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Interest rate derivatives house of the year

Credit derivatives house of the year

Hedge fund derivatives house of the year

Deutsche Bank

Survival lessons

Market participants have endured a 12-month period of dramatic upheaval. Despite the challenges they faced, some companies managed not just to survive but to thrive – and helped clients to do so, too. By Matt Cameron, Laurie Carver, Mauro Cesa, Clive Davidson, Ramya Jaidev, Peter Madigan, Mark Pengelly, Joe Rennison, Nick Sawyer, Michael Watt and Duncan Wood

Risk Awards 2012

As the US debt ceiling talks laboured towards their eleventh-hour agreement last year, market participants quietly began to prepare for what would have been a catastrophic event: the country's default. At JP Morgan, the bank's risk managers and senior business leaders found themselves planning for events that seemed unthinkable just a few months earlier. The bank discussed how it would handle benefits cards through which banks offer credit that is repaid by the US government, for example, and drew up a script for branch and call centre staff to use when government employees tried to cash pay cheques.

It was that kind of year – old certainties vanished and doomsday scenarios felt very plausible. When 2011 began, many of this year's award winners would have been surprised to learn of decisions they would later take, or challenges they would face.

Deutsche Bank, for example, worked on behalf of Postbank to reduce the group's combined eurozone exposure by €8.4 billion in the first six months of the year – €7 billion of which was Italian risk – and had to accelerate the de-risking as market sentiment became rapidly more gloomy.

At Barclays Capital, the US debt ceiling talks concluded shortly before the execution of a huge foreign exchange options trade for IT giant Hewlett-Packard – and the country's resulting downgrade meant the transaction went ahead in a period of intense uncertainty. The bank managed to keep the trade quiet, but it involved hedging with a variety of correlated currency pairs and initially accepting some risk mismatches.

Following Japan's tragic earthquake in March, JP Morgan's equity derivatives team weighed up the short gamma and short vega positions the bank was carrying and decided to reverse them – it managed to do so within 90 minutes of the Japanese markets reopening.

To remain upright – and open for business – dealers in every asset class had to be risk-focused, responsive and nimble last year. And those qualities mark out other award-winners, too – Allen & Overy, for example, which advised the International Swaps and Derivatives Association's credit default swap (CDS) determinations committee on the fast-changing situation in Greece; or LCH.Clearnet, which tried to expand its global interest rate swap clearing business during a period when regulation was in flux.

Our winners were not the only firms to display these traits, which made it difficult to decide many of the categories – pitching institutions put their best foot forward and often had strong stories to tell. That was particularly true in one of this year's new categories, the award for over-the-counter client clearing – a new business, and one already characterised by fierce competition.

Feedback from clients was a key factor in many decisions, but the *Risk* editorial team also received demonstrations of risk systems, and was provided with internal profit and loss numbers – as well as risk and balance sheet metrics – for some businesses. Without this co-operation and generosity, the awards would not work.

The judging process lasted three months, from October to December last year. Banks were asked to submit information on their business in each of the asset class and product categories during 2011, and shortlisted companies underwent a series of face-to-face and telephone interviews. *Risk* then performed a lengthy due diligence process, contacting banks' clients to confirm that trades referenced in pitches took place and that customers were satisfied with the results.

In making the final decisions, a number of factors were considered, including (but not restricted to) risk management, liquidity provision, quality of service and engagement with regulatory issues. ■

The roll of honour

Interest rate derivatives house of the year
Deutsche Bank

Credit derivatives house of the year
Deutsche Bank

Hedge fund derivatives house of the year
Deutsche Bank

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INTEREST RATE DERIVATIVES HOUSE OF THE YEAR
DEUTSCHE BANK

Well-timed trades can appear lucky – hindsight revealing that a decision to buy or sell coincided precisely with a market trough or peak. On the other hand, it's often said that luck is self-made – the decision is informed by some conviction or intuition that later proves to be correct. Certainly, Deutsche Bank would argue the latter was behind one of 2011's biggest strategic calls – the dramatic and rapid reduction in eurozone holdings, particularly Italian exposure, following Deutsche Bank's acquisition of a major stake in Postbank.

