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GLOBAL EQUITY FLOW

#1 OVERALL IN EQUITY DERIVATIVES

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Risk
INSTITUTIONAL
INVESTOR RANKINGS
2014

Narrow margins

Institutional derivatives users have relied heavily on their dealers over the past 12 months, as swap market reforms took effect in the US, introducing new liquidity risks. Barclays topped this year's Risk institutional rankings, ending Deutsche Bank's four-year tenure at the top.

Peter Madigan reports

For participants in US interest rate and credit default swap (CDS) markets, the past year has seen arguably the biggest structural change in the history of these products, with new rules forcing the use of central counterparties (CCPs) and new trading platforms. European firms face the same hurdles over the next couple of years, with clearing rules due to take effect in early 2015.

Complying with these changes has been an uphill struggle for even the biggest dealers and hedge funds, but the burden has been felt most keenly by institutional clients – especially smaller firms bereft of large legal and compliance teams, which have had to rely on outside help to navigate the reforms. Many have needed guidance, advice and services from dealers, as they sought first to hit compliance deadlines and then to smooth off the rough edges.

"The industry landscape has been challenging for institutional investors as a result of the large-scale changes in market structure. We have helped clients navigate this and have educated them with respect to upcoming changes. Even though we are now through the initial dates for mandatory clearing and, more recently swap execution facility (Sef), a lot of uncertainty remains," says Nat Tyce, head of rates trading at Barclays in London.

Central clearing for vanilla interest rate swaps and index CDSs was introduced in the US in three phases during 2013, with mandatory use of a Sef for some of these trades following last October – although the regime did not bite in practice until February 2014. While the first phase of clearing went off without a hitch, as several dozen hedge funds and dealers started clearing, phases two and three were more problematic – some asset managers did not sign clearing agreements until the days leading up to the go-live date, leaving dealers facing a wall of onboarding work. But dealers say the process went well overall, given the size of the task.

"Overall, the adoption of central clearing and mandatory execution among institutional investors has gone rather well, but that said, there have been some challenges around this market change among selected investors. I don't think that's too surprising, though, given this has been the biggest swap market structure change of the past 20 years, at least," says Tom Hartnett, head of rates and investment-grade credit trading for the Americas at Deutsche Bank in New York.

Deutsche Bank slipped to third in this year's institutional rankings, after having held the number one spot for four years in a row, with Barclays topping the poll.

The UK bank performed particularly well in interest rate products, where it finished first in four categories, including interest rate swaps and options, repurchase agreements and inflation swaps. JP Morgan finished second on the back of a strong performance across all major asset classes, scoring particularly well in exotic interest rate and foreign exchange products. Meanwhile, Goldman Sachs came fourth, with a healthy lead over fifth-placed BNP Paribas after performing strongly in interest rate options and swaptions.

But while central clearing and Sef trading is now in full swing in the US – and will be soon in Europe – institutional clients are still leaning on their dealer counterparts for guidance on other pieces of the regulatory reform agenda, says Barclays' Tyce.

"Institutional investors are interested in the Basel III requirements and how developments such as the leverage ratio will impact their ability to do business. It is natural they are concerned about the implications of these regulatory changes and are looking for guidance," he says.

Some of these client concerns are highlighted in responses to a qualitative survey Risk runs alongside the rankings. It shows pricing remains the top issue for institutional derivatives users – the perennial winner – but regulation is, for the first time, tied as the lead concern, while collateral requirements finish a surprisingly close second. Just over 40% of respondents also said they would consider changing their use of OTC derivatives as a result of the new collateral posting requirements. Of those respondents, 28.4% said the probable response would be to cut their derivatives usage.

Equity products – Overall

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.3**
2	2	BNP Paribas	11.7
3	3	JP Morgan	10.1
4	10	Morgan Stanley	9.5
5	5	Goldman Sachs	8.9
6	4	Deutsche Bank	7.3
7		Credit Suisse	6.6
8=	6	Bank of America Merrill Lynch	5.7
8=	7=	Barclays	5.7
10	7=	UBS	4.4

Source: Risk Magazine

Under US Commodity Futures Trading Commission (CFTC) rules, users of clearing must post both initial margin and variation margin against swaps positions. Meanwhile, buy-side firms with uncleared swap notionals of at least $8 billion will also be required to post variation and initial margin on non-cleared trades from 2019 under new rules published by the Basel Committee's Working Group on Margining Requirements (WGMR).

