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FX Futures: Digital Boardroom Report

Introduction

FX Futures continue to grow in popularity among the buy side and it is clear that greater adoption from asset managers will necessitate innovation from futures exchanges and technology providers as well as continued support from the buy and sell side.

With this in mind, The Finance Hive gathered a small group of Head FX Traders looking to expand their use of futures to talk about the reasons why, the hurdles holding them back and some of their requests for innovation. We also invited a handful of traders from CTAs with a wealth of Futures experience to share their expertise and speak of ways the proposed innovation around products and technology might be used in practice on the buy side.

Completing the line-up were representatives from 360t, Eurex and SocGen, who were present with the intention of updating the buy side on how they were supporting advancements in the space and learning of their key challenges that remained unaddressed. This short report summarises the key findings from the group's discussion, along with a response from Marc Putter, Head of Trading at Transtrend.

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What are the benefits of using Futures?

- Ability to execute anonymously on futures exchanges
- Price transparency is seen as a major positive
- Data capture is easy as strong electronic infrastructure
- Cost efficiencies of trading classic and rolling spot Futures versus currency forwards and swaps.
- Reduction of Counterparty Risk
- Reduction of IM requirements and notional amounts under UMR
- UMR's potential to create a bifurcation of cleared and uncleared FX derivative pricing could make futures a cheaper option as banks pass on costs to their OTC clients
- Ability to leave passive orders in the market
- A true, all to all, marketplace in which the best bids and best offers are visible rather than a customised pool of liquidity

So, what's holding people back?

- Education of asset owners - buy side are driven by their clients, and there is little awareness of the benefits
- Pension funds tend to meet infrequently and on a committee basis so getting the benefits of FX futures on their agenda is a slow process without regulations forcing them
- Not enough screen liquidity – especially in EM and NDF currencies
- Lack of flexibility around dates
- Minimum contract sizes remain an issue
- Bank algos do not generally integrate with fx futures exchanges and clients cannot access OTC and Futures liquidity together – this is a key technological hurdle to adoption
- Banks are unwilling to invest and automate in FX futures liquidity provision as they don't see demand from the buy side – how can we break this cycle?

Key takeaways and next steps to increase adoption

- Off exchange liquidity can plug some of the gaps in EM and NDF currencies and forms part of the overall futures ecosystem
- Accessing OTC liquidity in the form of futures would be to everyone's benefit, and exchanges, banks and technology providers should work with the buy side to make this a reality
- Buy side to demand more of the sell side when it comes to futures and quiz them on why they do not offer
- Exchanges, technology providers and buy side to work together to educate asset owners and raise awareness of FX Futures benefits
- Innovation will require exchanges and buy side to do a better job of informing and educating the asset owners and the wider market
- There is a consensus that UMR can push things forward and bring about a change in demand
- "Translation Services" to bridge the gap between OTC and Futures liquidity is a work in progress but highly sought after – this should benefit OTC as well as futures users and increase the overall liquidity pools for less liquid currencies
- Improving the overall liquidity picture is a job for the sell side but the buy side can apply pressure to drive change
- Stay alert to technological changes in workflow to stay flexible
- Market making: Can algo providers integrate better with exchanges? This would give a wider pool of liquidity
- It is important people are engaging with futures, keeping abreast of how people are interacting with futures products will be to your advantage
- Communication with clients is key
- People talk about peer-2-peer trading, but with futures this is already possible by posting interest in the orderbook

Key Question: How would a "Translation Service" work in practice and what would be the benefits?

The main function of an exchange is a central marketplace where buyers and sellers can meet and transact. The exchange provides the infrastructure and the clearing house helps with financing. Mostly an exchange matches buyers and sellers of the same product with certain specifications. But there are sometimes variations possible; for example by having a range of delivery conditions, or by trading "off-floor" through blocks or EFP's. For the clearing house, all sorts of products are taken into account for the margining of positions. Certain clearing houses even account for OTC positions versus futures positions. So flexibility from exchanges or clearing houses is already on the rise, with not just directional positions being squared off but also directional risk being squared off too.

One of the asset classes well suited for flexibility is FX. There already are trades where one leg is cleared and the other side is not cleared. A great next step would be to have one leg cleared as a future and the other not.

At the moment, trader A who wants to sell currency X as OTC and trader B who wants to buy currency X as a future aren't able to meet and therefore can't transact. Some middlemen do exist though to serve as a conduit for these traders. Many market makers quote on exchange screens basis the cash market and vice versa and match up their risk. An exchange should be also able to serve as this conduit, this translation service, just as well....if not better.

Key Question: How would a "Translation Service" work in practice and what would be the benefits?

How would the "translation service" between FX Futures and OTC liquidity work? A first step would be that the exchange matches the futures bid with the OTC forward offer. Dates already match, risk directions are exact opposites, and sizes would be matched as much as possible. A second step would be to match up the futures bid with an OTC spot offer and a swaps price in the market. This is a more complicated step but with the various platforms available to an exchange, it is not an insurmountable challenge.

The main benefits of the "translation service" to asset managers and to CTAs such as us is being assured that you are trading at the very best price available in the market; not just the best price available in your own niche. That is best execution.

At Transtrend I would hope we would use this as often as possible. But to be honest the biggest challenge would be at the exchange / clearing house. If it all works seamlessly, an end-user such as ourselves would notice nothing."

Marc Putter, Head of Trading, Transtrend