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Risk
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Risk.net January 2015

Derivatives house of the year

Risk Awards 2015

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Societe Generale

For dealers, the financial crisis has been followed by an identity crisis. More than six years after the collapse of Lehman Brothers, banks are still working out what businesses they want to be in and how best to offer them, a task prolonged by evolving regulations and record-low interest rates that are putting a brake on fixed income, the traditional motor of the franchise. For the most part, and particularly among Europeans, dealers are on the back foot: reviewing, revamping, retrenching and reluctant to commit capital to new businesses and new ideas.

Societe Generale (SG) is an exception. The bank decided a long time ago that it wanted to be an equity derivatives powerhouse, with cross-asset expertise when it comes to advisory, solutions and structuring, plus just enough fixed-income clout to meet clients' needs.

"SG has been consistent in doing what we are best at doing. We have a policy to be relevant with the accounts and businesses we have chosen – for example, equity derivatives – but also to build around this where the markets are changing and we see opportunities," says Didier Valet, the bank's Paris-based head of corporate and investment banking (CIB), private banking, asset management and securities services.

It's the kind of bar-bell strategy many other houses aspire to – strong in complex, high-margin businesses, while executing low-margin flow business cheaply – but SG's long-standing commitment to the model has two great advantages. First, it means the bank has become a fierce competitor in its chosen markets and is able to tell clients, investors and regulators a consistent story; second, it's a mix that is very profitable – return on equity (ROE) for SG's global markets businesses was 18%

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during 2013 and 17% for the first nine months of last year – giving it more freedom to invest and innovate, particularly in places where other banks are choosing to cut and run.

As examples, the bank finalised the acquisition of Newedge in May last year – the big futures and options broker and clearer it had previously co-owned with Crédit Agricole – and hopes regulatory tailwinds plus an integration budget of €118 million will turn the struggling business into a

Photo: Christian Fournier

Christophe Mianné (left) and Didier Valet, Societe Generale

cross-selling engine. SG also snapped up four credit default swap (CDS) portfolios worth a total €140 billion in 2014, during a period when some players have been backing away from the market, and stepped into a portfolio of inflation swaps with a large UK pension fund.

These are capital-intensive businesses – or, in the case of Newedge, low-margin ones – but SG's profitability makes it easier to integrate them, says Christophe Mianné, deputy head of CIB, private banking, asset management and securities services in Paris. More to the point, the pressure other banks are under means there are bargains to be had. Being contrarian "is where you capture value sometimes," says Valet.

Among recent innovations, the bank revived the market for index credit-linked notes (CLNs), showed off a new approach to the longevity business in a €1.4 billion trade with Dutch insurer, Aegon, and designed an index that allows clients to access the Euro Stoxx 50 without incurring the costs that arise from the structural collapse in equity repo rates. Trades of this kind helped the bank win this year's awards for equity derivatives and for risk solutions – it was also a strong contender in structured products (see pages 4–5 and 6–7).

But SG can also point to a rich legacy of innovation, from the first equity correlation swaps to the organisational innovation it displayed in 2003 when creating a cross-asset solutions group within CIB, where non-linear products of all stripes are handled by a single group of traders and risk managers.

SG had a hand in finding its path – and committing to it – from an unlikely source: Jérôme Kerviel, the rogue trader who lost the bank €4.9 billion. The losses, announced at the end of January 2008, could hardly have come at a worse time, forcing a restatement of SG's 2007 earnings and kicking off a brutal year for the bank and the markets (*Risk*

February 2008, *www.risk.net/1506258*). SG CIB booked a loss of just over €2 billion for 2008, while the bank's share price fell almost two thirds.

It could have torn the markets business apart – Mianné says some investors pressed the bank to exit the more complex corners of investment banking – in fact, it forced SG to agonise about its identity far earlier than its rivals, and the bank came out of the process stronger, more focused and more committed.

"Many banks had their baptism moment during the crisis, and ours came earlier than most," says Daniel Fields, the London-based head of global markets. "I think Kerviel was notable because it solidified the team enormously. The loyalty to the business, and the feeling that these are our markets, was tangible in the post-Kerviel period. The teams were determined not to let Kerviel destroy what we'd built over the previous decade."

