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FX·Invest

Deeper markets, broader opportunities

Is regulation spelling the end of foreign exchange as an asset class? Absolutely not. The whole 'will they, won't they' debate on whether regulators will exempt foreign exchange swaps and forwards does pose some interesting questions. But by no means is the ability to generate returns from the forex markets as it stands today – without crashing the global financial system – in doubt.

The US Treasury agrees. In April, it proposed to use its discretion to exclude FX swaps and forwards from mandatory clearing under the Dodd-Frank Act. To ensure unison, on July 5, the European Parliament recognised that the characteristics of the FX market call for an "appropriate regime that would rely notably on preliminary international convergence and mutual recognition of the relevant infrastructure".

There is a valid reason for their position – the predominant risk in FX is settlement risk, which has largely been dealt with through the extensive use of CLS Bank. In June, CLS settled on average $5.12 trillion a day, up 21% from $4.23 trillion in June last year.

Meanwhile, credit and liquidity risks are also effectively self-regulated through increased use of credit support annexes and credit valuation adjustments (CVA) across client segments. And four of the top FX prime brokers have teamed up with six of the most active trading platforms to introduce a kill switch, to cut off clients that exceed credit limits and pose systemic risks to the market.

What does all this mean for the FX investor? There are changes afoot. Forex options and non-deliverable forwards don't seem to have been given a reprieve from requirements to be traded on exchange-like venues and mandated central clearing. This has implications for the way collateral works (see 'All clear' and indeed how markets themselves can be accessed (see *Day of the aggregators*), in the new world.

Similarly, a growing number of products are emerging in the market to take advantage of the high levels of volatility and the seemingly endless supply of event risks (see 'Facing the Fear'). And then there are the emerging markets. Despite the liquidity trap that was the 2008 crisis, with $4 trillion traded a day in FX, it does represent the most liquid asset class giving opportunities to take advantage of any market conditions (see 'Emerging opportunities'). The platforms reflect this deep liquidity, with volumes traded on Icap's EBS platform up 17% to $174.1 billion in June.

So what are you waiting for?

Saima Farooqi, Editor

Forex veteran targets best execution with Ogg Trading

NEW YORK – Demand for best execution in foreign exchange is resulting in a proliferation of banks and vendors offering algorithmic execution services.

Technology vendor Ogg Trading in New York, headed by industry veteran David Ogg, aims to deliver its first tools to clients in the second half of 2011. It is partnering with New York-based Pragma Securities, which specialises in liquidity aggregation and algorithmic trading in the equity market, to roll out in foreign exchange.

David Ogg, founder of Ogg Trading

"Best execution is not a new concept, but our goal is to increase profitability by delivering an advanced methodology. There is a huge market for this product," says Ogg. "In partnership with Pragma Securities, we will develop individual algorithms that will give our clients a competitive edge."

Ogg will bring foreign exchange expertise to the table, having founded electronic FX platforms Hotspot FX and LavaFX, and managed FX trading rooms at Credit Suisse, HSBC, Lehman Brothers and Dresdner Kleinwort.

"Buy-side and sell-side firms are interested in gaining as much access to the market as possible, and seeing the tightest spreads across many currency pairs. Additionally, buy-side firms are concerned about protecting their identity," says Ogg.

Reflecting on his time at Hotspot, Ogg says the venture was successful because it answered a specific need of the buy side – something he hopes to achieve with Ogg Trading. "Prior to Hotspot, the buy side could only trade one-to-one with banks. Hotspot allowed them to have access to the broader market and to trade not just with banks, but also with other buy-side firms," he says.

On announcing its launch in May, Ogg Trading said Michael Kahn would be its chief operating officer and head of sales. Kahn joins from State Street Global Markets, where he managed the growth of the foreign exchange trading business in the US and Europe. He also has experience at Lehman Brothers and Credit Suisse, where he worked alongside Ogg.

Further partnerships and appointments will be announced in the coming months as the firm continues its launch, Ogg says.

EIB signs Citi for collateral management

LUXEMBOURG – The European Investment Bank (EIB) has signed Citi as its collateral management and collateral custody agent responsible for the EIB's derivatives operations.

Citi is using its OpenCollateral software to mark derivatives collateral to market, carrying out margin calls and settlement responsibilities on behalf of the EIB. The EIB will continue to value its own derivatives transactions to preserve confidentiality with counterparties. Citi is also acting as global custodian for the securities collateral.

As part of a growing trend among dealers with custody arms, Citi is increasingly involved in supplying third-party services as an integrated component of its derivatives servicing capabilities. This enables buy-side players to delegate certain functions, generally back-office and derivatives clearing services, which improves customer efficiencies across a number of collateral management business areas.

BAML live as FX prime broker on FXall's Order Book

NEW YORK – Bank of America Merrill Lynch (BAML) has gone live as a foreign exchange prime broker (FXPB) on Order Book, an anonymous electronic communications network (ECN) developed by institutional FX trading platform vendor, FXall.

As of June, clients of the US bank can trade anonymously using its credit line while also gaining access to FXall's multi-dealer system.

According to Robert Gomprecht, in FXPB sales at BAML in New York, clients are increasingly looking for best execution and being a clearing broker on the Order Book ECN will help them achieve that.

"Upcoming regulatory change in the US is also driving interest. Companies trading FX are exploring new opportunities and options for best execution, and this relationship will allow us to expand our ability to service those clients," says Gomprecht.

He adds BAML has identified FXPB as an area for growth over the past year, and the partnership with FXall will create extra liquidity options and trade-processing efficiencies for clients. BAML already provides pricing to FXall's portfolio order management system, an automated system for managing spot FX, non-deliverable forwards, and metals for institutional and retail customer orders.

Jim Kwiatkowski, head of sales for the Americas and Asia at FXall in New York, adds asset managers are engaging in sophisticated trading strategies and require a variety of execution avenues. "They like to trade actively and via a choice of execution methods that best fits their trading objectives," he says.

Industry rallies to prevent forex flash crash

LONDON – Citi, Deutsche Bank, JP Morgan and Morgan Stanley have teamed up with six electronic foreign exchange trading platforms to establish a central credit monitoring system for high-frequency traders designed to prevent a flash crash in the FX markets.

The system, called CreditLink, connects FX prime brokers (FXPB) to Bloomberg Tradebook, Currenex, EBS, FXCM, Hotspot FX and Thomson Reuters in real time, enabling prime brokers to monitor their clients' credit risk across multiple electronic communications networks (ECN).

The vanilla nature of the market, combined with low barriers to entry through FXPBs and margin FX trading systems, has meant high-frequency traders have become an increasingly dominant force in the foreign exchange market. According to research from Boston-based consultancy Celent, high-frequency trading contributes 20–30% of FX spot volumes a day, equating to 8–12% of total FX volumes.

By providing centralised, automated and secure ECN limit management, credit risk for all counterparties will be greatly reduced, the companies said. CreditLink enables FXPBs to act on exceptions in a single integrated dashboard, and open, change or close credit lines to manage risk. With real-time integration to ECN credit and post-trade application programming interfaces, the system will notify the prime broker of limit breaches, enabling it to modify credit lines or terminate trading activity with an integrated 'kill-switch' capability.

"FX has a number of disparate liquidity pools, so to deal with that complexity we decided to put a central credit facility and kill switch in place. While there have been no issues in the FX market, we don't want to put anything to chance," says Andrew Coyne, head of FX Prime and G-10 electronic commerce at Citi in London. "We want to make sure we're able to limit any impact on the market."

The system is an enhanced version of the Harmony CreditLink technology developed by post-trade technology vendor Traiana. It includes processing capabilities and risk analytics across high-frequency and retail FX trading models and was first tested by Deutsche Bank in March this year.

"The FX industry is leading the way in terms of putting measures in place to significantly reduce risk throughout the post-trade process," says Jason Vitale, London-based global head of FX prime brokerage at Deutsche Bank. "Collectively, we have acted to put a solution in place that would provide the level of control and management we felt was necessary to reduce risk."

Buy-side cautions on collateral

TORONTO – More than half of buy-side traders would like to see eligible collateral extended to include equities, according to a survey produced jointly by technology vendor Algorthmics and consulting company Chromozome Consulting, in June.

The survey reveals that the buy-side would like to use the assets already in their portfolios as alternatives to eligible collateral asset types such as cash, government or corporate bonds. Of the respondents, 55% would like to use equities and 32% a share of funds. However, central clearing counterparties (CCP) are likely to require cash and high-quality bonds.

Asked how CCPs would affect bilateral collateral activity, 56% of respondents expect to need more collateral and 25% expect to see more counterparties collateralised.

A quarter of respondents are interested in optimising collateral. At a time when the costs of collateral funding could increase, this comes as no surprise: optimising collateral offers a way of minimising collateral cost through efficient reuse of collateral balances. For the same reasons, 22% cite measuring concentration limits on collateral positions as a priority.

Just over half of respondents (54%) say they make weekly rather than daily margin calls – despite 84% using vendor or outsourced collateral management systems. The vendor notes weekly margining will not meet the requirement for more frequent margining in central clearing.

The companies polled 80 buy-side institutions globally, including asset managers, hedge funds, pension funds and custodians.

Of them, 75% had between 100 and 500 CSA pairs, 75% had portfolios in excess of 500 live OTC positions and 72% use initial margin with 50% or more counterparties.

RBS research: volatility trading comes up trumps in June

LONDON – Currency managers going short volatility would have come out top in June, indicates research from the Royal Bank of Scotland (RBS).

