



The Trade

lifecycle

*Behind the Scenes
of the Trading Process*



ROBERT BAKER

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Preface

Trading has evolved from a humble apple grower wanting a stable price for his produce come harvest time, to a complex and exciting industry comprising a significant share of the global economy.

Trading is the fundamental activity of investment banks, hedge funds, pension funds and many other financial companies. There is no better way to understand the workings of a financial entity than to follow the progress of a trade through its lifecycle and all the activities performed upon it.

This book will dissect a trade into its components, track it from conception to maturity and describe the *raison d'être* of the business functions of a financial entity all arising from the processing of a trade. Having seen the full path of a trade, the reader will gain a more complete view of the world of finance which will answer some fundamental questions such as why, what and how do people trade.

Derivatives are complex variations of standard trades. By contrast and comparison with the lifecycle of standard trades the reader will glean a better understanding of these often misunderstood financial instruments.

Credit derivatives are another important set of products in our post credit crunch world. How do these instruments work and where do they differ from their non credit counterparts? This book has a special section devoted to them.

Together with the trade itself, the book will explore essential activities such as booking, confirmation, settlement, risk management, legal obligations, finance, and control functions such as credit, market risk and auditing. Almost every person working in an investment bank or hedge fund has a large part of their work connected to the lifecycle of a trade. It is the glue by which all the departments are bound and the aggregated success or failure of each trade determines the survival and growth of the entire organisation.

The various approaches to systems for the management of trade lifecycles are illustrated. The essential raw material to the measure of any trade is data and the book looks at what data is needed and by whom and how to cope with missing or unreliable data.

WHY THIS BOOK?

Many volumes have been written on the business side of trading and related activities such as market risk management. Although particular areas of the processes behind trading have been

explained, I have not found the complete lifecycle of a trade fully described in one book. I feel a thorough end-to-end guide would be of interest to:

- anyone seeking work in the financial services industry;
- people already in the industry who want to see how their work fits into the organisation as a whole;
- those with an interest in the activities of a financial entity. They could include clients, academics, pension holders and people making investments of all sizes;
- people selling products and services to the financial sector such as software vendors.

The importance of the financial sector to the world economy has been brought into focus by many recent events: the credit crunch, the collapse of companies such as Lehman Brothers and a recession affecting most countries across the world. The result has been a demand for better inspection and regulation of trading activities. No longer is it sufficient for firms to return profits, they have to convince investors, shareholders and regulators that they are employing due diligence and managing risks.

In writing about the trading process, my aim is to reveal all areas subject to potential risk. Once a risk is known, it can be monitored and managed even if the eventual decision is not to take action – forewarned is forearmed.

Although any financial entity engaged in trading activities will have already arrived at a set of processes spanning the trade lifecycle, these are not always performed in an optimal fashion; they may have evolved more by historical accident than by design. A careful reappraisal of the *entire* trading processes can lead to:

- a reduction in risks
- exposure of weaknesses
- lower operating costs
- elimination of wastage
- better overall awareness leading to more confidence in the trading process.

I hope that this book might encourage all participants in the trade lifecycle to look again at their activities and those of their colleagues and see where improvements can be made to reduce risk and enhance the reputation of a battered industry.

Gaining employment in the financial sector is becoming increasingly competitive. It is no longer sufficient to have the skills and experience in one business function. Applicants must demonstrate an understanding of where they fit into the organisation and have the ability to communicate with other business functions – every activity in the trade lifecycle being connected to others. This book is written with a view to helping this understanding.

I have tried to make the book a readable progression through all the important activities and components of the trade lifecycle. Detailed explanations are given where necessary, but the book is intended as a comprehensive overview and therefore I have avoided too much detail where it might hinder the reader's ability to see the full picture.

Any mistakes are mine. All views expressed are entirely my own.

Author's Note

This book is divided into four parts. The first part is entitled “**Products and the background to trading**”. It starts with a chapter on trading giving an overview of trading in general as well as that related to the financial services industry. The next chapter is a background to risk which is another important theme of the book. We then look into specific trades by examining asset classes, derivative products and a special chapter on credit derivatives. Part I concludes with a look at three important aspects of trading – liquidity, price and leverage.

Part II is “**The trade lifecycle**”. It starts with an anatomy of the trade which is the core element of the lifecycle. Then the lifecycle is analysed in detail followed by a chapter on cashflows and asset holdings which are directly influenced by the lifecycle. We then move on to four methods of direct monitoring of trades throughout their lifetime: risk management, market risk control, counterparty risk control and accounting. The part concludes with a discussion of P&L attribution.

