FOREIGN EXCHANGE

Transitioning & Optimising FX Trading

Executive Summary

- Uncleared margin rules (UMR), together with pressures on dealer balance sheets and a continued focus on best execution, are driving a material revisit of the FX marketplace.
- Legacy market structure resulted in many hedge funds and proprietary trading firms intermediating their trades against an FX Prime Broker (FXPB), whilst asset managers often remained on a purely bilateral basis against each of their liquidity providers. The direct and indirect impact of regulation such as UMR means that all of these client types may need to transition and optimize at least a portion of their FX trading behaviour in order to mitigate or avoid increased costs on their businesses.
- This summary document outlines the main factors driving clients to consider transitioning their FX trading, along with some of the potential alternatives available in the FX market. We encourage clients to engage with us further to analyze and understand specific solutions for their businesses.

Key Features

Liquidity & Best Execution

- OTC clearing and futures enables access to more liquidity providers.
- Trading on a regulated CLOB helps demonstrate price discovery and best execution.

Ease of Allocations and Operational Consistency

- Use of OTC clearing and futures can enable clients to more easily trade one block and allocate across all of their funds.
- Use of futures also enables clients to utilize average pricing functionality.
- All 26 CME CSFs ('G10 NDFs') use the WMR 4pm London rate for the fixing. This centralizes and standardizes the fixing process.
- Cleared FXO auto-exercise against the 10am NY WMR rate helping to remove manual processing and PIN risk.

Initial Margin

- OTC cleared and exchange traded derivatives are not included within the average aggregate notional amount (AANA) calculation when ascertaining the direct impact of UMR. Migrating to OTC clearing or futures may remove clients from the direct impact of UMR.
- Using cleared products also enables potential IM efficiencies to be achieved. For example:
  - FX options are included in the bilateral Initial Margin calculation, but typical delta hedge instruments (physically settled FX FWDs) are not. This can, therefore, generate bilateral IM requirements. Clearing FXO can optimize the IM via both netting and model benefits, and the delta hedge can be cleared alongside the FXO within CME in order to further optimize the IM requirement.
  - FX Link enables customers to consolidate their spot and FX Futures positions in order to optimize their IM requirements.

Constraints on Trading

- Using OTC clearing and futures can help clients manage limits on deliverable FX, mitigate counterparty risk and free up bilateral credit lines.
- OTC cleared cash-settled forwards and cash-settled options can provide unique solutions to obtain FX exposures without needing to pay or prepare for physical settlement at expiry.

Optimization of FXPB

- Use of OTC clearing and futures can be more capital efficient for dealers than bilateral trades while also delivering similar netting and access to liquidity benefits for clients.
- Centralizing trades versus a CCP helps optimize dealer capital and allows the use of CME compression tools such as blending.

What are the Challenges and Considerations for Different Styles of FX Trading?

Current Trading Approach	Challenges & Considerations
G10 FX FWDs / Swaps	Deliverable FWDs are currently included in the AANA calculation to determine impact of UMR Some entities have limits / constraints on amount of deliverable FX exposure they can hold Broken dates are hard to compress so remain open until expiry / being rolled, which consumes dealer balance sheet
Non-Deliverable Forwards (NDFs)	NDFs are included in the AANA calculation to determine impact of UMR, and are also included in the IM calculation under ISDA SIMM Broken dates are hard to compress so remain open until expiry / being rolled, which consumes dealer balance sheet
Bilateral G10 NDFs	Fixing risk against each dealer counterpart
FX Options	FX options are included in the AANA calculation to determine the impact of UMR. They are also included in the ISDA SIMM IM calculation Have to manually manage expiries by calling dealers PIN risk / uncertainty around strikes close to ATM The typical delta hedge is a deliverable FX FWD which isnt included in the ISDA SIMM calcution, and as such the ISDA IM for FXO can be very large
FX Futures and Bilateral FX Spot	Bifurcated positions mean IM posted to CME for the futures and IM posted to a Prime Broker for the spot activity

CME Group Tools

The transition of existing trades in to either OTC clearing (backload) or to futures (EFRP) can remove the gross notional of those trades from the AANA calculation

The compression of legacy (existing) trades can reduce the gross notional included in the AANA calculation

Using OTC cleared trades or futures for new risk can remove the gross notional of those trades from the AANA calculation

Included*
in the AANA Calculation

- FX Options
- Swaptions
- Hedging Trades
- NDFs
- FX FWDs

Not Included
in the AANA Calculation

- Centrally Cleared OTC Swaps
- Exchange Traded Derivatives (Listed Futures & Options)

* List is not exclusive

Average Aggregate Notional Amount (AANA) Calculation in the US

AANA is calculated by summing up the notional amount of all in-scope OTC derivatives on the last business day of each month in the observation period

Phase	Observation Period	AANA Threshold	IM Compliance Date
4	March, April & May 2019	>USD 750bn	Sept 1, 2019
5	June, July & August 2019	>USD 8bn	Sept 1, 2020

FX Trading & Clearing at CME Group

Broadest Product Offering

Trading: 100 FX futures & options contracts

Clearing: 11 NDF pairs, 26 cash-settled forwards (CSFs), and 7 pairs of cash-settled FX options

Portfolio Margining Opportunities

CME has regulatory approval to support the portfolio margining of FX futures versus OTC cleared FX. Potential savings of up to 85% for NDF futures vs. NDFs

Growing Volumes

Trading: $100bn average daily volume

Clearing: Over $22.6 billion notional and 2,500 trades cleared across 23 currency pairs since September 2018

Connectivity

CME is connected to leading affirmation platforms including MarkitWire, Traiana, and Bloomberg VCON, along with optimization providers triBalance and Quantile

Dealer Support

Trading: 6 liquidity providers have traded CME cleared OTC FX trades

Clearing: 3 FCMs are actively clearing OTC FX trades for their clients and 4 more FCMs are onboarding for readiness in 2019

Clearing Fees

OTC FX is free for all clients for whole of 2019 to encourage early adoption

Portfolio Margining analysis conducted in Q1 2018. All other figures accurate as of 1 May 2019.

To discuss FX solutions for your business, please contact a member of our team:

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