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Equity derivatives house of the year

SOCIETE GENERALE
Corporate & Investment Banking

Equity derivatives house of the year

Societe Generale

To many, the marriage of Societe Generale (SG) and Newedge last year looked like one of convenience – the French bank bought the rest of the agency broker from wantaway joint owner Crédit Agricole after the two banks reportedly considered selling their stakes. SG's executives see it more as the happy culmination of a long courtship.

Previously the only top-tier lender without an equity prime brokerage business, the bank has, at a stroke, gained one of the largest footprints in the business, giving SG's equity finance desk access to a roster of 450 hedge funds (see pages 1–3).

But the biggest win is on the execution side, says David Escoffier, deputy head of global markets at SG Corporate & Investment Banking and Newedge chief executive. SG has grown its brokerage footprint 10-fold in terms of volume by combining it with that of Newedge, which commanded a market share in listed derivatives of 13% globally, to form an agency execution powerhouse.

"At SG, we have always looked to offer agency and principal execution to our clients wherever possible. With Newedge, our agency staff has increased fourfold to 400 account executives. We can concentrate all the orders we have from, say, futures rolls and option blocks, where we have both an agency desk and an internal trading desk. Newedge also has a very large electronic access team, which, combined with SG's e-commerce team – as our new global execution services unit – means our clients can access 155 markets via one connection. That's clearly something we couldn't do before," says Escoffier.

The agency ethos sits well with SG's resolve to remain a risk-conscious flow house, crossing as many client orders internally as possible and warehousing fewer risks. But SG is not slow to set aside capital if it spots a good opportunity: for instance, it won a mandate for a multi-billion US dollar accelerated stock repurchase for a US corporate client last year, beating a field of mainly US rivals by virtue of its quicker response.

This mix of capabilities seems to be paying off: despite a poor first half for many equity derivatives businesses, when revenues among the largest dealers collectively shrank by almost a fifth, according to data from Coalition, SG's revenues climbed 11%.

The bank's powers were put to the test when volatility surged during October, peaking in the middle of the month, following the collapse of the $54 billion mega-merger of pharmaceutical firms Shire and AbbVie (*Risk* December 2014, *www.risk.net/2384515*). With the Euro Stoxx 50 shedding 4.2% on October 15 and 16 and the Nikkei skidding 3.2% on the second day alone, the bank expected a surge of demand for dispersion plays on the major indexes, in which clients

Photo: Scott Williams

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take opposing positions in index and single-stock options. Any bank transacting that flow would acquire significant volatility exposure to the indexes. SG anticipated the demand, and sought to begin offloading the exposure to hedge fund clients as soon as possible.

"To be able to do that profitably, you need a deep and diversified client mix," says Stéphane Mattatia, SG's global head of financial engineering. "When clients know they can come to you when markets start tumbling, it creates a virtuous cycle; you get to see most of the flows, so you have a better perception of what's happening in the market. You can take more risks and afford to be more aggressive in the knowledge that, in the end, you're going to be able to match those flows. In the old days, you could take on that risk and hope for the best. Not any more."

In addition, SG saw a huge amount of big-ticket hedging on the FTSE 100 index on October 15 and 16, for example taking down a €1 billion hedge that had been due to expire in December 2014 for one client and selling a £200 million call for December 2020 to another. This is the fruit of a concerted attempt to build its flow business with big UK institutions, which has seen the bank rise from an also-ran to among the largest players on FTSE hedges.

Product innovation is another area where clients say SG is ahead of the pack. Last year Morgan Stanley won the equity derivatives award, partly for correctly anticipating the collapse in long-term equity repo rates on major indexes and hedging its exposure using forwards; but in 2014 dealers found themselves cornered by a rise in hedging costs (*Risk* January 2014, *www.risk.net/2319109*). SG went looking for a longer-term solution to what it believes is a permanent market dislocation.

