DeutschesRisk

Simplicity is best

Derivatives dealers face uncertainty on several fronts – among them, low interest rates and Brexit – and are offering clients simplicity as regulatory change continues apace. By Pauline McCallion

Uncertainty has reigned over the past year in European markets. Dealers and clients have faced political upheaval in the form of the Brexit vote, with the UK's shock decision to leave the European Union (EU) necessitating a readjustment of long-term investment strategies and hedging needs, particularly in relation to currency risk management. In addition to that, the European Central Bank (ECB) has kept rates at or below present levels, sending investors on a hunt for yield and adding to the need for market risk management solutions. Throughout all of this, the all-too-familiar drumbeat of regulatory change has continued steadily in the background, necessitating an overhaul of risk management infrastructure to ensure compliance with new regimes such as the clearing requirement of the European Market Infrastructure Regulation (Emir) and the upcoming *Fundamental review of the trading book* (FRTB).

According to banks, their clients are looking for simplicity when it comes to risk management solutions as a result of these conditions. In a bid to find yield where they can, investors are looking for non-traditional assets, and dealers must develop operating models that can ensure compliance with new financial regulations, as well as supporting the changing risk management needs of their clients.

Commerzbank has topped the 2016 *Deutsches Risk* Rankings, which were compiled from votes cast by dealers, brokers, corporates and asset managers in Germany, Austria and Switzerland. UniCredit and Deutsche Bank placed second and third, respectively, while the top five was completed by JP Morgan followed by Frankfurt-based co-operative banking group DZ Bank. Across the individual categories, Commerzbank was ranked top dealer in interest rate and currency derivatives in the region, while UniCredit leads the equity products and risk management categories.

According to Nikolaus Giesbert, head of fixed income and currencies at Commerzbank, "decomplexity" has been a key trend over the past year, as German financial market participants have faced a variety of new issues stemming from regulation, geopolitical events such as the Brexit vote, and "very, very difficult" market conditions due to the current yield environment and the ECB's ongoing quantitative easing programme. As such, Giesbert says that cash trading has been less liquid, with asset managers and institutional investors employing more buy-and-hold strategies. "They are looking for yield, which generates more primary market activity in terms of origination and distribution," he says.

The governing council of the ECB has held rates at 0% for main refinancing operations, 0.25% for the marginal lending facility and –0.40% for the deposit facility since March 2016. Prior to that, these rates were at 0.05%, 0.30% and –0.30%, respectively – the latter having been pushed into negative territory in June 2014.

Laurent Dupeyron, global head of the financial institutionals cluster at UniCredit, says recent ECB actions have been the most significant factor affecting client activity over the past year. "This is really the main driving factor in terms of the investment philosophy of our clients right now," he says. This has resulted in demand for more non-traditional investments as UniCredit clients look for yield. "We've seen what I would call a hunt for yield, which, in practice, means demand for infrastructure assets, infrastructure bonds or equity related to infrastructure, renewable energy and project

Overall

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>
> Nikolaus Giesbert, Commerzbank

finance assets. So, long-term investments with quite good visibility on cashflow, but a decent yield as they are less liquid … this is something we have observed over the last one to two years, and we think it's in direct relation to the European interest rate policy."

And, in terms of risk management activity specifically, Commerzbank's Giesbert says negative rates have created disruptions in the market as financial institutions have faced the costs of the sub-zero rate. As a result, the market for sub-zero strikes in the options market, for example, has seen an increase in demand. Giesbert expects further dislocation as a result of sub-zero rates. "Banks would find it difficult to pass on sub-zero deposit rates to clients, and the negative yield has also increased demand for yield-enhancing products in general, due to investors' need for better returns." Consequently, he says, this has led to a decline in institutional investors' willingness to take on risk in relation to credit positions, as well as increased demand for ways to manage market risk through derivatives. "Overall, with less trading and more demand for buy-and-hold strategies and market risk management, demand has increased for less complex, plain vanilla swap business. This is on the foreign exchange side from a structured perspective, as well as from a position perspective in terms of forex overlay strategy management, currency management or forex forward swaps." Commerzbank topped the currency rates categories in this year's *Deutsches Risk* Rankings, leading the rankings in forex swaps, options and forwards.

