Steps to success

Deutsche Bank has topped Risk Australia*'s inaugural derivatives survey. However, recent volatility in the credit markets has created a challenging environment for banks. By **Pamela Tang**, with research by **Xiao-Long Chen***

Australian markets have performed strongly this year – at least until the past couple of months. The benchmark ASX200 equity index was up more than 23.7% for the fiscal year 2007, implied volatilities had fallen, credit spreads were tight enough to support a rash of leveraged buyout activity and the country's commodity behemoths had full order books.

The benign environment provided an opportunity for large dealers to share product ideas often generated in far-flung locations such as London and New York. Equity structured products, although less complex than those offered in other parts of Asia, sold well. And bank portfolio managers adjusted their liability exposures by seeking cheaper funding options as interest rates rose. Complex credit derivatives structures like constant proportion debt obligations were also popular in both Australia and New Zealand.

But that all changed in July. Rising delinquencies in the US subprime mortgage market led to revelations of large losses at several firms that had invested in collateralised debt obligations (CDOs) referencing subprime loans, including Sydney-based hedge fund Basis Capital. What started as a subprime mortgage problem spread across the credit market, causing spreads to widen sharply and liquidity in the secondary market to dry up.

This changing landscape has put pressure on banks to adapt to a new reality and – so far – it appears that the top banks in *Risk Australia*'s inaugural derivatives survey are poised to deal with the market changes. "One of the largest issues [with the recent volatility] is that it has highlighted the risk premium in products that clients normally assume as liquid, so certainly some prices have widened in liquid instruments," says Ian Martin, the Sydney-based director of rates at Deutsche Bank, which took top honours in the poll with 11.7% of the total vote. The German bank placed first in the interest rate categories, second in credit, third in equities and fourth in currency.

"Clients appreciate that Deutsche is willing to commit to provide liquidity in key market places so clients can transfer risk," adds Martin. "We have always positioned ourselves as a client-orientated organisation and servicing the client has been at the forefront of the bank's mission."

Current market volatility levels have resulted in concern regarding short-term liquidity, particularly the difficulty in rolling over short-term commercial paper. However, bankers are confident that present conditions will not derail the buoyant growth in Australia's credit markets. They believe that, as short-term liquidity returns, the focus will switch to the refinancing of term debt from frequent issuers, again primarily financial issuers and asset-backed issuers. Structured flows in the form of CDOs, however, are likely to be on hold for the foreseeable future.

"Issuers that require cash to meet funding or capital requirements will have to come to market – post the northern hemisphere summer – and new clearing levels for that debt will be established," says Kevin Kosovich, Deutsche Bank's head of credit trading for Australia and New Zealand in Sydney. But, he says, determining clearing levels and future direction will rely on a number of external factors including the continued health of the real economy, resulting stock market movements and the performance of related financial sectors outside of subprime – in particular consumer finance. "The one thing that's reasonably certain is that we're very unlikely to return to the technically driven low credit spreads and volatility levels seen earlier this year," Kosovich adds.

David Hawkins, executive director of credit trading at JP Morgan in Sydney, says the key to riding out volatility is being flexible and meeting the challenges posed by clients. "Although the tone has generally been very negative in the past few weeks, it is important to remember that sudden rebounds caused by short squeezes can also be extremely painful," says Hawkins. "It is important to listen to clients, not just in our immediate business but also across other areas of the bank. So, for example, we have a better understanding of how developments in the commercial paper market or flows in the foreign exchange market might impact the credit default swaps (CDSs) market."

Hawkins says JP Morgan's global presence has helped the Australian operation this year. "Although it is always important to keep in contact with our counterparts in other locations, in times of stress it is vital that we can access and distil the wisdom and vision of the franchise, whether it be an innovation coming out of a trading group in London or macro research from New York drawing parallels to the aftermath of the Asia crisis in 1997," he says. This gives the dealer sufficient expertise to enable clients to achieve their goals, Hawkins adds: "It's also important for traders on the ground that they feel they have the support and understanding from management to continue to provide support to clients in the darkest hours."

