

# Currency Derivatives House of the Year Deutsche Bank



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Deutsche Bank



The logo for the Risk Awards 2008 is a blue square tilted to the right. Inside the square, the word "Risk" is written in a large, bold, white sans-serif font. Below it, the word "Awards" is written in a smaller, white sans-serif font, and "2008" is written in a white sans-serif font at the bottom.

## CURRENCY DERIVATIVES HOUSE OF THE YEAR DEUTSCHE BANK

*Deutsche Bank is the two-tonne elephant in the currency derivatives market, but that has not stopped it from being swift with new innovations and developing cutting-edge products. This year, its continued dedication to new ideas has ensured it has remained at the head of the pack."*

"This has been a tremendous year for Deutsche Bank's currency division. It's going to be a record year in terms of volumes and revenues, and in order to achieve that, you need to criss-cross every single frontier. Whether that's through proprietary risk-taking, our short-term interest rate trading, our options business or our complex risk division – they've all had a record year," says Zar Amrolia, global head of foreign exchange in London.

One of the standout areas has been Deutsche Bank's complex structured products division, which has grown on the back of its index business, increased dealings of target profit forwards (forwards that terminate when a pre-defined profit level has accumulated), and its growing presence in the deal-contingent swaps market.

In particular, Deutsche Bank has made huge strides in the index space. Its Harvest indexes – rules-based products based on carry trade strategies, which dynamically go long high-yielding currencies and short those currencies with low interest rates – have proved popular with hedge funds, asset managers, pension funds and even corporates looking to reduce their cost of funding. The notional invested in these products increased by more than 500% last year, and stood at more than €2 billion as of December 13. The bank also launched its Deutsche Bank Currency Returns index in March, a product designed to capture long-term systematic returns in the currency markets by replicating three foreign exchange strategies – carry, momentum and valuation.

Despite volatility in the currency markets this year, which has seen bouts of widespread unwinding of carry trade strategies, the indexes have held up well. For example, an investor who took exposure to the Harvest Balanced index on July 23 – near the height of the market turmoil – would have seen a return of –0.4% as of November 30.

Meanwhile, the bank teamed up with New York based consultancy Mercer Investment Consulting to launch the Mercer Currency Manager index, which tracks the perform-

ance of 10–15 foreign exchange funds. The managers are chosen by Mercer from Deutsche Bank's FX Select platform, which comprises more than 70 currency managers employing a range of investment styles, from discretionary to systematic. Since its launch, the index has yielded a return of 2.3% net of fees, or 5.3% gross of fees.

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The Mercer index is just one example of how FX Select can be tailored to create bespoke indexes. In August, a large Asian life insurance company executed a seven-year, \$200 million notional delta-one trade on a customised index comprising 11 funds. Although the index is currently down 2% net of fees as of mid-December, an investment manager at the life insurance firm says the product met its primary need – which was to diversify away from bond and equity markets. The client can switch any of the managers at any time, and the investment manager says his company is currently considering doing so. "This product has given the firm access to the currency managers and allowed it to get a better feel of their styles and views," he adds.

Index-linked products have not been the only strong growth area – the notional volume of target profit forwards (TPFs) executed by the bank has more than quadrupled over the past year. These products attempt to address a common predicament for clients who want to hedge in the future with some degree of certainty. While products such as knock-out forwards offer users a more attractive rate than the forward

rate, a sharp move in exchange rates could cause the hedge to terminate – meaning clients risk losing their hedge just as they really start to need it. In contrast, TPFs also offer a better than forward rate, but only terminate when the client has accumulated a pre-defined profit. The customer can hedge their exchange rate risk at regular intervals and retain all previously accumulated profits.

“My favourite has always been Deutsche Bank – in terms of the currency pairs they’re offering, trading with their brokers and trading on their electronic platform,” says one head currency trader at a large Connecticut-based hedge fund.

In essence, TPFs package a dynamic hedging strategy into one product. But the uncertainty around the notional, strike and timing of execution make the structure extremely difficult to risk-manage. “As we are big and have greater scale than our competitors, we can offer better pricing than anyone else because we can hedge it more cheaply by trading on tighter spreads internally, thanks to our dominant vanilla options and cash businesses,” explains Rashid Hoosenally, global head of foreign exchange structuring at Deutsche Bank in London.

Elsewhere, the bank has continued to build up its presence in the deal-contingent swaps market, executing around \$12 million notional this year. These products enable prospective acquirers to pre-hedge interest rate and currency exposures that would arise from the financing of an acquisition. However, the swap terminates if the deal falls through, either because of a regulatory veto or failure to win shareholder approval.

For instance, Deutsche Bank created a deal-contingent hedge in June for Castle Harlan, a \$3 billion New York-based private equity fund. The firm was simultaneously negotiating a management buyout of Polypipe Group, a large UK-based plastic pipe producer and sanitary system manufacturer, and a refinancing of the business – leaving it with a complex forex exposure. Castle Harlan was keen to hedge, but because the two parts of the negotiation were mutually exclusive, the company could not be sure either of the notional or the tenor of the hedge.

In response, Deutsche Bank structured a deal-contingent hedge to match the firm’s risk profile, so that the swap’s notional

and maturity changed as the target corporation’s refinancing situation altered. (The company had two refinancing options.)

“This was a highly innovative deal to the degree to which Deutsche Bank stepped up as a partner to accept risk in this trade, and there was no doubt it was cheaper than hedging the different possible outcomes separately,” says Tom Hickey, New York-based managing director at Castle Harlan. The firm entered the trade on July 25, and the hedge was triggered on August 14 with the signing of the purchase agreement for Polypipe Holdings.

Hoosenally says Deutsche Bank has placed dedicated foreign exchange specialists into the investment banking division to keep an eye out for deals of this sort, and to educate would-be acquirers on the dangers of foreign exchange risk – and this has had an impact on the volume of trades the bank has executed. “Currency risk is frequently larger than people realise, and we’ve seen examples where unhedged currency has killed an merger and acquisition deal. So, we review every cross-border transaction at the outset with the bankers to make sure any currency risk is identified to our client immediately,” he explains.

Elsewhere, the bank made changes to its pricing models during the first half of 2007 – a move Amrolia says was critical in its ability to risk-manage the spike in volatility in August. Specifically, the bank enhanced its stochastic local volatility currency model and put a greater emphasis on how the volatility surface changes with variations in the spot price. “We put a lot of effort into improving our risk management techniques across all our products, which has helped improve consistency in terms of pricing for clients. When the storm hit, many of our competitors pulled out of the yen options markets, for example. But we knew our risks, so our doors were open for business,” he explains.

For the year ahead, Amrolia says one of the bank’s main goals will be to increase its investments into algorithmic trading and execution for clients. Last year, it launched cross-product functionality (futures, money market, interest rate derivatives) and improved the option capabilities on its currency platform.

The changes have spawned a healthy e-commerce business, with volumes up 75% year-on-year – a feature that has invoked praise from clients. “My favourite has always been Deutsche Bank – in terms of the currency pairs they’re offering, trading with their brokers and trading on their electronic platform,” says one head currency trader at a large Connecticut-based hedge fund.



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