Electronic Currency Derivatives: prospects for the future

Frances Maguire asks if the FX industry will ever successfully trade FX options electronically or if the hybrid model is here to stay.

Francis Maguire

The hotly contested debate over whether electronic options can ever truly be traded electronically, without the need for any telephone negotiation, is continuing as some in the industry are just getting on with moving first generation and the more vanilla options on to the screen and letting time, and fast-moving technological developments, take their course in enabling more complex products to slowly move away from the hybrid model.

Last year GFI Group took the decision to open up its interbank options hybrid trading system, ForexMatch, to selected hedge funds, bringing to the FX market the closest it has to an ECN. Evgeni Mitkov, manager, electronic trading, at GFI Group says that technology gains in recent years have made it possible to trade options electronically, in real time. The key driver of growth in electronic trading is the demand for a liquid multi-contributor electronic FX derivatives market, similar to spot, from traders.

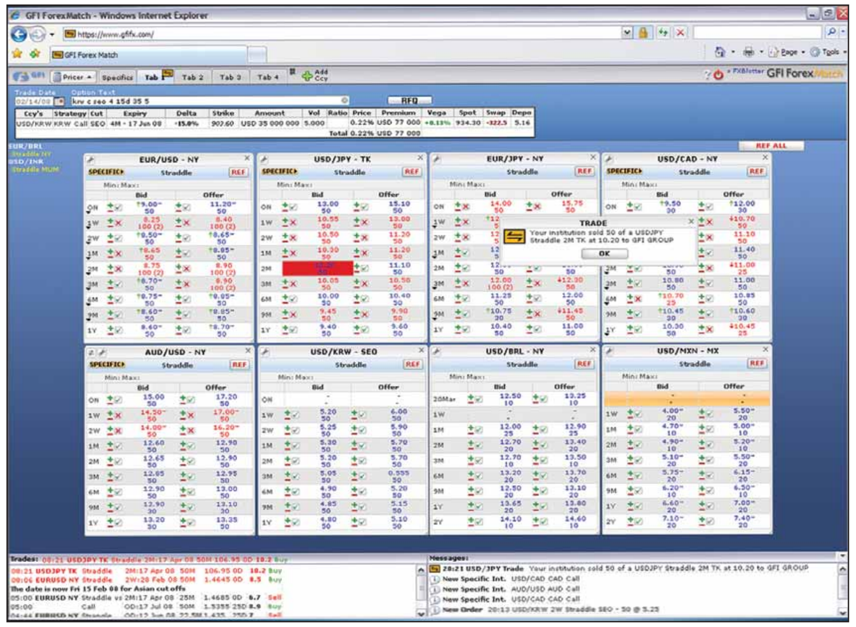
Mitkov says: "FX options growth has been restricted by the lack of transparency and phone execution. There have been swift increases in volumes and renewed interest from participants that have shunned or under-traded the market because it was not traded electronically. Naturally hedge funds and banks that are looking

Evgeni Mitkov

"FX options growth has been restricted by the lack of transparency and phone execution"

to grow their FX options business have been the major drivers behind the trend. As with FX spot, the early adopters are already reaping the benefits and are ahead of the curve."

He believes that most of FX derivatives have come of age now and are considered commoditised. For this reason GFI is putting specific FX options online, and



ForexMatch

Mitkov believes complexity is no longer the issue. "As soon as the interbank had electronic trading, hedge funds wanted to be in that market. With access to electronic trading in options, hedge funds and smaller banks can now play in a market that required significant headcount in the phone era. The established banks have also used this to leverage more their traders."

He says that first and foremost, the buy-side is looking for a multi-contributor transparent platform, where it can trade options just like FX spot or equity options – something that was not available to buy-side firms only 6 months ago. "FX option pricing is helpful on a platform and it eliminates double entry. Risk management has remained on the client side or prime broker side," he says.

Algorithmic trading

According to Mitkov, the same players using algorithms to trade equity options are already re-tooling their models for FX options. "Several banks have been working hard on their algo models to stay ahead of the pack and their efforts are starting to pay off. Capital requirements are intensive for long-dated options, so expect most of the action to be in the sub-three-month tenors. The popularity of FIX not only in spot but in equity options has made it very easy for new participants to enter the FX option market." Mitkow puts the success of the hybrid-trading model for FX options down to the volatility in market conditions where voice brokers excel at bringing market participants together. But, he says that voice brokers at GFI have actually been the driving force in pushing the electronic platform and helping traders migrate their trading electronically. "This way they can service the existing clients better, service a bigger client base, and trade more sophisticated products by voice."

