Contents

Foreword from the First Edition xvii
Foreword to the Second Edition xix
Preface xxii
Acknowledgements xxiii
About the Author xxv

PART ONE Products and the Background to Trading

CHAPTER 1 Trading 3
1.1 How and why do people trade? 3
1.2 Factors affecting trade 3
1.3 Market participants 4
1.4 Means by which trades are transacted 5
1.5 When is a trade live? 7
1.6 Consequences of trading 7
1.7 Trading in the financial services industry 8
1.8 What do we mean by a trade? 10
1.9 Who works on the trade and when? 11
1.10 Summary 12

CHAPTER 2 Risk 13
2.1 The concept of risk 13
2.2 Risk is inevitable 13
2.3 Quantifying risk 14
2.4 Methods of dealing with risk 15
# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.5</td>
<td>Managing risk</td>
<td>15</td>
</tr>
<tr>
<td>2.6</td>
<td>Problems of unforeseen risk</td>
<td>16</td>
</tr>
<tr>
<td>2.7</td>
<td>Summary</td>
<td>16</td>
</tr>
</tbody>
</table>

## CHAPTER 3

### Understanding Traded Products – Follow the Money

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Spot trades</td>
<td>18</td>
</tr>
<tr>
<td>3.2</td>
<td>Future (forward)</td>
<td>20</td>
</tr>
<tr>
<td>3.3</td>
<td>Loan</td>
<td>21</td>
</tr>
<tr>
<td>3.4</td>
<td>Deposit</td>
<td>23</td>
</tr>
<tr>
<td>3.5</td>
<td>Swap</td>
<td>23</td>
</tr>
<tr>
<td>3.6</td>
<td>Foreign exchange swap</td>
<td>25</td>
</tr>
<tr>
<td>3.7</td>
<td>Equity spot</td>
<td>26</td>
</tr>
<tr>
<td>3.8</td>
<td>Bond spot</td>
<td>27</td>
</tr>
<tr>
<td>3.9</td>
<td>Option</td>
<td>27</td>
</tr>
<tr>
<td>3.10</td>
<td>Credit default swap</td>
<td>30</td>
</tr>
<tr>
<td>3.11</td>
<td>Summary</td>
<td>31</td>
</tr>
</tbody>
</table>

## CHAPTER 4

### Asset Classes

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>Interest rates</td>
<td>33</td>
</tr>
<tr>
<td>4.2</td>
<td>Foreign exchange (Forex or FX)</td>
<td>40</td>
</tr>
<tr>
<td>4.3</td>
<td>Equity</td>
<td>44</td>
</tr>
<tr>
<td>4.4</td>
<td>Bonds and credit</td>
<td>46</td>
</tr>
<tr>
<td>4.5</td>
<td>Commodities</td>
<td>53</td>
</tr>
<tr>
<td>4.6</td>
<td>Trading across asset classes</td>
<td>58</td>
</tr>
<tr>
<td>4.7</td>
<td>Summary</td>
<td>59</td>
</tr>
</tbody>
</table>

## CHAPTER 5

### Derivatives, Structures and Hybrids

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1</td>
<td>Linear</td>
<td>61</td>
</tr>
<tr>
<td>5.2</td>
<td>Nonlinear</td>
<td>62</td>
</tr>
<tr>
<td>5.3</td>
<td>Some option terminology</td>
<td>66</td>
</tr>
<tr>
<td>5.4</td>
<td>Option valuation</td>
<td>67</td>
</tr>
<tr>
<td>5.5</td>
<td>Exotic options</td>
<td>67</td>
</tr>
<tr>
<td>5.6</td>
<td>Structures and hybrids</td>
<td>69</td>
</tr>
<tr>
<td>5.7</td>
<td>Importance of simpler products</td>
<td>70</td>
</tr>
<tr>
<td>5.8</td>
<td>Trade matrix</td>
<td>71</td>
</tr>
<tr>
<td>5.9</td>
<td>Summary</td>
<td>72</td>
</tr>
</tbody>
</table>