The exposure to equity repo arises from the structured products business, in which dealers sell huge volumes of index calls to clients – via autocallable structures, for example – creating a short forward and long repo position. In the past, banks could hedge this exposure reasonably cheaply by buying forwards, futures or trading total return swaps. Other banks' delta one desks often act as the counterparty, but accreting layers of costs have choked off that supply, causing the equity repo level to collapse and hedging costs to rise (*Risk* August 2013, *www.risk.net/2285279*).

A client buying an at-the-money call on the Euro Stoxx 50 with a delta of 50%, could end up paying 3–4% more than it ought to because of this dislocation, says Mattatia.

Frustrated by the rising costs of the existing hedges, SG set out to build an alternative. In partnership with Eurex, owner of the Stoxx Indexes business and winner of this year's exchange category, it developed the Euro Stoxx 50 futures index (*www.risk.net/2387886*). Because the index can be replicated very cheaply, by rolling short-term futures on the Euro Stoxx, it is a far cheaper hedge for equity repo exposure, says Mattatia.

"Rolling futures on Euro Stoxx generates a repo cost. But I'm rolling three-month positions, and the uncertainty that is priced into the short-term rate is considerably lower than it would be for, say, an eight-year forward. The three-month repo on Euro Stoxx futures is around 40 basis points. For long maturities, that number would be more like 120 bp. For a client, that equates to a discount of about 7–8% on the cost of their hedge. Even if we sell them an at-the-money call, that would be cheaper by around 4%. That gives them more flexibility if they want to trade slightly out of the money or buy some protection," says Mattatia.

So far, the bank has executed €800 million worth of options on the Euro Stoxx repo rate for clients, with the first-ever trade being a clip of €300 million on the one-year rate in October 2014. This enabled it, in turn, to buy back spot-repo correlation.

"This is a great illustration of why we're proud of our simplest ideas," says Mattatia. "We went to Euro Stoxx with the idea because we want this to become a reference price. If we had gone out to our clients and simply explained the methodology behind the index, it would look highly complex. But when you explain the principle and tell people that it's now our preferred way of hedging, they get it. We would be happy if all the other structured products providers piled in. What we don't want is for everyone to create copycat hedges using different futures, because it would be confusing for all our clients."

Another point consistently praised by clients is the bank's ability to price products rivals are no longer willing to, such as correlation swaps on single stocks. Mattatia says this is because the bank is confident its traders and sales staff will be able to recycle the inventory acquired when selling the products – a risk most rivals can't afford to take, he claims.

"If you have a limited inventory, you take a huge risk when you do that. If I sell you a basket, I'll sell you some correlation too. But if this is my only trade, I won't buy back correlation through a swap, because if the market moves a lot, the product I sold you will lose all of its correlation sensitivity. That means I've created an imbalance in my book. But when you have a huge inventory, you can be certain that – even if the market moves and some correlation vanishes – because you trade a lot of products across a range of strikes across the market, some sensitivity will reappear," says Mattatia.

Escoffier says the rationale was the same when the bank continued quoting variance swaps through the darkest days of the crisis in 2008, after rivals had withdrawn in the face of significant losses. "We lost some money at various points on the back of some bizarre market moves, but in the grand scheme of things it was minimal. We carried on because we were confident in how to go about hedging them," he says.

While clients of all stripes are quick to praise the consistency of SG's pricing, many agree it's rare for the bank to be the most aggressive. There's a straightforward explanation for that, says Escoffier.

"It's not unusual, particularly in a bull market or where you get a new entrant who's looking to shine, for a dealer to start selling risk at zero. Suddenly, a client will come to us saying our price is no good. We always tell all our clients, from the start: it's easy to make a price when the going is good; our motivation is to provide the best service, rain or shine, but not necessarily the best price, otherwise we'll be out of business. One of the good things about the current market environment is that clients are starting to fully recognise this: consistency, high levels of service and quality advisory are key." **R**

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