JP Morgan performed strongly in the credit derivatives categories, with 17.8% of the overall vote, giving it a firm lead over rivals Deutsche Bank, which came second with 14.5%, and Morgan Stanley, in third place with 10.2%. JP Morgan came first in all five subcategories – single-name investment grade CDSs, single-name high-yield CDSs, iTraxx Australia tranches, synthetic CDOs (whole capital structure) and bespoke single-tranche CDOs.

Australian banks

Australian banks also performed well in the survey, with the Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), ANZ and Westpac coming in third, fourth, fifth and sixth, respectively. These domestic banks swept all the top spots in the currency category, with Westpac, ANZ and CBA taking the top-three places, with 14.5%, 12.3% and 9.9% of the vote, respectively.

Currency dealers have also had to deal with some challenging market conditions – most notably the ramp-up of carry trades (where investors take advantage of cheap funding in Japanese yen or Swiss francs and invest in currencies with higher interest rates in countries like Australia and New Zealand).

"Deutsche is willing to commit to provide liquidity in key market places so clients can transfer risk"

Ian Martin, Deutsche Bank

The carry trades have tended to ignore economic fundamentals for long periods of time, says Graeme Edie, Sydney-based global head of foreign exchange derivatives and risk at Westpac. He says the performance of the New Zealand dollar has defined fundamentals and that a sharp rise in the current account deficit typically would undermine the currency. However, this has not been the case for much of the year.

The Australian banks say their established domestic presence offers them an advantage in being well positioned to handle and even take advantage of the flow activity – particularly that of the unwinding of the carry trade, which has taken place during the past couple of months. "Westpac's prominent role in the Australian dollar, New Zealand dollar and Asian currencies has positioned us well to see and interpret the effects of the carry trade on foreign exchange markets, especially the increasingly important Japanese retail sector," Edie says. "This group of investors has had a large influence on the market by not only reducing volatility for large periods of time but also exaggerating periods of high volatility for short periods of time. Staying on top of this flow is very important to us and our clients."

Brendan White, general manager for institutional and corporate sales at CBA, agrees. "We know that we are entering a period of continued volatility, risk and uncertainty but, because we have clients on both sides of the market, we are in the position to provide the liquidity, pricing support and individual product and risk management solutions to support our clients," says White. "We are in a good position in terms of where the markets are placed and that scale allows us to provide liquidity to the market."

Liability hedges

The interest rate market has also experienced a roller-coaster year, moving from a period of relative stability to one of significant volatility. The interest rate markets have been dominated by rising rates during the past 12 months, and this has created some opportunities in the market as increased expectations of higher rates pushed clients towards liability hedging.

Hedge funds were also active in the market as they took advantage of interest rate differential between Australia and Japan. "Earlier in the year, our business was focused on the leveraged flows from global hedge funds, as well as the ongoing investment from the Asian region," says David Ioannidis, head of interest rate trading for Australia and New Zealand at Citi. "Lately, we have seen a decrease in the amount of leveraged money being put to work and also some unwinding of the carry trade."

These changes in the markets have challenged banks' ability to manage their interest rate businesses. And some dealers appear to have thrived. NAB, for example, came second in interest rates, earning 12.2% of the vote in that category – it also took three top spots and two second places out of 15 subcategories in total. "We have placed more emphasis on the interbank market in the past 18 months. Being a large commercial bank in Australia, we wanted to be a fairly aggressive player in key areas such as derivatives," says John Feeney, NAB's global head of rates and credit.

"We are the largest player in the domestic bank bill market, giving us a lot of interest in the short-end derivatives. This, in turn, increases our interbank interest in overnight index swaps and forward rate agreements," says Feeney. "Also, we have been more active in supporting prices in the broker markets across the yield curve to attract more interbank business."

