Profit & Loss in the currency and derivative markets

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CME: A Working Model

No article about innovations would be complete without an update from CME, which is credited with the launch of financial futures back in 1972. Julie Ros talks to the current chiefs of the exchange about future developments, as well as to the godfather of financial futures, Leo Melamed, about the benefits of the exchange model.

Although the Chicago Mercantile Exchange (CME) is the first, and largest, exchange platform for FX futures contracts, its overall volume represents just a niche of the overall market. But this niche – which is said to account for 2-3% of the overall $1.5 trillion in average daily FX turnover – does address many of the requirements of the market's most active hedge funds and CTAs (which account for 50% of the Merc's clients), namely, a centralised counterparty, transparency, anonymity and multilateral transaction execution.

"There is a confluence of things driving structural change in FX," says Craig Donohue, president of CME. "We have not seen this rate of change in the last 20 years. It is a function of technology and a desire for more efficiency – transaction execution, as well as clearing and credit."

"FX is a mature industry, but one with a lot of overheads. Technology reduces these, by creating efficiencies," adds Rick Sears, managing director, FX.

"There has been much debate about whether FX will evolve to the exchange model," notes Donohue. "The innovation of the Reuters link-up puts us ahead of the curve in that evolving market structure – and I don't think this innovation should be downplayed in terms of how it will transform how we do business."

In late May, CME and Reuters signed an agreement to provide CME's electronic FX pricing (shown in spot equivalent format) to Reuters' client base over Dealing 3000. The agreement, which is due to be launched in London during Q4, expands CME's distribution and enhances Reuters customers' ability to seamlessly trade FX spot, forwards and futures, according to the companies.

Leo Melamed

Sears adds that the Reuters/CME deal will give banks access to a client sector that they may not have previously been able to transact with. "And for the first time," he says, "they will have STP because CME eFX on Reuters uses Reuters' TOF, which sends deal details straight through to the risk management systems, which you haven't been able to do with futures on the bank side before."

Rick Sears

Credit

Sears notes that prime brokerage is playing a crucial role in the market's current development. "The market is now moving to a new phase – prime brokerage. While not as optimal as the exchange model, prime brokerage provides back office efficiencies and price transparency among its benefits," he says. "But credit is where the market is headed next. We haven't squeezed the costs out of credit yet. Whether the market will evolve to an exchange model is still up for debate; however, I do believe it will move to a central counterparty model. This allows for important bilateral relationships to remain in place, but will provide efficiencies such as post-trade processing."

Craig Donohue

According to Donohue, CME is becoming more important as a source of liquidity generally. "The tremendous growth in average daily volume in the FX product line is a function of e-trading. Two and a half years ago, daily volume in our FX contracts was averaging 80,000, today we are seeing about 180,000," he says. "There is no doubt that the exchange model is increasingly prevalent and successful. I don't expect the entire market to become exchange-like, but one way to capitalise on our position as the world's largest derivatives clearing firm is to offer clearing for transactions in forwards, which won't be exchange-like. By clearing forwards through CME, you are squeezing credit costs out of the business model."

"I think we will see more exchange-like execution mechanisms and will see a movement for greater centralised clearing and capital efficiencies – on the back-end/non-execution side – which puts us in an enviable position," Donohue adds.

Globex has undoubtedly seen exponential growth in recent years, particularly in the currency quadrant. "The cash and futures markets will not fully converge for some time – with separate pools of liquidity, one regulated and one unregulated," says Sears. "But as volumes continue to grow (and we've seen them grow on Globex from $4-5 billion initially to $26 billion daily notional value in June), I think we will see similar products for cleared forwards, where lines between cash and forwards continue to be blurred. This makes forwards more accessible because it provides a credit solution."

CME's central counterparty model clearly reduces the need for large credit allocations. "When a position resides at CME, there is no capital necessary – so capital allocation for credit goes away, which means your need to squeeze costs goes away," adds Donohue.

Donohue notes that CME's Clearing House, the world's largest such organisation, clears 85% of all financial futures in the US, and has tremendous scalability (it is fully collateralised, with a twice daily mark to market). On January 2, CME began providing clearing services for all Chicago Board of Trade (CBOT) products. On the capital and credit side, CME has a mutualised risk structure with 80 of the largest financial institutions providing financial guarantees for the clearing house.

"This means there are tremendous network effects in terms of clearing," says Donohue. "By clearing 85% of all financial futures in the US, our model becomes increasingly attractive, particularly if you are already doing business with us."

He adds that CME's integration with CLS, which was started last year, creates further capital savings. "We use CLS for all currencies that we jointly offer, so there is only a single payment per currency pair per delivery, which dramatically reduces the cost of execution."

Sears further points out that Basel II is impacting views on credit and the use of capital. "Basel has potential to dramatically increase the current requirements for capital allocated to FX businesses. CME's clearing house brings more value to the equation," adds Sears. "Our STP and quarterly contracts reduce the number of payments. The fewer payments required also reduces operational risk and, in turn, the need to allocate capital to operational risk. This puts us in a sweet spot regarding the new Basel II capital requirements."

Globalisation

Looking ahead, Leo Melamed, chairman emeritus and senior policy advisor of CME and the man credited with launching the first financial futures as founding chairman of CME's IMM in 1972, suggests a more radical view of the world. "The way events are moving indicates that we are heading in the direction of a globalised market and therefore, a single exchange," says Melamed. "There is a movement towards one world in commerce and nothing can stop it.

"There are three major forces of a single marketplace – Europe, US and Asia – with plays between the currencies of those three regions," he adds. "I can foresee an Asian vs Euro vs North American index in FX that can be applied as an overlay to what you are doing on an underlying basis. There is a great deal of room for innovation in that direction."

"In 1972, we launched the idea of FX futures," Melamed continues. "What I was seeing then was a New World based on the first stages of technology. The transistor was born in 1948; in 1958 it began to be understood; by 1968 some of us recognised that it would mean instantaneous communication. One of those developments would be that all FX market participants would get instantaneous information and therefore needed a market to utilise it. So our goal must be to be the single exchange for foreign exchange. We have the history, the mechanics, the expertise and the vision. CME will be the hub of FX in coming years."