Keeping up

Changes in the industry are spurring a wave of innovation in market practice, products and services. Some firms are coping better than others. By Lukas Becker, Matt Cameron, Laurie Carver, Mauro Cesa, Clive Davidson, Peter Madigan, Tom Newton, Joe Rennison, Nick Sawyer, Nazneen Sherif, Michael Watt and Duncan Wood.

For long periods in 2012, it seemed as though the markets were on mute. Volatility was low, volumes were lower and the noise of the trading floor receded into the background. In the hush, it was possible to focus on the slower, structural changes that are taking place. Many of this year’s awards recognise firms, products and individuals that have done most to adapt to these changes – or, in some cases, to bring them about.

In the last month of 2012, Goldman Sachs was a counterparty to the first trades executed using the new standard credit support annex (CSA), a document drawn up over the past two years to help resolve the valuation headaches caused by the market’s post-crisis shift to overnight indexed swap discounting for cash-collateralised trades. Because the relevant discount rate is determined by the currency of the collateral being posted – and because existing CSAs often give counterparties a list of collateral options – the pricing of even plain vanilla trades has become more complex, and valuation disputes have become common.

Goldman is widely seen as the first bank to accept the new valuation orthodoxy, and to have played the biggest role in driving its wider adoption, but it has never spoken about it publicly – as this year’s interest rate derivatives house of the year, this breaks that silence.

Another topic where there is a lot of heat but not much light is the reduction of risk-weighted assets (RWAs) – an imperative if bank trading businesses are to survive in a world of heavier capital requirements. In theory, those businesses have to make simple – although not necessarily easy – changes, and some of this year’s award winners did that in 2012. But existing RWAs also need to be cut, which remains a black art. At Credit Suisse, our derivatives house of the year, this involved complex, set-piece transactions – many of which were executed by a new division the bank created at the end of 2011. But it also required a change in thinking. To get out of many trades, the division had to pay, and colleagues elsewhere in the bank could not, initially, see the rationale. Despite the friction, the bank stuck to its guns, and chief executive Brady Dougan argues Credit Suisse is now closer than any of its peers to having “the investment bank of the future”.

The introduction of mandatory central clearing is another big step for the market – affecting the buy side as well as the sell side, and two of this year’s awards honour firms that stood out for trying to smooth the path. The clearing business at Citi was praised by clients for fighting their corner, while CME Group has been ahead of its rivals in rolling out products and services designed to lighten the burden in terms of margin posting.

Elsewhere in this year’s awards, Pierre Henry-Labordère is quant of the year – recognition for two papers published in Risk last year that have been widely admired, and that run slightly against the grain. In a profession that has reined in some of its ambitions in recent years, Henry-Labordère is a quant’s quant – deeply passionate about mathematics and unwilling to compromise.

As always, it was not easy to pick winners. Where decisions were tight, client feedback often helped settle the issue. The Risk editorial team thanks all participants for their help.

Banks were asked to submit information on their business in each of the asset class and product categories during 2012, and shortlisted companies underwent face-to-face and telephone interviews. Risk then gathered feedback from clients and other market participants. In making the final decisions, a number of factors were considered, including (but not restricted to) risk management, creativity and innovation, liquidity provision, quality of service, and engagement with regulatory issues.

The roll of honour

Derivatives house of the year
Credit Suisse

Lifetime achievement award
Leo Melamed

Interest rate derivatives house of the year
Goldman Sachs

Currency derivatives house of the year
Deutsche Bank

Equity derivatives house of the year
Société Générale Corporate & Investment Banking

Credit derivatives house of the year
Credit Suisse

OTC client clearing service of the year
Citi

Commodity and energy derivatives house of the year
Deutsche Bank

Inflation derivatives house of the year
Royal Bank of Scotland

Structured products house of the year
Goldman Sachs

Hedge fund derivatives house of the year
Deutsche Bank

Bank risk manager of the year
Goldman Sachs

Quant of the year
Pierre Henry-Labordère, SG CIB

Exchange of the year
Eurex

Clearing house of the year
CME Group

OTC trading platform of the year
UBS

OTC infrastructure service of the year
Markit

Sovereign risk manager of the year
Turkish Undersecretariat of Treasury

Hedge fund of the year
CQS

Corporate risk manager of the year
Heathrow Limited

Pension fund of the year
PGGM

Law firm of the year
Allen & Overy

Risk management technology product of the year
FinCAD

Back-office technology product of the year
Isda/Markit

In-house system
Royal Bank of Scotland
CLEARING HOUSE OF THE YEAR
CME GROUP

Nobody knows how much margin will be consumed as over-the-counter derivatives move to a post-crisis regime based on central clearing and two-way collateral posting, but there is one certainty – the less an individual firm has to post, the happier it will be. The result is intense competition to develop low-margin products and services, and CME Group led the way in both respects during 2012 – first offering margin savings across cleared OTC and futures positions, and then launching a new swap futures contract that promises to mimic an OTC swap, but has lower margin requirements.