This means institutional clients, which unlike hedge funds have – for the most part – never posted initial margin before, will have to source large amounts of extra collateral to meet margin requirements – especially as many clients run heavily directional swap books. Some say this is manageable, as many firms hold large portfolios of sovereign and supranational securities, which are often deemed eligible collateral by CCPs.

The bigger problem is that clearing houses typically require that variation margin is posted as cash – but many institutional clients, particularly insurers, have long-standing collateral agreements with their dealer counterparts that allow for the posting of non-cash collateral such as corporate bonds. As a result of the shift to clearing, many firms will face further costs involved in converting the assets they have on hand into CCP-eligible collateral.

"Prior to clearing, there was a wide range of different margin terms in collateral agreements. Some had initial margin specifications, some did not, but typically larger counterparties would post either no initial margin or a very small amount. Smaller hedge funds, on the other hand, would have posted a lot of initial margin, but as the market has moved into central clearing, charges are going up for both," says David Moore, head of North America rates trading and global head of structured rates and currencies at Bank of America Merrill Lynch.

Necessary capital

Exactly how much collateral CCPs will hoover up is unclear – estimates range from $200 billion to $2 trillion. But coupled with the margin drain for non-cleared swaps – analysis by the International Swaps and Derivatives Association has suggested the WGMR rules could require anything from $1.7 trillion to $10.2 trillion of collateral in initial margin alone – institutional investors will probably find themselves short of eligible cash collateral to meet variation margin calls.

As a result, swap dealers are offering so-called collateral transformation or collateral upgrade services, which are designed to take non-eligible collateral such as corporate bonds, and exchange it for cash. "As the more frequent institutional users of derivatives start clearing, there is no question they have a major adaptation on their hands because posting collateral at clearing houses is much more onerous than on a bilateral basis. There are clients that have been very active market participants with large derivatives holdings but relatively low allocations to eligible collateral, and they are going to have to look at how they meet some of these collateral requirements.

We've been working with clients to come up with collateral transformation solutions, and I think we are going to see many more of these trades come through as clearing expands around the globe," says Shane O'Cuinn, head of the macro products group for the Americas at Credit Suisse in New York.

That may well happen but, so far, the services have not taken off, partly because institutional clients see the accompanying collateral haircuts as overly punitive.

"We have offered many collateral upgrade solutions to clients, but not many ended up using them because they are not the lowest-cost solutions. There are other options, such as doing contingent collateral trades in which clients would use swaptions or longer-term repo facilities to convert a bond into cash, so in the end there have been far fewer clients using them than we thought would be the case," says one New York-based interest rate swap trader.

Deutsche's Hartnett echoes the assessment, noting that some CCPs have offered transformation services to clients by offering to take limited quantities of lower-quality collateral. But he argues the use of dealer-provided services will increase as existing bilateral trades roll off and are replaced with fully margined cleared positions.

Additional uptake may also arise as buy-side firms are reluctant to hold extra cash buffers in portfolios – which would act as a drag on returns. Many are also sceptical of transforming assets in the repo markets, which have been caught in a regulatory crossfire – as they are penalised by Basel III's leverage ratio, for example – and can prove unreliable in times of market stress. As always, though, the main concern for institutional investors is the outright cost of trading, according to this year's survey. For uncollateralised swaps, prices have increased dramatically relative to pre-crisis years, as Basel III requirements have forced swap desks to hold extra capital against credit valuation adjustment (CVA) exposures, while banks are also now charging clients for funding valuation adjustments – a cost that was neglected pre-crisis.

Institutional investors do not trade on an uncollateralised basis as a rule, but while collateralised swaps are less capital-intensive than their uncollateralised cousins, the revised Basel III counterparty credit risk rules and initial margin funding requirements have driven up costs here as well.

"Uncollateralised swap prices are much higher now with CVA, funding charges and the risk-weighted assets capital requirement the bank incurs for holding the derivative position. But collateralised swaps are not capital-free, because even though you don't have a big CVA charge, the dealer still has its CVA value-at-risk to take into account, which essentially asks the dealer to calculate its maximum potential mark-to-market loss if no variation margin is exchanged for a period of 10 days," says Elie El Hayek, global head of rates at HSBC in London.

