

# The FX Market – Central Clearing versus OTC Model

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Less than a year after first being announced, FXMarketSpace – a joint venture between Reuters and the CME – went live last week and has received a good amount of fanfare. Because FXMarketSpace is the first centrally-cleared OTC FX trading platform, the significance of this event should not be underestimated. While the CME has been offering currency futures for years, market participants will now be able to trade FX cash products with the backing of the CME. This allows participants to trade anonymously and reduces the amount of effort in establishing bilateral credit agreements.

The FX market has historically been an OTC market. This has given banks the flexibility to tailor highly specific products and services to their investors. While this flexibility has allowed for banks to offer highly customized products to investors with specific needs, the OTC model results in higher costs for executing and processing a transaction. The vast majority of activity in the FX market has been in fairly liquid instruments – primarily FX spot and short-dated swap transactions – and historically the costs associated with processing these instruments has been relatively high.

To accommodate the increasing demand in these various liquid instruments, a number of different trade execution venues were created over the past five to ten years. This includes single-bank and multi-bank portals, and ECNs.

Additionally, many banks now offer trade administration services, such as prime brokerage, in addition to CLS netting services. This has made it easier for buy-side firms to enter the FX market as well as reduce settlement risk. Nevertheless, FXMarketSpace provides the first venue where the actual counterparty on the trade is the exchange. In this case it's the CME providing trade clearance and taking on the credit risk of the trade.

Will it be successful? There definitely has been a healthy debate surrounding this topic since FXMarketSpace was announced last May. While it's unclear if this particular venture will stick, there are clearly a number of advantages to an exchange model, including:

- **Liquidity.** The advantage to an exchange model is that liquidity can be pooled and accessed in a single location. Currently, there are too many places where FX can be conducted. This becomes particularly complicated to manage for the market-making trader, and it requires him/her to monitor pricing on a variety of venues.
- **Reduced Spreads.** Due to a larger, more liquid supply of currency, it would be expected that spreads would be narrower in a single, liquid marketplace.
- **Better, more transparent pricing for the investor.** In a regulated exchange, it is clear that the best price will be executed, thereby providing more fair, accurate pricing for the buy-side customer.

- **Common, consistent control mechanisms.** Consolidated trade execution across an exchange results in consistent controls.
- **Technology efficiencies.** A significant amount of time, effort and expense is required for all players to access multiple venues. In many instances the technology is different from one venue to the next, thereby increasing the amount of technology cost and support.
- **Credit risk.** An exchange model that allows for trading and settlement via a single clearing agency eliminates the requirement for establishing and maintaining bilateral credit agreements, further reducing the expense for trading FX.
- **Anonymous trade execution.** The exchange model eliminates the need to know the counterparty on the other side of the trade, thereby creating a fairer, more transparent marketplace.

However, there are some disadvantages to the exchange model that will prevent some from embracing this model or participating in the market at all. These include:

- **Competitive pricing advantages for certain institutions.** The most successful FX houses have been able to take advantage of technology, market, and price latency issues to generate significant revenues. These dealers will certainly be hesitant to disrupt the current model.
- **Reduced flexibility in providing specifically tailored products.** A central clearing model works for liquid products, but some of the specific FX instruments that have evolved are heavily customized and only make sense when offered and agreed directly between two parties. In addition, odd lots and trades settling on specific dates are much easier to offer in an OTC environment. This is particularly important for buy-side customers that are using the markets to hedge their market risk in a very specific manner.
- **Potential loss of direct, personal relationship with the investor.** The personal contact that a bank has with its customers is critical in its ability to attract and retain its customers and grow its business.

Some of the key issues that an exchange would handle have been effectively dealt with via prime brokerage and CLS. Credit and settlement risk have been reduced significantly to a point where many would argue that an exchange model is not necessary. There will always be pressure from the sell-side players, particularly the successful ones, to keep the existing model in play. They have likely been able to execute most effectively in the current environment and view this as a competitive advantage.

Nevertheless, there are many firms who will embrace the exchange model for FX cash products. This fact alone should bring business to FXMarketSpace, at least initially, and allow it an opportunity to be successful. The exchange model will be attractive to many and is likely to bring in a new type of investor that uses this model when trading in other asset classes such as equities. The key to FXMarketSpace's survival will be for enough trading to ramp up so that it provides for quick trade execution at fair market prices.

Interestingly, this is yet another example of how the entry barriers into the FX market are continually being reduced. The market continues to evolve as more firms are attracted to it. Ultimately, this will result in continued volume increases, and a side effect of this will be an increased demand for trade processing power. Firms that are most successful will be able to adapt to both the exchange and OTC models and will also be able to quickly and efficiently process a very high volume of transactions in a timely manner.

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