While Deutsche Bank will say little publicly about the de-risking – citing client confidentiality – it confirms the job of selling assets and buying credit protection was handled primarily by the bank's rates team, led by Michele Faissola, the London-based global head of rates and commodities.

Following the acquisition at the end of 2010, Postbank's management sought Deutsche Bank's advice on its strategy for managing the risk on its exposures. A small team that included members of the rates business started work to understand Postbank's portfolio, processes and strategy, and to match the risk appetite of the combined group.

Including the Postbank portfolios, Deutsche Bank was sitting on €12.1 billion in exposure to Greece, Ireland, Italy, Portugal and Spain at the end of 2010. By June 30 last year, that had been slashed to €3.7 billion, with the biggest reduction being a drop in Italian exposure from €8 billion to €1 billion. The bank announced the de-risking on July 26, as part of its second-quarter earnings.

The timing was impeccable. The yield on Italian 10-year bonds started 2011 at 4.7% and had widened slightly to 4.9% by the start of July, according to Thomson Reuters. But as markets became concerned by the failure of Europe's politicians to take decisive action over the eurozone crisis, contagion spread rapidly across national boundaries and asset classes, with Italy the worst-hit country. Its government bond yields peaked at 7.3% on November 25 and ended the year just below 7%, a level widely seen as unsustainable.

The cost of protection on Italian bonds was also hugely volatile – as of June 21, credit default swaps (CDSs) were still trading as low as 166 basis points, but the spread surged during the following weeks and months, widening 30bp on July 8 alone and then a further 51bp by the close of the next trading day, July 11 – an increase of 37% in just two days. By July 18, Italian CDS spreads had reached 330bp, and went on to record their peak for the year of 587bp on November 15.

So, was it luck? Not according to Dirk Becker, deputy head of banking sector research at Kepler Capital Markets in Frankfurt. "It continues a trend for Deutsche Bank – the bank has exited many asset classes just before they got very risky. In 2007, for example, it got rid of most of its collateralised debt obligations and mortgage-backed securities at what seemed like very low prices at the time – of course, it meant Deutsche avoided years of pain and worse losses. I think the bank has very good timing, a very good sense of risk," he says.

Deutsche Bank itself says much the same, and efforts to reduce eurozone exposure intensified as the market outlook became gloomier. "We had to be very nimble in accelerating asset sales as our and Postbank's market view became increasingly negative. Every option was considered to ensure the portfolio was de-risked at the best possible levels against the backdrop of the intensifying sovereign debt crisis. In the end, Deutsche Bank worked on behalf of Postbank to execute the de-risking through substantial asset sales, as well as through buying protection," the bank says in a statement provided to *Risk*.

> "The idea is to be able to disseminate information and consolidate risk, while also informing our trading desks outside the zone of activity about what is going on"
> Wayne Felson, Deutsche Bank

Those months spared Deutsche Bank an unpleasant third quarter. Postbank used loan accounting for much of its eurozone positions – so falling prices for Italian bonds, for example, would not have translated into mark-to-market losses for Deutsche, says Kepler Capital Markets' Becker. But as the second half of the year wore on, there was intense scrutiny of European banks' sovereign exposure – producing share price collapses at the big French banks, and funding stress for many others, he notes. Deutsche Bank was relatively immune, and was even able to reopen the market for unsecured bank debt at the end of September, when it sold €1.5 billion of two-year notes – the industry's first unsecured issuance since July.

"Nothing would have happened in terms of reported losses, but Deutsche Bank would have appeared at the top of all these lists of sovereign exposure, which caused funding issues for other

banks. Deutsche managed this very, very well – it was even the first to reopen the senior unsecured market, and that created windows of opportunity for others," says Becker.

More traditional market-making activity continued, of course, where the bank had to cope with both illiquidity and volatility, particularly during the sovereign crisis-hit third and fourth quarters. "Market conditions deteriorated throughout 2011," says Faissola. "The year started with positive expectations of a recovery in the first quarter, but that was too optimistic. In Europe, liquidity diminished greatly and outflows created additional selling pressure from institutional real-money clients. We've also seen increased pressure on funding for European institutions."