Now that electronic trading of on-the-run options is picking up speed on ForexMatch, specific interest in vanillas is the next market that will go electronic within the next month. "The growth potential for vanilla FX options, forwards and cross currency basis swaps is the same as when spot went electronic. The really complex products are not going electronic anytime soon, because of the bilateral nature of trading"

GFI Group is also gearing up for the commercial launch of FENICS Enterprise later in 2008. It is already installed in a few banks to enable them to price and risk manage FX options and provide straight through processing for FX options. Richard Brunt, global head of sales for data and analytics at GFI Group says: "Banks already have elements of what will be known as FENICS Enterprise and the new elements are trading, client reporting and improved straight through processing, alongside FENICS' proven abilities in pricing and risk management, to help banks to streamline processing and lower the cost of trading through further automation."

Exotic FX options

Credit Suisse began offering the ability to trade structured exotic FX options on its new internet platform, Merlin, in Q3 last year, enabling banks to structure, price and execute complex, multi-legged exotic option transactions online, manufactured from vanilla options and a wide variety of first and second generation exotic options.

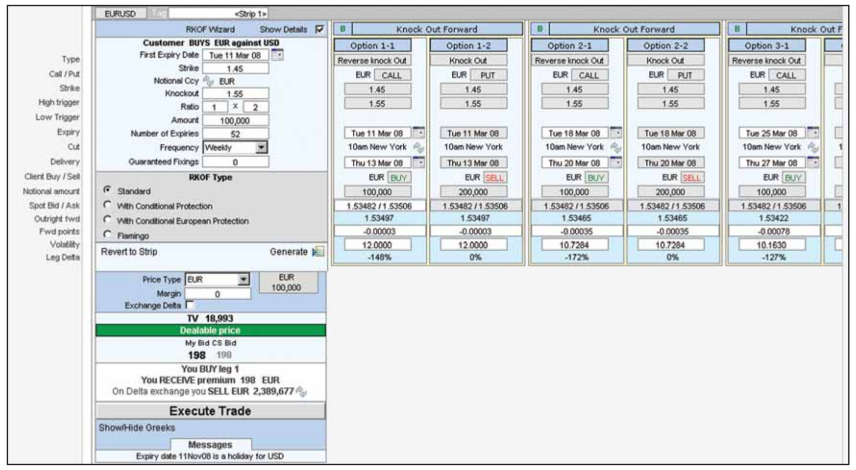
Richard Elliott, director, FX options e-commerce, at Credit

Suisse says: "There are certain parts of the market where electronic trading benefits both us and the client and in these areas we are increasingly looking to provide our clients with electronic access to our pricing and execution capabilities. There are clearly still some areas where this is difficult to do, where it is not appropriate and where there is no demand."

One of the key benefits of the Merlin platform is the ability to specify a complex trade once, and then it can be used by customer, sales person and trader without it being re-keyed, saving a great deal of time. Says Elliott: "We handle the full range of vanilla and first generation exotic options and our Merlin platform enables users to pick-and-mix these trades and put together an arbitrarily complex structure. Subject to a set of deal-ability checks, the platform will generate a deal-able price and allow execution the entire strip with a single click."

The platform generates a dealable price automatically before giving the client the ability to execute the trade online, providing more speed, transparency and direct control of the transaction for clients. The platform has already auto-executed structures of exotic options containing over 150 legs, and is being used by participants across the industry from wealth managers, to counterparty banks, to funds.

Elliott says: "The first stage is to be able to create the structure of the deal, easily and quickly, and then crucially to be able to get a deal-able price, without having to speak to a salesperson. Often



Merlin

when a user is putting these deals together they are trying out different features and repricing constantly. It is very inefficient if they have to get back to a sales person with each change, particularly when they want to experiment and see what these deals really look like when it comes to execution. Giving the option to execute on these dealable prices is the key cornerstone for Merlin's success." He adds that the hybrid model will continue to be used because it is not always possible to calculate a dealable price without some interaction from a trader. This is particularly true in the more exotic space where producing dealable prices can be complicated and where there are circumstances or transaction features that require a Credit Suisse trader or structurer to make the price.

