INSIGHT

Quantifi

NEWSLETTER

September 2014

TABB FORUM

Sell-Side Pains are Buy-Side Gains

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Avadhut Naik, Quantifi

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Amy Wierenga

BlueMountain Capital Management

MESSAGE FROM THE CEO

The OTC derivatives landscape has been forever altered. Market and regulatory changes are forcing firms to re-think their business operating models. Increased complexity and uncertainty have motivated forward-looking firms to avoid stop-gap measures and replace legacy systems with a new generation of holistic trading and risk management software that support front, middle and back office requirements across all assets.

Technology will play a key role in this disruptive change to the financial markets. The rapid pace of innovation in technology presents a whole new range of possibilities for how this technology can be leveraged. Firms that make good choices and manage their technology will be in significantly better positions in terms of their operating costs, their ability to measure and manage risk, and their ability to understand profitability across the organisation.

The combination of financial market transformation along with technology innovation has presented unique opportunities for Quantifi. We have a long tradition of re-investing significantly in technology and research and this has allowed us to leverage the benefits of new technology in the form of easier to use, more flexible, faster, and more scalable solutions. For our clients this translates into dramatically lower time to market, total cost of ownership and significant improvements in operational efficiency.

The last year has been Quantifi's strongest to date. We have strong client growth across all our solutions and continue to make significant investment in our global operations, most recently expanding our office space in Australia to accommodate our growth in this region. We also recently, in partnership with Deloitte, ran a series of webinars on valuation techniques under IFRS13 and how increased emphasis is being placed on calculating complex variables such as CVA and DVA.

Finally, we are hosting our second annual risk conference in London where industry professionals will gather to discuss the dynamics driving the OTC markets and hear from senior industry figures who will provide unique insights and sharing of best practices. I hope you are able to join us as we look forward to an exciting next twelve months.

ROHAN DOUGLAS, Founder and CEO

NEWS

Agence Française de Développement Selects Quantifi for Integrated Trading and Portfolio Management

"After extensive due diligence of other main solution providers we singled out Quantifi as the clear market leader. Quantifi provides a wide range of functionality including flexible reporting and superior analytics. The solution, combined with the high level of support we receive from senior experienced personnel, helps us strengthen our risk management capacity in the markets we operate in." Hannan Mohammad, Deputy Head of the Funding and Markets Division at AFD. (Phase 1 of implementation completed in under 5 months).

Nordic Bond Pricing Leverages Quantifi's Leading Edge Pricing and Analytics Technology

"Quantifi provides a level of transparency that allows us to adhere to a high standard of independence, which is important for the services we provide. The speed of implementation, in less than 4 months, has proved instrumental in the successful launch of our business." Vegard Annweiler, CEO NBP.

Quantifi Expands Australian Office in Response to Growth in Asia-Pacific

This expansion will enable Quantifi to meet growing regional demand. "We are making significant investment in our global operations so that we can strategically address increased demand and better serve our existing clients." Kathy Del Duca, Director of Operations.

EVENTS

WBS -10th Fixed Income Conference
Rohan Douglas Presents: The Impact of Incoming Regulatory and Clearing Charges
Barcelona, 24th - 26th September, 2014

Quantifi London Annual Risk Conference
The Dynamics Driving OTC Markets
London, 8th October 2014

Quantifi New York Annual Risk Conference
The Dynamics Driving OTC Markets
New York, 5th November 2014

SEMINAR

Quantifi & EY

on Resource Management, Regulation, & Accounting of XVA

Quantifi hosted a joint seminar with EY in Frankfurt. Senior practitioners from leading financial institutions, regulators and other market participants gathered for a compelling evening of unique insights and discussion on XVA, from a resource management, regulatory, and accounting perspective.

The four industry speakers, from BaFin, Commerzbank, EY and Quantifi, debated contrasting views on XVA from a resource management, regulation and accounting perspective, followed by an interactive Q&A session. Key talking points included:

- The absence of a harmonised approach to XVA results in inconsistent front office, regulatory reporting and accounting results.
- Close-out values at default or decision to terminate are not clearly defined: risk-free or risk-adjusted values?
- Daily resource management being critical to calculating and managing capital and funding costs.
- There are various approaches to calculating and interpreting FVA, with a trend towards 'cost of hedging', confirmed by the recent JP Morgan earnings report, becoming the standard.
- New OTC regulatory reforms occurring in shorter intervals present trading, operational and compliance challenges. One of the most recent being 'the standardised approach for measuring counterparty credit risk exposures.'
- Clear requirement to constantly rebuild models in order to keep up with faster changing regulation.

