Structured products Awards 2005

# Innovation of the year

## Derivate Forum

**Siegfried Piel,** Sal Oppenheim and Derivate Forum

> Germany's Derivate Forum may be only a year old, but its impact on the country's structured products market is already measurable. In fact, Derivate Forum is the only European body that has come close to issuing anything like an industry standard when it comes to rating structured products. Whereas bond investors have the likes of Standard & Poor's and Moody's to provide ratings, structured products investors have so far been deprived of risk ratings. Derivate Forum changed this.

Comprising Deutsche Bank, DZ Bank, Sal Oppenheim, West LB and HypoVereinsbank, Derivate Forum decided in July this year that it was time to address the situation. The Forum asked the European Business School (EBS) to help it build and launch a risk-calculation tool that rates warrants and certificates according to five risk classes.

Following its research with EBS, Derivate Forum found that the combined market for certificates and warrants grew by 25% in the first half of the year. The group has now increased its growth forecast for the full year to between 30% and 40%. And structured product-based assets under management for the forum members alone increased by €7 billion between January and June this year, and now stand at €34.7 billion.

Such growth necessitated a robust risk-rating system to boost investor confidence and grow the market even further, says Siegfried Piel, Derivate Forum chairman and managing director of trading and derivatives at Sal Oppenheim in Frankfurt.

The ratings tool, which was launched in mid-July and aimed at the private investor, calculates risk on a value-at-risk (VaR) principle using Monte Carlo Simulation, which randomly generates values for uncertain variables over and over to simulate a model. The varying loss probabilities (probability distributions) are then allocated to a product, resulting in the creation of five risk classes. Class one is the safest and class five consists of the more speculative products, Piel explains.

A total of 13,522 derivatives securities are expected to be rated by the end of the year, 90% of which have already been rated and posted on the Derivate Forum website for private investors to access free of charge, Piel says. As a result the German market has become that little bit more transparent. "VaR is a simple and understandable indicator: it takes correlations into consideration and makes it possible to evaluate baskets. A rise in VaR means a rise in risk," Piel adds.

"The idea is make these products transparent without having a PhD in mathematics," adds Stefan Armbruster, director of the investment products group at Frankfurt-based Deutsche Bank. "Investors tend to buy into these products based on gut instinct, but we want the market to move towards making decisions that are calculated."

And Derivate Forum's membership is on the up, largely thanks to the industry support for the ratings tool. Just last month Goldman Sachs and Dresdner Kleinwort Wasserstein joined the fold and Piel expects at least two or three more banks to join up and use the risk-rating tool by the end of this year.

A next step for Derivate Forum is the dissemination of the risk classification tool to the relevant financial portals and the integration in the databases of major data providers, Piel adds. "The ratings system could also be looked at by the regulator and endorsed as a standard ratings system and could be adopted by other countries," Piel hopes.

Evidence already exists that the new ratings tool is beginning to establish itself as an industry standard, at least among private wealth managers. Frankfurt-based Lutz Gebser, chairman of the Independent Asset Consultants Association, says: "With the new risk classification from Derivate Forum, we can now give our clients' securities accounts even better-tailored structures and adapt them to individual choices and risk profiles," adding that he would recommend this risk classification system.

### Why Derivate Forum won

Derivate Forum provides private investors with a much needed risk rating tool for structured products. No other body has attempted such a strategy. Its member banks are on the up and its risk ratings tool is rapidly gaining acceptance.

## Innovation