

Interest Rate Derivatives

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Derivatives

- Financial Derivative
 - Financial Instrument that is derived from the underlying real asset
- Derivative Instruments
 - Futures
 - Forwards
 - Options
 - Swaps
 - Caps
 - Floors etc

IR Derivatives

- IR Derivative
 - Derivatives that are derived from Cash Market or Reference Interest Rate
- Why IR Derivatives
 - Cheaper (less execution cost) than underlying instrument transactions
 - Quicker to adjust the portfolio positions
 - More liquid than the underlying instrument

IR Derivatives

- Popular IR Derivatives
 - IR Futures
 - IR Swap
 - IR Cap
- IRD Markets
 - Exchange Traded IRDs
 - OTC IRDs
- IR Categories
 - Short-term
 - Underlying security with maturity less than a year
 - Long-term
 - Underlying security with maturity more than a year

IR Futures

- IR Futures
 - Futures contract to buy or sell instrument at some future date
- Notional Coupon
 - Coupon rate on the underlying instrument
- Popular IRF Exchanges
 - CBOT
 - CME

Exchange Traded IRDs

- Treasury Bond Futures
 - Treasury Bond underlier
- Treasury Note Futures
 - Treasury Notes underlier
- Agency Note Futures
 - Fed Agency Notes like Fannie Mae, Freddie Mac etc
- Eurodollar futures
 - US Dollars deposited outside US
 - Based on LIBOR

IR Cap

- Buyer receives the money at the end of each period when interest rate exceeds the agreed strike price
- Used to protect borrower from adverse movements in interest rates
- Works as a Insurance
- Usually LIBOR is used as reference rate
- Equal to series of European Call Options
- Also referred as CAPLETS

IR Floor

- Buyer receives the money at the end of each period when interest rate falls below the agreed strike price
- Used to protect from lender from adverse movements in interest rates
- Works as a Insurance
- Usually LIBOR is used as reference rate
- Equal to series of European PUT Options
- Also referred as FLOORLETS