The bank's naive simulations of currency strategies revealed the short-volatility strategy was the top performer in the month, generating returns of 3.4%. Short-volatility positions on the euro, Swiss franc, Swedish krona and Norwegian krone put on at the end of May all gained. However, there were no positions at the end of June as the implied volatilities of all currencies were below their one-year averages, the bank said.

The biggest loser was the trend strategy simulation, with –3.7% in losses from positions in the euro, sterling, Australian dollar and Norwegian krone suffering from whipsaw. The Norwegian krone was the biggest loser among them. Only the Swiss franc held on to a long position throughout the month and subsequently was the biggest gainer.

Newedge hires in prime brokerage

NEW YORK – Newedge, a multi-asset brokerage, has made a number of hires in its prime brokerage origination and structuring team.

Miriam Zaitoun is to become an associate director in New York, concentrating on multi-asset, multi-instrument prime brokerage mandates in North America. Zaitoun recently left Deutsche Bank, where she held a variety of roles and played a vital role in the expansion of the bank's synthetic prime-brokerage platform.

Jasper Chua will initially focus on developing the foreign exchange prime brokerage component in his role as an associate director in New York. Chua has spent the past six years serving in various roles at Bank of America Merrill Lynch, including most recently as vice-president and head of foreign exchange prime brokerage structuring and integrations.

Michael Dolan will be based in New York as head of EdgeConnect, focusing on building an independent research platform. In the past, Dolan has worked for a variety of companies, including Sanford Bernstein, Goldman Sachs, Bankers Trust and Neuberger Berman.

John Pitt will join the EdgeConnect team as head of commission management services in New York. Pitt comes from Instinet, where he was a managing director, research director and operations head for Instinet Access.

Banks gear up for mandatory clearing

NEW YORK – A growing number of dealers are restructuring OTC derivatives and listed clearing businesses as part of efforts to introduce greater efficiencies across compliance, credit and operations ahead of mandatory clearing.

In June, Deutsche Bank merged its over-the-counter and listed derivatives clearing businesses, under the markets clearing banner, to provide listed execution and prime clearing services. The bank said it was responding to demand for integrated OTC and listed clearing solutions across foreign exchange, interest rates, credit, commodities and equities to meet mandatory clearing requirements.

> **"Financing and platforms are going to have a strong horizontal focus, as we get this convergence into central clearing"**
> Jon Hitchon, Deutsche Bank

Jon Hitchon, formerly co-head of the global prime finance business, and head of markets clearing at Deutsche in New York, said platforms will become more cross-asset across the market as the regulations come into force and all asset classes have to meet new clearing requirements. "Our view is that financing and platforms are going to have a strong horizontal focus, as we get this huge convergence into central clearing, which will allow clients to benefit from cross-margining across asset classes, and the optimisation of collateral and funding. Institutional clients, in particular, want access to clearing services across multiple asset classes on one platform," he said.

Deutsche Bank's strategy reflects a similar initiative taken by Bank of America Merrill Lynch last September, which created a global futures and derivatives clearing services (GFDCS) group in anticipation of the substantial growth in OTC derivatives clearing. GFDCS builds off the bank's futures business to enable agent-clearing services for rates, currencies, credit, equities and commodities derivatives.

But not all are convinced by the structure. "There are a lot of assumptions being made about efficiencies and commonality of purpose in making those kinds of decisions," said a senior dealer. "I don't think we're persuaded yet that that is the optimal way to provide services to clients in the new market."

Meanwhile, JP Morgan has now moved Andres Choussy, formerly head of CDS clearing for North America, into a newly created role as global head of foreign exchange clearing in New York. Choussy took up the post in May and has been tasked with replicating the work achieved in CDS and interest rates derivatives clearing, in FX.

The bank was the first to clear a client index-linked CDS trade in December 14, 2009 on Ice, and has since also gained traction in the interest rates derivatives market.

He replaces former global head of FX prime brokerage, Peter Klein, in London who is taking an alternate role at the bank.

Nomura merges rates and FX

LONDON – Steve Ashley, global head of rates at Nomura, will relocate from Tokyo to London in August to head 'global macro products', a new business encompassing rates and FX. He will still report to Tarun Jotwani, head of global capital markets.

Ashley joined Nomura in May 2010 after leaving Royal Bank of Scotland, where he was head of rates trading. He was appointed by Nomura to consolidate its flow and rates products under global leadership.

RBS expands CVA quant team

LONDON – Royal Bank of Scotland is expanding its team of credit value adjustment (CVA) quantitative analysts, with a view to developing an institution-wide CVA infrastructure.

The bank has appointed Shahram Alavian as a director in the team in London, reporting to its head, former Goldman Sachs quantitative analyst Andrey Chirikhin, whose appointment in December initiated the expansion. Alavian will help design and oversee the construction of the firm's CVA infrastructure for internal risk management.

He joins from Barclays Capital, where he was most recently a counterparty risk specialist in the quantitative analytics team. Before joining Barclays Capital in 2009, he worked in the CVA quantitative team at Lehman Brothers, from 2004.

Deutsche Börse buys stake in platform vendor Digital Vega

■ **LONDON –** Deutsche Börse has bought a minority stake valued at below $10 million in multidealer FX options trading platform vendor Digital Vega, as its plans to position for mandated clearing of standardised derivatives contracts as part of G-20 commitments.

The acquisition marks a coup for the London-based vendor, which is rivaling efforts from GFI Fenics, SurfaceExchange, FXCM as well as single-dealer platforms considering aggregator models to capture electronic FX options business (*see 'Day of the aggregators' on page 15*).

Deutsche Börse has so far had limited activities in the FX markets. But the proposition has become more attractive as regulations in the US and Europe look set to require FX options to be traded on exchange-like venues, said Brendan Bradley, senior vice-president in business development at Deutsche Börse in London. The exchange said it could not only add value pre-trade and during the trade but also be deployed for post-trade processing.

Mark Sutter, chief executive at Digital Vega in London, said the investment enables the platform to grow faster. As it stands, the company has gone live with seven liquidity providing banks and Pareto Investment Management, owned by BNY Mellon Asset Management as a client.

"Deutsche Börse is an institution with huge global reach and this partnership gives Digital Vega the opportunity to really build our business quickly; it will allow us to deliver ever increasing functionality, as well as massively increase our global distribution capabilities" he said.

Deutsche Börse's new headquarters in Eschborn

Dubbed Medusa, the system enables RFQ trading in vanilla options including puts, calls and risk reversals across the major currency pairs, with plans to expand into calendar, vertical and butterfly spreads later this year. Emerging market currencies are also proving popular, with requests for the Mexican peso and Turkish lira against the dollar, said Sutter.

Meanwhile, Bank of America Merrill Lynch went live as a liquidity provider on GFI Fenic's options trading system Fenics Trader at the beginning of July. Banks that have gone live on the system since it was launched in February include BNP Paribas, Commonwealth Bank of Australia, Credit Suisse, UBS and Unicredit Bank.

SurfaceExchange and FXCM are both due to go live coming weeks, say sources close to the initiatives.

Deutsche launches two DXY ETNs

■ **NEW YORK –** Deutsche Bank has launched two exchange-traded notes (ETNs) linked to the US dollar index (DXY). In partnership with Invesco PowerShares Capital Management, the German bank is launching the new notes as a means of gaining triple-long and triple-short exposure to futures contracts on the DXY.

Deutsche already has two exchange-traded funds that track the performance of the US dollar. The first, UUP, has $1.2 billion of assets under management, and the second, UDN, has $150 million of assets under management.

"We have about $1.4 billion tracking this index in single unlevered funds. We wanted to provide investors a leveraged product with a little more volatility," says Martin Kremenstein, a director at Deutsche Bank in New York.

According to Kremenstein, the new ETNs will appeal to those clients already using UUP and UDN, as well as some retail investors. He expects them to be used as a hedge and for speculation. "The leverage implicit in them means they are useful as a hedging product within a portfolio," he says.

The DXY reflects the value of the US dollar compared with the world's six most traded currencies. The new ETNs are listed for trading on the New York Stock Exchange Arca under the symbols UUPT and UDNT.

New York's DTCC and Swift eye forex trade repository

■ **NEW YORK –** The chance the New York-based Depository Trust & Clearing Corporation (DTCC) will be selected to operate a foreign exchange trade repository rose in June after it emerged it would assume the responsibility for the commodity derivatives market.

DTCC's Deriv/Serv unit has operated the trade information warehouse to hold a central record of trades in the credit derivatives market since November 2006. In the wake of the financial crisis, legislators in Europe and the US have demanded that reporting to a trade repository be extended to all over-the-counter asset classes, including FX.

Through selection processes facilitated by the International Swaps and Derivatives Association in each asset class since the financial crisis, DTCC has been selected to operate, either by itself or in partnership with another entity, the trade repository for equity derivatives and interest rate derivatives. On June 14, Isda said DTCC Deriv/Serv had also been selected to develop the commodity derivatives repository, together with German energy trading software company EFETnet.

Forex is the last remaining asset class for which a trade repository has to be selected. The global FX division of the Association for Financial Markets in Europe (Afme) has been carrying out the selection process and ended a public request for proposal (RFP) on May 6. It is understood six entities have entered the RFP, and DTCC said it had submitted a proposal in partnership with Brussels-based networking specialist Swift.

Hong Kong fixing sets benchmark for CNH

Hong Kong interbank participants have created the first US dollar to offshore renminbi price fixing, giving the city first-mover advantage as an offshore centre for renminbi products, reports Georgina Lee

THE CREATION of a new offshore spot USD/CNY (HK) fixing in Hong Kong is expected to promote the development of offshore renminbi derivatives in the city. The development is likely to benefit FX options business as well as enable the trading of over-the-counter contracts with longer tenors, say bankers in Hong Kong involved with the offshore renminbi business.

