

OTC Clearing: the rapid growth of FX prime brokerage

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ARE YOU UNCERTAIN ABOUT OTC REGULATORY CHANGE? DO YOU WISH YOU HAD ACCESS TO A BETTER CREDIT RATING WHEN TRADING FX? COULD YOUR INFRASTRUCTURE BE IMPROVED? AN FX PRIME BROKER SHOULD BE ABLE TO HELP WITH ALL THESE ISSUES, AS WELL AS MANY OTHERS.

Market development

FX clearing or FX prime brokerage (FXPB) as it is commonly known has been one of the fastest growing areas of the FX market over the past few years, and looks set for further dramatic expansion in 2010. We estimate that the number of organisations using FXPB services has increased from around 500 to over 1,000 since 2007, and believe that it will double again by 2011.

The growth in the FXPB industry has been exponentially driven by the expansion in high frequency algorithmic trading, retail FX trading, and the growing popularity of FX as an asset class (a trend that has led to a marked increase in the number of currency managers and currency-orientated hedge funds).

Until 2008, FXPB services were largely utilised by hedge fund clients. Following the credit events of 2008 and 2009, new client types began to realise the benefits which FXPB offers. In the last few years we have seen real money organisations such as pension funds, mutual funds, insurance companies, sovereign wealth funds and corporations sign up to FXPB services.

The industry has gone through dramatic change, with many clients shifting their business to firms with strong credit ratings, and several banks closing down their FXPB operations because of their inability to compete in the quickly changing landscape.

2010 is likely to be another dramatic year with major regulatory changes expected that will require prime brokers and their clients to make significant changes in their day-to-day operations.

What is FX prime brokerage?

FX prime brokerage is a multi-product service offered by banks to clients that are frequent users of FX products.



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The main services are:

Trade execution access

FX prime brokerage allows clients to trade with whoever they want using their prime broker's credit profile and infrastructure. Clients simply sign a single legal agreement with their FX prime broker, thus removing the need for multiple legal and credit documents with each of their trading parties.

Trade clearing

FX prime brokers provide a centralised clearing facility where clients are able to consolidate post-trade reporting, risk management and settlement across all of their execution counterparties, no matter how the trade was done.

Trade consolidation

All the trades executed are 'given up' to the FX prime broker, which assumes the client's credit risk and that of their counterparties. The FX prime broker then consolidates the trades and calculates a single margin payment for the client that will cover all their trades.

Post-trade risk management

FX prime brokers provide risk management tools and systems that allow clients to monitor their risk exposures in real time, identify potential risk or operational issues and hedge undesired risks.

Trade reporting

Most FX prime brokers provide interactive, real-time mark-to-market reporting products which can be customised to the clients' needs.

Client service support

FX prime brokers maintain 24-hour global support teams to resolve issues encountered with trades. These teams are in separate locations from sales and trading to ensure complete confidentiality.

Strategic advice

Many FX prime brokers offer strategic advice to clients on a wide range of legal, accounting, market, risk management and technology issues.

Cash management

Some FX prime brokers offer cash management products that allow clients to increase the return on the cash or securities being held as collateral.

Capital introduction

Some FX prime brokers can help their clients to find investors by arranging meetings and by structuring investment products linked to the performance of currency funds. These products are becoming increasingly popular; particularly products issued from managed account programs such as Deutsche Bank's Select Platform.

Benefits of prime brokerage

Liquidity

FX prime brokerage allows clients to trade with a large number of institutions round the clock from a single platform including second and third tier banks, and banks specialising in exotic currencies.

Reduced margin requirements

By consolidating trade exposure into one net account, FX prime brokers can reduce the amount of collateral that their clients need to post to execute their FX trades.

Reduced operational risk

The auto-matching technology used by FX prime brokers and their 100% straight-through processing services can significantly reduce operational risk.

Reduced credit risk

Prime brokerage allows the client to face the primary credit profile of their FX prime brokers, thus removing bilateral credit exposure to their end-dealing partners.

Costs of prime brokerage: fees and margins

FX prime brokers only charge a clearing fee for trades which are not executed with the prime broker's franchise trading desk. Thus, it is important for a client to partner with a strong FX house.

Margin requirements are calculated on a net open position basis which consolidates the client's entire portfolio, taking into account the currency pairs involved (G10 currencies requiring less collateral than EM currencies).

Some FX prime brokers offer cross-product margining facilities that allow clients to offset positions held via their prime broker in other asset classes such as listed futures, interest rates and equities.

Future trends

Competition between prime brokers

Over the past year, we have seen an increase in the number of firms offering FXPB services. We believe that this trend is likely to continue during 2010 because of the value that FXPB business adds to the client's business model.

This is great news for users of FXPB services since it should lead to greater competition between providers and spur product innovation.

Clearing

Regulators in the US and elsewhere are in the process of introducing new rules which may require portions of the OTC FX market to be cleared via a centralised counterparty.

The final details of the new regulations (such as which types of trades will be covered) are still being debated, but it is certain that major changes in the way trades are cleared will develop over the course of 2010 and beyond.

For some clients, this will be a major challenge. If their systems are not fully compatible with the centralised

clearing counterparties, they will not be able to execute many types of FX trades. Clients need to partner with an FX prime broker which has proven expertise in adapting its service to an ever-changing landscape.

Deutsche Bank is at the forefront of these developments and has a platform which can easily adapt to the developing marketplace, ensuring that its clients are well positioned for change.

For clients with single and multi-asset clearing needs covering FX, OTC interest rates, credit, equity derivatives, and exchange-traded products, Deutsche Bank has launched **dbClear**.

Conclusion: growth and continued innovation

When the FXPB industry began in 1993, the market was restricted to a tiny number of US and UK users (nearly all hedge funds) and an even smaller number of providers (Deutsche Bank among them). Today, it is a global industry servicing well over 1,000 different organisations. The innovative solutions FXPB has delivered to its clients and the skill sets which FXPB experts employ are well suited to the changing global marketplace.

This growth looks set to continue, making FXPB an integral component of the overall FX market.



Wherever you're going in FX, it pays to have the right support.

New economic realities and uncertainty ensure that change is ever-present in FX. In this environment, you need to be sure of the strength and reliability of your support. Deutsche Bank delivers market leading expertise and innovation. Make the right choice.

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