As a result of this stress, clients prized consistent and reliable market-making above anything else – and say Deutsche was one of very few dealers to deliver on that score.

"From time to time, we trade in large size. Deutsche Bank has been very competitive on pricing, and we've been satisfied with the way it has been handling the volume. It also has a good understanding of our business, so its input into our strategies has been valuable. Many firms try hard and don't fully understand what we're looking for, but Deutsche Bank does," says Anders Bewiz, Stockholm-based head of fixed income and foreign exchange at Folksam, the Swedish insurer.

In addition to liquidity provision, clients praise the bank's pricing, risk appetite and sales team. "Deutsche Bank does everything well. It has a good risk appetite and consistent pricing on trades. It also has really good salespeople who make sure we're taken care of. It does what we want and it does it well," says one US-based deputy treasurer at a major financial institution.

One example of the bank's market-making strength came during the second quarter of last year. Faced with strict regulatory requirements on solvency, one Scandinavian pension fund turned to Deutsche Bank for advice. "We provided the client with an analysis of its asset-liability matching requirements, as well as detailed advice around execution," says Wayne Felson, Deutsche Bank's European head of rates in London. The fund ended up transacting a mammoth one-year versus 20-year receiver swaption with a notional size of €6.5 billion – a multiple of the size typically seen in the market, says Felson. Hedging was a challenge as a result.

"We had to execute in a way that would not move the market against ourselves or our client, and we did that. We managed that through sophisticated risk transfers," he says. That involved effectively offsetting the risk with a variety of different instruments and maturities, including bond options and one-year versus 10-year swaps, for example.

The trade subsequently paid off, and by September, Deutsche Bank advised the fund to unwind and restructure the transaction. Once again, the bank was able to successfully unwind the massive trade with minimal disruption, despite continued market turmoil.

There are several reasons why Deutsche Bank was able to be a reliable liquidity provider – its view on the eurozone crisis, for one – but the bank also continued to tweak its risk management framework during 2011, creating a new risk management committee headed by Felson, which brings together all global rates trading heads as well as market risk managers, and has the power to drastically cut exposures.

"The idea is to be able to disseminate information and consolidate risk, while also informing our trading desks outside the zone of activity about what is going on. This year, it's been largely about Europe," he says. In particular, the committee helped the bank anticipate the second-order effects of the sovereign debt crisis, such as a widening in the spread between Libor and overnight indexed swap (OIS) rates, and the impact on cross-currency basis swaps that resulted from squeezed bank funding markets, and the particular strain on dollar funding for European banks.

The team (l-r): Stuart Lewis, Michele Faissola and Wayne Felson

Photo: Scott Williams

"We were able to position ourselves favourably in Libor-OIS and cross-currency basis, well before the volatility we saw in September this year. That was a direct result of our understanding of the European funding situation and our ability to analyse our risk, share information and make collective decisions," says Felson.

The bank has also been seeking to trade on terms that will be sustainable once new regulations have been introduced. In particular, that means avoiding uncollateralised business, which will attract punitive capital requirements when Basel III is introduced. Faissola says the bank has been able to increase the proportion of trades covered by two-way credit support annexes, which provide for bilateral collateral posting.

But the bank has also chosen to restructure or assign trades, particularly where counterparty risk is positively correlated with the trades themselves, he says. Such wrong-way risk has become a focus for regulators in recent years and Deutsche Bank has been seeking to get ahead of the issue. "We have adjusted our portfolio to minimise wrong-way risk or correlated exposures. You need to build a portfolio to behave in the right way, and when you have a crisis, correlation tends to be much higher between different asset classes," Faissola says. ■

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HEDGE FUND DERIVATIVES HOUSE OF THE YEAR
DEUTSCHE BANK

Some hedge fund investors are getting jumpy. It's been more than three years since the surge of hedge fund redemption requests following the market turmoil in 2008 caused many funds to impose gates and halt redemptions – and many are still locked. With new capital rules for banks and insurers on the horizon, these investors are aware the illiquid and heavily discounted shares they own will be severely penalised, and have been searching for ways to offload their exposure.

