Taming the OTC market

Frances Maguire

No matter how much volumes grow on derivatives exchanges, it is still the tip of the iceberg when it comes to the global FX market. Frances Maguire looks at the advantages of trading on a regulated exchange.

The foreign exchange market that has grown up in the interbank market is still proving resistant to attempts by the derivatives exchanges to woo them with the numerous advantages they offer -- such as credit efficient, anonymous trading via central counterparty clearing, extremely liquid markets and total price transparency not available on many other trading platforms.

CME sets record volumes

The volume in FX products traded at the largest exchange, Chicago Mercantile Exchange (CME), rose by 49% between February 2004 and 2005. In December 2005, CME had set several FX volume records, including a new total FX volume record of 872,271 contracts, representing $96 billion in notional value. This surpassed the previous record of 748,050 futures and options contracts traded achieved in June 2005.

Rick Sears

Rick Sears, managing director of FX at CME, says: *"There is an underlying demand from buy-side customers for increased efficiencies in all models. There are still more efficiencies that can be gained around the credit model in the foreign exchange market and this is one of key benefits that CME offers. It doesn't really matter what a platform offers – whether it is diversified order flow, access to liquidity, or transparency – if you don't* *have access to credit. CME has the largest clearing house in the world and can probably offer the most efficiency around offsets on respective risk positions on other futures products."*

CME carries out pre-trade netting so that no matter how many trades you do in one currency, there is always only one payment, per currency, per delivery period. This significantly reduces delivery fees.

But rather than simply promoting the security of trading on-exchange, the CME is bending over backwards to mirror the interbank market. Sears says: *"Our goal is better integrate ourselves in to the cash foreign exchange market. We are doing this with joint ventures like CME FX on Reuters, and by changing our options contracts exercising and expiration convention to one that mirrors the cash market. We are very aware of the fact that we have a product that is a proxy for the spot market, and we clearly want to win a bigger piece of the OTC market."*

Sears claims hedge funds are traditional customers of CME. Up until a decade ago a lot of banks did not understand or have a lot of appetite for hedge fund credit, so they came to the central counterparty model. This has changed now, with increasing numbers of banks having built prime brokerage desks, but historically they did not have access, from a credit perspective, to all lot of counterparties, and they certainly did not have access to a lot of electronic matching platforms.

According to Sears, there are already a tremendous number of FX algorithmic trading systems in action. He says: *"We can tell from a message traffic perspective. Algorithmic models may send in hundreds of messages per second. No human could do that so we know how many black boxes are out there. We also register users. It is important to have algorithmic trading as it creates liquidity. CME is widely considered to have the lion's share of the algorithmic trading participants because we have the matching technology that allows us to process that message traffic."*

NYBOT appealing to a broader audience

The New York Board of Trade (NYBOT), and its subsidiary FINEX Europe, trades a total of 29 FX products on its two trading floors in New York and Dublin, and in January launched the first ever futures contract to be based on a Euro index.

Joe O'Neill

Joe O'Neill, vice president of NYBOT believes that, although it is early days, the FINEX Euro Index contract will appeal to hedgers and fund managers but may take some time to get established.

"The euro index is a completely new concept and nobody has any real risk that is denominated exactly in a Euro index, but after a while we will see take-up as a lot of the European banks and hedge funds realising if they want to take a view on the Euro, this is a better vehicle. The proxy chosen can be the wrong proxy if you are trading the euro against another pair, whereas this is a clean and easy way take a view on the Euro."

He is also confident that when NYBOT gets its electronic platform up and running towards the end of this year they will be able to appeal to a broader audience. NYBOT has an agreement with the Chicago Board of Trade to host the platform for the exchange and work has already begun to enable NYBOT's currency and equity index products to be traded electronically side-by-side with the continued floor trading.

There is also a possibility that NYBOT's flagship US dollar index contract may be re-launched with a half-sized contract, or mini, to attract new FX traders with the smaller contract size. He says: *"The floor trading will continue to grow, but the electronic platform will help us to those traders, especially FX traders, who like to trade screen only."*

EUREX US the new entrant

A new entrant into the FX market, Eurex US, launched its first six major USD currency pairs and four cross currency pairs in September 2005. Similar to CME, Eurex US designed the contracts to mimic the interbank market as closely as possible. For this reason, the contract size is 250,000 currency units, which is larger than the other exchange, and notional and quoting conventions are consistent with spot markets. Also, to attract hedge funds, Eurex US waived surcharges on the exchange for physical (EFP) trades.

Michael McErlean, director of sales and marketing at Eurex US, says: *"Volumes and open interest levels have varied, but we've been encouraged by the number of EFP trades that have driven up open interest numbers. Our customers are able to realise significant cost savings with our EFPs while managing their currency risks through futures."* He says that Eurex's FX products were designed to meet the growing demand for exchange-traded foreign exchange contracts, as hedge funds and other non-traditional market players explore new asset classes.

Michael McErlean

"An exchange environment like ours offers anonymity, central clearing and first-in, first-out matching that is not available in over-the-counter markets. Traders and funds benefit from features like central clearing, transparency, anonymity and 60/40 tax treatment (in the U.S. market) that doesn't exist with the unregulated cash and OTC markets. Eurex US's fees are also extremely competitive with the cash market, bringing in new participants that have been previously priced out of currency futures markets," says McErlean.

To date, the Euro/U.S. dollar contract has been the most traded contract on Eurex US. But because most of the EFP business has been in the cross currencies, the exchange recently launched a further eight FX pairs -- one US dollar pair and seven cross currencies. Hedge funds and commodity trading advisors (CTAs) have spurred growth in the derivatives markets in general and a big driver of this has been black box trading methodologies. Says McErlean: *"Our FX product was designed to meet their needs in several ways. Our technology is robust and meets the needs of 'high message traffic' trading methodologies that are often employed in the hedge fund and CTA community."*

Conclusion

Foreign exchange is the most actively traded asset class in the world, with over $1.2 trillion in average value traded every day, according to the Bank for International Settlements. Commercial banks are the single largest segment of the global FX trading community, representing 56 per cent of all volume. The FX market has long resisted developing a central counterparty for spot foreign exchange as being too expensive due to the sheer size of the market. However, if hedge funds are behind the growing trend of trading FX as an asset class in its own right, the spot market alone is unlikely to be able to cater for them – especially as many hedge funds do not trade cash products at all. This is perhaps reflected in the growth the derivatives exchanges see year after year, but it will always be the tip of the iceberg.