RISK MANAGEMENT | DERIVATIVES | STRUCTURED PRODUCTS

Risk 20: July 2007/Volume20/No7

The Risk 20 Awards

When we conceived the idea of the Risk 20 awards, our aim was to recognise those institutions that have helped drive the development of the derivatives market over the past two decades - those responsible for the birth of the markets and at the forefront of innovation. We very quickly came up against a major problem: few of the banks that really helped get the market off the ground in those early years are still around. Bankers Trust, Chemical Bank, Salomon Brothers and Security Pacific are just four that immediately spring to mind. But there was something else: very few institutions had gone through the 20 years without some form of blow-up, loss or crisis. Bankers Trust, for instance, was an undisputed leader and innovator in the derivatives markets in the 1980s, but its reputation will always be sullied by the allegations of mis-selling by Procter & Gamble and Gibson Greetings.

Was there a way we could recognise the contributions of the early pioneers, those who had dreamed up so many of the products still traded today and done so much to get the infrastructure of the markets in place, but also recognise those firms that have taken the market on to the next level and have been consistently strong over the past decade?

We decided to split the awards into two: the pioneers and modern greats. The pioneers are those institutions that led the development of their respective derivatives markets. They were the early innovators, were instrumental in the development of the first derivatives products, and helped set up the framework and infrastructure for their markets. In many cases, the early innovators no longer exist.

The modern greats are those firms that have taken the market to the next level by developing second- or third-generation products. These are the firms that may or may not have been in the early wave of innovators, but which have shown thought leadership, innovation, trading savvy, commitment and good client service over the past five to 10 years.

We also wanted to highlight some of the key industry developments over the past 20 years that have helped shape the risk management and derivatives industries. We've picked four - the G-30 report, the International Swaps and Derivatives Association master agreement, the use of internal models to calculate regulatory capital for market risk, and Basel II. There were many others to pick from, and narrowing it down to these few was extremely difficult.

These awards were decided by a Risk editorial committee. Unlike the end-of-year awards that Risk publishes in January, these were more an exercise in research based on past awards, polls, third-party research and Risk articles over 20 years.

By Nick Sawyer, Navroz Patel, Rachel Wolcott, Alexander Campbell, Gareth Gore, Jayne Jung, Mark Pengelly, Wietske Blees, Clive Davidson and David Rowe.

Currency Derivatives Pioneer: Salomon Brothers

Absorbed into Citigroup almost a decade ago, Salomon Brothers no longer exists as an independent company. But in the 1980s, it was famous - an emblem of the new aggressive Wall Street culture. And, as well as its notorious fixed-income trading department and its innovations in mortgage-backed securities, it was one of the pioneers of the currency derivatives business.

Salomon Brothers brokered what many believe to be the first currency swap. In 1981, David Swenson, a banker in Salomon's corporate finance division (now chief investment officer for Yale Endowment) and his colleague Jon Rotenstreich devised a swap between IBM's Deutschmark and Swiss franc debt and the World Bank's dollar-denominated borrowings, which gave one side - IBM - the ability to match its largely dollar-denominated sales to its liabilities, while allowing the other to circumvent its country caps on borrowing without having to pay higher US interest rates.

The next year, Salomon Brothers started its foreign exchange product department - the same year that Arnie Staloff, a securities specialist at the Philadelphia Stock Exchange (PHLX), created the first exchange-listed currency option contract. The new product was a rapid success and Salomon capitalised on it. A former intern and new recruit, Bill Lipschutz, was put in charge of building the forex options desk within Salomon's foreign exchange department, and by the mid-1980s Salomon was responsible for 50% of currency option volume on the Philadelphia exchange, which reached $4 billion a day in 1988.

The volume traded by Salomon Brothers and others helped the PHLX become the dominant foreign exchange trading centre by 1984. Although the exchange's equity volumes were tiny compared with other bourses, its first-mover advantage in the forex space helped it fight off a challenge from the Chicago Board Options Exchange, which gave up on its own forex market in 1987 after four years of trying. The exchange and Salomon Brothers' foreign exchange options business grew together as the forex market blossomed in the 1980s.

Under Lipschutz, Salomon took heavy proprietary positions - reportedly making $300 million a year by 1985. In October the next year, the bank put on the largest options trade in history - 30,000 sterling put options, expiring in December 1986.

Lipschutz, by then global head of forex, left the firm in 1990, later to co-found the asset management company Hathersage Capital Management. Shortly after his departure, Bill Strack, his operations manager, also left. The two founded various foreign exchange trading companies before Lipschutz set up Hathersage Capital, which Strack joined earlier this year.

In the 1990s, Salomon's pre-eminence started to wane. In 1991, its government bond trading division attempted to corner the market in US Treasury bonds by submitting fraudulent bids in the names of customers who had not put in orders. The chairman and vice-chairman who had built Salomon's prop trading business in the 1980s, John Gutfreund and John Meriwether, were forced out, and the bank was fined a record $290 million by the US Securities and Exchange Committee.

Salomon merged with Travelers Group in the 1990s, later to become part of Citigroup. The new owners shut down most of the prop trading groups, including the forex group that had brought such success in the 1980s - then-chief-executive Sandy Weill cited his dislike of the earnings volatility that it brought with it.

Today, the business Salomon Brothers helped start continues to flourish; interest rate and currency swaps are the largest traded sectors in the derivatives market. (Overwhelmingly, however, the forex options market is now an over-the-counter one; volumes on the PHLX collapsed in the 1990s from a peak of over 13 million contracts a year to current levels of a few tens of thousands.) While banks such as Barclays Capital, JP Morgan and UBS now dominate the field, Salomon Brothers, the epitome of 1980s Wall Street, pioneered it.

THE CONTENDERS

- Bankers Trust
- Chase Manhattan
- Merrill Lynch
- Salomon Brothers
- SBC