Lawrence Lam, chair of the Treasury Markets Association (TMA) market practices committee and chair of RBS greater China, based in Hong Kong, says while the new USD/CNY (HK) fixing is unlikely to spur a sudden, explosive growth of offshore renminbi-denominated derivatives, it represents a highly recognised and credible benchmark for trading offshore renminbi spot, on which long-term derivatives contracts can be referenced.

There is nothing to stop interbank participants in other financial centres vying to become offshore renminbi hubs, such as Singapore and London, developing their own offshore renminbi fixings. But Lam says once an investor starts to open derivatives positions using the Hong Kong fixing, it will become almost necessary for the investor to square off and close out the long position with the same spot USD/CNY (HK) fixing to avoid basis risk. This means Hong Kong could gain a first-mover advantage.

The latest spot USD/CNY (HK) fixing is not its first offshore benchmark for the exchange-controlled currency. In December 2006, the TMA also introduced the renminbi swap offer rate, which traders say represents the price difference between the renminbi non-deliverable forwards and the onshore renminbi fixing.

A dealer notes that the fixing does not use the CNH symbol often used to reference offshore renminbi, to appease Chinese authorities. The source says that Chinese government officials and banking industry participants argue there could only be one form of renminbi – CNY – regardless of the degree to which the currency is allowed to be traded, converted, delivered or settled outside China.

> **"We are seeing continued growth in liquidity for CNH on Thomson Reuters Matching, not just out of Hong Kong, but also regionally in Singapore and internationally out of London and New York"**
> Michael Tsang, Thomson Reuters

On June 30, the new spot USD/CNY (HK) fixing, which was set at 11.00 am Hong Kong time, was at 6.4661; in China, the onshore daily mid-point fixing announced at 9.15 am by the People's Bank of China was at 6.4716.

A total of 15 banks are contributors for the calculation for the new offshore spot fixing, which is done by Thomson Reuters. Michael Tsang, managing director of treasury for Asia, at Thomson Reuters, says CNH spot-trading volumes on its electronic trading platform saw a general pick-up in and outside Asia since the new fixing was launched on June 27.

"We are seeing continued growth in liquidity for CNH on Thomson Reuters Matching, not just out of Hong Kong, but also regionally in Singapore and internationally out of London and New York," says Tsang, who did not comment on its volume figure. Apart from Thomson Reuters, interdealer broker Icap also trades spot CNH on its EBS electronic platform.

Justin Chan, deputy head of global markets for Asia-Pacific and head of Hong Kong trading at HSBC, says the new spot fixing has made it possible for investors in CNH deliverable options to take cash settlement, instead of just physical settlement, whereby the writer or the buyer must receive the entire amount of the renminbi upon exercise.

"Once we have fixing in place, the two parties can set the exercise price with a view to cash-settle the contract," says Chan. "So upon exercise, the settlement could be done by working out the difference between the contract rate and the fixing, and settle payment on that difference; rather than deliver the whole amount of renminbi as determined when an order is placed." FXInvest

No margin for error

Saima Farooqi looks at the wave of upcoming regulations relating to central counterparty clearing, and what it means for collateral management

The foreign exchange industry is about to be hit by the biggest set of regulations ever to be written. It's still not clear whether FX swaps and forwards will get their much-desired exemption from mandated clearing under the US Dodd-Frank Act and, potentially, the European Market Infrastructure Regulation (Emir). But with FX options and non-deliverable forwards seemingly swept into the broader US OTC derivatives rules ratified last July, clients of FX are sounding alarms.

Concerns become even more pronounced when discussions move onto proposals for collateralisation under the new central counterparty clearing (CCP) model, rather than the incumbent credit support annexes (CSA). Chief among the changes is the introduction of initial margin, which would not only have to be posted on a dollar-for-dollar basis with the CCP through a clearing member-owned futures commission merchant (FCM), but would also have to be marked to market daily.

And to protect such collateral from possible misuse, the Commodity and Futures Trading Commission (CFTC) proposes it be placed in a segregated account at the FCM, which acts as the guarantor to the CCP. The only credit risk the client assumes is that of the CCP.

"The FCM guarantees the client obligation to the CCP, so it says to the CCP: 'I'll make you whole if the client goes bad,' and then there's a series of exceptional procedures that occur in the event something goes wrong," says Joseph Buthorn, global head of foreign exchange prime brokerage at BNP Paribas in New York. "That's different to what happens today, where the client and the bank have each other's bilateral credit. It's a fundamental difference that has implications for how things are collateralised; it has significant

> **"Large numbers of clients who today don't post collateral in the new world will have to find places to get eligible collateral – and it's not clear yet exactly how that's going to happen"**
> Joseph Buthorn, BNP Paribas

differences in what happens in the event of a default by one of the three parties."

Specifically, Buthorn cites the proposal that client collateral posted with the CCP via the FCM be on a gross basis, with no netting taking place at the FCM. This differs from the current futures model, where client assets sit in a common account at the FCM, which satisfies obligations of all clients, while a separate FCM account exists for proprietary house business. What is then posted to the CCP is the net of all obligations.

"[Under the CFTC proposal for collateralisation of swaps] every dollar of required margin we receive from clients at the FCM we will forward straight to the CCP. That's fundamentally a different collateralisation structure, which has implications for funding and for credit risk management," says Buthorn.

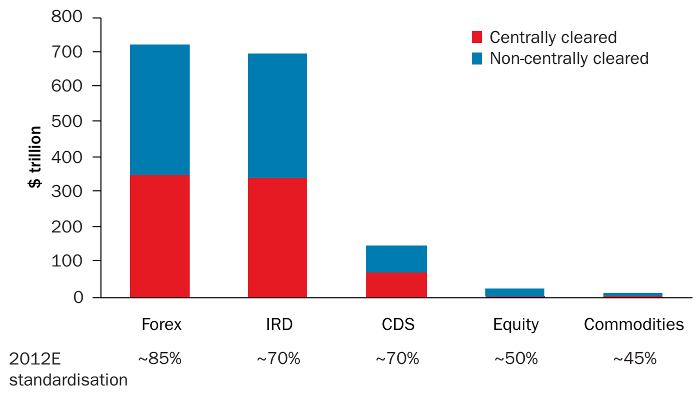
A further point is that most CCPs will require variation margin be posted in the underlying currency of the contract. This differs from the existing requirements under CSAs, which accept collateral in currencies such as the US dollar or euro. Andres Choussy, global head of FX clearing at JP Morgan in New York, says that, although under the new construct a client could continue to post collateral in major currencies, they will incur a funding charge by the clearing member, who will then have to transform that currency and fund the underlying currencies out into the clearing houses.

"Some firms might elect to post the underlying currencies directly themselves," says Choussy. "In which case, instead of getting a single currency collateral call, you might end up having multiple currency calls, which you will need to meet through different instructions."

The ability to transform or upgrade collateral becomes much more pertinent when looking at the numbers. According to research published by Morgan Stanley and Oliver Wyman on February 16, as much as 40–50% of the total annual traded volume of over-the-counter contracts could be cleared by 2012/13, creating an additional collateral requirement of between $2 trillion and $2.5 trillion.

Adding to this, the proposed ban on rehypothecation of initial margin will, dealers say, lead to short-term funding risks. "Large numbers of clients who today don't post collateral in the new world will have to find places to get eligible collateral – and it's not clear yet exactly how that's going to happen," says Buthorn. "They're reaching out to their banks and their custodial banks to potentially provide collateral transformation, but of course those banks have to

Figure 1: Forecast of centrally versus non-centrally cleared global value traded in OTC derivatives (2012/13,US$trn)



Graphs source: Oliver Wyman, Morgan Stanley

get it from somewhere too."

Perceiving a significant burden of obligations, JP Morgan supported letters by FIA and Isda to regulators for an expansion of the defined eligible collateral (see page 14). "This is in line with the commentary and feedback provided to regulators as part of the ANPR [advance notice of proposed rulemaking] process," says Choussy. "Particularly for asset managers, insurance companies or any entity that generally holds very little cash and sits on securities – unless the proposed rules are changed, clients will need to transform those assets into clearing-eligible collateral to be posted to their clearing member."

But valuing that call, or indeed closing books at month-end, comes with its own set of headaches, particularly as it pertains to cross-border foreign exchange trades. Under the proposals, valuation agents will be the clearing houses, which will mean there is no room to dispute margin calls and also introduces complexity in that each clearing house will have its own end-of-day price.

"So you might have particular contracts cleared through multiple clearing houses that could potentially have different prices, and will end up requiring a different amount of variation margin for the same client," says JP Morgan's Choussy.

JP Morgan began supporting the transition to the central clearing model from a legal and operational standpoint in 2010, when it started documenting clients for credit and rates using the OTC addendum format. "In North America, the current model relies on an Isda and CSA but, under the new FCM clearing model, documentation will rely on a futures agreement with an OTC addendum. The OTC addendum will be a different document but, where possible, will mirror most of the terms existing in the Isda and CSA," says Choussy. "Some new terms will be introduced, such as zero threshold value, and clients will need to adjust to that."