Mianné says: "We faced strong pressure to close all the exotic and structured books, but we decided to keep them. We have the DNA, the people, the clients and the systems."

Traders who joined SG at the time found an institution in the throes of painful, cultural change, but change that was ultimately for the better.

"It was like nowhere else I'd been at that point," says one former member of the CIB team. "The organisation became more introspective than other houses because they had survived something existential. You had senior risk-takers that were very focused on operational issues, post-trade issues; they wanted to know how certain products settled, where they cleared. Appropriateness of trades became a very hot topic within the bank well before the recent scandals and fines."

A senior equity derivatives trader at another bank puts it more simply: "If you go through a near-death experience – which those guys did – it traumatises you. But it has also made them very close-knit."

They have certainly proved durable. Valet has been with SG since 2000, but only moved into his current role in 2012 – taking over "part-way through the journey," he says. Mianné joined in 1988, with Fields coming on board in 1994. David Escoffier, chief executive of Newedge and deputy head of global markets, joined in 1999. Eric Litvack, SG CIB's head of regulatory strategy – and the recently appointed chair of the International Swaps and Derivatives Association – has been with the bank since 1986. Danielle Sindzingre, the bank's global head of fixed income, credit and currencies, has been with SG since 1997.

It's hard to think of another bank with that kind of longevity in the management team for its markets business. "It's remarkable," says Fields. "I think much of what we do works because we've known each other for a long time. The managers in my executive committee have been here for an average of about 20 years. Everybody I work with has been here in that range of time. And that just means the conversations are fluid, the conversations are open."

Clients and analysts agree the bank stands out, with many focusing on its willingness to be creative and embrace complexity. The treasurer at one big European corporate says SG is the first bank he calls when looking for advice on complex problems; the head of equities at a smaller investment bank says his firm did several correlation swaps with SG in 2014, claiming few, if any, other banks are still willing to price the trades; a senior private banker says he wishes he could distribute more of the bank's structured products, but has run into his firm's per-issuer concentration limit.

Kinner Lakhani, a bank analyst with Citi in London, notes SG had a second brush with catastrophe in the form of the US dollar funding squeeze that hit French banks in August 2011, before spreading to affect many other European names. Valet, formerly the group chief financial officer for SG, took charge of the CIB division five months later, leading a revamp of its liquidity and funding structure (*Risk* October 2012, *www.risk.net/2213391*).