"Investors have been holding onto these positions for more than three years, and it is starting to become a real issue for those who will be subject to Basel III and Solvency II. There is a lot of pressure to get rid of the trades given the punitive capital treatment they will receive, which in a lot of cases far outweighs the discount these shares are trading at," says Tarun Nagpal, European head of fund derivatives at Deutsche Bank in London.

But liquidity providers are few and far between. Only a handful of banks play in the space, after many scaled back or shut down their hedge fund derivatives businesses in the wake of heavy losses in 2008. Deutsche Bank is one of the few remaining – and investors rave about its willingness to provide a secondary market for illiquid hedge fund holdings.

"Only one bank really participates in illiquid and gated funds flow, and that is Deutsche Bank. It's been doing it for years, and it is the only bank that brings significant liquidity to this space. It is able to take down single manager and fund of hedge fund trades in big ticket sizes. If you want liquidity, it is the go-to bank," says one broker.

Deutsche had a prolific year in the secondary market, transacting more than 20 complex trades involving gated, suspended or side-pocketed portfolios, buying more than $500 million of structured products linked to impaired hedge funds and fund of hedge funds – a number of which were issued by competitor banks – as well as participating in more than 1,500 secondary trades on hedge fund-linked certificates involving 50 underlying funds of hedge funds. The bank also set up a tender offer for a Dutch private bank, allowing its many clients to tender their shares under one process; created a Cayman Islands vehicle to buy 40 different line items from a liquidating fund of funds; and wrapped impaired fund positions in pass-through notes for sale to investors who were interested in obtaining exposure to those portfolios.

"It is a key part of our business," says Stephane Farouze, global head of fund derivatives at Deutsche Bank in London. "The reason we are able to take down a lot of these trades is because we have a large portfolio and have been in the business of trading and market-making hedge fund positions in the secondary market for almost 10 years."

But because trading in illiquid and gated funds is balance-sheet intensive, Deutsche Bank has also decided to team up with Rosebrook Partners – a fund that specialises in buying illiquid and gated hedge fund portfolios – to launch a fund that aggregates and then manages down distressed hedge fund holdings. The fund will offer exposure in two ways: it will allow clients to swap their distressed positions for shares in the commingled fund managed by Rosebrook and Deutsche Bank; and will allow new investors to gain exposure to distressed funds as an asset class.

"We are one of the main market-makers for distressed hedge fund trades, but because we have balance sheet constraints, we looked to develop a product that would increase our capability to help clients get out of distressed trades, without affecting the size of our balance sheet. The partnership with Rosebrook was the ideal solution, which combined our complementary skills," says Farouze.

Apart from being a stand-out liquidity provider in the distressed space, Deutsche Bank has also pushed the boundaries in other areas – most notably in structured trades. The firm has a structured portfolio of more than $25 billion, comprising more than 500 fund-linked trades, of which 70 were transacted in 2011.

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>
> Stephane Farouze, Deutsche Bank

The stand-out last year was an all-singing, all-dancing structure designed for a southern European insurer. The challenge was to structure a trade that would not only be capital efficient for the insurer, given the heavy risk weights assigned to hedge fund investments by Solvency II, but would also be structured in the Ucits format and have a guaranteed, long-term profit lock-in mechanism allowing the client to capture any gains – at its request – and realise profit.

The result was a long-dated, principal-protected Ucits product using constant proportion portfolio insurance (CPPI) – an approach that rebalances the allocation between risky and safe assets to provide capital security – to invest in a portfolio of funds on the dbalternatives managed account platform. The safe

Photo: Scott Williams

Stephane Farouze and Tarun Nagpal, Deutsche Bank: providing investors with a way out of locked funds

assets were southern European government bonds, rather than the more usual zero-coupon bond issued by the product provider – the insurer did not want to take exposure to Deutsche, but had a benign view of the risk associated with its own sovereign. The portfolio of funds was dynamically allocated, and the deal also had an external adviser.