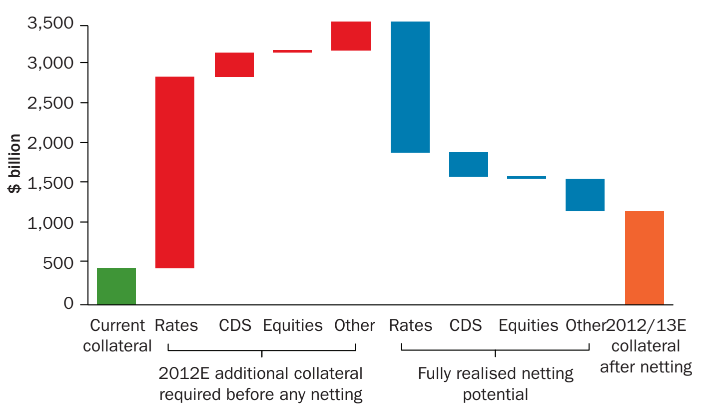
So far, CME, Ice, LCH.Clearnet and SGX are known to be looking to launch FX clearing businesses. The CME said in May it is ready to clear the Chilean peso, though no trades have been done. SGX is due to go live with Asian forwards in September, while LCH.Clearnet is eying a year-end launch for its FX options clearing product, ForexClear. Australia, Hong Kong, Japan and South Korea are also looking to establish OTC derivatives clearing houses.

Choussy highlights Asia as a region aggressively trying to meet a G-20 set of commitments and a 2012 timeline to introduce clearing for standard OTC derivatives. "The region is moving ahead and actively trying to meet those time-frames," says Choussy. "Local requirements, such as to clear through a local clearing house, pose additional sets of issues. However, we have been working with local regulators, clearing houses and other market participants to ensure the clearing model operates under a robust risk management framework and that we are ready to service our clients."

He continues: "When clearing houses were set up for credit and rates, we spent a lot of time ensuring that the risk management, the infrastructure and the overall risk that the clearing members were exposed to was appropriate. Back then, clearing houses were set up a lot faster, but this time there is still work to do before we can fully understand the risks involved to both banks and their clients.

"One of the biggest lessons we've learnt from the credit and rates clearing experience over the past two years, is the actual time it takes to design an efficient and comprehensive risk management framework. The chosen structure needs to take into account all the different risks introduced into the systems, ensuring the risks and rewards are properly allocated to the clearing members. We are in a better position now because we have a better understanding and knowledge of the risks we're exposed to." FXInvest

Figure 2: Estimated margin requirements for centrally cleared OTC derivatives, 2012/13E in US$bn



Graphs source: Oliver Wyman, Morgan Stanley

US rules could lock down $6 trillion in assets

Requirement for banks to post initial margin when trading with each other will result in huge amounts of liquid assets being locked down, according to analysis by one US prudential regulator. By Matt Cameron

An estimated $2 trillion worth of liquid assets will have to be segregated in third-party custodial accounts under US proposals on margining for uncleared over-the-counter derivatives trades, according to one US prudential regulator. The proposals would compound the impact of other rules – on bank liquidity buffers and central clearing – which also require liquid assets to be locked away. In concert, the rules could generate a requirement for $6 trillion or more of similar assets.

The proposals for margining of uncleared derivatives lay out prescriptive requirements for the calculation, posting, collection and segregation of margin. Today, market participants have considerable freedom to negotiate their own margin agreements, and the posting of initial margin between banks is almost unheard of. Compelling the industry to start doing so, while also preventing rehypothecation, would have a huge impact, according to an impact analysis conducted by the Office of the Comptroller of the Currency (OCC), one of five prudential regulators responsible for the margin proposals.

Based on an annual average growth in notional swap amounts of $15 trillion, in addition to an unspecified proportion of renewal and replacement trades, the OCC estimates that initial margin in one year could total $2.56 trillion. However, assuming that 20% of trades are centrally cleared, the initial margin estimate would be $2.05 trillion – an impact the OCC claims would likely be reduced if dealers use internal margin models, which allow netting and hedging benefits within four risk categories.

But some dealers claim the regulators' estimate is on the conservative side. "Using one of the proposed initial margin models, we calculated that the total amount of margin we would be required to collect and segregate from our largest 34 counterparties would total $1.4 trillion. I just can't believe the regulators didn't take into account the liquidity impact of these proposals. We might as well just shut down the US financial system and go home," says one derivatives dealer at a large US bank in New York.

Concerns over the potential impact of segregation are widespread. "We made the case to regulators that initial margin in dealer-to-dealer trades would be ludicrous if we didn't have the ability to rehypothecate. By requiring that the assets be segregated, the regulators have created a liquidity vacuum," says another derivatives dealer.

The draft rules on margin requirements were published at the start of April and apply to swaps entities.

> **"I just can't believe the regulators didn't take into account the liquidity impact of these proposals"**
> New York derivatives dealer

Both sets of rules require swaps entities to post and collect initial and variation margin from other swaps entities, and also require that initial margin be parked with a third-party custodian, with restrictions on rehypothecation. In addition, swaps entities must collect initial and variation margin from financial end-users in certain circumstances – a category that includes non-US sovereigns. The proposals would limit collateral to cash, US Treasury bonds and securities issued by certain government-sponsored entities.

The concern for market participants is that the proposals are the latest in a series of rules that use liquid assets as a credit or liquidity risk mitigant – potentially overwhelming the supply of those assets.

First, under Basel III, banks will be required to hold enough liquid assets to see them through a one-month period of stress, a rule known as the liquidity coverage ratio. Second, derivatives clearing requirements will result in large amounts of liquid assets being hoovered up in the form of initial margin. Finally, insurance companies may be encouraged under Solvency II, the incoming European capital adequacy regime, to hold more government bonds.

In total, estimates of the demand generated by those three rules add up to $3 trillion–4 trillion in assets. With the impact of the US margin proposals on top, that figure could reach $6 trillion – with the potential to shoot far higher if other jurisdictions decide to copy the US rules.

Part of the problem with the US rules, dealers say, is the approach to initial margin calculation. The proposals sketch out two models: a standardised look-up table or an internal margining model, which would need to be approved by the relevant prudential regulator. The look-up approach sets initial margin as a percentage of the notional size of a trade, with no netting allowed.

Under the internal model approach, a limited amount of netting is permitted – but only within each of four regulator-defined asset classes – and the model has to be at least as conservative as the margin models used by derivatives central counterparties (CCPs). The proposal requires a minimum time horizon of 10 days to be used when calculating the possible price move – and, hence, the margin requirement. Typically, CCPs assume a horizon of three to five days.

Dealers also fear inter-affiliate trades may be caught up in the rules, which would increase the margin burden. "If my bank trades with another swaps entity, we both have to post margin to each other that will be locked away. But if I manage my risk through a different legal entity – bank B – I have to back-to-back the risk to bank B, which, given the lack of clarity in these proposals, might also be subject to initial margin requirements. The issue is compounded if bank B decides to hedge the risk with another swaps entity, which will also require initial margin to be posted and segregated. The numbers are going to be scary," says one New York-based lawyer at a US bank. FXInvest

Day of the aggregators

The Dodd-Frank Act created a multitude of would-be swap execution facilities (Sefs) – trading platforms that will aggregate dealer liquidity. Now, dealers want to hoover up the Sefs by building their own aggregation services, but it's a strategy that could force the over-the-counter derivatives business into strange new territory. By Duncan Wood

The golden age of the swap execution facility (Sef) is over. It lasted less than a year and ended before any Sefs had actually opened for business – or so dealers would have you believe.

When the Dodd-Frank Act was signed into law on July 21 last year, it made it obligatory to execute clearing-eligible over-the-counter derivatives trades on an exchange or Sef – defined as a system or platform that brings together multiple participants on both sides of the market. In fewer than 100 words, the relevant sections of the legislation relegated dealers to the role of homogeneous price providers, with Sefs becoming the new shop window for the OTC market.

Perhaps. Dealers argue their customers won't want to connect to more than a handful of Sefs, but also won't want to miss out on the liquidity spread across this fragmented market. With as many as 20 Sefs now waiting in the wings, there's a role for an aggregator. Enter single-dealer platforms. Robbed of their ability to execute clearable trades by Dodd-Frank, these platforms could now gain a new lease of life as super-Sefs, collecting prices from competing venues and once again making banks the gateway to the OTC markets. In essence, Dodd-Frank enabled Sefs to leapfrog the dealers – and dealers now hope to pull off the same trick.

"We're discussing internally how to be the aggregator. We're trying to find a way to make it easy to execute across cash, futures and OTC markets as a way to separate ourselves from the Sefs," says Rhom Ram, the London-based head of Autobahn, Deutsche Bank's single-dealer platform.

Deutsche is not alone. E-commerce specialists at five other banks all argue that dealer-run aggregators will be the way clients choose to access the market, and one claims to have a beta version of a Sef aggregator up and running already.

"Sefs will appear and this will change what we offer to the client," says Ian Green, head of e-commerce for fixed income, currencies and commodities at Credit Suisse. "In some markets, we'll continue to use our risk management expertise to offer clients tight executable prices, while in other markets we'll serve the client better with aggregation and routing expertise. If the question is how to get clients the best access to liquidity that's fragmented in different places, we see that as an opportunity more than a problem."

If it's not a problem for the banks, it is for some of the Sefs. In particular, existing trading platforms such as Tradeweb and MarketAxess, which already allow users to trade with a number of different dealers, don't want to be locked away behind someone else's platform and compete with other venues for a share of the flow.

> **"If the question is how to get clients the best access to liquidity that's fragmented in different places, we see that as an opportunity more than a problem"**
> Ian Green, Credit Suisse

Asked whether Tradeweb will allow itself to be aggregated, the company's New York-based president, Billy Hult, is fairly unequivocal: "One of the main reasons for forming Tradeweb was to pool dealer liquidity, and we've now been providing institutional investors with an electronic request-for-quote for more than a decade. With all the major swaps dealers already making markets to their clients on Tradeweb, it's hard to see the benefit of Sef aggregation to end-users."

