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Sustaining in a changing environment
Derivatives Trading within the European Asset Management Industry

Foreword

As the new liquidity paradigm continues to reshape the global financial services industry, there are many institutions who are viewing this as an opportunity to 're-invent' the way they do business. These institutions are examining what structural changes their business will require in future, what long-standing business processes need updating to meet the new market reality, and what legacy systems are in need of an overhaul. They are also examining their strategic direction, deciding what markets they want to compete in, and even challenging the type of financial institution they should be categorized as.

One area of the industry currently facing questions about its future is the continued use of financial instruments – including the market for derivatives. The recent struggle to 'untangle' bad mortgage-backed assets from many of today's complex instruments, has led to a backlash against financial engineering and complex products. In addition, a change in oversight seems to be on the way for these types of instruments, with financial authorities expressing the need for new regulation.

However, despite all these challenges, derivatives are unlikely to disappear. In fact some commentators see the increased use of derivatives as a key part of the solution to the current crisis. It is therefore an opportune time for institutions to upgrade their derivatives processing and risk management capabilities, to reduce cost and risk, and to prepare for future growth. This survey, conducted last year, highlights the views of executives at Europe's leading asset management institutions, and what they think the future holds for derivatives trading across Europe.

As the financial landscape continues to change, Deloitte's *Global Financial Services Industry* network is committed to providing continued thought leadership, surveys, and studies on the issues most important to global financial institutions. Deloitte's aim is to help guide clients through these challenging times and provide them with insights useful in not only *surviving* the credit crisis, but essential for clients to continue 'thriving in a changing environment'.

Regards

Stuart Opp
Global Investment Management Leader
Deloitte LLP

Introduction

In recent years, there has been increased usage of derivatives in the asset management industry. However, as most studies about derivatives tend to focus mainly on trends within investment banking and hedge funds, trends specifically for the European asset management sector have been hard to come by. This study, which was conducted between February and August 2008, is therefore providing the first assessment of the *Derivatives Trading within the European Asset Management Industry*.

The main objectives of the study were to assess the use of derivatives and the capabilities of asset managers to process derivatives. The study identifies trends and industry pitfalls and provides an overview of:

- Derivatives trading volumes;

- Breadth of traded derivatives instruments used in the sector;

- Growth plans;

- Operational environment; and

- Risk management within leading European asset managers.

The participants of this study are leading traditional European asset management institutions across six European countries. The participants fall into one of the following types of business segments:

1) Retail oriented asset managers;

2) Subsidiaries of insurance companies; and/or

3) Asset managers with a balance between retail and institutional business.

This study is based on questionnaires sent out to participants as well as one-to-one interviews. As the timeframe demonstrates, the main impact of the current financial market upheavals was outside the data collection phase. The findings are based on quantitative as well as qualitative data collected through the surveys, interview sessions and Deloitte industry knowledge.

At the start of the study, market sentiment among asset managers was "cautiously optimistic". It is no surprise that the drastically changed market environment since September 2008 has impacted the participants' perspectives substantially. When discussing results with the participants, most indicated that they now expect an extended time period with slow or no growth in derivatives trading. General expectations reveal increasing governmental involvement on a global level, particularly on the OTC side, which suggests further regulatory changes affecting the entire financial services industry, including Asset Management. While these changes are likely to be significant in the future, they were not prevalent during the data collection period of this study.

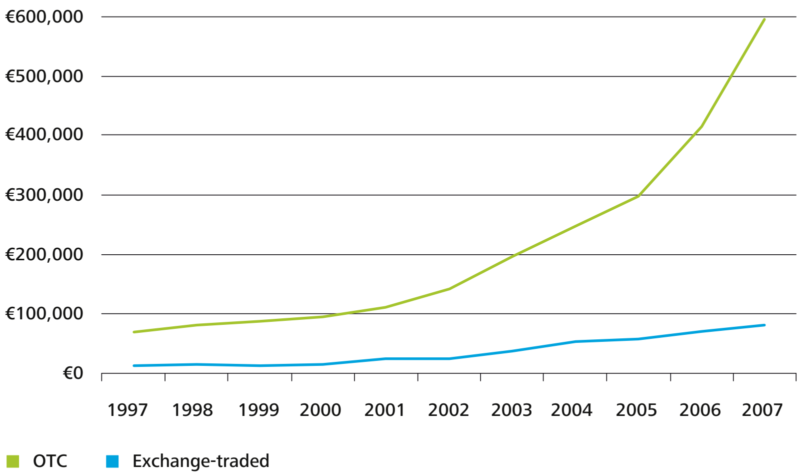
Breadth of instruments traded and growth plans