Part III, “**Systems and procedures**” begins with a full description of the business functions in the lifecycle and the people who run the systems and procedures. The next chapter examines the notion of business processes followed by a chapter devoted to incorporating new products into the lifecycle. The chapter on systems illustrates the key role played by information technology followed by testing. The following three chapters on data, reports and calculation examine the scope of business processes – what goes in, what comes out and what happens in between. Next is a chapter on validation of mathematical models and systems. The concluding chapters look at overall procedures connected to legal and regulatory issues and business continuity planning for disasters.

Part IV, “**What can go wrong, the credit crisis**” discusses the events of the well-known crisis of 2007.

Finally the appendix summarises the risks arising from the trade lifecycle.

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Contents

Preface	xxiii
Author's Note	xxv
Acknowledgements	xxvii
PART I PRODUCTS AND THE BACKGROUND TO TRADING	1
1 Trading	3
1.1 How and why do people trade?	3
1.2 Factors affecting trade	3
1.3 Market participants	3
1.3.1 Producer	4
1.3.2 Consumer	4
1.3.3 Speculator	4
1.3.4 Market maker	4
1.4 Means by which trades are transacted	4
1.4.1 Brokers	4
1.4.2 Exchanges	5
1.4.3 Over-the-counter	5
1.5 When is a trade live?	6
1.6 Consequences of trading	6
1.7 Trading in the financial services industry	6
1.7.1 Two types of trading policy	7
1.7.2 Why does a financial entity trade?	7
1.8 What do we mean by a trade?	9
1.9 Who works on the trade and when?	9
1.10 Summary	10
2 Risk	11
2.1 Introduction	11
2.2 Risk is inevitable	11
2.3 Quantifying risk	11

2.4	Methods of dealing with risk	12
2.4.1	Ignore	12
2.4.2	Minimise	12
2.4.3	Avoid	12
2.4.4	Remove	13
2.5	Managing risk	13
2.6	Problems of unforeseen risk	13
2.7	Summary	13
3	Asset Classes	15
3.1	Interest rates	15
3.1.1	Deposit	15
3.1.2	Future	15
3.1.3	Swap	15
3.1.4	Tradeflow issues	17
3.2	Foreign exchange (FX)	17
3.2.1	Spot	17
3.2.2	Futures and forwards	17
3.2.3	Swaps	17
3.2.4	Baskets	18
3.2.5	Tradeflow issues	18
3.3	Equity	19
3.3.1	Synthetic equities (index)	19
3.3.2	Lifecycle issues pertinent to equity trades	19
3.4	Bonds and credit	20
3.4.1	Bonds	20
3.4.2	Other credit risk bearing instruments	24
3.5	Commodities	27
3.5.1	What are commodities?	27
3.5.2	Agricultural commodities	27
3.5.3	Examples of animal products	27
3.5.4	Energy	28
3.5.5	Precious metals	28
3.5.6	Industrial metals	28
3.5.7	OTC commodities	28
3.5.8	Localised nature of production	28
3.5.9	Time lag	28
3.5.10	Utility of commodities	29
3.5.11	Precious metals as a currency	29
3.5.12	Physical settlement	29
3.5.13	Other tradeflow issues	29
3.6	Trading across asset classes	30
3.7	Summary	30
4	Derivatives, Structures and Hybrids	31
4.1	What is a derivative?	31
4.2	Linear	31

4.3	Nonlinear	31
4.3.1	Trade process issues relating to options	33
4.3.2	Exercise	33
4.3.3	Optionality	33
4.3.4	Leverage	33
4.4	Some option terminology	35
4.5	Option valuation	35
4.6	Exotic options	36
4.6.1	Issues with exotics	37
4.7	Structures and hybrids	37
4.8	Importance of simpler products	38
4.9	Trade matrix	39
4.10	Summary	39
5	Credit Derivatives	41
5.1	Introduction	41
5.2	CDS	41
5.3	CLN	42
5.4	CDO	43
5.4.1	CDO reference pool	44
5.4.2	Static and managed CDOs	45
5.4.3	CDO pricing methodology	46
5.4.4	Other terminology	47
5.5	Data relating to CDOs	48
5.5.1	Reference pool data	48
5.5.2	Tranche data	49
5.5.3	CDO deal details	49
5.6	Practical aspects of CDO management	49
5.6.1	What is happening?	49
5.6.2	What has happened?	50
5.6.3	What is likely to happen and what is the worst that can happen?	51
5.6.4	What opportunities do I have?	51
5.6.5	Reporting	52
5.6.6	Limits	52
5.6.7	Alerts	53
5.7	Practical aspects of CDO valuation	53
5.8	Why are credit derivatives different?	54
5.9	Summary	56
6	Liquidity, Price and Leverage	57
6.1	Liquidity	57
6.1.1	Two types of trading	57
6.1.2	What is liquidity?	57
6.1.3	Asset liquidity	57
6.1.4	Measuring liquidity	57
6.1.5	Risks associated with liquidity	58