Richard McVey, chief executive of MarketAxess, which offers electronic trading for bonds and credit default swaps and plans to expand into interest rate swaps as a Sef, says the future he envisages is one in which users come directly to the platform to trade. "We've been successful in aggregating a total of 80 dealer market-makers that are active on our system. Once you get to 80, there's not much left to aggregate. We think of ourselves as a super-Sef already for credit," he says.

Other multi-dealer platforms are sitting on the fence. Would FXall allow its prices to be aggregated? "Well, possibly," says chief executive Phil Weisberg. "It would come down to the aggregation rules and whether we can be successful in that environment. We'd prefer not to be aggregated if the differentiating features of the platform were lost. But realistically, people are unlikely to buy the value proposition of aggregation until we know how many Sefs there are and that they're viable."

One bank's e-commerce head argues that Bloomberg ought to be particularly worried by the prospect of Sef aggregation: if market participants can go to a single entry point and access practically all OTC derivatives liquidity, they may decide they don't need a Bloomberg terminal on their desktop. Ben Macdonald, Bloomberg's global head of fixed income, claims not to be losing sleep – and says the company itself could conceivably act as a super-Sef. "Aggregating is distribution. I'm not sure I have a view on whether that's a good or a bad thing for us. At the end of the day, we'll probably go where our customers want us to go – and I could envisage a scenario where we provide aggregation of different Sefs over the terminal, but it's not somewhere we are right now," he says.

In essence, everyone is fighting over the same thing – relevance to customers – and there's a widespread belief among both dealers and Sefs that relevance is bequeathed by enabling clients to execute whatever they want, whenever they want, at the best price available. Sefs try to achieve that by aggregating multiple dealers and putting them in competition. Dealers are now preparing to do exactly the same thing with the Sefs themselves. Whether Sefs like the idea or not, the logic is irresistible, bankers say.

"Ultimately, if everyone does this, the Sefs and exchanges will be required to adapt. If most of the liquidity is coming through consolidators – three of them or five, or however many there are – then that will drive the model," says Paul Hamill, chief operating officer for US credit trading at UBS in Stamford, Connecticut.

It may make sense, but that doesn't make it easy. Even if Sefs can be persuaded to play ball, aggregation faces a host of questions: how to commingle different types of price, for example, and whether

Illustration: Laurence Whiteley, nbillustration regulators will smile on the concept. Arguably the biggest challenge, though, is the cultural and organisational shift that will be required.

Sef-aggregators already exist in cash equity and listed derivatives markets, although not by that name. It's common practice for agents to provide clients with access to various stock and futures exchanges and then bolt on an array of associated services and products, such as algorithmic tools that split execution across a number of venues to get the best all-in price. But this business model is alien to the OTC market, dealers admit. It is hard to imagine a bank that may have spent upwards of $100 million developing its platform happily using the technology to direct its clients to an array of Sefs, where they could end up executing with rivals – at least, it's hard to imagine the bank's traders being happy about it.

"If you're saying to people 'here is our portal – we'll help you find the best liquidity', then you have to be prepared for the fact that the liquidity on the other side might not be your firm's liquidity," says a senior operations executive at one bank. "You might be bringing in 100 orders a day and other banks might be filling 95 of them. So everyone will build the technology, and I think it will be driven a lot by sales and prime services and groups like that, but the trading mindset is where the challenge lies – a lot of those guys will still be out there wanting to fight for the order."

This picture isn't necessarily rosy for the firms winning the execution business either – they may be jealous that their involvement with the client is limited to making a price, says Bloomberg's Macdonald. "What's being suggested is that as a client of dealer A, I can access the liquidity of a series of other dealers on A's platform – and the obvious issue with that model is, who owns the client relationship? If dealer A and B compete for the same client base, does B want A to be the guy who has desktop real estate with his client? Probably not."


Andrew Challis, Barclays Capital

Dealers expect this cultural shift will need to be accompanied by an organisational one, with users of an aggregator demanding some degree of separation between a bank's agency and principal business. The head of rates at one European bank argues there will need to be strict Chinese walls between the two, because clients will not want their trade data to be visible by the principal business of the bank providing the aggregation service.

Banks may need to go further than just protecting client information, argues one dealer. "Building a Sef-aggregator is the easy bit. The hard part is how you set up an agency business model alongside a market-making business model. And it isn't clear to me they can be the same business. That's the bit I think people will find it hard to get to," says the operations executive.

Banks may need to create a separate management team and governance structure for the venture, he argues – a strategy that may be necessary to make an aggregator work, and may also open more doors.

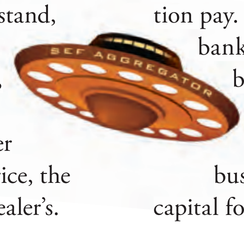
"Where things might get interesting is if dealers are open to the idea that some sort of agent could be allowed to find their non-Sef liquidity as well. That's why I think the precise identity of the aggregator is important. If I went to JP Morgan tomorrow and told it I was setting up an aggregator that would capture the prices it puts on Sefs, it would say 'fine – we can't stop you'. But if I said that I'd also like to show my clients JP Morgan's axes, its off-the-run stuff, its cash positions, it would say 'not a chance – you're a rival, why would I do that'. And the answer to that is that I'm not a rival bank – I'm an agency business and I'm representing clients independently of the market-making business. That's when this model really gets taken to its extremes, and is where it could really start to make a difference," he says.

That's if Sef-aggregation is possible at all, of course. Some speculate that the aggregator model wouldn't be allowed by regulators such as the US Commodity Futures Trading Commission (CFTC) – although there's nothing explicitly forbidding it at the moment. If banks want to promote their own platforms as a gateway to Sefs, a regulatory specialist at one interdealer broker argues those platforms would need to meet the same data management and data monitoring standards as the Sefs themselves.

FXall's Weisberg puts it more pithily. "Can you be a Sef of Sefs without being a Sef? If we're a Sef and are trying to comply with the regulations, wouldn't we need to regulate the aggregator too? You could see this as taking away the ability of the CFTC to approve the execution mechanism by creating a new one," he says.

There are practical problems, too. Sefs will be allowed to use two broad types of trading protocol – request for quote (RFQ), as used by existing multi-dealer platforms, and central limit order books, as used by exchanges – but the two approaches generate prices that are not necessarily comparable, dealers say.

In an RFQ model, a user will ask a dealer to provide a price for a given trade and then choose which to accept – in other words, the quotes provided are completely firm and the decision to execute is ultimately the user's. Central limit order books potentially require dealers to offer streaming, constantly updated prices, but are relatively new to the OTC markets. As things stand, when dealers provide streaming OTC prices electronically today, they typically come with a 'last look' for the provider. So if a user wants to trade against a given price, the final decision to execute is the dealer's. That's a problem for would-be aggregators, says Andrew Challis, head of rates e-distribution and strategic investment for fixed income, currencies and commodities at Barclays Capital in London.



"Commingling the two protocols is actually very, very challenging. Do you allow the central limit order book to stand in front of or alongside the RFQ responses? With the former, the dealer has the last look and with the latter it's on the client. If you commingle, you'd probably have to force the streamed liquidity to be 100% firm, which means it wouldn't be subject to credit-checking or last-look," he says.

Jamie Cawley, chief executive of Javelin Capital Markets – a start-up trading platform that has its eye on achieving Sef status – says this contrast between protocols means his firm can't be aggregated with its competitors. "When we look at the market, we see MarketAxess and Tradeweb as our primary competitors, both of which are RFQ. Our model is central limit order book first, RFQ second – so where they don't have live prices, we do, and it's tough to aggregate live prices with 'on the wire' quote requests. It doesn't mean they won't have live prices in the future – we expect they will – but not at the moment," he says.

Last, but by no means least, dealers will have to work out how to make Sef-aggregation pay. One e-commerce head says his bank estimates execution profits will be cut by 20% in the new regime – a combination of thinner bid-offer spreads on cleared business and more consumption of capital for uncleared positions. One way to recoup some of that lost profit is to mimic futures or equity-market agents and charge commission to users of an aggregator, but that would be a leap for OTC businesses, dealers say.

"Commission – we don't know what that word means in fixed income," says David Bullen, London-based head of e-commerce for Citi's global rates and credit business. "When you start talking about applying a futures model, where you charge a turn on the way in and out of markets – effectively a small commission – fixed income isn't set up to do that on either the buy or sell side. On the front end, accounting systems and the format of confirmation messages would need to be changed, and on the back end there are considerations such as tax implications of charging and accruing an explicit commission."

A senior trader at one large European bank says his team has been discussing three different approaches. The first would be to charge a connection fee to users of an aggregator, possibly determined by monthly usage of the service, on the basis that the bank is doing the hard work of hooking clients up to a multitude of different venues. A second idea is to make the service free for clients, but then to expect a certain proportion of their business in return – although, in practice, regulators may prevent clients selecting a single preferred dealer for clearable trades. Finally, Sefs could pay the banks if volume comes their way from an aggregator, he says.

Whatever the industry's choice, observers have no doubt that dealers will find a way to recover much of the profit that regulation is set to erode – by charging for aggregation and associated services, but also through the various tasks dealers will perform for customers when acting as their clearing broker.

"What they'll provide is end-to-end execution and clearing services for their clients," says a strategy director at one large interdealer broker. "So, you decide what you want to trade, then you submit that trade to your dealer and they get it done and cleared for you in any way, shape or form – and all you know in the end is that you're done. I think that's the way it's going, and there are quite a lot of places in that model where they can charge. I'm sure banks will find a way of charging their clients." FXInvest

Sef FAQ

Where did swap execution facilities come from?
The 2009 Group of 20 summit in Pittsburgh called for all standardised derivatives to be traded on exchanges or electronic trading platforms where appropriate by the end of 2012. The Dodd-Frank Act, signed into law on July 21, 2010, made it illegal to trade clearing-mandated derivatives anywhere other than a Sef or an exchange.