"This is a structure that had everything – alternatives exposure in a capital-efficient format, structured via a Ucits, with a profit lock-in mechanism, and a capital guarantee. Also, the client didn't want to have any exposure to Deutsche Bank, so we came up with the idea to provide the guarantee based on sovereign debt. But the problem is that Ucits rules require a certain level of diversification, so we had to use a different series of government bonds to effectively manage the duration. It was a very complicated trade to put together, but we were able to lower the risk weight substantially for the insurer," says Nagpal.

Another highlight of 2011 was on the financing side. The bank was asked by a large US fund of funds manager to provide a financing facility for its funds of private equity funds offering – which Deutsche calls a whole new spectrum of risk. The difficulty was the unpredictability of the cashflows generated by the fund – the only security the bank had. "There was a lot of uncertainty about the timing of proceeds from the assets in the portfolio. We hedged the risk through over-the-counter gap risk tranche hedging and market hedges to offset the risks around the timing of cashflows – as well as using our deep access to the secondary market for private equity interests. We also underwent a very deep due diligence process – including the underlying assets within the single private equity funds – to validate the risk and expected cashflows, as well as using our position as a market-maker to validate the valuation of these assets, which are not subject to mark-to-market valuation. We also imposed intricate guidelines on the portfolio in terms of names, vintages, industries, geography and individual portfolio company exposures to ensure sufficient diversification at all levels. Our analysis on expected cashflows and the weighted average maturity profile of the illiquid credit instruments enabled us to also put in place the appropriate OTC hedges," says Farouze.

Deutsche Bank also continued to build on its substantial managed accounts offering. After successfully delivering the first ever customised managed account platforms for EIM Group and Permal-SIG in 2010, following a long competitive selection process, a large European fund of funds and a large US asset manager each awarded the bank similar mandates last year worth in excess of $1.5 billion in assets under management. The bank also added 10 new hedge funds to its customised managed account platform.

Meanwhile, the bank has continued to expand its dbalternatives managed account offering, adding 14 new managers in 2011 across expanded strategies – including Brevan Howard, Tudor Investment Corporation, Omega Advisors and TT International. The managed account platform now has assets under management of more than $7.5 billion – a jump of $3 billion on 2010, and the bank now plans to launch a managed account seeding platform, which will go live in the first quarter this year. The platform aims to invest in funds of select emerging hedge fund managers. In return for committed capital, seeding investors receive fund returns and a share of the manager's revenue.

The platform continues to impress its customers. "They have significant experience and their level of understanding of the risks involved is second to none. They put a lot of effort and resources into understanding potential sources of tracking error with the goal of eliminating them. We've also been impressed by the quality of investors they have introduced us to at the events they have asked us to participate in," says one hedge fund manager on the dbalternatives managed account platform.

In addition, Deutsche's Ucits offering has continued to expand and now houses more than $3.5 billion in assets under management. During 2011, the bank added three more single managers to its Ucits range, including the Traxis Global Equity Macro Fund, the Sloane Robinson Asia Fund and the Millburn Multi-Markets Fund. ■

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CREDIT DERIVATIVES HOUSE OF THE YEAR
DEUTSCHE BANK

The credit derivatives market has not seen a year like 2011. Volatility was higher in the aftermath of the Lehman Brothers collapse in September 2008, but it focused primarily on financial names. Last year's fear was less discriminating, encompassing US and European banks, peripheral eurozone sovereigns, but also – for the first time – infecting the continent's core nations, while countries far from the European crisis experienced their own, idiosyncratic bouts of turbulence.

On June 7, Germany's credit default swap (CDS) spread hit 36 basis points – a low for the year. As of December 19, it was almost three times higher, at 107bp, according to data provided by Markit. Italian spreads, after trading as low as 123bp in April, were at 586bp by mid-November. China saw its spread go from 66bp at the start of the year to 148bp on December 19. Until August, Brazil's CDS spread fluctuated between 100bp and 120bp – by September 22, it had blown out to 219bp, in tandem with a collapsing real (*Risk* December 2011, pages 16–20, *www.risk.net/2129954*).