"And clearly there are some products that are too complex to be able to generate a dealable price quickly and that are complicated to hedge when it comes to execution. But there are a lot of second generation products that can go electronic and the same benefits apply – such as the ability to look at basket options or accumulators and get a dealable price, experiment with the transaction features and ultimately execute," he says. Credit Suisse will be adding second-generation exotic options to the Merlin platform later this year.
He believes the platform is enabling Credit Suisse to service its clients better. The evidence is that clients are requesting more prices electronically than they ever did over the phone. Also, some of the first generation products are becoming more commoditised and so naturally should move to a more efficient platform, which is partly a function of the availability of electronic platforms.

David Perkins, managing director and head of Tullett Prebon's electronic broking division for EMEA, says that the broker has recently increased its focus on electronic broking. "The heightened interest in electronic broking is due to many factors which include; client demand, efficiency gains and greater scalabilty than a pure voice broking model. Additionally, in terms of regulation, trading electronically produces audit trails

Demand for other exotic option structures

and the use of STP not only supports this requirement but also improves our clients work flows".

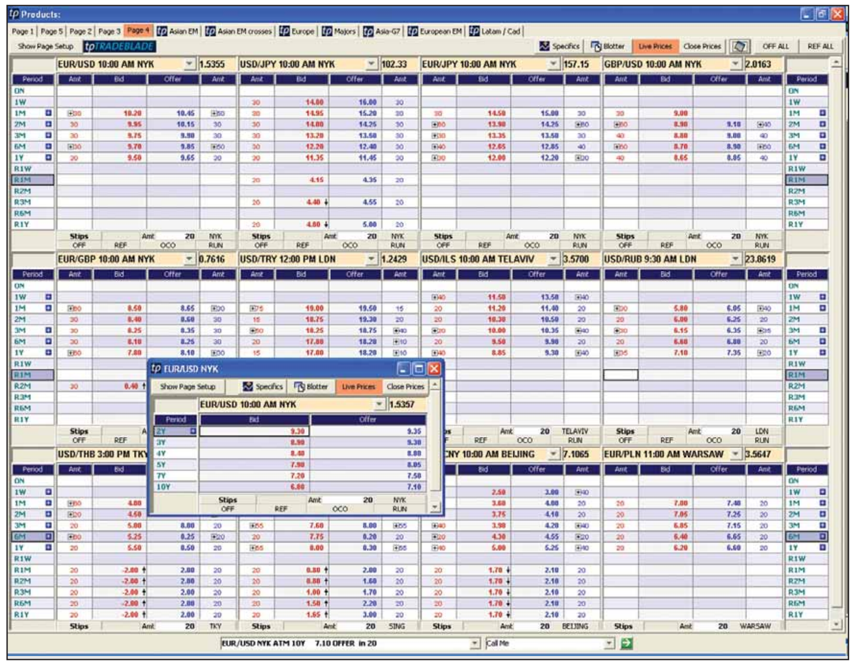
David Perkins
"electronic broking strategy is complementary to the voice business"

Tullett Prebon has built an electronic trading platform for FX options, which, since November, when Perkins joined with a team from ABN Amro, has seen a dramatic increase in screen liquidity and subsequent traded volumes. He says: "Tullett Prebon has such a strong franchise, we are the number one voice broker in many markets, that it is important that this market position is also reflected in our electronic business. Part of our strategy centres around a re-branding exercise, for all of our global electronic platforms, which are either live already or are in development."

A Live Hybrid model

The FX option platform in Europe, tpTRADEBLADE, is Tullett Prebon's first rebranded product. One of the main advantages Perkins believes Tullett Prebon has over its peers is that its electronic broking strategy is complementary to the voice business. "We see this as being very important. The electronic platform for FX options has been developed in conjunction with the voice brokers so that they can leverage the screen liquidity to improve their overall business. It is very much a live hybrid model, and this is why it is growing in popularity with our users," says Perkins.

