A Maturing Equity Derivatives Market in Asia ex-Japan

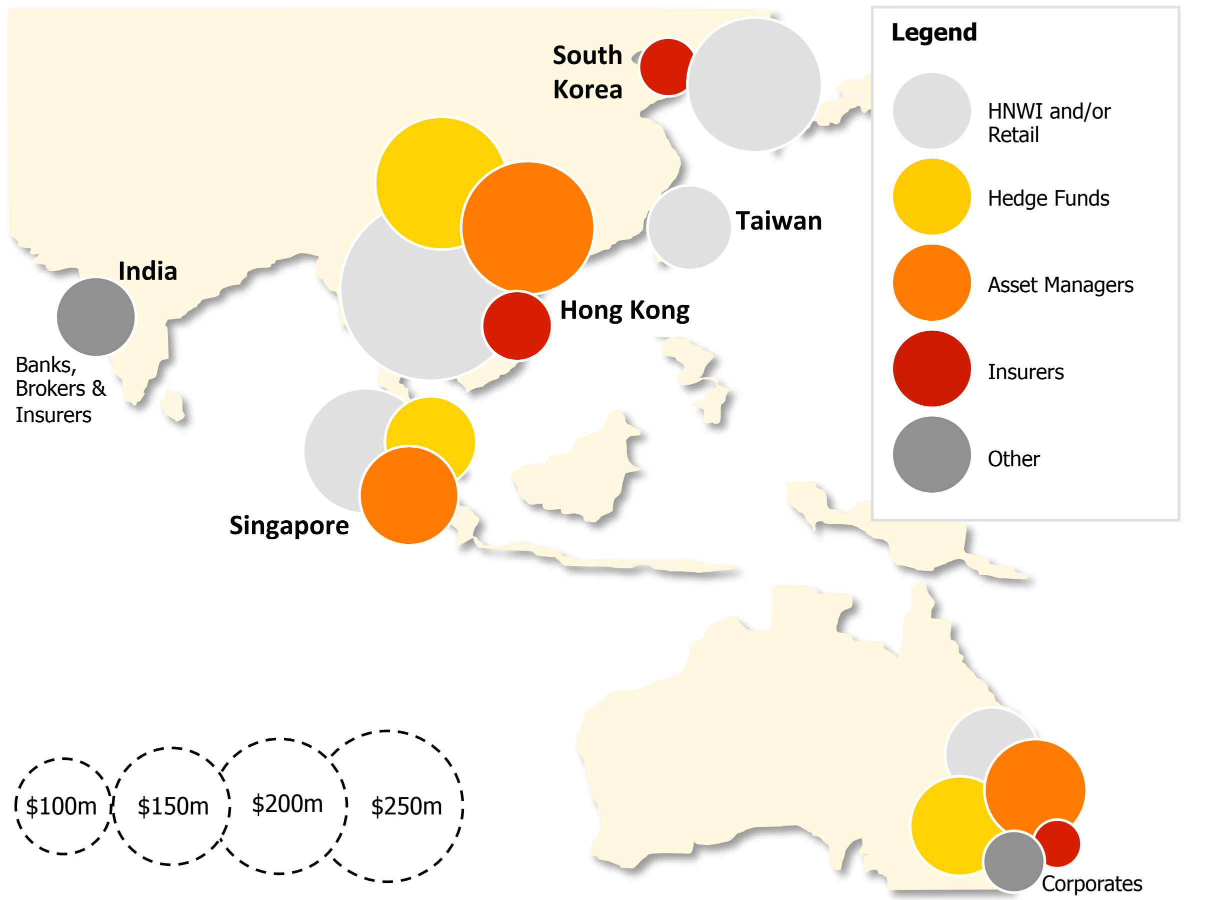
- The market is growing, and maturing. Investors seek lightly structured, tailored product.
- We highlight 16 significant market segments, as defined by the size of clients' 'wallets'.
- Successful banks appear to have a 'balanced client portfolio' across multiple segments, allowing them to manage risk more effectively.

As the equity derivatives market in Asia-Pacific (excl. Japan) matures, the attributes required for success are evolving too. Prior to and immediately after the 2008 crisis, the market was dominated by retail structured products. Those products were sold into loosely regulated markets, generating high returns for the banks involved. Investor interest was often focused on the latest 'trend', so a key challenge for banks was avoiding excessive one-way risk. Often, the only way to deal with one-way risk was through proprietary trading with other banks and brokers. As a result market shocks often led to losses for both investors and any banks who had bet on the wrong risk profile.

The last two years have seen the Asian market mature. Regulators have clamped down on a range of questionable practices, investors are wiser, and – perhaps most significantly - domestic institutional investors and hedge funds (comprising both locally-based firms and subsidiaries of international firms) have grown in size and increased their appetite for equity derivative products. In this market, the most successful investment banks have a portfolio of client sectors, balancing retail and high net worth individual (HNWI) clients with locally-based asset managers, insurance companies, and hedge funds. Overall, investors prefer lightly structured but customised product, prompting banks to invest in technology and automate product generation.

In our 2011 review of the APAC ex-Japan equity derivatives market, featuring the top 10 global investment banks, we identified Credit Suisse, J.P.Morgan, and Societe Generale as the dominant banks; their combined revenues equalled 35% of the peer group's regional total. Below, we highlight 16 significant client/market segments as defined by the FY11 revenue earned by Top 10 players.

