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Risk Awards 2013

Lifetime Achievement

Leo Melamed

CME Group

Risk Awards 2013

Keeping up

Changes in the industry are spurring a wave of innovation in market practice, products and services. Some firms are coping better than others. By ***Lukas Becker****,* ***Matt Cameron****,* ***Laurie Carver****,* ***Mauro Cesa****,* ***Clive Davidson****,* ***Peter Madigan****,* ***Tom Newton****,* ***Joe Rennison****,* ***Nick Sawyer****,* ***Nazneen Sherif****,* ***Michael Watt*** *and* ***Duncan Wood***

For long periods in 2012, it seemed as though the markets were on mute. Volatility was low, volumes were lower and the noise of the trading floor receded into the background. In the hush, it was possible to focus on the slower, structural changes that are taking place. Many of this year's awards recognise firms, products and individuals that have done most to adapt to these changes – or, in some cases, to bring them about.

In the last month of 2012, Goldman Sachs was a counterparty to the first trades executed using the new standard credit support annex (CSA), a document drawn up over the past two years to help resolve the valuation headaches caused by the market's post-crisis shift to overnight indexed swap discounting for cash-collateralised trades. Because the relevant discount rate is determined by the currency of the collateral being posted – and because existing CSAs often give counterparties a list of collateral options – the pricing of even plain vanilla trades has become more complex, and valuation disputes have become common.

Goldman is widely seen as the first bank to accept the new valuation orthodoxy, and to have played the biggest role in driving its wider adoption, but it has never spoken about it publicly – as this year's interest rate derivatives house of the year, it breaks that silence.

Another topic where there is a lot of heat but not much light is the reduction of risk-weighted assets (RWAs) – an imperative if bank trading businesses are to survive in a world of heavier capital requirements. In theory, those businesses have to make simple – although not necessarily easy – changes, and some of this year's award winners did that in 2012. But existing RWAs also need to be cut, which remains a black art. At Credit Suisse, our derivatives house of the year, this involved complex, set-piece transactions – many of which were executed by a new division the bank created at the end of 2011. But it also required a change in thinking. To get out of many trades, the division had to pay, and colleagues elsewhere in the bank could not, initially, see the rationale. Despite the friction, the bank stuck to its guns, and chief executive Brady Dougan argues Credit Suisse is now closer than any of its peers to having "the investment bank of the future".

The introduction of mandatory central clearing is another big step for the market – affecting the buy side as well as the sell side, and two of this year's awards honour firms that stood out for trying to smooth the path. The clearing business at Citi was praised by clients for fighting their corner, while CME Group has been ahead of its rivals in rolling out products and services designed to lighten the burden in terms of margin posting.

Elsewhere in this year's awards, Pierre Henry-Labordère is quant of the year – recognition for two papers published in *Risk* last year that have been widely admired, and that run slightly against the grain. In a profession that has reined in some of its ambitions in recent years, Henry-Labordère is a quant's quant – deeply passionate about mathematics and unwilling to compromise.

As always, it was not easy to pick winners. Where decisions were tight, client feedback often helped settle the issue. The *Risk* editorial team thanks all participants for their help.

Banks were asked to submit information on their business in each of the asset class and product categories during 2012, and shortlisted companies underwent face-to-face and telephone interviews. *Risk* then gathered feedback from clients and other market participants.

In making the final decisions, a number of factors were considered, including (but not restricted to) risk management, creativity and innovation, liquidity provision, quality of service, and engagement with regulatory issues. ■

The roll of honour

Derivatives house of the year
Credit Suisse

Lifetime achievement award
Leo Melamed

Interest rate derivatives house of the year
Goldman Sachs

Currency derivatives house of the year
Deutsche Bank

Equity derivatives house of the year
Société Générale Corporate & Investment Banking

Credit derivatives house of the year
Credit Suisse

OTC client clearing service of the year
Citi

Commodity and energy derivatives house of the year
Deutsche Bank

Inflation derivatives house of the year
Royal Bank of Scotland

Structured products house of the year
Goldman Sachs

Hedge fund derivatives house of the year
Deutsche Bank

Bank risk manager of the year
Goldman Sachs

Quant of the year
Pierre Henry-Labordère, SG CIB

Exchange of the year
Eurex

Clearing house of the year
CME Group

OTC trading platform of the year
UBS

OTC infrastructure service of the year
MarkitServ

Sovereign risk manager of the year
Turkish Undersecretariat of Treasury

Hedge fund of the year
CQS

Corporate risk manager of the year
Heathrow Limited

Pension fund of the year
PGGM

Law firm of the year
Allen & Overy

Risk management technology product of the year
Fincad

Back-office technology product of the year
Isda/Markit

In-house system
Royal Bank of Scotland

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LIFETIME ACHIEVEMENT
LEO MELAMED