6.2	Price	58
6.2.1	Over-the-counter price	58
6.2.2	Exchange price	58
6.2.3	Broker price	59
6.2.4	What can we infer from price?	59
6.2.5	Cost of unwind	59
6.2.6	Volumes	59
6.3	Leverage	60
6.3.1	Advantages of leverage	60
6.3.2	Disadvantages of leverage	61
6.3.3	Measurement of leverage	61
6.3.4	Current market position	61
6.3.5	Time	62
6.3.6	Asset class	62
6.3.7	Monitoring of leverage	62
6.3.8	Summary	62
PART II THE TRADE LIFECYCLE		63
7	Anatomy of a Trade	65
7.1	The underlying	65
7.2	General	65
7.3	Economic	66
7.4	Sales	66
7.5	Legal	66
7.6	Booking	66
7.7	Counterparty	67
7.8	Timeline	67
7.8.1	Dates relating to a trade	67
7.8.2	Fixed cash or asset exchange dates	67
7.8.3	Unknown cash or asset exchange dates	67
7.8.4	Example	67
8	Lifecycle	69
8.1	Pre Execution	69
8.1.1	Provisional trades	69
8.1.2	Orders	70
8.2	Execution and booking	71
8.2.1	Execution	71
8.2.2	Booking	71
8.3	Confirmation	72
8.3.1	Matching	73
8.3.2	Confirmation	73
8.4	Post booking	74
8.4.1	Trade scrutiny	74
8.4.2	Enrichment	75

8.4.3	Cashflows	75
8.4.4	Fees and duties	75
8.4.5	Error reporting	75
8.5	Settlement	75
8.5.1	The importance of settlement	76
8.5.2	Settlement instructions	76
8.5.3	Custodian	76
8.5.4	Cash or physical	76
8.5.5	Cash	76
8.5.6	Documentation	76
8.5.7	Physical commodity	77
8.5.8	Cash settlement of commodities	77
8.5.9	Nostro accounts	77
8.5.10	Risks	77
8.5.11	Advantage of quick settlement	78
8.5.12	Multiple settlement dates	78
8.5.13	Breaks	79
8.6	Overnight	79
8.6.1	Individual trade and aggregation with other trades	79
8.6.2	Date and time	79
8.6.3	Internal and external trade dates	80
8.6.4	Deciding time for end of day	80
8.6.5	End of day roll	80
8.6.6	Overnight processes	81
8.6.7	Pre overnight checks	81
8.6.8	Amalgamation between systems	81
8.6.9	Stale data	82
8.7	Changes during lifetime	82
8.7.1	Dividends	82
8.7.2	Coupons	83
8.7.3	Other corporate actions	83
8.7.4	Changes as a result of market data	83
8.7.5	Counterparty changes	84
8.7.6	Collateral	84
8.7.7	Changes to the trade	85
8.7.8	Management of changes	86
8.7.9	Risks	86
8.8	Reporting during lifetime	86
8.9	Exercise	87
8.9.1	Exercise date	87
8.9.2	When to exercise	87
8.9.3	Cash or physical	87
8.9.4	Exercise as a process	87
8.9.5	Fugit	88
8.9.6	Risks associated with exercise	88
8.10	Maturity	88
8.10.1	Final settlement date	88

