[Frequently Asked Questions]

[Derivatives (Part - 1)]

Subject:	Business Economics
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Frequently Asked Questions

Q.1. **What is a Derivative?**

Ans. A derivative is a risk transfer agreement, the value of which is derived from the value of an underlying asset. The underlying asset could be an interest rate, a physical commodity, a company's equity shares, an equity index, a currency, or virtually any other tradable instrument upon which parties can agree

Q.2. **What are the critical dates in a derivative transaction?**

Ans. The *trade date* is the date on which the parties agree the terms of a contract. The *effective date* is the date on which the parties begin calculating accrued obligations, such as fixed and floating interest payment obligations on an interest rate swap. The *termination date* (often called *maturity date*) is the date on which obligations no longer accrue and the final payment occurs. The *term* of a transaction lasts from the effective date to the termination date.

Q.3. **What is a Forward rate agreement?**

Ans. A forward rate agreement is a forward contract on a short-term interest rate, usually Libor, in which cash flow obligations at maturity are calculated on a notional amount and based on the difference between a predetermined *forward rate* and the market rate prevailing on that date. The settlement date of an FRA is the date on which cash flow obligations are determined.

Q.4. **What are the critical dates for an interest rate swap?**

Ans. In addition to the trade date, effective date, and termination date mentioned above, the *reset date* is the date on which a new floating rate becomes effective. The new floating rate is typically determined two days before the reset date (sometimes called *fixing date*). Floating rate payment amounts are calculated for a specified *calculation period*. The first calculation period is the period between the effective date and the first *period end date*; thereafter the calculation periods are the time between period end dates.

Q.5. **What are the risks associated with swaps?**

Ans. A party entering a swap takes on exposure to a given interest rate; the exposure can be long or short depending on whether a counterparty is paying or receiving the fixed rate. At the same time, each party take on the risk - known as counterparty credit risk - that the other party will default at some time during the life of the contract.

Q.6. **What is the value of an interest rate swap?**

Ans. The value of an interest rate swap to a counterparty is the net difference between the *present value* of the payments the counterparty expects to receive and the present value of the payments the counterparty expect to make. At the inception of the swap, the value is generally zero to both parties, and becomes positive to one and negative to the other depending on the movement of interest rates. *Present value* is the value of a quantity to be received in the future, adjusted for the time value of money (interest foregone while waiting for the quantity).

Q.7. **What is LIBOR?**

Ans. LIBOR, which stands for London Interbank Offered Rate, is the interest rate paid on interbank deposits in the international money markets (also called the *Eurocurrency markets*). Libor is commonly used as a benchmark for short-term interest rates in setting loan and deposit rates and as the floating rate on an interest rate swap.

Q.8. **What is a notional principal?**

Ans. Notional principal, or notional amount, of a derivative contract is a hypothetical underlying quantity upon which interest rate or other payment obligations are computed.

Q.9. **What is Forward Contract?**

Ans. It is an agreement to buy or sell an asset at a certain future time for a certain price. It can be contrasted with a spot contract, which is an agreement to buy or sell an asset today.

Q.10. What is Future Contract?

Ans. futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future for a certain price. Unlike forward contracts, futures contracts are normally traded on an exchange.