If a roll call had been taken at the lectures given by the economist Milton Friedman at the University of Chicago in 1970, it would have shown that, among the 30 to 40 people in the building's small, boxy lecture rooms, was an outsider carrying a pen and pad to disguise himself as a student – an interloper who was only there to hear Friedman speak and who never asked a question for fear of attracting attention. It was Leo Melamed, chairman of what was then universally known as the Merc – the Chicago Mercantile Exchange (CME).

Melamed had been elected chairman a year earlier and the exchange was doing well enough – a butter and egg market for most of its 50-year existence, the Merc was forced to diversify into other commodities after new production techniques meant volatility, and volumes, in its original contracts collapsed. When Melamed took over, it was offering contracts in soya beans, sugar, lumber, cattle, oats and concentrated orange juice. But pork bellies were the real money-spinner, accounting for 79% of all trades on the CME in 1969. Melamed worried the exchange was overly reliant on that market, and so was looking for new products. In Friedman's writing and lectures, he found the idea that would catapult the Merc from Chicago's second-biggest commodities market to the world's biggest futures exchange – contracts based on currencies and other financial underlyings.

Today, still trading stocks and currencies as an 80-year-old, he holds the post of chairman emeritus – recognition of an almost-unbroken 59-year association with what is now CME Group. During that period, Melamed rose from a runner's job to become a member of the exchange – thanks to a $3,000 loan from his father – cracked down on the lawlessness that saw the Merc described as "the whorehouse of LaSalle Street", launched the first financial futures contracts, giving rise to today's mighty eurodollar market, and helped persuade the US Congress not to give oversight of the futures market to the Securities and Exchange Commission following the 1987 stock market crash. Most recently, Melamed faced down a member revolt – incurring death threats in the process – in order to drag CME Group into the electronic age in 2003 and ensure it survived the challenge of Germany's all-electronic Eurex.

Ask him what the institution means to him, and he answers quickly: "It's my baby. People call me the father of financial futures, but I'm also responsible for what the CME is today."

Others share that view – and credit him with an influence that continues to this day. "The politics of the Merc have been pretty fascinating – we've seen presidents come and go, we've seen chairmen come and go – but there has been one constant. Leo Melamed, to this day, in the view of most professionals, establishes policy for the Merc," says John Damgard, president of the Futures Industry Association (FIA) from 1982 to 2012.

Melamed's first big policy decision was to clean up the CME and modernise a rule book that was – literally – held together with sticky tape. He still has that original rule book in a cabinet in his office. His second step was to try to put the exchange on a robust commercial footing.

"I knew that, basically, if you're a one-product exchange and something happens, then you are a goner – you've got to have more than one product line and they shouldn't be related. We were now trading pork bellies, cattle and hogs, but those were all meat products. So I tried apples, I tried potatoes, I tried shrimp, I tried turkeys. None of it worked, but I kept trying," he says.

> "It's my baby. People call me the father of financial futures, but I'm also responsible for what the CME is today" Leo Melamed

He started reading Friedman's work – and was so taken with the argument that personal and economic freedom were linked that he started sneaking into the economist's lectures.

"I walked in with everyone else, but I didn't know anyone there and nobody knew me. They never took attendance, so it was just like I was a student – of course, I came with a pencil and paper and I took notes. And there was Milton Friedman. I'd loved the guy from afar and read everything he wrote. I became a disciple and later, fortunately, we became friends," says Melamed.

Friedman's most famous work at the time was his collection of essays, *Capitalism and freedom*, published less than a decade earlier. It included a chapter arguing the Bretton Woods system of fixed exchange rates, introduced in 1944, should be abandoned in favour of floating rates. For Melamed, a door opened.

"I thought, 'My God – I'm looking for a new product, and here it is right in front of me. The world is changing. Milton Friedman says Bretton Woods isn't going to last, so here's my chance – I'll launch a currency futures market,'" he says.

