



## Life Cycle of a Financial Derivative

The financial press usually concentrates on how financial derivatives are utilized to hedge or speculate or on the use of derivatives causing significant financial losses. Yet, key legal and operational risks in the global use of financial derivatives remain a mystery, even to many practitioners in this rapidly growing global industry. Transacting derivatives is detailed and document intensive. The very architecture of derivatives' front, middle, and back office functions can present numerous challenges both to on-site and off-site bank examiners, auditors, and compliance professionals. These professionals require specialized and routinely upgraded supervisory skills to meet their demanding objectives.

This two day interactive course is tailored for bank examiners and supervisors, auditors, and compliance professionals who need to understand the operational and legal risks of major foreign exchange, interest rate, equity, and credit derivatives. The course will consist of an interactive lecture and in-depth exercises. Additionally, relevant articles highlighting recent regulatory, examination, and risk trends in financial derivatives will supplement this course.

### Targeted Audience

Bank examiners and supervisors, auditors, and compliance professionals who need to understand the operational and legal risks of major foreign exchange, interest rate, equity, and credit derivatives.

### Special Offer

Clients who register for this course will receive a complimentary 4-month subscription to FT.com. The Financial Times is the world's most respected financial newspaper, providing a broad assessment on finance, business and the industrial sector. The move to the electronic version follows an ongoing review of our environmental responsibilities as a global business and as part of the Pearson group. FT.com also has features that are not available in hard copy, such as: Special Reports, Alphaville, editor blogs, education sections and much more! Subscriptions will start within 6-8 weeks of the start of class and are limited to one subscription per client. (Please note: as of May 1, 2011, the electronic subscription replaces the hard-copy 3-month Financial Times subscription.)

### Advance Preparation

No advance preparation required.

## **Prerequisites**

Introductory understanding of financial derivatives

## **Learning Objectives**

Students will be able to:

- . Review mechanics of key foreign exchange, interest rate, equity, and credit derivatives
- . Evaluate major components of the 2002 ISDA®\* Compare and contrast responsibilities and best practices of banks' front, middle, and back offices (importance of operations to avoid systemic risk)
- . Apply concepts in the course to a risk based supervision examination or audit of derivatives at a financial institution
- . Evaluate the influence of Basel II implementation on the treatment of financial derivatives
- . Identify key elements in the life cycle of a financial derivative
- . \* ISDA® is a registered trademark of the International Swaps and Derivatives Association Master Agreement and their application to financial derivatives

## **Follow-Up Courses**

Credit Derivatives: Intermediate

Derivatives Suite: Strategies, Trading & Valuation

**Level: Basic**

**CPE Credits: 14.0**

**Instructional Method: Group-Live**

## **Detailed Outline**

**Day I**

## **Module I: Financial Risks and Risk Management**

- . Define risk
- . Review risks that can arise from financial products: credit; market; liquidity; strategic
- . Evaluate evolving definition of legal risk: documentation; compliance
- . Evaluate evolving definition of operational risk: people; processes; technology; external influences
- . Compare and contrast best practices to effective risk management steps
- . Identify influence of Basel II on operational risk (Possible influence on legal and liquidity risks?)
- . Case Study: Société Générale
- . Article for discussion

## **Module II: Overview of Key Financial Derivatives**

- . Review mechanics of key derivatives and how they are used to hedge or speculate (foreign exchange, interest rate, equity and credit)
- . Debate influence of Basel II's implementation on the treatment of financial derivatives
- . Case Study: Bear Stearns Hedge Funds
- . Exercise: Take a derivative and identify its potential financial risks

## **Module III: ISDA®**

- . Identify key components of the 2002 ISDA®
- . Specifications
- . Schedules
- . Confirmation
- . Netting
- . Collateral / Credit Support
- . Opinions
- . Users' Guides
- . Protocols (2005 Novation Protocols)
- . Annexes: their purpose and how they are interrelated
- . Highlight differences with the 1992 ISDA®
- . Discuss credit and operational issues within the Agreement
- . Article for discussion

## **Module IV: Trading Operations**

- . Describe organizational structure and best practices expected at a front office (identify transaction flow and reporting)
- . Describe organizational structure and best practices expected at a middle office
- . Identify key areas of a back office and expected best practices for operations:
  - . - Internal controls
  - . - Ticket flow
  - . - Trade transactions: confirmations; clearance (netting and its uses; discuss role of clearance facilities; DTCC)
  - . - Evaluate requirements for margin
  - . - Settlements (discuss risks during settlement process)
  - . - Foreign payments
  - . - Reconciliations
  - . - Discrepancies and disputed transactions
  - . - Revaluation
  - . - Documentation and record keeping

Exercise I: participants will break up into groups to discuss and apply key components of a risk based bank examination of a trading function using foreign exchange derivatives and interest rate swaps. Emphasis will be on best practices that examiners and auditors are looking for throughout the front, middle, and back offices of a financial institution. {Reading before the exercise: Examination Procedures and Internal Control Questionnaire, Trading and Capital Markets Activities Manual}

Exercise II: participants will break up into different groups from the previous exercise. They will walk through a five-year equity swap and a single name credit default swap from the point after a deal is agreed upon through final maturity of the swap. Scenarios exploring possible risks during the instruments' life time will be explored. {Reading before the exercise: Letter of 18 Major Dealers to President Timothy Geithner, 24 October 2007.}

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