Equity Derivatives: APAC ex-Japan 16 key market segments (US$m, FY11)



Source: Tricumen. Note: Bubble size indicates client revenues of top 10 global capital markets players in our core coverage.

Asia-Pacific excl. Japan: Insurers and the Variable Annuity Market

The use of derivatives in the Variable Annuity Market is growing in Hong Kong, Korea and Taiwan. Thus far, unfavourable regulation, lack of option tenor, high execution costs and gap risk have all hindered the development of effective hedging solutions. A new breed of products is, however, addressing these issues; we expect the market will experience healthy growth in the medium term.

Asia-Pacific excl. Japan: Hedge Funds

Our research suggests there were approximately 400 significant regional hedge funds in 2011, managing some US$70bn. In recent years, these hedge funds have seen a shift in their investor base: as private individuals withdrew their money, institutional accounts – particularly pension funds, foundations, and sovereign wealth funds – moved in. This had a dramatic impact on the competitive landscape. Institutional investors favour large funds; they grew stronger at the expense of smaller operators, a number of which closed their doors. On the product side, customised swaps and structured solutions gained in popularity.

Australia: Corporates

Demand from Australian corporates for equity-based risk solutions is not abating. Only a few deals are executed annually, leading to 'lumpy' revenues; that said, individual deals can be highly profitable, generating revenues of $1-10m each.

Australia, Hong Kong, Singapore: Asset Managers and Pension Funds

The core real-money institutional investor base has grown in recent years. The 'safe haven' reputation of Hong Kong and Singapore during the Credit Crunch attracted international money managers, which in turn aided development of local managers; meantime, Australian investors have adopted an increasingly international approach to investments. Across the market spectrum, funds have made greater use of derivative hedging strategies, especially those geared to countering volatility shocks. More sophisticated funds also purchased structured investment products utilising derivatives.

Australia's asset managers, pension funds and insurers have arguably been at the forefront of innovation, as lower latency prompted the greater integration of equity cash and equity derivatives services. Banks have also started to market their services based on the cheapest end-to-end solution covering execution, clearing and settlement.

Australia, Hong Kong, Singapore: HNWI Markets

The Hong Kong and Singapore structured product markets aimed at HNWIs have bounced back after being curtailed during the financial crisis and the associated 'Mini-Bond' scandal. This time around, however, the dynamics have been reversed: fierce competition amongst private bankers is driving innovation based on their client's needs, rather than by investment banks pushing product in a 'create-and-distribute' model.

The structured products used are much simpler than those created before the crises and are designed to create risk-adjusted returns. The market in Australia is somewhat different and, although developed in some ways, only around 5% of HNWIs use structured products (the take-up in the mass affluent market is slightly higher); tax-advantaged products also offer a significant revenue opportunity.

South Korea, Taiwan: Retail Markets

The South Korean and Taiwanese markets are both centred on retail investors, rather than HNWIs. Both have suffered contraction and have seen increased regulation, causing some banks to withdraw, or adapt their business to the changes. Notable exceptions include Credit Suisse and J.P.Morgan.

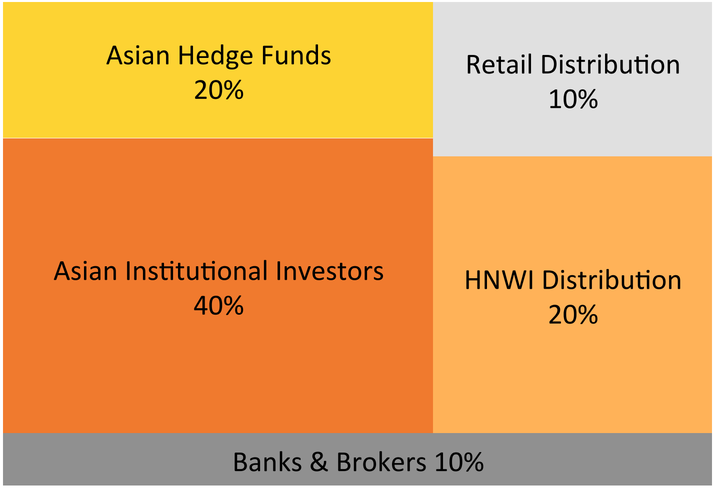
India: Brokers, Banks and Insurers

India is the most unusual of the local markets: due to regulation, almost all domestic trading is exchange-based and onshore bank legal entities are barred from holding significant risk positions. OTC structured products are therefore developed offshore, typically in the form of unit-linked equity products or equity-linked notes. These are then sold via banks and insurance companies or one of the country's many brokers. Any residual unwanted risk is then typically hedged through the onshore listed markets.

Market Leaders and the future

The market leaders of the post-Crunch era boast a balanced client mix. Specifics vary between banks, products, and markets, but our research suggests that, at the regional level, the most effective client base mix in the next couple of years will emphasise locally-based institutional investors, followed by local hedge funds and HNWIs; with banks and brokers, and retail investors accounting for a much smaller slice of banks' revenue.

Typical balanced business mix of a successful bank



Source: Tricumen

In the medium term, we expect to see three main developments. First, the drive to greater automation and customisation will continue. While this will likely impact margins, cost reductions should compensate to a significant degree. Second, domestic investor base will continue to grow, supported by both local players and international firms setting up regional subsidiaries. Finally, we expect the growth of the clients' 'wallets' in mainland China and Indonesia to outstrip that of other regional markets.

Notes & Caveats

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