This is forcing clients to answer some fundamental questions, he adds: "Customers are having to justify whether they really need to trade derivatives – if so, in what size and for how long – or whether they can go back to trading bonds or other alternatives. Look at the example of a forward rate agreement (FRA). Clearing the FRA is much more expensive than trading the equivalent future – almost five times more expensive, so with all the regulations that have been introduced, the OTC derivative has become much more expensive relative to a bond or a future embedded with the same risk."

As a result, some clients have toyed with the idea of abandoning swaps in favour of exchange-traded products, including the much-vaunted swap future. In this year's survey, nearly 24% of respondents said they would reconsider their use of OTC derivatives and would select traditional futures as an alternative, with 14.9% saying they might turn to swap futures.

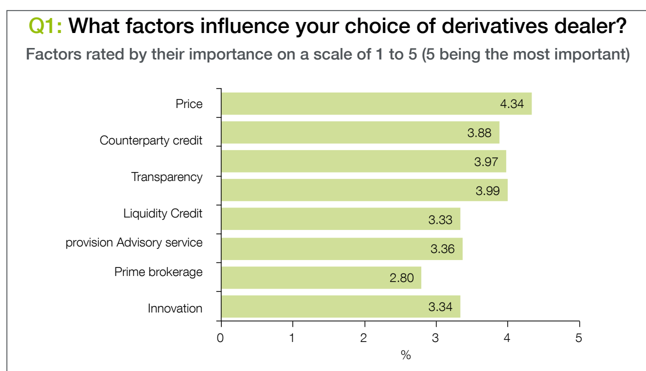
However, that trend has not yet produced a wave of business. While open interest on CME Group's deliverable swap future contract has increased from 94,000 contracts in September 2013 to 126,500 contracts as of May 16, the credit index futures product offered by Ice had just 70 contracts of open interest as of October 2013, and

was subsequently deemed to have "largely failed" by chief executive Jeff Sprecher.

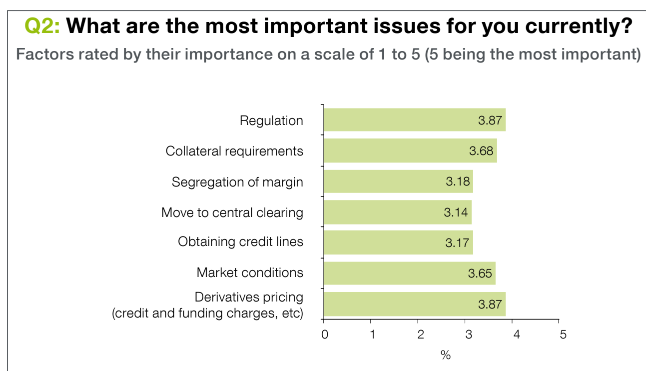
However, it is early days yet, and the lack of uptake in credit swap futures may be symptomatic of the collapse in notional outstanding volumes in CDS markets.

According to data from the Depository Trust & Clearing Corporation, notional volumes across all credit products slumped from $25.8 trillion in January 2012 to $23.1 trillion in January 2013 and dropped again to $20.4 trillion as of May 17 this year – a flop that signals significant pullback by traditional institutional investor participants.

"Single-name CDS volumes have shown a sharp decrease in volumes, but I would say all the names represented in CDS indexes and the most liquid other names continue to see liquidity in the tens of billions. Today, we are in a benign credit cycle so the use of CDSs as a hedging instrument is more limited, and most CDS players are now specialised credit hedge funds or CVA desks at banks hedging their counterparty exposure, so the universe of players is generally much smaller than before," says Benjamin Jacquard, global head of credit at BNP Paribas in London.