The temptation for market-makers was to pull up the drawbridge – and many dealers did, to a greater or lesser extent. Those that remained active were inundated with demand for protection, particularly from other banks desperate to hedge uncollateralised derivatives counterparty risk with European sovereigns as credit spreads exploded – a trend driven partly by Basel III's looming capital charge for credit value adjustment (CVA) (*Risk* November 2011, pages 16–20, *www.risk.net/2120808*).

"We saw liquidity drying up in the market, especially for eurozone sovereigns, and sensed an opportunity to define ourselves as the most consistent provider. Because of the way we had positioned ourselves over the past couple of years, we were able to continue offering the liquidity our clients need," says Colin Fan, head of global credit trading at Deutsche Bank in London.

The business ran a counter-cyclical strategy based on a strong macro view that the situation in Europe was worse than it seemed. Starting in the third quarter of 2009, Deutsche halved its inventory of sovereign CDS positions, and attempted to flatten the book's exposure. This allowed the bank to expand liquidity provision to clients when the market contracted in the second half of 2011 – the bank says there were occasions in this period when it traded as much as €25 billion of CDSs in a single day. As a result, the credit business was on course to beat targets for revenue and market share, with annual volume of more than €1 trillion – but has been able to run the business at roughly half of its daily €70 million value-at-risk limit.

Deutsche's decision to wind down its exposure prior to 2011 is mainly credited to its head of European credit trading, Antoine Cornut – who Fan refers to as a "perma-bear". Cornut and his team first formed an opinion – at a time when the Greek CDS spread was around 200 basis points – that the country's debts were unsustainable and that it would need to be bailed out. They concluded the politics of this would be so difficult any resolution would take several years, and positioned the business for a crisis that would end only after a prolonged period of high volatility.

As contagion increased last year, the consensus outside the bank was that the size and importance of the Italian bond market meant European politicians would be forced to take drastic action as soon as Italy's CDS spread hit distressed levels. But again Cornut and Fan took the contrarian view that an enduring period of Italian stress was possible, and that even France was not safe.

"The core view was that it was going to be a long and winding road," says Cornut, "with no magic bullet that will solve everything. We tried to remain nimble, being aware of what we wanted to take on, going shorter when we were doing too much and – when the relative value blows out of proportion – going long. When spreads really started to blow up, we were trading short at the time so it was easier for us to provide liquidity."

This allowed the bank to continue making markets in Italian CDSs as other dealers backed off in the third quarter – spreads jumped 127bp in the first seven trading days of July – and there was tangible evidence of that in December's revisions to the European Banking Authority's stress tests that identified Deutsche as counterparty to €34 billion Italian CDS contracts by notional, with a net sold position of €2.5 billion. Cornut puts this in context. "On a mark-to-market basis it's closer to flat. We have more short-dated exposure at six or nine months. So even though the notional is large, the risk is small. In my view there is no risk of an Italian default in the next six months, at least as things stand today. The residual exposure reflects positions in reverse repo trades or index arbitrage," he says.

> "Europe is entering recession, so we are analysing every name to see if they can survive a severe downturn" Antoine Cornut, Deutsche Bank

One trade that panned out for the team came in June, when a European insurer needed to buy protection on €200 million of exposure to one southern European sovereign. At the time, spreads on the country had rocketed and the insurer was unable to find another counterparty willing to provide liquidity. Because of Deutsche's de-risking programme, the bank was sufficiently short the name that Cornut felt comfortable taking on the trade – and, rather than hedging with the same name, Deutsche instead bought protection on another southern European sovereign that was at the

time trading below the first country. In the time since, the two have swapped around – producing gains for the bank.

Another big trade saw Deutsche take the lead role in the de-risking of a peripheral European bank's €8 billion sovereign CDS portfolio in December. The bank was facing a large collateral call on out-of-the-money positions in dollar-denominated CDSs, partly due to currency movements, rather than credit. Deutsche wrote quanto CDS protection for the bank and hedged with fully collateralised credit-linked notes and currency forwards. The de-risking is likely to be completed in January.

