AsiaRisk AWARDS 2011

CURRENCY DERIVATIVES HOUSE OF THE YEAR

Goldman Sachs

Goldman Sachs has embarked on a concerted effort to move beyond the provision of clever trade ideas to sophisticated financial institution clients and confident proprietary trading to substantially expand its capabilities in local Asian markets as well as deepening its client footprint in the region, notably with corporate entities.

The move has come against the backdrop of a broader appreciation trend of Asian currencies compared with the US dollar during the past year, which has resulted in corporate treasurers and other market participants in the region reconsidering their referencing of US dollars when looking at simple currency hedges or cost-cheapening trades. Increasingly they are seeking local currency crosses that better reflect their payables and receivables instead.

This is most noticeable with transactions related to China, with risk management linked directly or indirectly with the Chinese currency becoming essential for many entities operating in Asia. Hedging options for onshore institutions in China in home markets are still limited, but the rapid development of the offshore deliverable renminbi (CNH) market in Hong Kong has created a blossoming new business for risk transfer.

Meanwhile, appetite for sourcing yield from Asian currencies has increased, especially among hedge funds operating both within and outside the region as they look to exploit changes in risk appetite. Many asset managers spent much of the year seeking cheaper ways to express their views on Asian currency appreciation and rewarded dealers capable of coming up with structures that enabled them to save costs.

But for both institutional investors and corporates alike, there was a need for currency counterparties to deliver actual execution after offering good trade ideas rather than merely expressing the ideas on paper. Goldman Sachs drew praise from multiple counterparties for its consistency in delivering on its promises to clients. For example, the treasurer for an affiliate of a large Chinese state-backed investment holding company listed in Hong Kong says the US dealer's co-ordinated, cross-asset approach in delivering and hedging currency exposures was second-to-none.

Moreover, he adds this capability more than makes up for the limited banking presence Goldman Sachs has onshore in China, saying the US dealer's ability to tailor-make renminbi hedging solutions covers "100%" of his company's needs.


Geoffery Lee, Goldman Sachs


Dimitrios Kavvathas, Goldman Sachs

Goldman Sachs officials, meanwhile, say during the nine months to September this year CNH/CNY delta-one business volume has increased by 60% from a year ago, mainly due to the growth of CNH and flows related to CNH/CNY arbitrage. "This has helped fuel the bank's non-Japan Asia delta-one volume year-on-year growth of 13% over the same period, despite a more challenging market environment," says Geoffery Lee, managing director of Asia-Pacific ex-Japan macro trading at Goldman Sachs, based in Hong Kong.

Several clients *Asia Risk* spoke with say the US bank, which was once perceived as "prop-trading oriented", has in the past couple of years shifted that perception to more "corporate-friendly". "While other banks might say they would try to tailor-make the structure according to our needs, at best their products are only an 80% fit," says the Hong Kong-based treasurer. "Also, solutions from Goldman are more user-friendly as they contain fewer variables than those from other banks, which make it difficult for the end-client to understand."

To help the Chinese investment holding company listed in Hong Kong to hedge its USD/CNY exposure from a renminbi liability related with a bond issue, Goldman Sachs wrote a three-year, US dollar put spread/CNY call spread on a large notional to hedge against the risk of CNY appreciation. The spread involves the simultaneous buying and selling of an option, which can be executed either through a pair of calls or puts.

Forward thinking

Prior to the re-emergence of eurozone sovereign debt fears that emerged in the third quarter and resulted in risk coming off the table, the forward market was pricing in a lot of renminbi appreciation, making the three-year CNY call spread on the large notional expensive for the corporate. To reduce the cost of the call spread for the client, Goldman Sachs enabled the treasurer to choose from among several of its proprietary algorithmic indexes that exhibit low volatility but good historical return compared with benchmark indexes and, if the performance was good, the hedge costs would cheapen.

One of the indexes chosen was an equity index, backed by an algorithm that automatically goes long liquid conviction-buy recommendations issued by Goldman's equity research team while shorting the benchmark market index; while the other was a commodity algo that attempts to capture seasonality and backwardation effects in commodity prices. The premium of the CNY call spread was linked to the performance of Goldman Sachs' proprietary indexes and the treasurer says, thus far, the two indexes have performed and successfully cheapened the call spread cost.

