Deutsche Bank
Global Markets

FX Derivatives – Changes to Market Structure in the Recent Past and Near Future

David Wayne, January 2012

Passion to Perform
Factors Driving the FX Derivatives Market.

- Trends in client flow.
- Market participants and risk tolerance.
- Evolution of liquidity access and the roles of participants.
- Advances in pricing and risk analytics.
- The predicted impact of regulation.
CVIX – A Measure of FX Volatility

$$CVIX = \sum_{i=1}^{9} w_i \cdot vol_i$$

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<th>Currency Crosses and Weights In CVIX</th>
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<td>EURUSD</td>
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<td>GBPUSD</td>
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Risk Premium in FX Derivatives Returned Post Crisis

Average Risk Premium (CVIX 3I - CVIX 1R)
Why has the Risk Premium Returned?

• Uncertain economic environment.
• Fewer clients selling volatility. Corporate clients are largely buyers of options for hedging purposes.
• Risk attitude of market makers. (‘puttability’, capped payoffs and client suitability).
• PRDC products drove out the risk premium over a period of years. These markets are now largely about risk management.
• Hedge fund flows have increased.
• This leads to higher volatility of volatility.
Volatility of Volatility Remains Elevated.
Volatility of Liquidity Remains High.

![Bid-Offer Spread 1month EURUSD Volatility Chart](chart.png)
Changes to the Interdealer Market.

- Actively managing and pricing liquidity is vital.
- Decline in IDB volumes as more risk is hedged internally and in the direct market.
- More sophisticated models at the larger banks mean less need to clear contract specific risk.
- Less barrier option business in the brokers due to improved risk management analytics and higher levels of implied volatility.
- Increase in volume on single bank platforms.
- Hybrid clients – both market maker and customer.
Moving Towards a More Electronic Market.

• Prospective regulation has focussed attention on electronic information and execution.
• Currently little electronic liquidity is available to market makers, but a large amount is available to clients via single bank platforms.
• RFQ with inter-dealer brokers is increasing.

• Multi bank platforms are in their infancy.
  • IDBs
  • RFQ based models
  • Multi to Multi limit order book style platforms
In Summary

• The risk profile of clients and market makers will continue to shape the market.
• Risk premium, which was squeezed out in the years before 2008, has returned and is likely to remain.
• The price of liquidity is volatile.
• Prospective regulation is accelerating the move towards a more electronic market.