8.11	Example trade	89
8.11.1	The trade lifecycle	89
8.12	Summary	91
9	Cashflows and Asset Holdings	93
9.1	Introduction	93
9.2	Holdings	94
9.3	Value of holding	95
9.4	Reconciliation	96
9.5	Consolidated reporting	97
9.6	Realised and unrealised P&L	97
9.7	Diversification	97
9.8	Bank within a bank	98
9.9	Custody of securities	98
9.9.1	Registered securities	98
9.9.2	Bearer securities	98
9.9.3	Use of custodians	99
9.10	Risks	99
9.11	Summary	99
10	Risk Management	101
10.1	Traders	101
10.1.1	Desirable exposure	101
10.1.2	Undesirable exposure	101
10.2	Risk control	101
10.3	Trading management	102
10.4	Senior management	102
10.5	How do risks arise?	102
10.5.1	Spot trades	102
10.5.2	Futures and forwards	102
10.5.3	Options	103
10.5.4	Exposures to fixed or float income streams	103
10.5.5	Exposure to debt	103
10.5.6	Exposure to group of products	103
10.6	Different reasons for trades	103
10.7	Hedging	103
10.8	What happens when the trader is not around?	104
10.8.1	Availability of other traders	104
10.8.2	Stop and limit orders	104
10.9	Types of risk	105
10.9.1	Delta	105
10.9.2	Gamma	105
10.9.3	Vega (sometimes known as kappa)	105
10.9.4	Rho	105
10.9.5	Theta	106
10.9.6	Additional risks for credit products	106
10.9.7	Default risk (or jump to default)	106

10.9.8	Recovery rate	106
10.9.9	Correlation risk	106
10.9.10	Risks in general	106
10.9.11	Dreaming ahead	107
10.10	Trading strategies	107
10.10.1	Front book	107
10.10.2	Back book	107
10.11	Hedging strategies	108
10.11.1	Delta hedging	108
10.11.2	Stop-loss hedging	108
10.12	Summary	109
11	Market Risk Control	111
11.1	Various methodologies	111
11.1.1	Scenario analysis	111
11.1.2	Value at Risk (VaR)	112
11.1.3	Instantaneous measures of risk (sensitivity analysis)	113
11.2	Need for risk	114
11.3	Allocation of risk	114
11.4	Monitoring of market risk	115
11.5	Controlling the risk	115
11.6	Responsibilities of the market risk control department	116
11.7	Limitations of market risk departments	116
11.7.1	Everything correlated	117
11.7.2	The tails	117
11.7.3	The human factor	117
11.7.4	Balanced approach	117
11.8	Regulatory requirements	117
11.8.1	Basel II	117
11.8.2	Capital Adequacy Ratio (CAR)	118
11.9	Summary	118
12	Counterparty Risk Control	119
12.1	Reasons for non fulfilment of obligations	119
12.2	Consequences of counterparty default	119
12.3	Counterparty risk over time	120
12.4	How to measure the risk	120
12.4.1	Expected loss	121
12.4.2	Credit exposure	121
12.4.3	Potential future exposure (PFE)	122
12.4.4	Netting	122
12.4.5	Back-to-back	123
12.5	Imposing limits	123
12.6	Who is the counterparty?	124
12.7	Collateral	124
12.7.1	Example of a collateral agreement	124
12.7.2	Advantages of collateral in general	124

12.8	Activities of the counterparty risk control department	125
12.8.1	Set policies for estimating exposure	125
12.8.2	Assign limits based on credit worthiness	125
12.8.3	Measure exposure	125
12.8.4	Deal with breaches	126
12.8.5	Policies for new trade types	126
12.8.6	Maintain legal data	126
12.8.7	Managing margin payments and receipts	126
12.8.8	Interface with management	127
12.9	What are the risks involved in analysing credit risk?	127
12.9.1	Correlation between counterparties	127
12.9.2	Added complication of credit risk	127
12.9.3	Insufficient consideration of counterparty risk	127
12.9.4	Sudden counterparty changes	127
12.10	Payment systems	128
12.11	Summary	129
13	Accounting	131
13.1	Balance sheet	131
13.1.1	Fixed assets	131
13.1.2	Investments	131
13.1.3	Cash	131
13.1.4	Debtors	132
13.1.5	Creditors	132
13.1.6	Capital	132
13.1.7	Profit and loss	132
13.1.8	Events that affect balance sheet items	132
13.2	Profit and loss account	133
13.2.1	Introduction	133
13.2.2	Realised	134
13.2.3	Unrealised	134
13.2.4	Accrued	134
13.2.5	Incidental	134
13.2.6	Worked example	134
13.2.7	Individual trades	135
13.2.8	Who is responsible for producing P&L?	136
13.2.9	Risks associated with reporting P&L	136
13.3	Financial reports for hedge funds and asset managers	137
13.3.1	Overview	137
13.3.2	Fees	137
13.3.3	Reports	137
14	P&L Attribution	139
14.1	Benefits	139
14.1.1	Catches mistakes	139
14.1.2	Reconciliation	139
14.1.3	Better understanding of the trades and the market	139