Melamed immediately tried to convince the 12 members of the CME board to back his idea for futures contracts based on currencies rather than commodities. They were not impressed – "This is Chicago, we trade pork bellies. What do we know about the Swiss franc?" was the general tone, Melamed recalls – and


Leo Melamed

the chairman's idea was voted down. So Melamed contacted Friedman directly and persuaded him to meet in July 1971, at the Waldorf Astoria in New York, while the economist was at his holiday home in Vermont.

What Melamed wanted was a vote of confidence and – if he got it – a feasibility study penned by Friedman himself. The stakes were high.

"This became an obsession with me, truly – I lived it day in, day out. I was so obsessed with the idea. As far as I knew, nobody else had thought of it, but I would keep looking behind me to see if someone else was rushing to build the same thing I wanted to," he says. "So when we met for lunch, I was nervous. I told him what I'd been thinking, and he said, right off the bat, 'What a wonderful idea'. And right to this day, I remember my shock that Milton Friedman was sitting in front of me saying what a great idea it was. So I asked him to repeat it. And he said, 'It's a wonderful idea – do it'. I asked him if he understood that futures markets had always been based on agricultural products, never financial underlyings. He said, 'It makes no difference – it will work the same way.'"

By the end of the lunch, Friedman had agreed to write the study Melamed needed to convince the CME board – for a fee of $7,500. A month later, the Bretton Woods system collapsed. And in December, Friedman delivered his study. The board was duly impressed and in May 1972, the CME started trading futures on seven different currencies.

Newspaper headlines tell the story of what happened over the following decade. "CME to start foreign money futures trade," said the *Chicago Tribune* on December 21, 1971. A year later, it was "Officials bullish about money market". The cover story of the *Chicago Sun-Times* magazine in February 1974 was "Playing the global money game – Chicago style". In 1976, the *Tribune* profiled Melamed – "The man behind the CME boom growth" – and the *New York Times* did the same in 1978. By 1982, the *Wall Street Journal* was writing about a "futures frenzy" in which Chicago's exchanges were overshadowing those of New York.

It was, says Melamed, "unbelievably exciting". It took a while for currency futures to take off – he says he knew the market was going to succeed by 1974, and by the middle of that decade, volumes were growing 40% each year. The CME followed those contracts with others that proved even more successful. Futures on US Treasury bills were launched in 1976, the eurodollar contract debuted in 1981 and stock index futures followed in 1982. Before long, financial futures were the lifeblood of the Merc. Today, says Melamed, they account for the bulk of the exchange's volume.

One of the reasons for the success of currency futures was the way in which they were launched. Melamed knew he would need to attract Wall Street firms to trade at the CME if the new contracts were to succeed, but a pre-launch conversation with an executive at Salomon Brothers had not been encouraging. "I asked him if there was a chance Salomon would trade currency futures if we launched them and he said, 'Absolutely not. You think we would buy a membership to trade at the pork belly exchange? Are you guys crazy?'"

As a result, the contracts were listed on a newly incorporated venue, the International Monetary Market – albeit one that shared the growing CME's new premises at West Jackson Boulevard. As well as the big currency trading firms, Melamed wanted to attract hungry, young traders to the new market, so he offered membership for $10,000 – a tenth of what it cost to join the CME at that point.

"I thought we should try to bring a younger element to the exchange. Guys that couldn't afford $100,000 but wanted to have a chance in the market and could maybe muster $10,000. It turned out to be a very important idea, because it did attract the younger element, who became an army of mine," he says.

Thirty years later, elements of Melamed's army would mutiny – and if it wasn't for his strong ties to the membership, victory may have been beyond him. The fight was over Globex, the electronic trading system Melamed had introduced to the CME in 1987,

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although it remained largely unused by the exchange's membership, which had no incentive to switch from open-outcry trading to a screen-based system that would bypass the market's broker community.

Then, in 2003, Eurex announced plans to launch a US futures exchange. The CME's top brass was scared, with good reason – over a period of roughly two years, starting in 1997, the German exchange had managed to wrest control of the market in Bund futures trading from the London International Financial Futures and Options Exchange, and it had done so in large part because it was an electronic venue competing against an open-outcry pit. The same dynamics would be at work in the US because, while Globex had been available for more than a decade at the CME, trading in its biggest contract, the eurodollar, remained resolutely floor-based.

The result was something like a Mexican stand-off. As a first step, the CME board passed a resolution that would give members 90 days to move 25% of all volumes in the front two months of the eurodollar business on to Globex – or have floor trading in the contract suspended completely – but the exchange's rules required it to pass a member referendum, giving traders and brokers the whip hand. Soon after, a meeting was called, at which Melamed – now holding the posts of senior policy adviser and chairman emeritus – and Terry Duffy, the chairman of the CME board, tried to persuade furious eurodollar brokers that refusing to budge would mean the death of the market.