"Cross-margining is a very important feature for clients trading across different product sets. The rate of savings is going to depend on the duration of a portfolio, but when we look at interest rate futures versus swaps, over time the savings can be as high as 90% on some portfolios," says Kim Taylor, president of CME clearing. "Most portfolios would save 60% to 70% at least. It is a very material reduction in the capital that is constrained."

The service, based on offsets between interest rate futures and OTC interest rate swaps that are cleared at the CME, launched for members of the clearing house in March last year, and was extended to cover clients of those firms in November.

Cross-margining is not new to CME Group. The central counterparty (CCP) first offered a similar service in 1989, offsetting margin across its own stock index futures and equity options handled by the Options Clearing Corporation. The firm’s plans in cleared OTC markets are to offer offsets in energy and foreign exchange next – although no launch date has been set.

The basic idea is to reflect correlations between two different products, so if one type of trade is highly likely to gain value at the same time that another loses value, then there is no need to post margin on each individually – an amount can be charged that covers the net risk at any point in time. And CME has the advantage of a huge pool of cleared interest rate futures, so allowing offsets with OTC swaps ought to make it cheaper for users to do everything in one place.

"If you were clearing futures and swaps at different CCPs, then you would have to pay losses and collect profits in different places – here they net across," says CME’s Taylor.

The obvious danger is that CCPs have a big commercial incentive to promise more than they can safely deliver, potentially leaving themselves under-margined. With cross-margining, the key thing to get right is the degree of correlation between two products, and its permanence.

For product sets with a similar tenor, CME Group assumes a correlation of 90% or higher. As the difference in tenor increases, the correlation reduces to between 50% and 80%, depending on the specific product. Regardless, CME says it will always hold enough margin to ensure price volatilities are covered – part of the correlation benefit is held by CME and not passed on to the customer, creating a buffer. And product sets must maintain their correlation throughout periods of stress, says Phupinder Gill, chief executive at CME. “To the extent it doesn’t hold up against a correlation threshold over time, even if it is high most of the time, then it will not be eligible to benefit,” he says.

CME’s Taylor says each product set is back tested and modelled to different periods of market stress to determine the maximum risk offset possible. “We might not just consider key statistical analysis of correlation risk and back testing, but would also use our own judgement on whether we anticipate something different in the market in the future,” she says. “We would not offer risk offsets if we did not think they were warranted and we would be in a safe position to liquidate a portfolio.”

The CME’s rivals aim to deliver the same kind of benefits. The Depository Trust & Clearing Corporation (DTCC), New York Portfolio Clearing (NYPC) and NYSE Euronext currently run a one-pot margining scheme that allows users to benefit from margin efficiencies between interest rate futures traded on NYSE Liffe US and cleared through NYPC, and fixed-income cash and repo trades cleared by the DTCC’s Fixed Income Clearing Corporation (FICC). On March 14, 2012, the firms announced Project Trinity – an agreement with LCH.Clearnet’s interest rate swap clearing service, SwapClear, to add swaps to the existing one-pot cross-margining arrangement.

But Gill stresses that project is still on the drawing board. “So far, there have been margin offsets of more than $1 billion through CME’s rates cross-margining and we have only just got off the ground. Project Trinity has not achieved any kind of savings – I’m not sure it is even operational yet,” he says.

Down the line, CME hopes to offer cross-margining internationally. The firm has applied for approval to launch a London-based exchange – CME Europe – which will also offer local clearing services. It currently clears predominantly commodity products, but the plan is to expand into other asset

“We would not offer risk offsets if we did not think they were warranted”

Kim Taylor, CME
classes and, ultimately, to ensure a customer using CME’s clearing services in Europe and the US will only have to post a single net margin amount across the two cleared portfolios. Taylor says CME Group has already spoken to both the Commodity Futures Trading Commission (CFTC) and the UK’s Financial Services Authority about the possibility of cross-margining between the two CCPs. But it’s still early days.