So, what is a Sef?
According to Dodd-Frank, it's "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants".

How are regulators doing?
The Commodity Futures Trading Commission (CFTC) proposed its rules on January 7. The Securities and Exchange Commission (SEC) followed on February 2 – its rules apply to security-based swaps, which include credit default swaps, total return swaps and equity variance or dividend swaps on single names or baskets of up to nine names.

Do the CFTC and SEC agree?
No. Both would allow Sefs to trade using request-for-quote (RFQ) or central limit order book models, but the CFTC calls for any RFQ to go to a minimum of five price providers, while the SEC says RFQs can go to a single provider

Where is Europe on this?
Lagging. On December 8, the European Commission published a consultative paper for its review of the Markets in Financial Instruments Directive, proposing all clearing-eligible derivatives be traded on exchanges, multilateral trading facilities or "a specific sub-regime of organised trading facilities, to be defined in Mifid".

Facing the fear

Nikki Marmery reports on the emergence of indexes looking to trade event risk

Once-in-a-lifetime financial shocks used to be just that. But the past three years have offered ample opportunities to work out how to protect yourself in extreme trading environments. And the answer, it seems, is to take a punt on the fear and uncertainty itself: trade volatility.

This is not news to the buyers of some million contracts a month on the Vix, the Chicago Board Options Exchange's volatility index of global equities – dubbed the 'fear gauge'. The index, based on implied volatility of S&P500 options, is the most looked at indicator of expected global volatility. It recorded its busiest ever month in March, amid the Japanese earthquake and nuclear crisis, and the worsening situation in Libya and the Middle East. To May this year it reported 20 consecutive months of year-on-year growth as investors increasingly turn to it to hedge equity risk.

Now a number of banks are launching similar indexes based on currency market volatility. They argue foreign exchange volatility can act as a good indicator of risk in other assets in times of extreme stress – and because the FX market is so liquid and so broad, it can be cheaper to trade volatility in FX than in other asset classes.

"We were seeing a lot of demand from clients – FX and non-FX – who are interested in using FX for tail-risk hedging," says Simon Hards, global head of FX options trading and structuring at Credit Suisse in London. Tail risk is the risk of unlikely but damaging events, such as the Lehman Brothers collapse in September 2008. "Investors want to create a hedge in such a way that they have substantial returns in stressed environments but don't make significant losses when volatility subsides."

So Credit Suisse set about creating a product that would fit that bill, and in February unveiled the Credit Suisse Advanced Volatility Index – CSAVI.

The portfolio includes 12 of the most-liquid G-10 currency pairs and uses jump diffusion – an options pricing model that prices moves by jumps, as well as continuous 'diffusion'; this allows for the larger price moves seen in extreme events.

FX is particularly suited to tail-risk hedging, says Anthony Ring, index specialist in FX structuring at Credit Suisse in London, because it is a liquid market, and because there is less systematic positioning than in equities as people trade FX for a variety of different reasons rather than just investment. “The market isn’t as crowded with one particular view,” says Ring.

Previously these customers might have dabbled in the FX market for the same purpose – putting on big rouble trades, for example as a hedge against large movements in the price of oil. Another popular strategy recently, says Hards, is to buy long-dated dollar/China high strikes. “The market expectation is that the currency would move the other way: in a major global crisis, hedgers would expect to see a good return on this strategy.”

The index format, however, makes strategies like these more accessible. “Many investors will be restricted in their ability to enter these types of specific over-the-counter contracts. This could be due to external regulation, internal trading policy or simply a lack of time and expertise in that particular area,” says Ring.

As such, CSAVI has gone down well with pension and insurance fund clients, who might be limited by rules and regulations, and with hedge funds who might want to buy in time savings and expertise.

The index has been designed to deliver strong positive returns during extreme events, but crucially, not to dip into negative performance in the good times. “This has been created as a buy-and-hold strategy, since, by their very nature, it is not easy to predict when an extreme event will happen,” says Hards.

Between July 2007 and January 2011, for example, the strategy generated a Sharpe ratio of 0.87, compared with –0.34 for the Vix Futures Index (the figure is 0.02 for the S&P 500). In the stressed environment of July to December 2008 it generated a Sharpe ratio of 4.54 compared with 2.97 for the Vix (and –0.95 for the S&P500).

BNP Paribas has also been hard at work developing products in this area.

> **“There is operational difficulty with trading volatility: mistakes can be costly. Customers that buy an index are outsourcing this issue, and pushing all this risk onto someone else”**
> Angelo Mastromarini, BNP Paribas

It is about to launch an entire family of indexes trading FX volatility to exploit the volatility risk premium – that is the difference between realised (or actual, historical) volatility and implied (or future, expected) volatility.

“Historically, implied volatility tends to overestimate realised volatility for short-dated options. This is because investors are willing to pay a premium for options to guard against the possibility of a major shock,” says Vincent Berard, European head of interest rates and FX structuring at BNP Paribas in London.

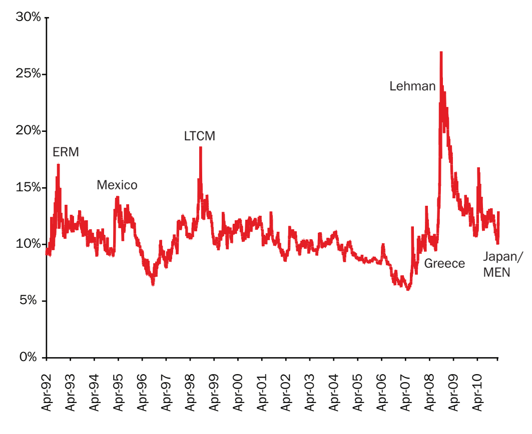
The family – collectively called Nebula – is divided into three-sub-groups of six. Each index buys straddles on the same 12 currency pairs and delta hedges daily; they all operate in the same way, but at slightly different times or in slightly different ways.

Nebula 1 comprises six ‘consistently short’ indexes; the Nebula Enhanced group all have various risk management features embedded in them; and Nebula Plus are all long biased volatility indexes. Clients can combine them to get the exposure they want, or customise indexes to reduce the number of currency pairs.

Nebula is targeted at sophisticated institutional clients who see volatility as an asset class, and who are looking for a way to diversify exposure, says Angelo Mastromarini, senior systematic strategy and index structurer at BNP Paribas in London. These clients could of course execute an equivalent trading strategy themselves, but buying exposure in an index is cheaper and cuts out all execution risks, he explains.

“The cost of trading the underlying varies a lot: EUR/USD is liquid, and the spreads are tight, but when you move to less-liquid currencies, the cost is more meaningful. Buying Nebula, customers can substantially reduce the cost of trading the underlying as the indexes are managed in conjunction with the option trading book of the bank,” he says. “Secondly, there is operational difficulty with trading volatility: mistakes can be costly. Customers that buy an index are outsourcing this issue, and pushing all this risk onto someone else.”

JP Morgan VXY Global since 1992



The Nebula range follows on from another currency volatility index the bank launched two years ago, called Vola. This is a weighted average of the three-month realised volatilities of the six most traded currency pairs. By buying forward contracts on the index, you can express a view on volatility in the same way as you might on the Vix.

Backdated, this strategy would have returned 65% during the Lehman crisis

– from mid-August 2008 to the end of that year, compared with the S&P losing 30%.

During the Long-Term Capital Management crisis in November 1998, it would have returned 64%, compared with a 13% loss for the S&P.

"This strategy is super-efficient for systemic crises," says Berard.

The downside is that it does not work in extreme events that do not spread to FX – for example the dotcom bust in 2001/02, when it would have lost 45%.

"Then the volatility that was present in equity markets did not spread to FX because it was a specific crisis. There is no 'one size fits all' in risk protection," he says.

JP Morgan's offering is quite different. It has three separate indexes, which it describes as 'indicators' of implied currency volatility rather than tradable benchmarks. The VXY for G-7 currencies and VXY-EM for emerging markets were first launched in 2006, but have recently been updated to add new currencies and rebalance the currency weights according to more recent market share statistics. VXY Global was launched in March and aggregates 22 currencies from the VXY and VXY-EM indexes.

Underlying volatilities are based on three-month at-the-money forward options and the indexes are weighted by market share of options pairs as determined by the latest Bank for International Settlements triennial survey (the most recent data is from December 2010).

The three indexes provide clients with indicators for use in their own trading models, rather than an off-the-shelf investible product to generate returns, says John Normand, head of global FX strategy at JP Morgan in London.

"A lot of investors are looking for volatility signals to trade in the cash market, and VXY provides an easily accessed input for their models," says Normand. "It also allows them to compare volatility in currencies with that of other asset classes, such as the Vix, for investors who think that, on occasion, movements in volatility in one market might lead movements in other markets."

Normand says the indexes are useful for any client – corporate or investor – who finds value in tracking the derivatives markets for evidence of complacency or excessive pessimism. "Extremes in volatility are often associated with turning points in cash markets," explains Normand. "Above-average volatility usually suggests pessimism is excessive, so the dollar could soon fall and high-yield currencies rally. Below-average volatility suggests complacency is widespread, so the dollar could then rally and high-yield currencies fall."