Brexit uncertainty

Another major source of uncertainty for the market at the moment is the likely denouement of the Brexit saga. The exact details surrounding the UK's decision to leave the EU, set in motion by a referendum held on June 23, 2016, remain murky. Markets are still in the dark as to when the UK will invoke Article 50 of the Lisbon treaty, which would start the exit process, as well as the future relationship between the City of London and other financial centres in Europe. Dupeyron calls Brexit "the big uncertainty at the moment", but says UniCredit is ready for various outcomes as this situation unfolds. "We feel we are quite well prepared due to the nature of our business," he explains. "UniCredit covers institutional clients from three main centres: two in continental Europe, which are Munich and Milan, and one in London. If it's necessary, we have multiple options to adapt to all scenarios."

For clients of Commerzbank, Brexit has caused a re-examination of long-term strategies, as well as hedging needs in the forex space, specifically due to weakness in sterling since the June vote. Giesbert says there has been some surprise in relation to how well the market has digested the news so far, but there is also a degree of impatience in relation to the likely timing for Article 50.

"Many investors have held back investments because they want to better understand the UK's position going forward," Giesbert says. Unsurprisingly, the regulatory overhaul that has been occurring in the aftermath of the 2008 financial crisis has also continued to make its mark on German financial market participants over the past year, as it has across the global financial sector. However, organisations are getting to grips with the ins and outs of many of the new requirements, which has allowed for the development of new solutions to address changing compliance needs. This has led to greater efficiencies in many areas, particularly in relation to the use of automation. On the other hand, it is also likely to continue to affect cost structures and the product offerings of banks.

Emir overhaul

As part of the global effort to reduce systemic risk in the financial markets, the new requirements under Emir mean organisations must now clear certain types of over-the-counter derivatives through a central counterparty. In implementing the necessary changes to systems and processes to ensure compliance, derivatives market participants have, and will continue to, encounter new developments in relation to how dealers operate and what they can offer to their clients. "It's completely changing the way we do business with clients because the products are more standardised and there is much more electronic business, more automated processes," Dupeyron says of the new rules. "As a consequence of that, fewer people are needed to execute the same amount of business, or much more business can be done with the same amount of people – whichever way you want to look at it."

But while new rules have triggered infrastructural overhauls within banks that should lead to increased efficiencies, there will also be implications for costs and product offerings. According to 63% of respondents to a survey conducted by *Risk.net* among banks, asset managers, hedge funds and corporates that voted in the rankings, derivatives pricing will increase by up to 5% as a result of the clearing regulation. Giesbert agrees that, as organisations prepare to comply with new regulations, costs will increase, particularly when market participants experience any uncertainty pre-implementation.

"The increased regulatory burden means the overall cost of supplying products increases and, quite simply, I think banks have to continuously review and streamline their product range," he says, adding that any products that require the use of multiple IT platforms to replicate risk with a long maturity tend to be very costly and will only increase in price.

As such, Giesbert sees a real need for an emphasis on efficiency going forward. He says that new regulations such as the Basel Committee on Banking Supervision's FRTB – which overhauls existing market risk capital requirements – are currently driving organisations to manage their IT and operational resources with more efficiency. He adds: "The platforms that have been built in the past start to be expensive without the necessary bank balance sheet to support the liquidity. And, on the other hand, clients are less willing to enter into transactions in a negative yield environment, particularly when there is no expectation that this environment will change. That is why it gains importance to be very focused on cost management, 'decomplexity', and front-to-back production costs."

more active and dominant in this space," Dupeyron says. "Our key positioning is to move to a model based on partially distributing the financing of these assets." As such, the bank will offer clients products tailored to meet this growing demand for non-traditional, long-term investments it has identified in recent years.

As new financial regulations are rolled out in a range of areas, and organisations begin to fully understand and develop the necessary compliance infrastructure in response, regulatory uncertainty has started to dissipate – in relation to certain regime changes, at least. However, this sense of uncertainty has simply transferred to new issues and events over the past year, ensuring that market participants continue to search for simplicity when it comes to investing and managing risk in the current market conditions.

