



Buy-Side Technology

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Volatility, Vega and German Efficiency

While commentators speculate about the likelihood of a double-dip recession, markets continue their death spiral, and intra-day swings occur with such frequency and severity that it's impossible to predict what's next, echoes of the financial crisis continue to resound. Risk exposure is of significant concern for market participants, especially when it comes to derivatives markets.

Delta and Gamma risk are primary concerns for investors in these markets, naturally, but Vega risk is an often overlooked, yet vitally important, factor, according to Dr. Laurence Wormald, head of research at SunGard APT. "Everybody knows how to calculate Delta and Gamma on a derivative position," he says. "With Vega, everyone assumes that it's going to be small. But when volatility spikes, for example as it has in the last two weeks, Vega risk—that is the amount your derivative has changed just because of volatility—can make a huge difference."

This isn't news for some national regulatory bodies, such as the Bundesanstalt für Finanzdienstleistungsaufsicht (Bafin) in

Germany. "Pretty early on, the Germans developed a derivatives regulatory framework, which became known as the most aware [sophisticated] in Europe," says Wormald. "When there was a bit of a panic about derivatives eight to 10 years ago, Bafin showed itself to be one of the best regulators in terms of understanding what you really need to do with derivatives—you don't ban them, but you do ask for evidence that people understand the risks that they're taking with such instruments."

Bafin recently issued revised minimum requirements for risk management and a tightening of reporting guidelines—*Mindestanforderungen an das Risikomanagement (MaRisk)*. This prompted AmpegaGerling Investment GmbH, the investment arm of the Talanx Group, to work with SunGard APT to develop a bespoke solution in response to the new rules. "Those regulations ensure that you think about every aspect of the risk—not just the obvious aspect of the price changing, but other things too, like right now, we're seeing a volatility spike, and that's causing a big change in derivatives prices," says Wormald. "We spent a

long time working with Ampega to develop a very specific surface model for Vega, which ensures they are not just compliant, but actually ahead of the game. And the regulators seem to have recognized that."

Indeed, according to Wormald, Bafin has long held a reputation for working with the industry to develop its regulation. "Bafin actually talked to the traders, and the people who made markets in these derivatives, rather than looking at it purely as an outsider," he explains. "They really engaged with the industry, and I think that's helped the German regulation."

It's not just effective rulemaking that resulted from this engagement, he continues, but also a deeper knowledge of the issues at hand. That, in turn, feeds back into other important areas for regulators to consider. "Some regulators clearly have more depth of knowledge than others," Wormald continues. "Bafin clearly demonstrated that, and other regulators need to keep that same attitude of engagement. They're less politically driven, I think it's fair to say, than other regulatory authorities." ■

—James Rundle