happening in the world of FX Clearing.

No, this is not another article from a clearing house proclaiming the buyside are routinely using OTC FX Clearing -- because they are not. Most client volume remains centred around the smaller non-member banks as clients of clearing member firms, clearing interbank (but not necessarily inter-member) activity.

While there is genuine client-side interest in FX clearing in response to UMR and the impact of SA-CCR on bank spreads, the settlement setup underpinning deliverable OTC FX clearing needs fundamental change to make it viable for critical mass of buyside. Given the regulatory constraints in this area, this is likely to be at least two years away, at best.

So, if it's not OTC FX clearing in focus, then what is it?

Despite that, there is a real momentum building up within banks to build and offer a different form of FX clearing service to their clients. They want to provide something where the client can still interact with the highly liquid OTC FX that they know, need and want, using the tools they already have, but while also providing the benefits that central clearing can offer.

Something where each LP can still monetise their OTC relationship business, retain their clients and can offer each one the ability to have their OTC FX activity cleared as an add-on service.

While some LPs already bundle the clearing with their OTC liquidity provision, in 360T the client can also choose to ask LPs to compete for the clearing once an OTC position has been built, so they are not tied to one OTC FX provider for any cleared trades they need to do.

This is EFP. Sure, you may have read about EFP (exchange for physical) and EFRP (exchange for related position) trades (which in FX are actually just different exchange's labels for the same thing), but perhaps you previously dismissed these as just something that 'futures trading firms' might be interested in. But if this is the case, then you're missing the clearing land grab that is underway right now.

So what is an EFP?

The EFP is a two-leg transaction, in FX most commonly sell spot & buy futures – with the rate quoted being the 'basis' between the two covering the forward points and any otc/listed conversion fee applied by the LP.

A typical institutional use of EFP right now is where client instructs their bank to build a particular position within a target price, then roll the result into futures.

While this is similar to rolling a spot trade into a forward date bilaterally with your bank, the EFP gives you a cleared net futures position for that forward date, delivering maximum clearing benefits (even lower regulatory margin rates than the equivalent OTC FX cleared position). And, unlike a bilateral forward, there is no ongoing tie with the original trading counterpart, so you can manage your Futures using any of the available models (see box).

If it's just FX clearing, then why the excitement?

While the lack of a regulatory mandate to clear FX has ensured little-to-no development priority for many banks' OTC FX client Clearing offerings, the EFP sits firmly in the front-office, helping the bank to mitigate their SA-CCR constraints of existing bilateral client forward business, as well as introducing a new basis trading distribution. Additionally, with EFP development fitting well with existing FX Swaps electronification efforts – some considering EFP "just" a swap with near leg spot, far leg futures – there is real momentum here.

From a client perspective the stars are aligning too. As OTC execution can remain as-is, the EFP enables client's deliverable FX to be cleared by way of an operational lift to process futures, without a daunting full-scale front to back business change. Obviously once successfully using Futures, models should evolve to consider each type of futures execution and liquidity, but the point is that clients can start with EFP rather than requiring totally new trading paradigms.

Where does this all fit within 360T – an OTC FX platform?

> **THE THREE WAYS TO TRADE FX FUTURES**
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> There are three ways to establish and maintain a futures position:
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> 1. **The Exchange CLOB** - a central limit orderbook (CLOB) with an all-to-all model where everybody faces the same price up to the available size, interacting anonymously.
>   Suits active trading in smaller amounts, position adjustments or working an order over time seeking price improvement over a risk price, or where anonymity is key.
> 2. **The BLOCK Futures pool** – where you trade outright in the knowledge the result is to be cleared.
>   This is the tertiary, deep pool of futures liquidity – a disclosed OTC pool for FX Futures relationship trading - where buyer and seller agree the trade details then report it into the exchange to 'print' (execute and clear).
>   While buyer and seller are disclosed to each other, there is no bilateral exposure until the trade is cleared at the exchange - so counterparty selection can be based on suitability, rather than within the constraints of a bilateral credit/settlement relationship.
>   BLOCK futures transactions are most often used for immediate risk transference trades, where a party wants to trade in size beyond what is immediately available in the exchange orderbook.
> 3. **The EFP** - the bridge connecting OTC liquidity and FX Futures.
>   This is another type of off-exchange relationship trading transaction – typically used when a client favours price improvement potential over certainty of execution, but wants to use deep and reliable OTC FX liquidity pools and tools rather than the exchange CLOB directly. The EFP allows an OTC position to be built, then reported into the exchange to effectively roll this into futures.

At 360T we strive to offer the right execution and relationship model for the trades each client needs to do. Integration and automation are core to our DNA – and this is no different for our FX Futures support. So not surprisingly, we support all three futures execution models in 360T.

We have cleared FX functionality for clients to use within their workflows, and tools for LPs to form their e-distribution land grab in the cleared FX space – covering futures orderbook access, futures BLOCKs, and of course, EFPs.

The groundswell of efforts to fully exploit clearing through the use of EFP is fascinating and exciting – actually the market interest feels just like it did at the start of the electronification of the FX market i.e. it is still early, but there's a land grab beginning.

"While there is an observable capability difference in the Bank landscape for EFP right now, with so much attention on building out pricing, risk management, and distribution tools, I fully expect this to be a highly competitive electronic and cleared FX marketplace within the next 12 months."