## CHAPTER 6

### Liquidity, Price and Leverage

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1</td>
<td>Liquidity</td>
<td>73</td>
</tr>
<tr>
<td>6.2</td>
<td>Price</td>
<td>75</td>
</tr>
</tbody>
</table>
PART TWO

The Trade Lifecycle

CHAPTER 7
Anatomy of a Trade
7.1 The underlying
7.2 General
7.3 Economic
7.4 Sales
7.5 Legal
7.6 Booking
7.7 Counterparty
7.8 Timeline
7.9 Summary

CHAPTER 8
Trade Lifecycle
8.1 Pre execution
8.2 Execution and booking
8.3 Confirmation
8.4 Post booking
8.5 Settlement
8.6 What happens overnight
8.7 Changes during lifetime
8.8 Reporting during lifetime
8.9 Exercise
8.10 Maturity
8.11 Example trade
8.12 Summary

CHAPTER 9
Cashflows and Asset Holdings
9.1 Holdings
9.2 Value of holding
9.3 Reconciliation
9.4 Consolidated reporting
9.5 Realised and unrealised P&L
9.6 Diversification
9.7 Bank within a bank
CONTENTS

9.8 Custody of securities 123
9.9 Risks 124
9.10 Summary 124

CHAPTER 10
Risk Management 125
10.1 Traders 125
10.2 Risk control 126
10.3 Trading management 126
10.4 Senior management 126
10.5 How do risks arise? 126
10.6 Different reasons for trades 128
10.7 Hedging 128
10.8 What happens when the trader is not around? 128
10.9 Types of risk 130
10.10 Trading strategies 132
10.11 Hedging strategies 133
10.12 Summary 134

CHAPTER 11
Market Risk Control 135
11.1 Various methodologies 135
11.2 Need for risk 139
11.3 Allocation of risk 139
11.4 Monitoring of market risk 140
11.5 Controlling the risk 140
11.6 Responsibilities of the market risk control department 141
11.7 Limitations of market risk departments 142
11.8 Regulatory requirements 143
11.9 Summary 145

CHAPTER 12
Counterparty Risk Control 147
12.1 Reasons for non-fulfilment of obligations 147
12.2 Consequences of counterparty default 148
12.3 Counterparty risk over time 148
12.4 How to measure the risk 149
12.5 Imposing limits 152
12.6 Who is the counterparty? 153
12.7 Collateral 153
12.8 Activities of the counterparty risk control department 154
12.9 What are the risks involved in analysing credit risk? 157
Contents

12.10 Payment systems 158
12.11 Summary 160

CHAPTER 13
Accounting 161
13.1 Balance sheet 161
13.2 Profit and loss account 164
13.3 Financial reports for hedge funds and asset managers 168
13.4 Summary 169

CHAPTER 14
P&L Attribution 171
14.1 Benefits 171
14.2 The process 172
14.3 Example 173
14.4 Summary 176

CHAPTER 15
People 177
15.1 Revenue generation 177
15.2 Activities that support revenue generation 179
15.3 Control 189
15.4 Summary 200

CHAPTER 16
Regulation 201
16.1 Purpose of regulation 201
16.2 What regulators require 202
16.3 The problems 204
16.4 Risk-weighted assets 205
16.5 Credit valuation adjustment (CVA) 207
16.6 Summary 213

PART THREE
What Really Happens

CHAPTER 17
Insights into the Real World of Capital Markets – Here be Dragons! 217
17.1 How it used to be 217
17.2 Clash of cultures 219
17.3 The equality of money 219
CONTENTS

17.4 The politics of money 220
17.5 The good 222
17.6 The bad 222
17.7 The ugly 223
17.8 Where are we heading? 223
17.9 Summary 224

CHAPTER 18
Case Studies 225
18.1 Case study 1 – Bonds 225
18.2 Case study 2 – Front office foreign exchange 235
18.3 Case study 3 – Equity confirmations project 247
18.4 Summary 252