The net result of all this was a jump in Deutsche's market share. Nowhere was that more evident than in the electronically traded CDS market, a business that had previously been a virtual monopoly for JP Morgan. Deutsche and other banks had held back from entering the market, clinging to the traditional trading model. However, it became apparent that incoming regulation – the Dodd-Frank Act in the US and the European Market Infrastructure Regulation – will force much of the world's over-the-counter derivatives business onto electronic platforms, and that JP Morgan's success was no flash in the pan. In November 2010, Deutsche launched its own platform on Bloomberg.

Over the course of last year, the share of CDSs traded electronically at Deutsche moved from virtually nil in January to 25% in November. The growth of the electronic market generally – 70% of Markit's iTraxx index contracts were traded electronically in 2011, up from 30% in 2010 – meant this was big business. "This was a real focus for us this year. We knew this was the future and that we had maybe been a little slow in moving into this area. So we had to be aggressive," says Fan.

The big question is whether Deutsche has been able to do this safely – it says the contrarian approach makes the business sustainable and insists there are no nasty surprises lurking in the books. In part, that's because of a new risk dashboard put in place during 2011, that looks at every trade through the lenses of revenue, risk, and capital. "We look at a three-dimensional matrix with recalibrated metrics," says Fan. "Everyone at the trade level is aware of things that in the past were not as relevant. Profitability adjusted for resources and risk is the new VAR."

In particular, there's a new focus on assessing the capital cost for each trade. Risk-weighted assets (RWA) – the building-block for regulatory capital calculations – are evaluated at both the trade and portfolio level, and feed into the matrix. The RWA numbers are calculated using the new metrics introduced by Basel 2.5 from this month, which supplement the old VAR-based calculation with a stressed VAR measure, plus the incremental risk charge to capture default and spread migration, the comprehensive risk measure for the correlation book and new rules for securitisations and resecuritisations. Again, each of the contributions made by these components can be seen on a trade-by-trade basis, as well as at the desk and overall book level, Fan says.

The Basel 2.5 requirements dictate that stressed VAR should be calibrated using a one-year period of market turbulence relevant to the bank's portfolio. Like most banks, Deutsche currently uses a

Photo: Scott Williams

Colin Fan and Antoine Cornut: predicted a long and winding road

period that includes the Lehman Brothers default – for now, anyway. "This may change over the next 12 months, particularly as regards the sovereign portfolio – the stress on sovereigns was not very significant in 2008. We may find ourselves calibrating to a 2011 period this year," says Fan.

For flow business, incremental RWA is calculated according to benchmarks – for instance, a liquid UK corporate is used as the jumping-off point to gauge its peers. The spread level of the benchmark – and the portfolio's sensitivity to it – can be used to calculate an incremental VAR that Deutsche uses to work out the RWA contribution from trades with similar underlyings, Fan says. For structured credit deals, a full Monte Carlo simulation is performed for each trade.

Deutsche plans to extend this to full Basel III capital – including the CVA charge. Although this is normally calculated at a portfolio level, Fan believes a trade-level number will push traders towards more cost-effective business. "We are focused on being ready for Basel III and looking at the business through that lens. By making traders aware at a transactional level what the cost of capital is, we can get them to concentrate on making the calls that deliver better return on equity," he says.

In 2012, the team sees the eurozone crisis moving from the sovereign sector to corporates – bringing widespread credit deterioration, downgrades, and defaults. Cornut has been adjusting the focus of his traders accordingly. "Europe is entering recession, so we are analysing every name to see if they can survive a severe downturn – cyclical industries are at risk. But the biggest problem will be refinancing – some corporates will need to borrow again in 2012, but banks are no longer lending," says Cornut. He sees firms in the crossover ratings band between BB and CCC as having an increasing probability of default.

The team has been gutsy in making these calls – and some of them could be found out. That corporate crisis may not emerge. Italy may default in the next six months. The eurozone could even break up, with catastrophic consequences. The latter event is still considered too remote a probability – at least by Deutsche – to affect book positioning, says Fan. But, so far at least, Deutsche's decision to step up in a year that other houses were stepping back has not just been brave, providing the market with some much-needed liquidity – it has also been smart. ■

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