Equity derivatives

Meanwhile, equity derivatives in Australia have experienced significant growth over the past 12 months, thanks to the explosion of structured products business, says Steve Boxall, head of equity derivatives for UBS in Australia. "A lot of the risk mitigation in structured products lends itself to hedging in a single stock or indexes and so we have seen increased activity," he says. Index options, for example, have seen significant growth, fuelled by clients that want to overlay them across their broader portfolio to hedge against adverse market moves.

UBS finished first in the equity category, with 20.2% of the vote, and also took top spots in the single stock options and index option subcategories. Boxall says the bank's edge in this market comes from its strength in pricing, risk management, structuring and wrapping.

Equities did not escape the recent bout of volatility, which has seen the ASX200 trade through a 700-point range during August, although the index had been up 23.7% in the 2006/2007 financial year. But Boxall is confident that, when the dust has settled, clients will return to the market and has already seen indications of this happening. "We work closely with our clients to monitor their positions, so that we can offer them advice on what is best to do with their core positions," he says. "And, for some of our clients, these market conditions provide a good opportunity to put on new transactions at advantageous levels."

Like UBS, Citi in Australia appears ready to take on the challenges its clients have for its equities business. "We are a big bank and we want to embrace risk better than other houses. We have the ability to take risk from derivatives users around the globe and recycle it to other users," says Paul Darwell, head of equity derivatives at Citi. "A comprehensive derivatives platform in each of the world's major financial markets is at the core of this initiative. Australia is one of these major markets, and our business here covers the entire spectrum of users, from retail and hedge funds through to institutional and corporate clients."

Another way the bank differentiates itself is by comprehensive coverage of the markets. Citi, for example, has increased the number of stocks on which it makes markets to more than 80. In warrants – an area in which Citi took the top spot – the bank has shifted its focus from trading to investment-style products. According to Darwell, Citi has in the past few years moved from a focus on trading and barrier warrants to issuing instalment warrants, including a new series of self-funding products. In the past 12 months alone, Citi has issued over 300 instalment warrants. ■

How the survey was conducted

Risk Australia's inaugural Australian derivatives survey was completed by 207 dealers, brokers, corporates and asset managers in Australia and New Zealand.

Participants were asked to vote for their top-three derivatives dealers in order of preference in derivatives categories in which they had traded over the course of the year. The survey covered 38 derivatives categories, divided into interest rates, currency, equity and credit. The votes were weighted, with three points for first place, two points for second and one for third. Only categories with a sufficient number of votes are included in the final poll.

The survey includes a series of overall product leader boards, calculated by aggregating the total number of weighted votes across individual categories.

Overall top 10 banks

2007	Bank	%
1	Deutsche Bank	11.7
2	Citi	10.1
3	Commonwealth Bank of Australia	9.3
4	National Australia Bank	9.0
5	ANZ	7.7
6	Westpac	7.1
7	UBS	6.4
8	Goldman Sachs	6.2
9	Société Générale	5.7
10	Bank of New Zealand	5.2

Overall top 3 brokers

2007	Bank
1	Icap
2	BGC
3	GFI

BEST RISK MANAGEMENT ADVISORY

17 banks cited

2007	Banks	%
1	ANZ	15.8
2	Deutsche Bank	12.5
3=	Citi	11.2
3=	Goldman Sachs	11.2
5	UBS	8.5

BANKS

INTEREST RATES OVERALL

2007	Banks	%
1	Deutsche Bank	13.5
2	National Australia Bank	12.2
3	Citi	10.3
4	Commonwealth Bank of Australia	9.4
5	ANZ	8.8
6=	Bank of New Zealand	7.2
6=	Westpac	7.2
8	UBS	5.8
9	Goldman Sachs	5.4
10	Société Générale	5

CURRENCY OVERALL

2007	Banks	%
1	Westpac	14.5
2	ANZ	12.3
3	Commonwealth Bank of Australia	9.9
4	Deutsche Bank	9.4
5	UBS	7.4
6	Citi	6.6
7	National Australia Bank	6.1
8	Société Générale	5.4
9	Bank of New Zealand	5.1
10	Goldman Sachs	4.8