As a result of the global financial crisis, total growth and volumes for overall derivatives trading are expected to decrease in the short- to mid-term. This is mostly due to the reduction in proprietary trading of investment banks, the difficulties that portions of the hedge funds industry are facing and, in some cases, the general market illiquidity. Traditional asset managers, however, appear to be "less affected" by current market turmoil than the investment banks. As such, the derivatives trading volumes for asset managers in total are anticipated to stay the same or increase in the long-term, once markets have recovered and new regulations have been introduced.

Despite recent events, one should not forget that just before the financial crisis the global derivatives market had been growing at a rapid and accelerating pace for the past five years. This has led to growing complexity and cost challenges, which asset managers have tried to address.

Figure 1: OTC and ETD growth

International derivatives markets in bn Euro, Notional Amounts



Source: Bank for International Settlements, Deloitte calculations, 2007

Figure 2: Monthly trade volumes for OTC instruments

OTC instruments traded within volume categories

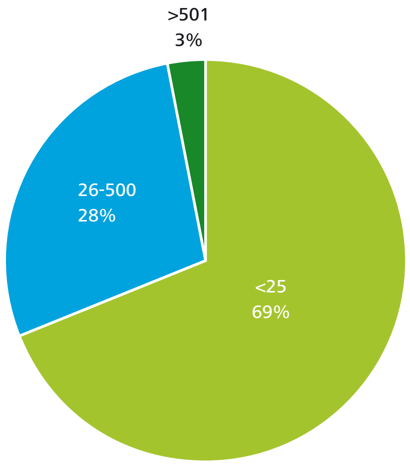
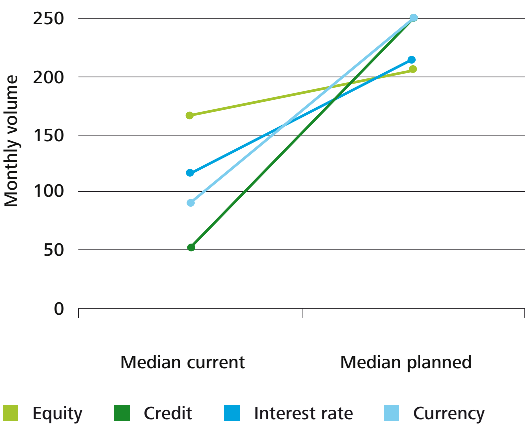


Figure 3: OTC growth trends

Planned monthly OTC growth trends per instrument type



When assessing the breadth of instruments traded by the participating asset managers, it became apparent that the focus is on vanilla instruments and, within those, frequently on equity and interest rate derivatives. The findings also demonstrate that the most significant growth is expected on the OTC side, with projected growth rates of up to several hundred percent (see figure 3). These enormous growth plans have to be seen in the context of participants' low starting points: 69% of the participants reported less than 25 trades per instrument within a month. On the other hand, asset managers showed a limited growth appetite for ETD trades. Since gathering the data, however, participants have begun to indicate that concerns about counterparty risks may cause this trend to reverse with the focus shifting back to ETD trades.

Current market turmoil is expected to trigger further regulatory changes. The Basel Committee is already focusing on practical and concrete efforts to strengthen risk management regulation and bring [back] confidence into the financial market[1]. Moreover, in a recent interview Lord Turner, Chairman of the FSA told the Financial Times, "…we have been doing supervision on the cheap"[2], heralding the probability of more stringent regulations in the near future.

