

Derivatives Counterparty Risk

What Have We Learnt After Lehman?

Scope and Objectives

- Lehman Brothers' bankruptcy brought the concept of counterparty risk to light across a variety of derivative* products. Market participants who were aware of master, collateral and netting agreements (such as ISDA, CSA, etc.) in principle had to quickly understand and apply them in order to settle their outstanding transactions.
- Post Lehman, and given continuing concerns about counterparty risk, it is important for those involved in the execution and operations of derivative transactions to understand how they work if the derivative counterparty defaults.
- Even more important is to understand the risk to, and collateral agreements in place with, a counterparty in order to put preventative measures in place before a default is even a concern.
- In this course participants will:
 - Review the key derivative products (futures/forwards, swaps and options) and their uses
 - Analyze the process of liquidating derivative trades post a counterparty default, including the general sequence of events laid out in master agreements, and how collateral and cross margining work
 - Use various derivative examples as case studies to illustrate the concepts of derivatives counterparty risk and liquidation
 - Discuss the current focus and trends in the market following Lehman's bankruptcy

Target audience

This course has been designed for audiences in front office, legal and risk management, to introduce them to the mechanics and applications of derivatives and round out their knowledge on the working of derivatives they would typically execute, document or risk manage in case of a counterparty default.

Training methodology

The course will focus on the practical realities of the market, rather than taking an excessively mathematical or academic approach. The course will blend discussion with case studies allowing the participants to think through the concepts and thus gain a more intuitive understanding of them.

Topics not included

- Pricing and modelling derivatives

The objective of this course is to provide a high level overview of how derivatives work if the derivative counterparty defaults. A discussion of pricing and modelling derivatives is beyond the scope of this course, but could be discussed in a follow-up course.

Course Agenda

Introduction and review

- What's special about derivatives?
- What is counterparty risk?
- How is it risk managed and mitigated?

This section will discuss the concepts of derivatives and counterparty risk at large and will help the trainer gauge the knowledge level of participants.

Derivatives

- Review of time value of money formula
- Concept and importance of Present Value (PV) and Mark-To-Market (MTM)
- Futures and forwards
 - Over-the-counter vs. exchange traded
- Swaps
 - PV of both legs of a swap should be equal
 - Concepts of positive and negative swap MTM
- Options
 - Comparing options to forwards

Case study: Calculating forwards

Case study: Mechanics of a swap

Case study: Option payouts

This section will review the concept and significance of time value of money before analyzing the key derivative products and their broad uses.

How derivatives work

- Do counterparty exposures look the same for all derivatives?
- How do CSAs work?
 - Controversial clauses, e.g., right of offset
- Does cross margining apply?
 - How does it work? Legal docs vs. practice
- What are the master agreement procedures when a counterparty defaults?

Case study: Interest rate forward contract with Lehman

Case study: Equity derivatives option with Lehman

Case study: Cross currency swap with Lehman

Case study: CDS on Lehman

This section will start with a general overview of counterparty risk in derivatives, and will then use case studies on various derivative transactions to illustrate the concepts of derivatives counterparty risk and liquidation.

Current markets

- Current state of markets
- Central clearing for CDS
- Calls for greater regulation

This section will discuss where we are in current markets with respect to derivatives, and will review the recent initiatives to reduce counterparty risk and increase market transparency.

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