"The whole tpTRADEBLADE model was designed in consultation with many of the key players," adds Marcus Bolton, managing director of the volatility division of Tullett Prebon. He believes that the demand for electronic trading in FX options is coming from the continuous steady increase in the number of currency pairs being traded in the broker market. "When you have this many currency pairs, from G-7 through to emerging markets and all the related crosses, there is simply too much information to broke successfully using voice



tpTRADEBLADE

alone. There needs to be a way of displaying electronically the vast range of currencies and tenors that can be traded today," he says.

Bolton adds: "Where there is a lot of interest and desire to close the price, the voice broker attracts the market's attention to that fact, but there also needs to be an element of passive broking where the information is generally broadcast, via pages of electronic prices. This leaves the voice broker free to address the exact points of active interest, where the probability of trading is very high."

Due to the diversity of products, the need for both active and passive information increases. Some users just want to know what is available so they can structure a product, while the flow desks are concentrating on the active deals that are going down on a minute-by-minute basis. "This is why the hybrid model is essential, because you can address both sides of the market simultaneously," says Bolton.

Marcus Bolton
"I cannot see any way in which voice broking could be completely replaced."

Multi-leg trade execution

Another important reason for the development of electronic trading is the growing demand from clients to be able to execute multi-leg trades at the click of a button. These trades are virtually impossible for the voice brokers to execute with the accuracy and speed of an electronic platform. With the inevitable information overload generated by these systems comes an understandable demand for aggregators, but, according to Perkins, it is too early for an aggregator, or an ECN, for FX options.

"If you look at one of the extreme poles of commoditisation, spot FX, the fact that voice brokers still exist indicates that there is some fundamental reason why pure electronic may dominate but will probably never be the only solution," says Bolton. Even in hitherto transparent and well-supported markets, when liquidity crunches occur customers do not wish to have their hand shown indiscriminately to the market. "Control of the market to ensure orderly execution of a trade at such times is very difficult on an electronic platform and in the short to medium term. I cannot see any way in which voice broking could be completely replaced. In addition there will always be illiquid parts of the market that cannot be executed wholly electronically, without voice."

Perkins adds that while the big broking houses embrace electronic platforms as a leveraging tool to complement voice in commoditised markets, it is very surprising how quickly other market possibilities develop. "Not too long ago you would not have expected such a breadth of product or functionality to be available on-line. The benefit of a good and relevant electronic trading platform is that it allows the brokers to concentrate on the more interesting and esoteric trades where they can add more value." He believes the majority of high flow, low margin products will be executed through the systems and subsequently free up the brokers' time to manage more bespoke solutions. "There is historical evidence of electronic trading improving the P&L of banks and bringing increased revenue growth to brokers by allowing them to do more specialised trades with their clients and letting the systems take the strain on the commoditised trades," he adds.

Graham Mansfield
"It would be very difficult to trade barriers and knock-outs etc electronically as there are often too many parameters to deal with"

Graham Mansfield, managing director of Kalahari, pricing systems provider, says that the hedge funds and the buy side are driving the growth of electronic trading in currency derivatives. "Hedge funds like electronic trading because they can see exactly where the market is, but electronic trading is suited to commoditised products, not FX options. Volbroker failed as a pure e-trading platform for this reason, however it is now widely used as a very successful high breed in that there is electronic ticketing and confirmations, along side voice execution," he says.

While electronic currency trading brings straight through processing, cuts costs and picks up errors quickly, Mansfield believes it can only really be used successfully for the more vanilla products. "It would be very difficult to trade barriers and knock-outs etc electronically as there are often too many parameters to deal with. Both parties would have to agree the spot price, the FX Forward price, barriers, knock-in dates, knock-out dates before a deal could be completed electronically. A lot of this is done by the broker, with a certain amount of negotiation, which cannot really be done easily on screen. More straight forward products like futures, spot FX and bonds are the instruments that have worked best electronically. As far as I am aware bonds options are still traded OTC."

Technology blurring lines

To a certain extent, Mansfield says that technology is blurring the lines between the buy and sell side as the hedge funds now use the names of their prime brokers to trade. In this way technology is breaking down barriers in providing anonymity, but the hedge funds will not go very far without funding from the banks, he adds. "There are less pure FX options funds, and hedge funds are very likely to want to take the credit risk on themselves."