1 Financial Times: Watchdog urges fundamental rethink of regulation after crisis, by Peter Thai Larsen, 17 October 2008

2 IBID

Operations

Finding ways of optimising operational processes for derivatives continues to be a major challenge within the asset management industry. Some participants have improved their operational effectiveness by automating parts of their value chain, primarily leveraging software solutions and in some cases working with outsourcing service providers. In-house solutions to drive automation appear to be a less prominent choice among participants. "We have chosen a vendor to improve our derivatives process… we just can't develop this in-house", confirms the Head of Operations of one of the participants. While drawing on software vendors and service providers may be a common approach, this does not mean that participants are happy with the choice of vendors available. Clearly, a number of participants expressed their disappointment with the limited number of outsourcing providers who have mature offerings. Other participants still largely operate manual processes, particularly for the more complex instruments.

> "We know we have a major challenge…our **STP rates** are at **0%** for **OTC** trades."
> **Head of Derivatives**

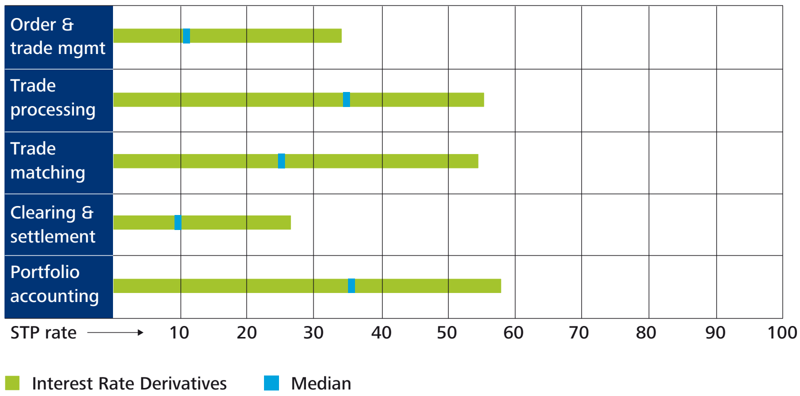
One of the major challenges is valuation, as all of the asset managers surveyed are struggling with a timely and reliable process that enables daily valuation of positions as well as collateral. Moreover, participants pointed out the following operational challenges on valuations:

- Conflicting third party pricing data;
- Incorrect pricing of OTC instruments in illiquid markets; and
- Inconsistent proprietary pricing models.

As shown in figure 4, this study has also found considerable variance of STP rates at each step across the participant's value chain. This reflects the different levels of maturity of the operational environments. A number of participants report STP rates as low as 0%.

Figure 4: STP rates across value chain

Automation of OTC derivatives processing: Example of interest rate derivatives



While value chain inefficiencies appear to be a common challenge within the industry, it is unexpected to find such low STP rates for ETD instruments, given their maturity and the automated nature of trading in this area.

Risk management

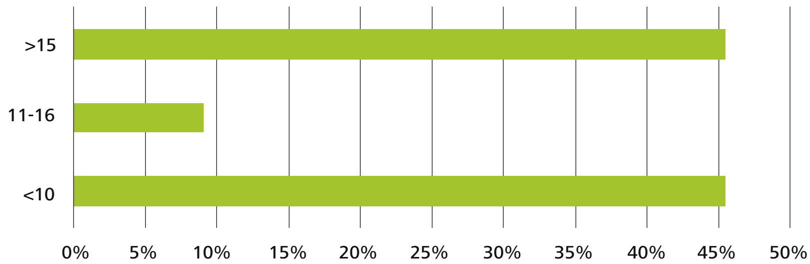
The findings around risk management practices also display a significant variance amongst the participant group. Generally, participants indicated confidence in their risk management function with respect to investment, market and credit risk. Yet, as the study progressed, a deeper look revealed some potential concerns, given that the number and sophistication of risk metrics and techniques applied varies greatly. Moreover, while the majority of participants are performing their risk management on a daily basis, there is a significant number of participants that do not yet follow this prudent approach. While some participants use as few as five risk metrics on the portfolio level, others use as many as 19 (figure 5). No considerable correlation has been identified between the number of metrics used and the trading sophistication.