Source: Risk Magazine



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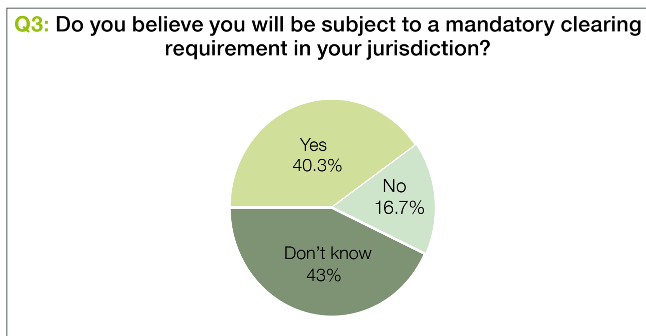

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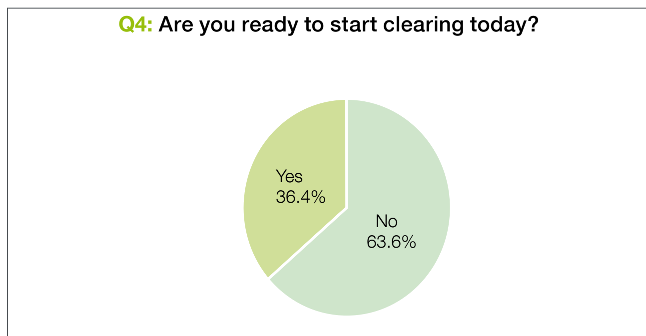

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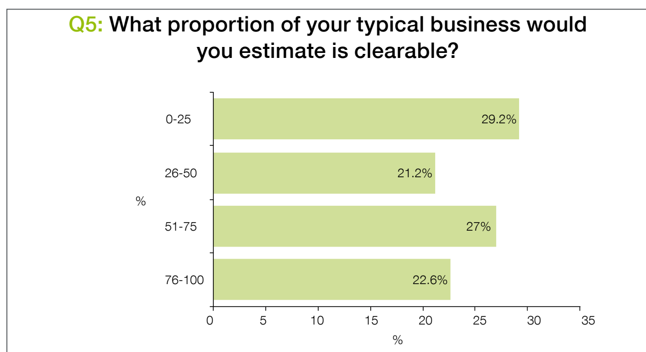

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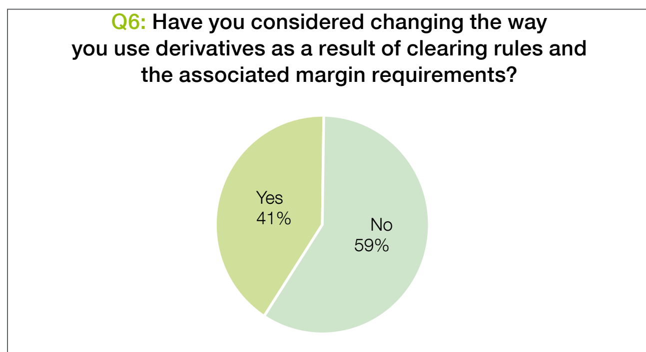
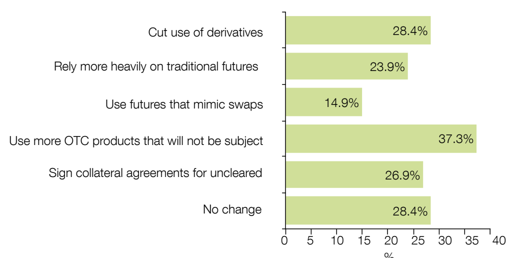


Source: Risk Magazine

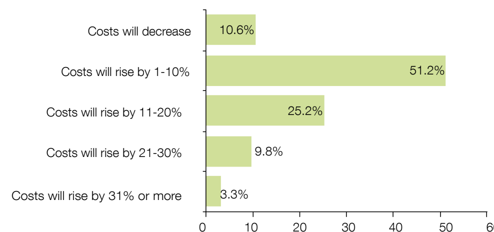
Risk INSTITUTIONAL INVESTOR RANKINGS 2014

Q7: If you answered yes to Q6, what courses of action are you most likely to take?



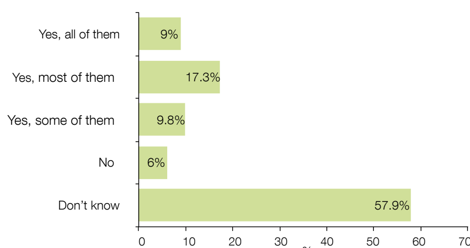
Source: Risk Magazine

Q8: What impact will clearing and prudential regulation have on pricing for the derivatives you currently use?