Dmitry Pugachevsky, Director of Research, Quantifi comments: "XVA cuts across many areas of a bank: there are trading, corporate risk management, and regulatory and accounting aspects that affect both the front and back office. Banks are transitioning their business models, generally moving away from capital intensive businesses and shifting decision making authority from the trading desks to central risk management groups." Dr. Pugachevsky continues: "Banks recognise the benefits of a centralised desk, however, the data, technology and operational challenges involved in implementing a XVA process can be overwhelming. Due to the complexity, firms are increasingly looking to vendor solutions."

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Shankar Mukherjee, Director, EY, said: "Given the still-evolving regulatory requirements and the changes in accounting standards, banks are continuing to upgrade the methodologies and operating processes around the fair value adjustments for derivatives collectively described as XVA. Some of the issues faced by banks relate to the observability of both inputs and secondary market prices for OTC derivatives required in order to validate the valuations. This is particularly true of some of the valuation adjustments, which are not, as yet, widely reported such as the Funding Valuation Adjustment. In an environment where banks are increasingly capital and liquidity constrained, these questions assume even greater importance: banks need to measure returns on businesses in order to determine which are consistently producing the appropriate returns on the financial resources required to support them."

COVER STORY

Sell-Side Pains are Buy-Side Gains

Interview with Avadhut Naik, Quantifi & Paul Rowady, TabbFORUM

"I think it's very difficult to predict where the market will go but as long as the solution is holistic and there is flexibility in scaling it along different dimensions, I think that's what everybody's looking for."

TABB Group principal and senior analyst Paul Rowady invited Avadhut Naik, Head of Solutions, Quantifi, to discuss desiloisation and defragmentation; primarily aimed at large, complex dealing banks and financial intermediaries on the sell-side.

P: I had always thought that de-siloising meant breaking down all those silos of business activity and risk and making them work together much more seamlessly and on an enterprise level. However, maybe some of those silos are just going to be jettisoned from the sell-side to the buy-side.

What do you see in terms of the nature of portfolios and certain kinds of risk that may be moving from the sell-side to the buy-side?

A: We do come across risk moving to the buy-side. This is largely on account of regulation and regulatory directives impacting the sell-side. We see this typically for books, like the correlation book for which there is a huge regulatory capital charge that the sell-side needs to take to hold onto that book. Therefore, the sell-side is interested in removing that risk off their balance sheet. On the other hand, there are buy-side firms seeking a higher return in a low interest environment. That's where some of these trades are happening, with risk shifting from the sell-side to the buy-side.

P: Tell me about the toolkit and the platform they need in order to assess this expanding spectrum of risk that they've never had to try and manage before.

SeA: Yesterday's buy-side firms were focused on a limited number of asset classes and a limited number of strategies. We see that changing as firms want to have the ability to be multi-asset, to manage their risk at a multi-asset level. There is increasing demand for an integrated solution that can provide a holistic picture of risk across multiple-asset classes and in general more sophisticated analytics.

P: In terms of newer entrants, I would think that the message is that your risk platform needs to be more holistic in nature, in terms of its ability to net out risk as well as to look at both market and credit and the cross pollination where the new opportunities may be. What are your views about that as a hypothesis considering that when you start out you still need to have this more holistic functionality?

A: Yes that's a very interesting point. What we are seeing is that new funds are looking for, what we like

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to call, the next generation of portfolio management tools that cover the analytics, the trading and the risk management piece. For risk management, it is more enterprise risk management, so a tool that can address market, credit and liquidity risk together. As far as trading goes, they are looking for pre-trade analytics, trade lifecycle management, as well as modeling and collateral management. Clearing has also become important, so initial margin, variation margin modeling requirements.