EQUITY OVERALL

2007	Banks	%
1	UBS	20.2
2	Citi	19.3
3	Deutsche Bank	17.5
4	Macquarie Bank	11.8
5	Goldman Sachs	7.8
6	Westpac	5.1
7	Société Générale	4.6
8	JP Morgan	4.1
9	ABN Amro	3.7
10	BNP Paribas	3.2

CREDIT OVERALL

2007	Banks	%
1	JP Morgan	17.8
2	Deutsche Bank	14.5
3	Morgan Stanley	10.2
4	Lehman Brothers	8.5
5	UBS	7.8
6	Westpac	7.1
7	Goldman Sachs	6.2
8=	ABN Amro	5.5
8=	Merrill Lynch	5.5
10	Citi	4.7

BROKERS

INTEREST RATES OVERALL

2007	Brokers
1	Icap
2	BGC
3	Tullett Prebon

CURRENCY OVERALL

2007	Brokers
1	BGC
2	Icap
3	OMF Limited

EQUITY OVERALL

2007	Brokers
1	GFI

CREDIT OVERALL

2007	Brokers
1	BGC
2	GFI

> "We're very unlikely to return to the technically driven low credit spreads and volatility levels seen earlier this year"
>
> Kevin Kosovich, Deutsche Bank

Risk Australia Rankings 2007

INTEREST RATES

INTEREST RATE SWAPS

Australian dollar
20 banks cited

2007	Banks	%
1	National Australia Bank	16.2
2	Commonwealth Bank of Australia	14.8
3	Deutsche Bank	11.1
4	Citi	10.1
5	Société Générale	9.5
Top broker	Icap	

New Zealand dollar
13 banks cited

2007	Banks	%
1	ANZ	21.1
2	Westpac	16.4
3	Bank of New Zealand	13.8
4	UBS	13.3
5	Deutsche Bank	11.3
Top broker	Icap	

US dollar
14 banks cited

2007	Banks	%
1	Deutsche Bank	14.2
2	Citi	12.3
3	National Australia Bank	10.4
4	JP Morgan	8.5
5	ANZ	7.5
Top broker	Icap	

INTEREST RATE OPTIONS

Australian dollar
14 banks cited

2007	Banks	%
1	Commonwealth Bank of Australia	15.5
2	National Australia Bank	14.5
3	Deutsche Bank	11.4
4	Citi	9.9
5	Société Générale	9.3
Top broker	Icap	

New Zealand dollar
13 banks cited

2007	Banks	%
1	Westpac	19.1
2=	ANZ	17.6
2=	Bank of New Zealand	17.6
4	Commonwealth Bank of Australia	11.4
5	Deutsche Bank	8.4
Top broker	Icap	

US dollar
15 banks cited

2007	Banks	%
1	National Australia Bank	12.5
2	Goldman Sachs	10.9
3	Deutsche Bank	9.4
4	JP Morgan	8.8
5	Société Générale	8.4
Top broker	Icap	

INTEREST RATE EXOTICS

Australian dollar
13 banks cited

2007	Banks	%
1	Deutsche Bank	15.5
2	Citi	13.2
3	Commonwealth Bank of Australia	11.9
4	UBS	9.1
5	Macquarie Bank	6.8
Top broker	Icap	

New Zealand dollar
12 banks cited

2007	Banks	%
1=	ANZ	19.1
1=	Bank of New Zealand	19.1
3	Westpac	14.3
4	UBS	12.3
5	Citi	9.5
Top broker	Icap	

US dollar
14 banks cited

2007	Banks	%
1	Goldman Sachs	14.6
2	Deutsche Bank	13.9
3=	Citi	11.6
3=	National Australia Bank	11.6
5	UBS	9.5
Top broker	Icap	

REPURCHASE AGREEMENTS

Australian dollar
13 banks cited

2007	Banks	%
1	National Australia Bank	15.2
2	Citi	12.9
3=	Commonwealth Bank of Australia	11.8
3=	Westpac	11.8
5	ANZ	10.6
Top broker	Icap	