CHAPTER 19
The IT Divide 253
19.1 What is the IT divide? 253
19.2 What problems does it cause? 255
19.3 IT in the middle 255
19.4 Improper use of IT 256
19.5 Organisational blockers 257
19.6 IT blockers 258
19.7 How to bridge the gap 259
19.8 Keeping up with change 260
19.9 What does the business want from IT? 261
19.10 What IT wants from the business 263
19.11 Particular challenges of the financial sector 264
19.12 Example of a good project 265
19.13 Example of a bad project 266
19.14 Summary 266

CHAPTER 20
The Role of the Quantitative Analyst 267
20.1 What is a quant? 267
20.2 Where do quants work? 267
20.3 Tools of the trade 269
20.4 Place in organisation 270
20.5 Where should quants sit? 270
20.6 The boundaries of Quantland 271
20.7 What does IT think of quants? 273
20.8 Different types of quants 274
20.9 Getting the job done 275
20.10 Summary 275
### PART FOUR

**Behind the Scenes**

#### CHAPTER 21

**Developing Processes for New Products (and Improving Processes for Existing Products)**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>21.1</td>
<td>What is a process?</td>
<td>279</td>
</tr>
<tr>
<td>21.2</td>
<td>The status quo</td>
<td>279</td>
</tr>
<tr>
<td>21.3</td>
<td>How processes evolve</td>
<td>279</td>
</tr>
<tr>
<td>21.4</td>
<td>Inventory of current systems</td>
<td>280</td>
</tr>
<tr>
<td>21.5</td>
<td>Coping with change</td>
<td>282</td>
</tr>
<tr>
<td>21.6</td>
<td>Improving the situation</td>
<td>284</td>
</tr>
<tr>
<td>21.7</td>
<td>Inertia</td>
<td>284</td>
</tr>
<tr>
<td>21.8</td>
<td>Summary</td>
<td>287</td>
</tr>
</tbody>
</table>

#### CHAPTER 22

**New Products**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>22.1</td>
<td>Origin of new products</td>
<td>289</td>
</tr>
<tr>
<td>22.2</td>
<td>Trial basis</td>
<td>290</td>
</tr>
<tr>
<td>22.3</td>
<td>New trade checklist</td>
<td>292</td>
</tr>
<tr>
<td>22.4</td>
<td>New product evolution</td>
<td>294</td>
</tr>
<tr>
<td>22.5</td>
<td>Risks</td>
<td>294</td>
</tr>
<tr>
<td>22.6</td>
<td>Summary</td>
<td>295</td>
</tr>
</tbody>
</table>

#### CHAPTER 23

**Testing**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>23.1</td>
<td>What is testing?</td>
<td>297</td>
</tr>
<tr>
<td>23.2</td>
<td>Why is testing important?</td>
<td>298</td>
</tr>
<tr>
<td>23.3</td>
<td>Who does testing?</td>
<td>298</td>
</tr>
<tr>
<td>23.4</td>
<td>When should testing be done?</td>
<td>299</td>
</tr>
<tr>
<td>23.5</td>
<td>What are the types of testing?</td>
<td>300</td>
</tr>
<tr>
<td>23.6</td>
<td>Fault logging</td>
<td>302</td>
</tr>
<tr>
<td>23.7</td>
<td>Risks</td>
<td>304</td>
</tr>
<tr>
<td>23.8</td>
<td>Summary</td>
<td>305</td>
</tr>
</tbody>
</table>

#### CHAPTER 24

**Data**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>24.1</td>
<td>Common characteristics</td>
<td>307</td>
</tr>
<tr>
<td>24.2</td>
<td>Database</td>
<td>308</td>
</tr>
<tr>
<td>24.3</td>
<td>Data</td>
<td>308</td>
</tr>
<tr>
<td>24.4</td>
<td>Bid/offer spread</td>
<td>310</td>
</tr>
<tr>
<td>24.5</td>
<td>Curves and surfaces</td>
<td>310</td>
</tr>
<tr>
<td>24.6</td>
<td>Market data</td>
<td>313</td>
</tr>
</tbody>
</table>