14.2	The process	140
14.2.1	Market movements	140
14.2.2	Theta	140
14.2.3	Unexplained	142
14.3	Example	142
14.4	Summary	143

PART III SYSTEMS AND PROCEDURES 145

15	People	147
15.1	Traders	147
15.2	Trading assistants	148
15.3	Structurers	148
15.4	Sales	149
15.5	Researchers	149
15.6	Middle office (product control)	149
15.6.1	Trade	149
15.6.2	Data	149
15.6.3	Implementing trade changes	150
15.6.4	Reporting	150
15.6.5	Valuation	150
15.6.6	Responsibility	150
15.6.7	Liaison	150
15.6.8	Processes	151
15.6.9	Security	151
15.6.10	End of day	151
15.6.11	End of month	151
15.6.12	Summary	152
15.7	Back office (operations)	152
15.8	Quantitative analyst	152
15.8.1	Short-term pricing	153
15.8.2	Long-term model development	153
15.8.3	Tools of the trade	153
15.8.4	Role of quantitative analysts	154
15.9	Information technology	154
15.9.1	Front-line support	155
15.9.2	Infrastructure	155
15.9.3	Architects	155
15.9.4	Programmers	156
15.9.5	Project managers	156
15.9.6	IT operators	157
15.9.7	Testers	157
15.10	Legal	158
15.11	Model validation	158
15.12	Market risk control department	159
15.13	Counterparty risk control department	159
15.14	Finance	159

15.15	Internal audit	160
15.15.1	Routine checks	160
15.15.2	Thorough audit of one area	160
15.16	Compliance	160
15.16.1	Due diligence	161
15.16.2	External regulation	161
15.16.3	Staff training	161
15.17	Trading manager	161
15.18	Management	162
15.18.1	Balance	162
15.18.2	Board of directors	162
15.19	Human risks	162
15.19.1	Too much knowledge in one person	162
15.19.2	Not enough knowledge	162
15.19.3	The wrong people	163
15.19.4	Not enough investment in people	163
15.19.5	Incentive	163
15.19.6	Short-term thinking	164
15.19.7	Conflicts and tensions	164
15.19.8	Communication	165
15.20	Summary	166
16	Developing Processes for New Products (and Improving Processes for Existing Products)	167
16.1	What is a process?	167
16.2	The status quo	167
16.3	How processes evolve	167
16.4	Inventory of current systems	169
16.5	Coping with change	170
16.6	Improving the situation	171
16.6.1	What would the ideal set of processes be?	171
16.6.2	Understanding the current processes	171
16.7	Inertia	173
16.8	Summary	174
17	New Products	175
17.1	Origin of new products	175
17.2	Trial basis	176
17.2.1	Why trial?	176
17.2.2	Features of the trial	176
17.2.3	Advantages of the trial	176
17.3	New trade checklist	177
17.3.1	Management approval	177
17.3.2	Legal and regulatory approval	177
17.3.3	Trading limits	177
17.3.4	Risk control limits	178

17.3.5	Models	178
17.3.6	Trade lifecycle processes	178
17.3.7	Middle office can book and mark the products	178
17.4	New product evolution	178
17.5	Risks	179
17.6	Summary	179
18	Systems	181
18.1	What makes a good system?	181
18.2	IT procurement	182
18.3	System stakeholders	182
18.4	The IT team	183
18.5	Timeline of a project	184
18.6	Project management	185
18.7	The IT divide	185
18.8	Techniques and issues related to IT	186
18.9	Systems architecture	191
18.9.1	User interface	191
18.9.2	Business logic	191
18.9.3	Data repository	192
18.9.4	Example	192
18.10	Different types of development	193
18.10.1	Rapid application development (RAD)	193
18.10.2	Dedicated IT team for a business function or area	193
18.10.3	Independent IT division	193
18.10.4	General comments	194
18.11	Buy versus build	195
18.12	Software vendors	196
18.13	Performance	196
18.13.1	Hardware constraints	197
18.13.2	Grid computing	197
18.14	Project estimation	197
18.15	General thoughts on IT	199
18.16	Summary	199
19	Testing	201
19.1	What is testing?	201
19.2	Why is testing important?	201
19.3	Who does testing?	202
19.4	When should testing be done?	203
19.5	What are the types of testing?	203
19.5.1	Stages of testing	203
19.5.2	Testing types	204
19.6	Fault logging	205
19.6.1	Types of fault	205
19.6.2	Workaround	205