New Zealand dollar
12 banks cited

2007	Banks	%
1=	ANZ	17.8
1=	Bank of New Zealand	17.8
3	Citi	16.4
4	Westpac	15.1
5	UBS	14.3
Top broker	Icap	

US dollar
9 banks cited

2007	Banks	%
1	Deutsche Bank	18.5
2	Citi	17.6
3	Commonwealth Bank of Australia	14.7
4	ANZ	11.8
5	National Australia Bank	10.2
Top broker	Icap	

FORWARD RATE AGREEMENTS

Australian dollar

11 banks cited

2007	Banks	%
1	Deutsche Bank	16.6
2	National Australia Bank	15.8
3	Commonwealth Bank of Australia	14.3
4	Citi	9.5
5	ANZ	7.9
Top broker	BGC	

New Zealand dollar

10 banks cited

2007	Banks	%
1	Westpac	22.6
2	ANZ	21.4
3	Deutsche Bank	15.5
4	Citi	14.3
5	Bank of New Zealand	10.7
Top broker	Icap	

US dollar

13 banks cited

2007	Banks	%
1	Deutsche Bank	15.2
2=	Citi	13.6
2=	Commonwealth Bank of Australia	13.6
4	Macquarie Bank	12.1
5	Goldman Sachs	9.5
Top broker	Tullett Prebon	

CURRENCY

CROSS-CURRENCY SWAPS

Yen/Australian dollar

14 banks cited

2007	Banks	%
1	Westpac	15.9
2=	Commonwealth Bank of Australia	13.8
2=	National Australia Bank	13.8
4	Citi	10.3
5	ANZ	8.6
Top broker	BGC	

Yen/New Zealand dollar

13 banks cited

2007	Banks	%
1	Westpac	16.1
2	ANZ	15.5
3	Deutsche Bank	11.9
4	Goldman Sachs	9.5
5	Commonwealth Bank of Australia	7.1
Top broker	BGC	

US dollar/Australian dollar

15 banks cited

2007	Banks	%
1	ANZ	14.9
2	UBS	12.8
3	Commonwealth Bank of Australia	11.2
4	Deutsche Bank	10.3
5	National Australia Bank	9.3
Top broker	BGC	

US dollar/New Zealand dollar

14 banks cited

2007	Banks	%
1	ANZ	20.3
2	Commonwealth Bank of Australia	19.2
3	Westpac	10.9
4=	Citi	9.4
4=	Deutsche Bank	9.4
Top broker	BGC	

CURRENCY OPTIONS

Yen/Australian dollar

11 banks cited

2007	Banks	%
1=	ANZ	15.8
1=	Commonwealth Bank of Australia	15.8
3	UBS	13.9
4	Westpac	13.3
5	Deutsche Bank	8.9
Top broker	BGC	

US dollar/Australian dollar

13 banks cited

2007	Banks	%
1=	ANZ	16.6
1=	Commonwealth Bank of Australia	16.6
3	UBS	13.9
4	Deutsche Bank	11.5
5	Citi	7
Top broker	Icap	

US dollar/New Zealand dollar

9 banks cited

2007	Banks	%
1	Commonwealth Bank of Australia	23.3
2	ANZ	20
3	Westpac	15.5
4=	Deutsche Bank	11.3
4=	UBS	11.3
Top broker	Icap	

CURRENCY (CONT.)

CURRENCY FORWARD

Yen/Australian dollar

12 banks cited

2007	Banks	%
1	Commonwealth Bank of Australia	18.8
2	Westpac	12.5
3	UBS	10.9
4	National Australia Bank	9.4
5	Goldman Sachs	8.2
Top broker	Tullett Prebon	

Yen/New Zealand dollar

11 banks cited

2007	Banks	%
1	Westpac	19.1
2	Commonwealth Bank of Australia	17.9
3	ANZ	12.8
4	Bank of New Zealand	10.3
5	Deutsche Bank	7.7
Top broker	OMFinancial Limited	