"A lot of investors are looking for volatility signals to trade in the cash market, and VXY provides an easily accessed input for their models"
John Normand, JP Morgan

As yet, it is impossible to tell whether these new products do what they say on the tin. That won't be clear until they pay off – or don't – in the event of the next big market blowout.

In the meantime, one investment firm sounds a note of caution.

"The financial crisis reminded us that things that behave in a certain way in certain market environments might change completely in other environments. This is particularly an issue when you're looking at tail risk," says Jeppe Ladekarl, director of research at First Quadrant in Pasadena, California.

"If you go into this thinking it will make you money, you will be disappointed. This is a type of insurance. You should go into it thinking: 'How much of my return should I pay to insulate against tail risk?'

"But even if you do get the event that you bought the insurance for, you might not recoup the premium that you paid for it. It's like partial insurance: you might not get the full replacement costs, but you're going to get something. Depending on your personal circumstances, that might be worth a lot." FXInvest

Carry indexes updated for 'new normal'

Currency volatility is just the latest trading theme to be packaged in an index. Until the financial crisis hit three years ago and took the shine off the carry trade, carry indexes were all the rage.

But the strategy – basically buying high-yield currencies funded by low-yielding currencies (usually yen) – falls apart in periods of high volatility and some indexes reported monthly downturns into double figures.

Now, after G-7 intervention to stop the yen appreciating, coupled with expectations of interest rate rises elsewhere around the world, carry is a profitable strategy again. And banks have made changes to their carry-trading indexes to add more safety measures.

Deutsche Bank for example, has created a new index called Haven, which has an in-built risk management feature to reduce drawdowns. "We looked at a lot of rules and we found one that was simple, powerful and robust," says Rashid Hoosenally, global head of foreign exchange structuring in London. "When short-dated FX volatility spikes, that is a good leading indictor of impending risk – so the index reduces exposure to carry when front-end FX volatility spikes."

Hoosenally also recommends buying an option rather than simply going long carry. "An option gives you all the upside of carry but limits your downside to the premium paid," says. "And unlike a stop-loss, it allows you to recoup your losses in any subsequent rally."

Citi has also made changes to its carry indexes. Jessica James, global head of quantitative investor solutions at the bank in London, explains that, since the financial crisis, the bank has broadened the range of triggers in its models to account for greater interaction with equity markets. "When an equity market rises, it's likely to attract flow into that currency, so we have a buy signal that is contingent on equity price changes," James explains. "It's not that this trigger has become more important – it is just more noticeable when you get the larger equity swings we see now."

"Implemented correctly, carry is as valid a strategy today as it has been in the past 10, 20 or 30 years," says Hoosenally. "There's nothing in the structure of the global financial markets that has reduced our expectations of the long-term excess returns that a properly implemented strategy can deliver."

Emerging opportunities

Saima Farooqi talks to Overlay Asset Management's Helie D'Hautefort about why his firm is sticking with emerging market strategies

As far as alternative investments go, currency investment is still the new kid on the block. So new that despite trading the most liquid markets, currency programmes were among the hardest hit during the financial crisis, suffering high levels of redemptions from cash-strapped investors who were unable to unlock money trapped in traditional funds.

And now a further risk – the US Dodd-Frank Act – threatens to put the kibosh on strategies aiming to take advantage of elevated currency volatility and emerging market (EM) growth, by proposing that FX options and non-deliverable forwards (NDFs) be centrally cleared. With 80% of its €15.8 billion in client assets invested in options and emerging market strategies, that threat couldn't be any more real for founder and chief executive at Overlay Asset Management (OAM) in London, Helie D'Hautefort.

D'Hautefort set up OAM in 1998 as an investment management company offering currency management services including overlay, managed account and pooled fund programmes. The company launched its first currency alpha programme in 2003, and by 2006 had some €10 billion in client assets under management. In December 2007, OAM extended its coverage with the launch of an emerging markets currency fund and as of April-end had €43.5 million in the strategy.

Despite the recent retracement, D'Hautefort is a big believer in emerging markets as a long-term trend. The company's EM strategy has been its top performer, with a return of 13.6% year-to-April with an annualised volatility of 8%. "Our EM fund has beaten all other strategies this year and even after retracing a little bit recently, it has still been the best strategy we've had on board," he says.

To ensure the fund is able to trade EM bull- and bear-market conditions, OAM uses a quantitative approach to establish which emerging market currencies it will be long and which G-10 currencies it will go short. "That is something we have worked on, because being just long emerging markets is almost

BIOGRAPHY

Before setting up Overlay Asset Management in 1998, Hélie D'Hautefort was the manager of a currency fund (Rosebud) for a period of two years. His previous assignments include five years at PSA International, within the exchange-risk management unit of Peugeot Citroën group in Geneva, where he was in charge of the use of derivatives products in currency management. Before that, he was in charge of currency options trading and their applications to customers in three different banking institutions. He began his career in New York in the currency options market in 1985 within Crédit Lyonnais' trading room. Hélie graduated from the Ecole des Hautes Etudes Commerciales (HEC), Paris.

Hélie is chair of Overlay Asset Management's executive and investment committees, and a member of the research committee.

a beta strategy and we want more of an active approach in those markets," says D'Hautefort. "So we use a two-fold approach where we have an investment process to select the emerging market currency we will be long of, or eventually short of, and then the G-10. It's a 100% quantitative and systematic process, with each strategy having an allocation in terms of risk budget – there's no judgemental approach to this one."

The strategy makes up the majority of the allocation in OAM's multi-strategy programme alongside its options strategy – they account for an interchangeable 40% each. The remainder is split between carry, trend, valuation and high frequency. However D'Hautefort says: "We are now more exposed to options due to the risk-on, risk-off environment. We think the probability of a short-term risk-off environment is big, so we're reducing carry and EM to the profit of the option."

At the moment options, and indeed all strategies, are traded over the counter because of the ability to design the maturity, notional value and counterparties to a trade, says D'Hautefort. "It's probably cheaper to trade OTC, and we also have long-term relationships with most OTC counterparts that are almost partnerships. The exchanges are different," says D'Hautefort. "We like the way we trade."

Across all products, OAM trades 80% electronically on single and multi-dealer platforms via FX prime brokers UBS and BNP Paribas. And perhaps owing to his grounding as a currency options trader on the sell side, D'Hautefort remains defiant about the use of OTC options even if mandated into central clearing by the Dodd-Frank Act and the European Market Infrastructure Regulation.

"Obviously we might have to look at other ways of trading after the regulations come, but we will trade OTC even if it's collateralised," says D'Hautefort. "We have a team of people who are dedicated to collateral and might also be used for the day where clearing is requested. As we use prime brokers, we are well advanced on that."

But D'Hautefort cautions the increased costs will hit some harder than others, notably pension funds – a segment that makes up one third of its client base. "To penalise pension funds that want to get rid of unwanted FX risk is detrimental. There are several of us in the industry

"We have long-term relationships with most OTC counterparts that are almost partnerships. The exchanges are different. We like the way we trade"

that are trying to convince the regulators that this is not a good idea for FX, we'll see if we succeed. But FX was never a source of issue during the crisis so it's a pity that regulators do not treat FX hedgers as an exception."

He says, by contrast, the sales pitch for currency management couldn't have been stronger post-crisis – not least because of the exceptionally high level of volatility to trade. Volatility has not only returned on dollar rates but also on the cross rates. At times implied volatility on euro-swiss has edged higher than the implied volatility on the dollar rates, such as dollar-euro or dollar-yen. "That's something that's quite new and good for the industry, from a manager's point of view," he says.

D'Hautefort continues that the crisis made the case for some form of currency hedging programme. "Whether it be passive or active, you cannot ignore the currency component of the portfolio. Pension funds from Australia or Switzerland that didn't have a currency process might have lost almost 30% of the value of their assets in their home currency on currency allocation. That's a lot, especially when the underlying assets are not performing to provide double-digit returns," says D'Hautefort. "Not to have anything on board can be detrimental." FXInvest

Quick-fire round

What is your view on the carry strategy?
We do have allocations to the carry trade and there's a fundamental reason for that. I used to manage the currency risk of a large multinational and one of the most important criteria for us to decide whether we would hedge our foreign currency exposure was to look at interest rate differential. If we had a hedging cost due to the interest rate differential, then we would delay the hedge. If it was positive on the contrary, then we hedged two, three, four years of sales in that country – and that's normal.

Since founding this company 13 years ago, the carry trade has been one component of our strategies. The initial weighting was one third and at times it was 10%. What we have always tried to look at is diversification because it is difficult to have a strategy that performs in all market environments.

Can you really generate alpha from the currency market or is it actually beta?
The industry as a whole has demonstrated over the years that by having a selection of managers, with the diversification effect in mind, we are able to generate alpha.

Just because one particular strategy such as carry has had problems for some time, doesn't mean you question the asset class as a whole, or at least the strategy as a whole. We do think currency investment and programmes can deliver an attractive risk-adjusted return, provided there is diversification in the investment process and managers accept they have to adapt strategies to the environment. More than before the environment is fickle and fluctuating, and that's why diversification is key.

Do you believe the US dollar is losing its role as a reserve currency?
There is a lot of debate and roughly two camps. One says the dollar will continue to be the main reserve currency and the other says it will increasingly lose this status for a more multi-polar world, including in the future the Chinese currency, but also emerging market currencies today.

I'm more in the second camp that says we are going towards a multi-polar world that is not dominated by a single currency. For example, Sino-Russian trades are increasingly invoiced in either rouble or renminbi without a reference in dollar. This is despite the fact most were energy trades, which is usually denominated in dollars.