He stresses that if past successes are anything to go on electronic trading has only really worked were there are only two numbers for a buyer and a seller to deal with, there is little or no credit risk, and there is a good underlying market. For this reason, he believes that one of the areas electronic trading might flourish is for options on exchange-traded FX futures contracts particularly now with the increased volumes in the underlying Spot FX Contracts

One of the main difficulties in FX Options going electronic is "Because they can be traded over any dates and not regular contract dates, whereas exchange traded contracts are standardised. As an example forward rate agreements (FRAs) remain over the counter and brokered by voice whereas the underlying futures are electronically traded. This is why the hybrid trading model will continue to flourish for FX options because this problem is not going to go away and while markets remain volatile it will be very difficult to support a new launch. I am sure that it will happen one day. It will most likely be a bank initiative, similar to Volbroker, which was perhaps before its time."

Alfred Schorno, managing director and head of sales, at 360 Treasury Systems, says that buy-side users that feel comfortable with using electronic platforms for FX and money market products have experienced stable workflows and good system performance but there is a natural barrier stopping them from trading complex options products wholly electronically.

The systems provider is seeing growing interest and trading volume in first generation OTC FX options from the buy-side. "Quoting and trading of live prices is still the most common trading mode for most of our customers, but we also record increasing interest to trade on volatility basis. Demand for higher transparency and requests for automated workflows and audit trails are the driving factor on the buy side," he says.

Alfred Schorno
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Schorno adds that the sell side is supportive of customer requests for OTC FX vanilla options, and after some time of manual quoting the growing volumes have led some banks to link in their automatic pricing engines for standard vanilla option products. He also adds that FX futures are easy adaptable to a technically flexible electronic trading platform, and that the electronic trading of currency derivatives has the potential to grow.

But while first generation options are traded on 360T's platform and the finishing touches are being made to introduce second generation options within the next few months, Schorno says there is little demand to bring third generation options on to the platform.

Buy-side perspectives

But talk to the buy-side and it seems the debate has moved on – it is not so much about the technological advances but the fundamental nature of the market they are looking at. Jenny Sullivan, a currency dealer at ABN Amro Asset Management, which currently does not trade FX options, says that the market continues to attract investors of different size, constraints and time horizon which is fragmenting liquidity and making it harder to access. However, while she has seen a recent shift in FX towards making an increasing capability and access to liquidity available to the buy side, she believes the goalposts have moved and that it is no longer deemed adequate for buy side traders to have access to a fast streaming price platform where they are essentially price takers.

Jenny Sullivan
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She adds that it is taken for granted today that all platforms will be fast and have sufficient access to a certain amount of liquidity. She says what the buy-side now want is ever deeper liquidity on platforms across all currency pairs in G10 and emerging market currencies, the ability to trade using algorithmic tools into dark pools, or directly into sell side price engines in the spot market, to be able to roll that spot trade to a few forward dates for hundreds of different allocations, fixed connectivity to order management systems, historical pricing data, dealer performance and best execution reports and data capture. "And, last but not least, we demand operational and downstream efficiency. As far as I am aware, this platform does not yet exist!"

According to Sullivan, buy side traders are not only increasingly demanding multi asset price aggregation across multiple venues, that has fixed connectivity to their order management systems, but now they also want the ability to interface with the market in the same way that sell side traders do, and in an anonymous fashion. "Whilst this may provide them with a wider range of 'tools' to access the market, this is not without risk and probably has implications for liquidity over the medium term - in very simplistic terms, the skill set required to be a 'price maker' is not necessarily the same as that of a 'price taker'," she says.

But, as always, any real moves are more likely to happen in the more commoditised markets than the options market. As Credit Suisse's Elliott points out when asked about the possibility of buy-side institutions entering the market as both price maker and price taker: "One of the features of offering liquidity in the options market is that the risk tends to hang around until expiry. So providers need to be committed to running an options book. This makes the blurring of the lines between buy-side and sell-side less likely than in the cash market."

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Tokyo +81 3 3552 5111

AUSTRALIA
Sydney +61 2 9240 5517

ASIA/PACIFIC
Singapore +65 6435 0442
Hong Kong +85 2 2537 8781

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