US dollar/Australian dollar

13 banks cited

2007	Banks	%
1	Commonwealth Bank of Australia	15.1
2	Deutsche Bank	13.8
3=	UBS	12.7
3=	Westpac	12.7
5	National Australia Bank	10.6
Top broker	Tullett Prebon	

US dollar/New Zealand dollar

12 banks cited

2007	Banks	%
1	Westpac	16
2	UBS	14.7
3=	Commonwealth Bank of Australia	9.3
3=	National Australia Bank	9.3
5	ANZ	8
Top broker	OMFinancial Limited	

EXOTIC CURRENCY PRODUCTS

US dollar/Australian dollar

10 banks cited

2007	Banks	%
1	Westpac	21.1
2	Commonwealth Bank of Australia	17.2
3	UBS	16.2
4	ANZ	12.3
5	Société Générale	10.3
Top broker	BGC	

US dollar/New Zealand dollar

9 banks cited

2007	Banks	%
1	Westpac	22.1
2	UBS	18.6
3	Commonwealth Bank of Australia	15.6
4	Deutsche Bank	12.5
5	Citi	9.4
Top broker	BGC	

COMMODITIES

AGRICULTURAL DERIVATIVES

10 banks cited

2007	Banks	%
1	Macquarie Bank	21.4
2	Rabobank	19.4
3	National Australia Bank	14.7
4	Barclays Capital	11.7
5	Westpac	8.8
No broker cited		

METALS

9 banks cited

2007	Banks	%
1	Barclays Capital	18.2
2	Goldman Sachs	17.6
3	Westpac	12.1
4	UBS	9.4
5	Morgan Stanley	8.4
Top broker	TFS	

CREDIT

SINGLE-NAME INVESTMENT GRADE CREDIT DEFAULT SWAPS

10 banks cited

2007	Banks	%
1	JP Morgan	15.9
2	Deutsche Bank	12.9
3	UBS	11.7
4	Westpac	10.4
5	Morgan Stanley	7.8
Top broker	GFI	

SINGLE-NAME HIGH-YIELD CREDIT DEFAULT SWAPS

9 banks cited

2007	Banks	%
1	JP Morgan	18.5
2	Deutsche Bank	16.5
3	Goldman Sachs	12.1
4=	Morgan Stanley	10.2
4=	Westpac	10.2
Top broker	BGC	

iTraxx AUSTRALIA TRANCHES

9 banks cited

2007	Banks	%
1	JP Morgan	19.4
2	Deutsche Bank	16.8
3	ABN Amro	14.8
4	Morgan Stanley	8.5
5	Lehman Brothers	6.5
Top broker	BGC	

SYNTHETIC CDOs – WHOLE CAPITAL STRUCTURE

11 banks cited

2007	Banks	%
1	JP Morgan	18.4
2	Deutsche Bank	17.1
3	Morgan Stanley	12.8
4	UBS	8.5
5	Lehman Brothers	7.8
Top broker	BGC	

BESPOKE SINGLE-TRANCHE CDOs

10 banks cited

2007	Banks	%
1	JP Morgan	19.9
2	Deutsche Bank	14.5
3=	Lehman Brothers	10.9
3=	Morgan Stanley	10.9
5	UBS	9.1
Top broker	BGC	

EQUITY

SINGLE-STOCK OPTIONS
Australia

14 banks cited

2007	Banks	%
1	UBS	21.8
2	Citi	18.4
3	Deutsche Bank	17.2
4	Macquarie Bank	10.2
5	Goldman Sachs	8.5
Top broker	GFI	

EQUITY INDEX OPTIONS
ASX 200

12 banks cited

2007	Banks	%
1	UBS	19.5
2	Citi	18.2
3	Deutsche Bank	15.3
4	Goldman Sachs	11.8
5	Macquarie Bank	9.4
Top broker	GFI	

WARRANTS
Australia

10 banks cited

2007	Banks	%
1	Citi	22.6
2	UBS	20.1
3	Deutsche Bank	17.6
4	Macquarie Bank	13.9
5	Westpac	11.1
No broker cited		

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>
> Brendan White, Commonwealth Bank of Australia