The dollar's demise

With the European sovereign debt crisis grabbing headlines, markets might be forgiven for overlooking the nearing end of a second round of quantitative easing in the US. Debate over its success raises deeper questions about the role of the US dollar as the world's reserve currency

The lessons of history are that all fiat currencies eventually end up valueless. Politicians normally over promise and under deliver. The superpower of the day always undertakes too much and gets into debt. They it gets out of trouble by trashing the currency they pay back. It was no different for Julius Caesar, or any other superpower since.

Robin Griffiths, technical strategist at Cazenove Capital in London, asks: is the dollar dead?

So for the concept of the dollar dying, it is not a question of 'if' but 'when'. My answer is "not in my lifetime". I am reminded that Woody Allen said, on reaching 65, that it came as quite a shock to realise that very nearly half his life was now over. On this basis, the dollar has at least 50 years left to go.

For 200 years, the UK was the dominant superpower and the pound sterling was able to be printed just as Bernanke's Federal Reserve has printed today's dollar. It is now half a lifetime since the empire was dismantled and Great Britain is back to being a small island again. However, sterling still exists as a currency and is still rather important. It is just not dominant. This is the fate of the dollar, or rather its destiny.

Under President Dwight Eisenhower, the US economy made up about 60% of the world economy. His dollar really bought something. All economies have grown since then, but now the US is only 24% of the global total. It is likely to be overtaken by China in the next 10 years. Another 10 years after that, it is probable it will also be overtaken by India. Incidentally, the combined economies of the eurozone are already bigger than the US and contain 550 million people, compared with about 300 million citizens of the US. On a 20-year view, the dollar will go from being the currency of a totally dominant super-power, to that of a number four power. It will still be a large and important currency, and it will still exist.

The Fed was created in 1914 and since then about 94% of the purchasing power of that dollar has already gone. Most of the damage has occurred since 1970. Astonishingly, half of all the dollars that have ever existed have been created since the year 2000. That is when the real downtrend started. It is therefore very much the current Fed policy that is trashing the dollar on the world stage.

It is already a fact, not even a forecast, that for much trade the dollar is no longer the 'go-to' currency. When China buys goods from Brazil, they price in real or renminbi. For most trades by China across Asia and particularly with southern hemisphere countries, this is bound to continue and grow.

In the short term, if stock markets go into 'risk-off' mode, the dollar will have a significant rally. This move would be likely to retrace half of what the dollar has lost in the past 12 months. Looking at the move against the Canadian dollar, Australian dollar or Swiss franc, this gives scope for a rise of 12% to 15%. In forex markets that is huge. So the dollar might be an aging elephant, but he is still the biggest in the zoo, and is capable of trampling small guys underfoot.

Looking into the future, both the dollar and the euro will survive. The latter might or might not have the Greeks among its members, but will essentially survive as a major currency. Over time, an Asian block will grow, led by the yuan or renminbi. This will also include the Indian rupee. Although the dollar has already lost its status as the only currency to price world trade, it is still far too soon, by about 20 years, for the Chinese currency to take up the role. We might in fact get an agreed basket of currencies that will include mostly the dollar, euro and renminbi. This basket will also include one element that no government can print, and that will be gold. FXInvest

Leonardo Castellana, chief investment officer at Palaedino Asset Management in Zurich, says the dollar will 'melt'

There are numerous reasons why the dollar should collapse, and they are well known by all as so many articles and research papers have dwelt on this subject. However, we are going to focus on why we think it will 'melt' – slowly but surely depreciate in value over time – rather than devalue abruptly.

The macroeconomic explanation

Some economists, mainly from the deflationists' camp, argue that a major drop in the value of the US dollar is needed to restore a new macroeconomic equilibrium.

We went through such a major dollar move during the 1980s. Between the beginning of 1985 and the early 1990s, the dollar fell by almost 50% against a basket of major currencies as measured by the dollar index to bring the US current account deficit back under control.

For the deflationists, we are in a classic liquidity trap. In a post-credit bubble environment like 2008, characterised by excess capacity, a bankrupt financial system and overly indebted consumers, Keynesian responses do not work. Indeed, the increased money supply created by the different rounds of quantitative easing does not reach consumers and personal consumption does not revive. For this reason, demand for US assets decline, inevitably leading to a depreciation of the value of the dollar over time.

The erosion of the dollar supremacy

We live, and have all been living, in a dollar-centric model. However, we think this status is slowly but surely eroding in favour of a new international monetary system. Look at China and Russia for instance. Both countries have decided to use their own currencies for bilateral trade rather than the US dollar.

Until recently, the US dollar had no credible alternatives. Indeed, dollar debt instruments are the most liquid and represent the deepest market in the world; it is a real reserve currency (still representing 60% of today's foreign reserve of central banks); and it is still the favoured invoicing currency in global trade.

We do not believe we are in the midst of a currency war. We rather think that an orderly dollar depreciation is in everybody's interest

According to a recent report published by the World Bank on May 17, 2010, Multipolarity: the new global economy, the monetary system will move from a dollar-centric reality towards a multi-currency regime. It argued the dollar would lose its status with the emergence of the renminbi and the euro by 2025.

China is moving quickly to internationalise the renminbi. However, we would still need to see full convertibility of its currency before it becomes a realistic alternative to the US dollar. We think we are going there, but the adjustment will not be immediate. This will be done step by step and at the pace dictated by the People's Bank of China.

For the euro to become an important player in the world balance, European governments need to create an integrated European bond market where the 'E-bonds' would jointly be backed by eurozone governments as a group. Comments from European Central Bank governor Jean-Claude Trichet to appoint a European finance minister follow the same underlying rationale. Again, there is still a long way to go but if European governments want the euro to survive and to avoid another Greek-style crisis, this is the only reasonable direction to take.

This power shift away from the dollar will clearly not happen overnight. But with the new debt paradigm that we see arising from the US, investors will be more and more reluctant to blindly accept US bond yield as being the recognised risk-free rate and the dollar as a safe haven. They will look for alternatives, and the renminbi as well as the euro can and should embrace this role.

The new global paradigm

We do not believe we are in the midst of a currency war. We rather think that an orderly dollar depreciation is in everybody's interest. No-one wants to say it, especially the US government or the Fed, but this is the reality.

This will reduce inflation in emerging countries, where stabilising prices has become the key objective of economic and social policymakers. It will also increase US competitiveness and exports, thereby stimulating output, which is the key objective of US economic policy.

We think an orderly adjustment or a gradual fall of the dollar value across the board will occur. A new economic order is unfolding, with a smooth shift from developed to emerging economies. We should see real economical decoupling and we can assume countries with surpluses would offer greater exchange rate flexibility with their respective currencies to find a new global equilibrium.

As asset managers, we have set up a solution to hedge against this 'melting dollar' risk. Because we do not know exactly how fast this scenario will unfold, and because the dollar will not lose its value uniformly against all currencies at the same time, the only way to play this strategically over the long run is to invest passively, but systematically, in the most diversified basket of currencies one can select. Our recently launched Palaedino Hard Currency Index aims precisely at satisfying this objective. FXInvest

Uncertainty boosts demand for gold and oil exposure

Continued uncertainty about inflation and deepening concerns over sovereign default risks in Europe are making the commodities increasingly attractive as hedging tools. Sarah Nowakowska reports

Photo: Mykl Roventine

WORRIES ABOUT the scale of sovereign debt – and the threat of a Greek government debt default in particular – are leading investors to accumulate positions in precious metals-based exchange-traded commodities (ETC), according to an ETF Securities report. ETC inflows have recently risen by $164 million, led by physically backed gold products.

"Rising market volatility, global economic uncertainty and geopolitical unrest have increased interest in gold as both a short- and long-term investment," says David Gardner, managing director and head of sales for Europe, the Middle East and Africa at iShares in London. "There are multiple uses of gold, the most widely quoted being for portfolio diversification, inflation hedging and as a potential 'safe haven' during periods of political or economic uncertainty."

Some investors do regard gold as a store of value and an alternative currency in times of financial distress, says Robert Farago, head of asset allocation at Schroders Private Banking. But the scarcity factor of oil also makes the private bank bullish on that.

"Our favourite commodity play is definitely oil," says Farago. "If you look back to the 1970s, all types of commodity – energy, metals, and soft commodities – rose together, but the latter part of the rally was led by oil and gold. We think there is a reasonable chance this could happen again. There is not enough oil to meet future demand and ongoing tensions in the Middle East are placing further pressure on production, increasing the risk of further price spikes," he says.

In Asia, demand for exposure to precious metals, oil and soft commodities to hedge against inflationary pressures also remains strong.

One of HSBC's popular structured product offerings includes a principal-protected, one-year Australian dollar floored barrier note linked to gold with a 5% coupon.

> "There are multiple uses of gold, the most widely quoted being for portfolio diversification, inflation hedging and as a potential 'safe haven' during periods of political or economic uncertainty"
>
> David Gardner, iShares

"The reason investors are attracted to commodities is because of inflation protection," says Ken Sue, managing director and head of wealth management sales, Asia-Pacific, at HSBC in Hong Kong. "We've seen a reasonable amount of interest in precious metals and some enquiries for soft commodities and base metals linked to concerns around inflation."

BNP Paribas' Twin Win autocallable product is also proving popular among Asian investors seeking exposure to oil. If the underlying stays within a set range, investors receive a coupon, the value of which falls if the underlying falls outside the range.

"People generally seek exposure to oil through this product, but we've seen requests for trades on other commodities, such as sugar, copper and silver," says Renaud Meary, head of structured equity, Asia-Pacific, for BNP Paribas in Hong Kong. "The product also exists on multiple underlyings, the most recurring examples being oil and gold." FXInvest

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