> "Clearly there is **no silver bullet**, but a combination of vendor- solution and leveraging in-house expertise appear to allow **higher STP rates** among participants."
> **Andreas Timpert, Director, Deloitte**

"For a significant number of these asset managers, the risk management function has not yet applied the learnings from the sell-side. Substantial upgrades seem required to meet today's challenging demands."
Steve Barnett, Partner, Deloitte

Figure 5: Number of risk metrics used on portfolio level

Risk metrics used by participants on portfolio level



An emphasis on more traditional metrics to measure risk was observed. The monitoring of tracking errors or use of Value at Risk (VaR) measures were among the preferred options. Given the limitation of VaR to reflect risk fully, the reliance on this approach alone has limited benefit. Generally, it appears that non-linear models are hardly used in spite of the potential limitations of linear models to assess the potential impact of non-linear events.

In light of these findings the stated high confidence levels as well as the fact that only a limited number of participants are planning to re-consider their risk management within the next 18 months seems surprising.

Trends and challenges

This study provides the first insights into derivatives usage in leading European asset managers for 2008. While significant market upheavals occurred since this study has been completed, the findings of the study still provide a good overview of the challenges that the use of derivatives has already presented to the asset management industry.

On a macro-level, participants' growth plans clearly focused on OTC. However, counterparty risk considerations are changing preferences from OTC to ETD trading – at least in the short run. It is still unclear whether the shift in preferences is temporary or becoming permanent. On a micro-level, some participants are trying their best to improve their processing capabilities and to utilise as many risk metrics as possible to establish an environment in which their pursuit of greater alpha and higher margins can be addressed through leveraging derivatives. The Head of Risk at one participant confirmed, "we are asking for more funding to enhance our risk management sophistication".

In summary, interviews with the participants led to the following common themes, which are discussed in more detail in the study:

- Lack of standardisation and an absence of automation have led to higher manual interventions and higher processing costs and error rates as well as operational risks;
- Changes in regulations (i.e., UCITS, Basel II, MiFID) as a result of current market upheavals are likely to bring even greater regulatory changes, which will change the landscape immensely;
- Lack of skilled resources and capabilities amongst service providers make many asset management institutions lag market demands; and
- A clearing house for OTC derivatives is needed to reduce risks and inefficiencies such as failed trades and counterparty exposure.

These challenges will continue to put pressure on the asset management industry to find new ways to circumvent these problems and to improve their internal processes to meet market demand. Already many investors are looking at how they deliver new investment possibilities such as 130/30 strategies, all in the spirit of trying to reduce volatility and/or improving alpha potential.

Consequently, current market conditions might in fact provide an opportunity for asset managers to "catch up". As the market climate will limit the growth of derivative instruments traded, both in terms of volumes and breadth, the industry should invest in upgrading their derivatives processing and their risk management capabilities, so that future growth can be supported:

1) Improving risk management: the volatility of markets over the course of recent months has made it apparent that asset managers need to have a risk management function in place that can support portfolio managers in making the right decisions in difficult markets as well as providing senior management with the information required to identify and manage overall risk exposure appropriately. Asset managers are now investing in improved processes and – where larger investments can be made – are also looking at state-of-the-art risk management systems to support the enhanced requirements for the risk management function.

2) Upgrading collateral management: the bankruptcy of Lehman Brothers, and threat of further failures of large banks, has turned counterparty risk into a major concern for senior management. Short-term, one of the responses is to increase collateral requirements. However, it is becoming increasingly important to establish a strong collateral management function due to the growing volumes of collateral, dealing with collateral other than cash and aiming to earn some return on large funds tied up as collateral. We are seeing asset managers throughout Europe assessing their options to address this challenge.

3) Further automating derivatives processing: as the study has shown, frequently STP-rates are too low to process significant trading volumes efficiently. Asset managers should therefore assess their opportunities to increase automation – through process improvements, system upgrades or outsourcing – with the objective to reduce the operational risk inherent in the current processing environments. As most traditional asset managers will reach substantial monthly transaction volumes for only a small subset of derivatives, in a lot of cases this can be achieved without having to reengineer the entire operating model.

Study outlook

Deloitte has been asked by most of the participants to undertake a second iteration of this study on a global basis. In the second half of 2009, Deloitte plans to commence a second study by drawing upon its global industry experts to provide deeper insights into the derivatives trading within the asset management industry.

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