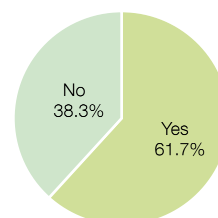
Source: Risk Magazine

Q9: Do your dealers use the OIS rate when discounting cash collateralised trades?



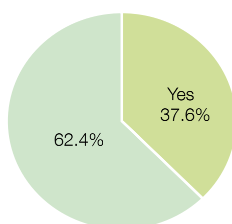
Source: Risk Magazine

Q10: Would you consider quoting prices for selected trades, if given the opportunity, via new OTC trading platforms?



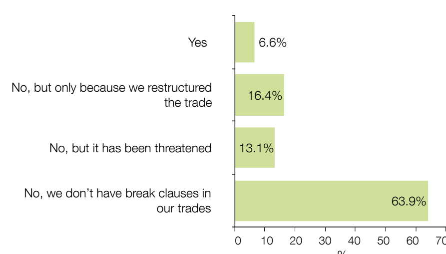
Source: Risk Magazine

Q11: Would you have any qualms about trading directly with another derivatives end-user rather than a traditional market-maker?



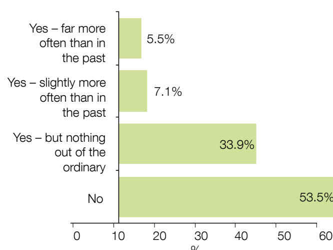
Source: Risk Magazine

Q12: Has a dealer exercised a break clause in a contract with you in the last three years?



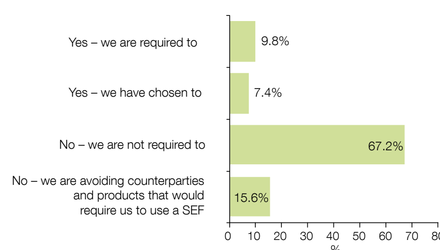
Source: Risk Magazine

Q13: Have you had any valuation disputes with your dealers in the last three years?



Source: Risk Magazine

Q14: Have you used a swap execution facility yet?



Source: Risk Magazine

Risk INSTITUTIONAL INVESTOR RANKINGS 2014

Overall

OTC single-stock equity options

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.3**
2	2	JP Morgan	10.3
3	8	Morgan Stanley	10.1
4	3	BNP Paribas	9.8
5	5	Goldman Sachs	7.0
6	7	Credit Suisse	6.7
7	4	Deutsche Bank	6.6
8	9	Nomura	6.0
9	6	Bank of America Merrill Lynch	5.6
10	10	Barclays	5.2

Source: Risk Magazine

Equity index options

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.0**
2	2	JP Morgan	10.6
3	3	BNP Paribas	10.2
4	9	Morgan Stanley	8.6
5	5	Goldman Sachs	8.3
6	4	Deutsche Bank	7.9
7	6	Bank of America Merrill Lynch	6.2
8	7	Barclays	6.0
9	10	Credit Suisse	5.7
10		Nomura	4.9

Source: Risk Magazine

OTC single-stock equity options

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**15.4**
2	2	BNP Paribas	12.3
3	6	Goldman Sachs	10.5
4	3	JP Morgan	9.6
5	9	Morgan Stanley	9.3
6=	8	Credit Suisse	7.4
6=	4	Deutsche Bank	7.4
8	7	Barclays	6.4
9	5	Bank of America Merrill Lynch	6.1
10		Nomura	5.5

Source: Risk Magazine

Equity products – OTC single-stock equity options

US

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.7**
2	2	JP Morgan	11.0
3	5	Morgan Stanley	10.6
4	3	Goldman Sachs	10.2
5	4	Bank of America Merrill Lynch	9.4

Europe

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**15.7**
2	2	BNP Paribas	11.1
3		Commerzbank	10.5
4	3	Deutsche Bank	10.2
5		Morgan Stanley	9.3

Asia

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**13.1**
2	2	Nomura	11.8
3	4	HSBC	9.8
4	5	JP Morgan	9.6
5	3	BNP Paribas	9.2

Source: Risk Magazine

HOW THE POLL WAS CONDUCTED

Risk received 657 valid responses from asset managers, hedge funds, pension funds and insurance companies globally.