“It is certainly our intention to provide our customers with the efficiency benefits of dealing with a global provider such as CME, so it is our plan to provide efficiencies between CME in Europe and CME in the US,” says Taylor.

At first, CME Europe applied for registration as a designated clearing organisation – a clearing house regulated by the CFTC. But that application has since been withdrawn and the suspicion in some quarters is that CME wants to be able to reassure European users of the CCP that it will not be subject to the extraterritorial application of Dodd-Frank Act rules.

Both Gill and Taylor say that’s not true. “We are building out the offering in Europe, both the CCP and now the exchange, based on feedback from customers in the region,” says Taylor.

“There are customers we do not capture fully with the US offering, so we are creating something that suits them. It’s a group that would otherwise not do business in the US, so we have just simply tried to serve a different client base.”

The CME’s new swap futures contract is the other big example of its attempts to offer margin efficiency. This is the second time it has launched the product – the 2002 version flopped after dealers refused to support it – but CME is betting the new regulatory environment will ensure history does not repeat itself, and there are some positive signs already.

An average webinar for a new product at CME tends to attract around 60 people in. When the firm launched its interest rate swap future, 900 people were on the call. “The interest among the community is very, very high,” says Gill. To emphasise the point, CME announced the product with four confirmed market-makers on board. By the launch date, that number had grown to 11.

The contract is a three-month future that delivers a CME-cleared OTC swap at maturity. The chief argument for using the contract instead of an OTC swap is margin efficiency. The CME product will initially be margined using a two-day holding period, as opposed to cleared OTC swaps, which will be margined using a five-day holding period at least, and potentially seven days. When the CME future is delivered into a swap, OTC market rules will apply. But few users are expected to take delivery, says Taylor.

“It is a futures contract for as long as it exists, and when it expires you take one side of an OTC swap,” she says. “It works just like any other futures contract for which there is a physical delivery. If you don’t want to take that swap, then you would roll your swap future into the next expiration. If you don’t want to take delivery and you no longer need your exposure, then you would close out your position before expiration and the delivery process.”

The contract has other benefits too. Although users will have to comply with incoming Dodd-Frank Act regulation for the OTC market at the point of delivery, the contract is a future at the point of execution, therefore avoiding the need to transact on the new swap execution facilities that are set up for OTC trading. Dealers overwhelmed with the task of on-boarding clients to clear OTC swaps may see swap futures as a good substitute, especially when clients already have futures accounts.

“Because there is a deadline – a big ticking clock – dealers are focusing only on key customers and may not catch everyone initially. The swap future allows people who may not have time to do all the documentation to go from a bilateral environment to a cleared environment and cover their exposure in the interval,” says Taylor.

Critics see the product as a regulatory dodge. CME’s Gill accepts it will appeal to participants who want to avoid the new OTC swap rules, but points out they are not evading supervision by the CFTC. "Currently, futures are required to be cleared and the CFTC regulates that. Under Dodd-Frank, swaps are cleared and the CFTC oversees that. So the oversight is the same. People are just looking for an efficient way to cover their exposure. They can’t dodge regulation – it is just not possible – but they can choose what regulation they are subject to,” he says.

These kinds of considerations have won CME Group a lot of fans – among non-dealer market participants in particular – but dealers can often be more ambivalent, or openly critical, of the exchange’s efforts. In part, that is down to years of ingrained hostility between the two. CME has tried repeatedly to eat into the lucrative OTC business by launching rival futures contracts and has crushed a number of dealer-backed competitors. But some accusations are harder to bat away – privately, dealers express concerns about the CCP’s margin methodologies for specific products, and about other elements of its risk management. Similar concerns are levied at the CME’s competitors too, however – in December, Risk revealed that LCH. Clearnet’s SwapClear had been forced to revisit its own margin model after members complained – and it’s fair to say that CCPs are still working on their financial safeguards (Risk December 2012, page 8, www.risk.net/2229594).

Getting these things right will be critical to the success of any CCP – as will rolling out the right products and services. “We are always concerned about competition, but at the end of the day, no other CCP can offer the same value proposition as us – we’re just focusing on adding value for our clients,” says CME’s Gill.
Confidence to invest

That’s what commercial lenders can achieve when they’re smart about managing risk. And smart lenders can seed innovative new businesses by working with CME Group, the world’s leading derivatives marketplace. Emerging growth companies and financial institutions around the world partner with us to manage virtually every kind of risk. Interest rate fluctuations, stock market movements, changing currency valuations – whatever the risk, we help the world advance beyond it. Learn more at cmegroup.com/advance.