

FX Markets

Dealers advancing electronic FX swaps trading on CME

Deutsche Bank is among a handful of dealers using CME's FX Link platform to help automate market-making.

By Joe Parsons

They're swaps, but not as we know them. Dealers such as Deutsche Bank are signing up to CME's FX Link platform to trade replicas of over-the-counter (OTC) foreign exchange derivatives. The German bank says it is using the service to help automate more of its FX swap pricing and, eventually, develop new execution algorithms.

FX Link was launched in 2018 as a way of connecting the OTC spot market with exchange-traded FX futures. The platform allows users to trade the spread between spot and futures via a central limit order book (Clob). Early backers included the likes of XTX Markets and Citi's FX prime brokerage business.

CME also touts the service's ability to mimic traditional FX swaps – bilaterally traded instruments with a spot leg and a forward leg – bringing potential capital and counterparty credit risk benefits through central clearing.

Now, dealers are looking to use the platform to further electrify their market-making capabilities in FX swaps, and the next step will be to develop algos that can plug into these electronic platforms, including FX Link.

"We are now targeting to launch client orders and algos in the FX swap space. So, FX Link could be one of the venues outside of Deutsche Bank's firm liquidity that we can offer to clients for them to access. It's a good addition to our existing electronic FX trading suite," says Shuo Wu, global head of electronic forwards trading at Deutsche Bank.

In effect, a trade on FX Link is a simultaneous spot and futures transaction. A hedge fund or asset manager can buy or sell, for example, a EUR/USD spot contract and

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concurrently a cleared FX future on an international money market (IMM) date for the far leg of the trade.

The spot rate is derived from the futures price minus the traded FX Link spread. The spot trade is sent to an FX prime broker for execution, while the futures trade is cleared and margined at CME via a futures commission merchant.

FX Link currently supports eight currency pairs, which combined account for 69% of the FX swaps market according to the latest Bank for International Settlements data.

Deutsche Bank joined as an active market-maker on FX Link in March. Since then, Wu notes that the bank has seen bid/offer spreads becoming tighter on the platform and liquidity getting deeper as a result of increased activity from market-makers, including Deutsche Bank.

Wu says the platform also provides the bank with a cost-efficient way to hedge swap risk by removing the need to manually hedge the spot component of the transaction. In a traditional FX swap, the dealer would expect to hedge the spot and the forward exposure with separate trades. With FX Link, banks need only hedge the spread risk.

Recently adopted global rules known as the standardised approach to counterparty credit risk, or SA-CCR, have also jacked up the capital cost of FX forwards.¹ Increased costs are passed on to clients in the form of wider spreads. Centrally cleared futures allow users to face the clearing house, which can help reduce counterparty credit risk. Lower risk-weighted assets mean the dealer can hold less capital against the trades.

While the futures market is typically done on exchange and is therefore anonymous, the venue allows disclosed block-size trading and exchange-for-related-physical (EFRP) trading. This enables market-makers to accept trades in a similar way to OTC but executed on exchange. Currently, 20 firms accept either block or EFRP trades, with three accepting both: proprietary trading firms Eagle Seven and Geneva Trading, and Societe Generale.

Most FX forwards are closed out with off-setting contracts that remain on the balance sheet, which can be an operational irritant for financial firms. FX swaps remain off the balance sheet. Wu notes that block trading and EFRP on FX Link could be used as a cost-efficient way for both clients and banks to trade FX swaps off-balance sheet.

Furthermore, trading on FX Link has also enabled Deutsche Bank to improve its electronic pricing of FX swaps in the bilateral market.

"Since going live on FX Link, we have been trading consistently throughout London and New York hours, and recently during Asia hours as well. This continuous trading enables us to gather information that we can use to sharpen our own OTC pricing," says Wu.

"I think from the bank's perspective, we're able to demonstrate that there's a path going forward for electrification of FX swaps."



Suits some, but not all

In June, CME reported several new records for FX Link, including a 200% increase in orderbook depth for EUR/USD and 59% rise in number of trades. On June 16, the platform also reached a new single-day record of 82,900 contracts traded, representing over \$7.2 billion in notional value, surpassing the previous FX Link daily volume record of 77,146 contracts set on March 10, 2020.

FX Link average daily volume also climbed to over 43,000 contracts traded per day in June, up from nearly 15,000 contracts per day during June 2021.

However, this still represents just a fraction of the overall FX swaps market. With futures limited to standardised monthly or quarterly IMM dates, CME can only provide pricing on a handful of points along the swap curve for firms to hedge their risk.

As a result, buy-side firms and banks continue to trade bilaterally to manage their day-to-day funding needs or to roll their posi-

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tions, largely because of the bespoke structures that swaps allow for. Tenors can be standard and non-standard – also known as broken dates – and in some instances, both legs can be traded as forwards.

Paul Houston, global head of FX at CME Group, says FX Link’s standardised IMM dates would align with the hedging

schedules of index fund managers that tend to roll their passive hedges and trade less frequently, as well as for hedge funds that trade to IMM in the interest rate and FX space.

“We built the marketplace around our liquid futures points, and we’ve added the swap component as a tradable basis. That’s very much about setting the foundations up for an automated electronic trading marketplace,” says Houston.

Furthermore, Deutsche Bank’s Wu says there is an existing client base that need to trade standardised instruments like IMM futures or that have dual exposures on both the OTC and listed side. **FX**

This is the first of a two-part series looking at the progress of electronic in the foreign exchange swap market. Part two looks at the development of execution algos

¹ J Parsons (April 2022), SA-CCR hits Citi’s FX forwards pricing, www.fx-markets.com/7946271