The UK's Brexit decision shocked the market and impacted activity, according to dealers. And while uncertainty remains in relation to how and when the UK will actually break away from the EU, the market has 'digested' the news to a certain extent. The low-rate environment that has dogged Europe due to the ECB's continued programme of rate holds and rate cuts has added another layer of difficulty for German financial market participants. This has been reflected in the increasing demand for primary financing and market risk management tools. As German dealers note, derivatives demand has continued to shift away from complexity as a result, and clients are increasingly searching for yield-bearing investments and risk management solutions that can weather the current market conditions. Banks expect this environment to continue and are adapting their offerings in response. **R**

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Developing a new approach

The current regulatory environment has encouraged Commerzbank to focus on improving its technology infrastructure, particularly electronic trading in relation to price identification as well as distribution channels, Giesbert says. "With the new regulations, the emphasis is on reporting an enormous amount of detail about each transaction, and this can only be achieved with robust infrastructure," he explains. The bank is also focused on reducing complexity – and therefore cost – and enhancing the efficiency of its entire value chain for clients. "The result is lean business, where we can help clients add liquidity through derivatives and obviously make sure that we are adapting to demand by focusing on fee structure and platforms. The intensity of cash movement is now of less interest to clients, so we must ensure we have growing liquidity for derivatives and that we are sourcing primary financing."

Similarly, the current low interest rate environment has prompted UniCredit to "reorganise the distribution and the way we are organised around these types of assets [non-traditional investments] so that we can become

Risk Deutsches Rankings 2016

Overall

Interest rates

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5	–	DZ Bank

Currencies

2016	2015	Bank
1	**1**	**Commerzbank**
2	–	UBS
3	2	Deutsche Bank
4	–	UniCredit
5	4	Bank of America Merrill Lynch

Equities

2016	2015	Bank
1	1	UniCredit
2	4	Deutsche Bank
3	**2**	**Commerzbank**
4	–	DZ Bank
5	–	JP Morgan

Interest rates

Interest rate swaps

2016	2015	Bank
1	**1**	**Commerzbank**
2	3	UniCredit
3	–	JP Morgan

Forward rate agreements

2016	2015	Bank
1	**1**	**Commerzbank**
2	3	UniCredit
3	2	Deutsche Bank

Cross-currency swaps

2016	2015	Bank
1	**1**	**Commerzbank**
2	5	Bank of America Merrill Lynch
3	–	Barclays

Interest rate options

2016	2015	Bank
1	3	UniCredit
2	**1**	**Commerzbank**
3	–	DZ Bank

Repurchase agreements

2016	2015	Bank
1	3	Deutsche Bank
2	4	UniCredit
3	**1**	**Commerzbank**

Currencies

Currency swaps

2016	2015	Bank
1	**1**	**Commerzbank**
2	3	Deutsche Bank
3	2	UBS

Currency options

2016	2015	Bank
1	**3**	**Commerzbank**
2	–	UBS
3	4	Deutsche Bank

Currency forwards

2015	2014	Bank
1	**1**	**Commerzbank**
2	–	UBS
3	3	Deutsche Bank

Equity

OTC single-stock options
Germany

2016	2015	Bank
1	1	UniCredit
2	–	DZ Bank
3	–	JP Morgan

OTC single-stock options
International

2016	2015	Bank
1	2	UniCredit
2	–	DZ Bank
3	–	Deutsche Bank

Equity index options

2016	2015	Bank
1	5	JP Morgan
2	4	Deutsche Bank
3	1	UniCredit

Exchange-traded funds

2016	2015	Bank
1	1	UniCredit
2	**2**	**Commerzbank**
3	4	Deutsche Bank

Other

Credit derivatives

2016	2015	Bank
1	–	UniCredit
2	**2**	**Commerzbank**
3	–	BNP Paribas

Commodities

2016	2015	Bank
1	**1**	**Commerzbank**
2	–	Bayern Landesbank
3	3	UniCredit

Structured products

2016	2015	Bank
1	2	UniCredit
2	**3**	**Commerzbank**
3	–	DZ Bank

Risk management consulting

2016	2015	Bank
1	2	UniCredit
2	**1**	**Commerzbank**
3	5	Deutsche Bank

HOW THE POLL WAS CONDUCTED

Votes were received from dealers, brokers, corporates and asset managers in Germany. Participants were asked to vote for their top three derivatives dealers in order of preference in products they had traded over the course of the past year. The survey categories were divided into interest rates, currency, equity, structured products and risk advisory. The votes were weighted, with three points assigned for first place, two points for second and one for third. Only categories with a sufficient number of votes have been included in the final results. The survey includes a series of overall product leaderboards, calculated by aggregating the total number of weighted votes across individual categories.