The survey covers 72 derivatives categories across interest rate, forex, credit and equity derivatives. Participants were asked to vote for their top three derivatives dealers in order of preference in derivatives categories they had traded over the course of the year.

This poll is not designed to reflect volumes traded in any particular market and is therefore not necessarily a direct reflection of market share – voters could base their decisions on a variety of criteria, including pricing, liquidity provision, counterparty risk, speed of execution and reliability. In that sense, this poll should be considered a reflection of how buy-side firms view dealers in terms of overall quality of service.

When aggregating the results, we look to strip out what we consider to be invalid votes. These include people voting for their own firm, multiple votes from the same person or IP address, votes from people using non-work email accounts, votes by people who choose the same firm indiscriminately throughout the poll, votes by people who clearly do not trade the product, and block votes from groups of people on the same desk at the same institution voting for the same firm. This is a process we take very seriously.

The votes were weighted, with three points for a first place, two points for second and one for third. Only categories with a sufficient number of votes are included in the final poll. To decide the overall winner, Risk uses the overall percentage of votes for each bank.

The survey also includes a series of overall product, currency and geographic leaderboards, calculated by aggregating the total number of votes across individual categories. These overall results are naturally weighted, as there are more votes in the large categories (for example, US dollar and euro swaps) than the smaller, less liquid categories.

Risk
INSTITUTIONAL INVESTOR RANKINGS
2014

Equity products – Exotic equity products

Exotic single-stock options

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.2**
2	2	BNP Paribas	11.5
3		Goldman Sachs	10.6
4		Morgan Stanley	9.9
5	4	JP Morgan	9.0

Exotic index options

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**15.9**
2	2	BNP Paribas	12.5
3		Goldman Sachs	10.1
4		Morgan Stanley	9.9
5	4	JP Morgan	9.6

Dividend swaps

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.5**
2	2	BNP Paribas	13.4
3	4	Goldman Sachs	11.6
4	5	JP Morgan	10.2
5	3	Deutsche Bank	10.1

Other exotic equity options (worst-of, cliquet, etc)

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.1**
2	2	BNP Paribas	11.9
3	5	Credit Suisse	9.8
4=		Goldman Sachs	9.7
4=		Morgan Stanley	9.7

Dividend swaps

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**15.3**
2	2	BNP Paribas	12.3
3	3	JP Morgan	11.4
4	4	Goldman Sachs	10.2
5		Morgan Stanley	8.9

Source: Risk Magazine

Equity products – Equity index options

US

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**15.1**
2	2	JP Morgan	12.7
3	3	Goldman Sachs	10.3
4	5=	Morgan Stanley	10.2
5		Deutsche Bank	9.5

Europe

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.7**
2	2	BNP Paribas	13.2
3	4	JP Morgan	10.7
4	3	Deutsche Bank	10.5
5		Commerzbank	10.3

Asia

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**13.7**
2	2	Nomura	12.4
3	3	BNP Paribas	11.3
4	4	JP Morgan	9.7
5		Goldman Sachs	9.2

Source: Risk Magazine

Exchange-traded funds

US

2014	2013	Dealer	%
1	1	Deutsche Bank	13.1
2	**3**	**Societe Generale**	**12.6**
3		Barclays	11.5
4		Goldman Sachs	11.1
5		JP Morgan	10.7

Europe

2014	2013	Dealer	%
1	2	Deutsche Bank	14.7
2	**1**	**Societe Generale**	**14.0**
3	4	Credit Suisse	10.5
4		BNP Paribas	9.9
5	3	Commerzbank	9.3

Asia

2014	2013	Dealer	%
1	**1**	**Societe Generale**	**14.1**
2	4	Nomura	12.5
3=	5	BNP Paribas	11.0
3=	2	Deutsche Bank	11.0
5		Credit Suisse	9.1

Source: Risk Magazine

LINKING FLOWS

IN EQUITIES & DERIVATIVES
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WORLDWIDE

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Risk INSTITUTIONAL INVESTOR RANKINGS 2013

Risk INSTITUTIONAL INVESTOR RANKINGS 2012

#1 IN EQUITIES OVERALL

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