AsiaRisk Awards 2016

Credit derivatives house of the year

Societe Generale

Playing in the credit markets is expensive and has become more so as regulators have tried to rein in the kind of reckless speculation that led to the financial crisis in 2008. Accordingly, a number of participants have pulled back from the sector, particularly as volatility has jolted the markets. But not Societe Generale, which remains, in its own words, "very much open for business".

SG has even taken up some of the slack left in credit markets from those that have decided to pull back – showing that it is not only open for business but prepared to expand its credit segment in order to continue serving clients' needs.

Last year, the French bank fought off at least four large international banks – a mix of US and European operators – to snap up a $1.3 billion book of credit default swaps (CDS), consisting of 52 Japanese names spread across roughly 350 contracts, from a bank that was looking to exit the business.

SG was able to win the deal because of its strength in bringing capital costs down. Thanks to its existing credit profile (which helped to reduce the leverage ratio of the deal) as well as sophisticated hedging capability, SG was able to push the capital cost of the new book of business down to an impressive 20% of its standalone value.

"This is a crucial point; if we had been able to only get it down to 30% I'm not sure that we would have won the deal," says Jerome Niddam, head of financial engineering, global markets, at SG.

Being able to bring the cost of capital down so dramatically allowed SG to put in an aggressive bid for the portfolio.

The leverage ratio depended on the mismatch between maturities in SG's existing book compared with the book that it was purchasing. The duration of the $1.3 billion back book wasn't extremely long-dated – maturities ranged from one to five years – but it was long enough that it would have been painful if SG's overall profile had been too short. SG reports that the duration profile was "fairly average" for an Asian book, which tends to have shorter positions than those weighted towards European and US names.

Bringing down the leverage ratio helped reduce the overall cost of capital of the deal by 30%, but that wasn't enough. SG achieved a further 50% reduction by analysing each of the contracts and deciding which of these should be hedged – principally those where underlying notionals were very big and the maturities so long that they would have hurt the capital position for some time into the future.

There were only about six regional names that proved too illiquid for SG to hedge, and so the bank took the decision that it could just live with this additional capital hit – which, given that many of the other long-duration names were successfully hedged, wasn't too much of an issue.

"It was important to have strong analytical capabilities in order to compute the leverage ratio and then a good execution capability so that we didn't give away our entire premium putting on the hedge," says Niddam. "We also had to make sure we weren't going to lose money on the cost of carry and the deformation of our book once the new book was integrated."

SG also had to consider the minimum ROE, or return on equity, that the bank targets at group level – which is just over 10% – and make sure the pricing of the bid was in line with this level.

Analysis for the deal was performed both in Asia and in Paris, with a dedicated team in Paris able to give a response in "just a few hours" in respect of how much the book would cost and how it would sit within SG's existing portfolio.

With much retrenchment already having taken place by banks, opportunities to buy an entire CDS book have become less and less common. SG says it is well positioned to consider similar deals in the future, but expects most future opportunities to be novated on a transaction-by-transaction basis rather than the full book.

> "Pricing may be fairly similar in a single-feature product, but when it comes to hybrid products – range accrual plus credit, for example – SG really is second to none"
> Senior investment manager at life insurer

Buying such a sizeable book demonstrates SG's clear commitment to the credit markets in Asia, and fits well with some of the bank's other successes around the region.

Hybrid credit

In Korea, SG has been working hard to add customisable credit exposure to some of its traditional payoffs – such as the steepener and callable range accrual payoffs – in order to offer a better yield pick-up. SG now offers a credit component in 20–30% of its Korean products, equating to $1.5 billion in outstanding transactions.

Many of these products embed Korean credit exposure, since this is what domestic clients tend to favour, but this year SG has stepped up efforts to diversify away from this and introduce more credit from international banks.

"The size of the Korean CDS market is not deep enough to absorb all the potential appetite from investors, and furthermore they don't want to be too concentrated," says Niddam.