> *"There is increasing demand for an integrated solution that can provide a holistic picture of risk across multiple-asset classes and in general more sophisticated analytics.*

In general, they are looking for a better analytic toolset across asset classes. A new fund would look for a single, integrated solution that would provide all of this.

P: So this isn't just a broader spectrum of product, this is actually a broader component of the workflow from pre-trade. In other words, historically you'd have to bolt together several systems, potentially to cover pieces of that workflow or across various products in order to achieve this functionality, and you'd have to get all the back end infrastructure to cooperate with that. So you're suggesting that it's possible to have a much more integrated piece of functionality, platform, right out of the box.

A: Yes absolutely and that is what the buy-side firms are looking for. They don't want the extra overhead of managing multiple systems - with portfolio managers having their own analytic systems and risk managers and operations having separate trade and risk management systems. Instead, they would very much like an integrated system that is easy to implement, easy to support, and leads to lower total cost of ownership (TCO).

P: Feeds into the whole more for less theme that we see these days.

A: Yes, and most importantly provides an integrated view of P&L and risk.

P: I know that a lot of this is still very new, but in terms of building upon even this value proposition, which access do you build on? Do you build more of the workflow in terms of maybe some of the research into signal generation or cross-product pattern recognition, maybe some quant add-ons, or is it an even further spectrum in terms of regions or products? Where do you stretch even this broad enterprise and holistic view from here looking forward?

A: I think it's very difficult to predict where the market will go but as long as the solution is holistic and there is flexibility in scaling it along different dimensions, I think that's what everybody's looking for.

P: I want to bookmark it there. That's a lot to digest especially when you follow the migration for how the sell-side jettisons, defragments, the risk ends up on the buy-side and that creates a whole new level of creativity and innovation about how to manage a broader spectrum. I think it is really a fascinating narrative that we seek to track quite a bit more closely moving forward.

Q&A with

Amy Wierenga

Head of Risk Management,

BlueMountain Capital Management

What is the history and background of BlueMountain Capital?

BlueMountain is a multi-strategy absolute return manager founded on the belief that organizational, regulatory, and behavioral constraints generate persistent fundamental and technical asset mispricing. Our investment approach combines deep interdisciplinary financial markets expertise, rigorous risk management, and a collaborative culture in order to create a repeatable investment process that capitalizes on these inefficiencies.

> *We believe that a holistic risk measurement language that encompasses all of these dynamics is a key ingredient for sound total risk-adjusted-return decision-making.*

Since our founding by Andrew Feldstein and Stephen Siderow in 2003 as a credit-focused relative value manager, we've expanded our investment and risk management platforms into adjacent asset classes to broaden and diversify the sources of mispricing that define our opportunity set. Our team of 275 professionals based in New York, London, and Tokyo currently manages $5bn in CLO assets and $15bn in 14 absolute return funds that invest across the capital structure and asset class spectrums.

How is BlueMountain different from its peers?

One of our most distinctive characteristics is how our core values - transparency, intellectual honesty, and cross-team collaboration - directly influence our investment and risk management processes. Our investment model demands a high degree of integration and expertise sharing between strategy managers, including non-investment-making teams. This collaborative and interdisciplinary approach results in better investment decision-making and better risk management.

Our advanced institutional infrastructure that supports trading, risk, operations, and finance also separates us from many of our peers. Hedge fund industry consolidation is a real and likely-to-continue trend, given barriers to entry from new buy-side regulation, prime finance business model regulatory impact, and the overall advantages of scale in securing and deploying investor capital. Our technological capabilities enable us to be nimble in response to these changes, as well as evolving investor mandates and opportunity sets.

What is your approach to risk management?

Our quantitative models are guided by a belief that market data provides a useful starting point for understanding potential volatilities and correlations. That data, however, must be married to intuition from ongoing analysis of changing market structure, behavioral incentives, and other forward-looking factors that give rise to the probability of future dislocations differing from historic or market-implied relationships. A material part of our risk taking lies in parts of the asset class spectrum where relevant historic data is limited or non-existent, which further underscores the importance of blending fundamental investment knowledge and market perspective with data-driven approaches.