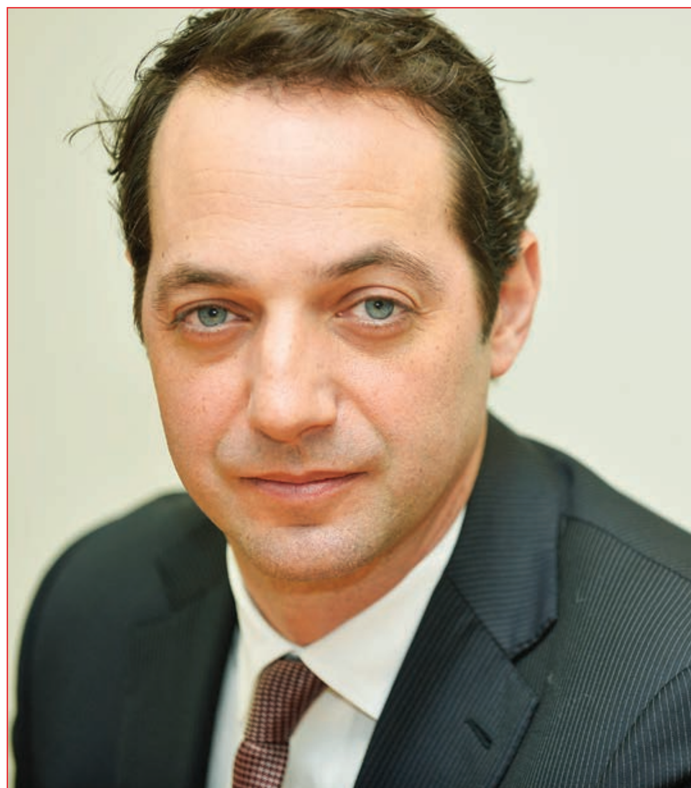

Photo: Scott Williams

Daniel Fields, head of global markets, SG CIB

Since then, Lakhani says the bank has been "generally been more disciplined and conservative" than its peers: "Where individual banks are today depends to a large extent on strategy and how quickly management got to grips with the new realities of this market. If you look at some of SG's competitors, they have been more ambitious and that has diluted their overall returns; I don't think the penny has dropped for some of them. In contrast, the past three years have seen SG generating Basel III returns of 15% on average, which is very respectable."

Jon Peace, a London-based bank analyst at Nomura, says the group's main challenge is improving the profitability of its international retail banking business: "The CIB business is clearly the jewel in the crown, with good cost efficiency and ROE compared with peers. SG has focused on its strengths, is the undisputed leader in global equity derivatives, particularly on the structured side, and has rightsized its cash equities and flow fixed-income business. The acquisition of the balance of Newedge is a good example of how the bank is looking to invest to grow the business."

The Newedge deal might initially look out of step with the bank's strategy. SG acquired the remaining 50% of the stake via an asset swap – with a 5% stake in asset manager Amundi going the other way – but in doing so ended up owning a business that has seen its earnings and market share slip in recent years, and is all about the nuts and bolts of execution, margining and clearing, rather than the complexities of options pricing.

That was exactly the point, says Valet: "Newedge is clearly additive in terms of clients to our franchise, and means we can capitalise on the growing importance of derivatives clearing and of post-trade services. We

feel there is going to be more and more stickiness or integration between execution, clearing and custody."

To put it more bluntly, Newedge brings with it more than 450 hedge fund clients, many of which were not previously trading with SG, and also allows the bank to offer new services to its existing customers, such as collateral transformation and optimisation, or equity prime brokerage, where it previously had to send many clients to other banks.

But Valet notes the business needs turning around as well. The aim, by 2016, is to cut €80 million in costs from Newedge and generate €120 million in additional revenue.

That work started in earnest on Escoffier's first day in the job, when calls had been convened with 24 of the firm's biggest clients. The idea was to explain that Newedge would be integrated into SG, benefiting from the bank's balance sheet and also a fresh injection of energy: "It is a competitive market, and futures and options volumes were down roughly 20% globally last year, so we were mindful the change of ownership might become an excuse for some clients to exit – but none did – it was only positive. With SG's credit strength behind Newedge, as well as fresh direction and focus, many of the clients said they would be giving us more of their business, and they are doing that," says Escoffier.

Since then, the bank has been trying to deliver some of the early cost savings available through integration, for example by pooling and harmonising IT resources, and merging some legal entities. It has also been testing the cross-selling benefits it hoped to see, creating a client management unit within Newedge to focus those efforts, giving customers access to the 155 different markets and 62 clearing houses Newedge is connected to, as well as opening up SG's capabilities.

Escoffier says he remembers the first over-the-counter derivative – a $200 million interest rate swap – that was sold by a Newedge team in the US to one of its existing clients in the second quarter last year. The client had previously only used the firm for futures and options broking: "Those first sparks, those first successes are very important, and we now have a flow of them."

SG's clients also stand to benefit, says Fields: "One of the most heartening things about the Newedge deal is that we've seen the industrial logic is real. What I mean by that is we have a good, global hedge fund business, but have often had funds asking what other business they can do with us – whether they can sign on for prime services, for example, and until 2014 the answer was always that we do not have prime, or we don't do listed products. The product range was limited to the OTC space, and did not include a lot of the financing they needed and that we would be happy to provide. Newedge completes that whole order."

In cases such as this, where the bank is expanding into mature businesses, it is humble. In providing equity financing for hedge funds, for example, it will be going toe-to-toe with established powers such as Citi and Morgan Stanley.

Mianné says the idea initially is to pick up some of the clients these firms are leaving behind as regulatory pressures force them to refocus. "We are not the only ones in this field, so we are humble, but we believe second-tier hedge funds need prime brokerage these days, and we believe we have the possibility to exist on this map," he says. The bank has set aside balance sheet to build the service this year, and Mianné suggests it should be able to generate "a few billion" euros of business fairly quickly.