"Through the CNH market, we are lessening our disadvantage of not having an onshore presence in China," says Melyvn Pun, managing director of Hong Kong corporate sales. "In this CNY call-spread trade linked to the two algos, it is an amalgamation of the capabilities of our macro structuring, commodity and equities teams."

Goldman Sachs' sharpening focus on the corporate sector comes at a time when the dealer has increased its FX headcount with a view to building onshore presence in Korea, Malaysia, Singapore and India. During the 12 months to July 2011, the bank also expanded its local macro sales team with hires in Singapore, India and Australia. Today, non-Japan Asia and Asia-Pacific macro sales comprises a team of 33 people, says Dimitrios Kavvathas, co-head of Asia Pacific securities division distribution and head of Asia Pacific sales and structuring at Goldman Sachs in Hong Kong. The firm also hired Pierre-Emmanuel Juillard as co-head of structuring for Asia Pacific, alongside HC Liu.

Meanwhile, while the co-ordination of Goldman Sachs' different business units draws favourable comments from clients, this is not just related to the firm's cross-asset focus. It also includes the way Goldman Sachs co-ordinates its front and back office functions. Tim Fallowfield, head of FX and rates for supply chain manager Noble Group in Hong Kong, says Goldman Sachs' credit officers are often proactive in giving corporate counterparties more flexibility in terms of risk limits.

An example was a one-year, renewable termination clause that helped both sides of an FX trade limit credit risk related to longer tenor trades. The facility gives both the bank and the corporate the right to break the transaction at prevailing market levels after one year should either side choose to; after which both sides will unwind the trade and settle the outstanding cash flow.

Fallowfield says credit officers at other banks often lack the same systems or flexibility to approve such termination clauses if asked by clients because of the substantial operational challenge of booking a 10-year trade and recognising the trade as a one-year credit risk. "Goldman is very much ahead of the game. Their emphasis on the back and mid-office is what gives them the flexibility," says Fallowfield.

Goldman Sachs' strength in producing good ideas and standing ready to execute them was also commended by hedge fund clients, one of which says he often finds "a good linkage between its macroeconomic and market views with the bank's sales and trading capability". This is often not the case, even at leading FX dealers where there is often "a disconnect" between what the researchers propose and the traders are willing to do for clients.


Pierre-Emmanuel Juillard, Goldman Sachs


Hector Chan, Goldman Sachs

Macro structuring

Hector Chan, head of macro structuring in Asia Pacific at Goldman Sachs in Hong Kong, says one Asia macro theme the bank presented to clients this year took advantage of the imbalance between realised and implied volatility of Asian currencies such as the ringgit and won. The dealer offered 'budget options' that enabled hedge fund clients to price options using their preferred volatility level, instead of those implied by the market, to express their views on Asian currencies appreciating in a low realised volatility environment. Chan says the bank has printed "billions" of notional since April this year.

The trade worked because before the global financial crisis, Asian corporates were big sellers of volatility to the market as they could get cheaper FX rates and better cash flow from the option premium. However, the adoption of International Financial Reporting Standards, which are currently being implemented in many Asian countries, likely will suppress the supply of vega moving forward, partly because net written options are not permitted for hedge accounting treatment. The constant demand of option protection will likely keep implied volatility at elevated levels. Meanwhile, the move by Asian central banks to curb their appreciating currencies in 2010 helped to keep realised volatility low. The resultant imbalance meant investors that expected a low, realised volatility environment for non-Japan Asian currencies could invest in budget options to save on option premium compared with vanilla options.

During September this year when many Asian currencies depreciated and volatility spiked, the directional view of investors that were long Asian currencies was proven incorrect, but hedge funds that bought budget options were relatively better off, since they had spent much less premium than if they had bought vanilla options. "We try to be pragmatic in viewing where the demand would come from and invest our resources accordingly. We anticipated there would be demand for budget options so we worked early enough in marketing and risk-managing that product," says Chan.