Another important objective for risk frameworks supporting multi-strategy funds is that they work well for single strategy risk analysis while also enabling coherent fund-level risk aggregation. We have found that a scenario-centric approach provides an effective and flexible foundation for doing so. We use a holistic suite of scenarios to understand different measures of risk capital, meaning that we quantify internal measures of market risk capital, levered market risk capital, and liquidity risk capital in addition to the actual capital required by the street to execute our strategies under different scenarios.

> *Our technological capabilities enable us to be nimble in response to these changes, as well as evolving investor mandates and opportunity sets.*

For example, we operate some strategies that have lower dealer margin requirements than the market risk capital that we associate with them internally. On the other hand, relative value strategies where unlevered assets are traded versus levered assets may require cash levels to fund margin calls that are greater than the net market risk PnL volatility. Still other strategies - particularly in low vol, low liquidity premia environments like the one we're in now - can look relatively attractive using an expected return versus PnL volatility lens, but require normalization for the wrong-way-correlated illiquidity risk they bear, particularly in funds where the duration of capital is shorter and disciplined asset-liability matching is important. We believe that a holistic risk measurement language that encompasses all of these dynamics is a key ingredient for sound total risk-adjusted-return decision-making.

What have been your priorities over the past 12 months?

Given the remarkably low vol environment and the steady march of market liquidity premia back to historic lows, we've begun exploring new ways to quantify the degree to which different strategies expose our funds to liquidity premia expansion and, in turn, the compensation we should require for this risk. Part of this study involves separating systematic risk exposure into fundamental market beta (e.g. default risk) and beta from other factors, and doing so in a harmonized way across positions ranging from liquid bonds to illiquid structured credit. Commercial applications of this exploration may include the ability to define different absolute risk tolerances and customized hedging strategies for fundamental versus non-fundamental beta depending on a fund's risk mandate and capital duration.

Quantifi Version 12.0 Features Enhanced Clearing, Reporting and Connectivity Capabilities

- Expanded asset coverage including recently launched exchange traded products
- Additional out-of-the box connectivity to clearing houses, prime brokers, administrators, and data providers
- Introducing new levels of usability, flexibility, and integration

Rohan Douglas, CEO, Quantifi: "OTC market participants need new valuation methods incorporating OIS Discounting, CVA that takes into account CSAs and collateral, new regulatory calculations, limit management based on PFEs, margining replication, and funding costs such as FVA and CVA. These are complex, front-office centric calculations that play to Quantifi's strength."

Quantifi has an open, service-oriented architecture (SOA), which can be implemented using multi-core or grid computing, or through the cloud. This is part of Quantifi's overall strategy for reducing the total cost of ownership for users and making the solution open and flexible. The light-touch architecture is easier to support and to integrate into a firm's existing technology stack and third party applications.

"As well as integrating all the latest regulatory and industry practices, Quantifi has applied latest technology innovations to provide new levels of usability, flexibility, and ease of integration. This translates into dramatically lower time to market, total cost of ownership, and significant improvements in operational efficiency." Mark Traudt, CTO, Quantifi.

Quants Hub (video)

Collateral Optimisation in Light of Credit Risk Regulation and Clearing

Key Topics Include

- Basics of Counterparty Risk
- Basel CCR Capital Charges
- Funding Valuation Adjustment

View video
http://www.quantifisolutions.com/videos.aspx

Whitepapers

- IFRS 13 Accounting for CVA & DVA
- Should Banks Charge for FVA?
- Comparing Alternate Methods for Calculating CVA Capital Charges under Basel III
- OIS & CSA Discounting
- Buy-Side Risk Analytics - RiskTech Quadrant®

Request a copy:
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ABOUT QUANTIFI

Quantifi is a specialist provider of analytics, trading, and risk management solutions. Our suite of integrated pre and post-trade solutions allow market participants to better value, trade, and risk manage their exposures and respond more effectively to changing market conditions.

Founded in 2002, Quantifi is trusted by the world's most sophisticated financial institutions including five of the six largest global banks, two of the three largest asset managers, leading hedge funds, insurance companies, pension funds, and other financial institutions across 16 countries.

Renowned for our client focus, depth of experience, and commitment to innovation, Quantifi is consistently first-to-market with intuitive, award-winning solutions.

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