When it comes to markets where SG has an edge, it is more assertive: "We are a smart bank. Our genesis is equity derivatives and structured products. We have a lot more to offer now, but that is where we started out, and it comes with a focus on engineering and advisory which I think defines who we are today. I don't see that as arrogant – I think that's recognised," says Fields.

Photo: Scott Williams

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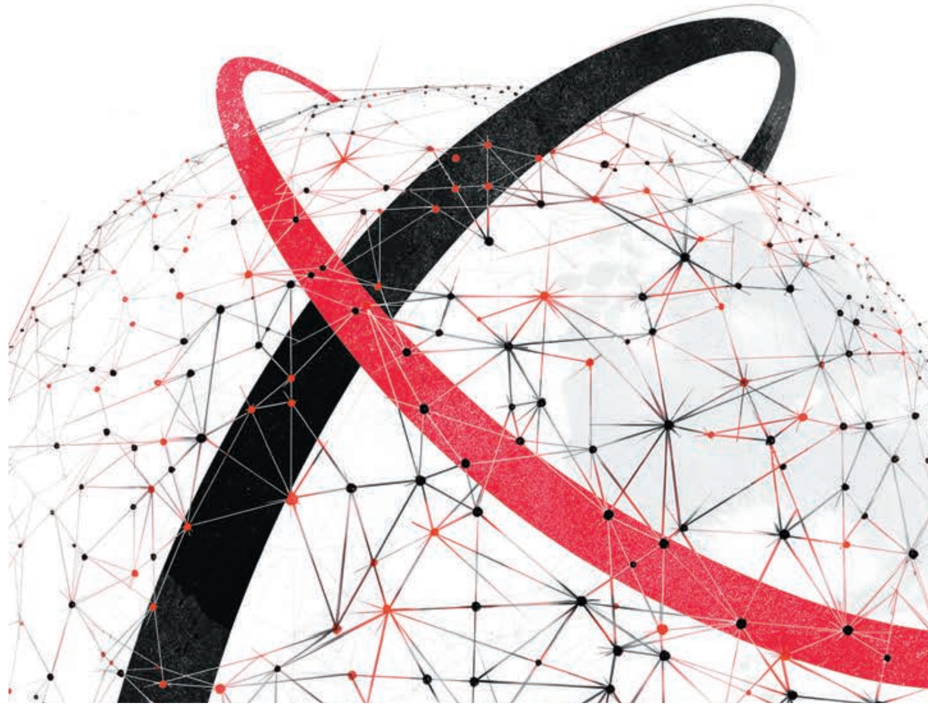
A good example is the CDS portfolio purchases. The deals were with two large European banks, closing in June and September, with the portfolios consisting of matched bought and sold positions. This makes the capital requirements for the trades immaterial, the bank says, but netting is not fully recognised by the leverage ratio, meaning the deals generated additional leverage exposure of around €5 billion.

There has been keen competition for these portfolios, with around three to five banks bidding in each case. SG's edge was the fact that it was able to achieve a "good" level of netting between the leverage exposures coming from the CDS portfolios, and the index roll positions that come from the bank's CLN business. "In a way, CDS purchases and the CLN business fuel each other, creating opportunities to buy portfolios on one hand, and reducing some of the roll positions in the CLNs on the other," says Mianné.

As a result, SG was able to bid more competitively in portfolio auctions, and also ramped up CLN issuance to €2.5 billion over the course of the year, with most of these trades being linked to a tranche of risk on CDS indexes, including Markit's iTraxx Crossover and high-yield CDX. Examples included notes that paid a 6% annual coupon as long as fewer than six index constituents suffered a credit event, and another that paid 3.5% if fewer than 21 reference entities defaulted. The products were a hit with private banking clients that were looking for higher-yielding products.

"It has allowed us to be among the best banks out there for simple, credit-linked products – private banks are telling us we're one of the only houses still active in this market," says Mianné. **R**

GLOBAL DERIVATIVES
HOUSE OF THE YEAR



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