"MF Global was a murder that was committed in the middle of the night. You can't prevent that kind of thing"

Leo Melamed

"There were 1,000 people there – half of them angry – and you could cut the atmosphere with a knife. Terry Duffy and I were mostly the only speakers, and we made our case strongly, but we didn't stop there. The plan I'd devised was to go into lobbying mode, meeting the membership in groups of five, 10, 60, until we'd spoken to everyone. It was those follow-up meetings that started to see a change in attitude," he says.

Damgard – the former FIA president – says it was a pivotal episode for futures markets in the US. "Leo showed incredible leadership skills. It was a huge step getting the Merc to approve the creation of Globex in the first place – had it not been there as a competitive vehicle, we could have lost the whole ball of wax. And he was also able to go down to the floor and twist arms better than anyone. Those guys knew their choice was to maintain open-outcry for a few more years – which would have been in their personal interests – or to do as Leo asked. And, almost to a man, they said, 'Number one, I do not want to make an enemy out of Leo. Number two, I owe it to Leo. And three, Leo is a hell of a lot more visionary than I am, and maybe it would not be a bad idea to have this institution around for a little while longer.' It wouldn't have happened without Leo."

If that was a triumph for the CME, it was a disaster for Eurex, which launched its US exchange in February 2004. By that time, the share of eurodollar volumes executed on Globex had gone way beyond the 25% minimum agreed by the CME board, eroding the new venue's competitive advantage. The events of the months leading up the Eurex launch are the subject of a lawsuit filed by the German exchange in 2003 – it accuses the Chicago exchanges of a series of tricks designed to slow its launch or undermine its chances of success (*Risk* October 2012, pages 18–22, www.risk.net/2208337).

Melamed denies that. "There was nothing underhand – nothing. It was straight up. We told our floor it was do-or-die time. All I knew was that Eurex had proven the value of electronic trading and I believed in that, so I think I met literally every member of the exchange to argue with them night after night, after the markets had closed, of course, sometimes down on the trading floor. Eurex just never expected that to happen. It didn't think we'd be able to do it," he says.

Today, the market is facing headwinds rather than existential threats – eurodollar volumes for 2012 were down 25.2% as of the end of November, and the regulatory environment feels more uncertain than it has for a while, partly as a result of MF Global's collapse at the end of 2011 and partly because of parallel reforms that are about to hit the over-the-counter derivatives market.

Melamed says CME Group has taken the loss of $1.6 billion in customer assets at MF Global extremely seriously – but he also cautions against reading too much into it. "MF Global was a murder that was committed in the middle of the night. You can't prevent that kind of thing," he says.

And he argues the futures market is fundamentally safe, because counterparty exposure is secured by the posting of initial and variation margin – but this is one of the emerging bones of contention among regulators. In September, detailed rules on clearing were finalised by the European Securities and Markets Authority, setting a minimum two-day period for the calculation of initial margin. In the US, most futures exchanges assume contracts can be liquidated in a single day and charge margin accordingly. Melamed argues there is no need to change.

"Look at Lehman Brothers. It had unbelievably big positions at the CME – around $1 trillion in notional value – but we didn't have any failures as a result of that because it had paid for its positions. Every day, the Merc collects margin twice – early in the afternoon and at the close of the day, so if anybody fails, then it may be painful but it's not critical," he says.

What has driven Melamed on – and by extension the CME – is fear, and a fierce survival instinct. Melamed credits that to his family's extraordinary history. Until the age of seven, Melamed lived in a wooden bungalow in Bialystok, Poland, with his parents. When the Nazis invaded the country, the family fled to Lithuania – the start of a two-year journey that took them across Russia to Japan, and from there to the US.

"When we were refugees running around the world – with the Nazis and, at other times, the KGB chasing my father – we were always afraid, there was always risk. My mother called it Bialystok syndrome and what she meant was that danger is around every corner, all the time, and you have to be prepared for everything that's coming. I got that. I lived it as a trader and as an administrator. I knew you had to be aware of what the next guy was doing, when he would do it. And I guess that has served me my whole life because the Merc is what it is today not by accident – we were able to stay one step ahead of the competition most of the time." ■

Photos: Ignacio Alvarez