> The Art of riskart

HEDGING DERIVATIVES: SWAP WITH DYNAMIC FIXING

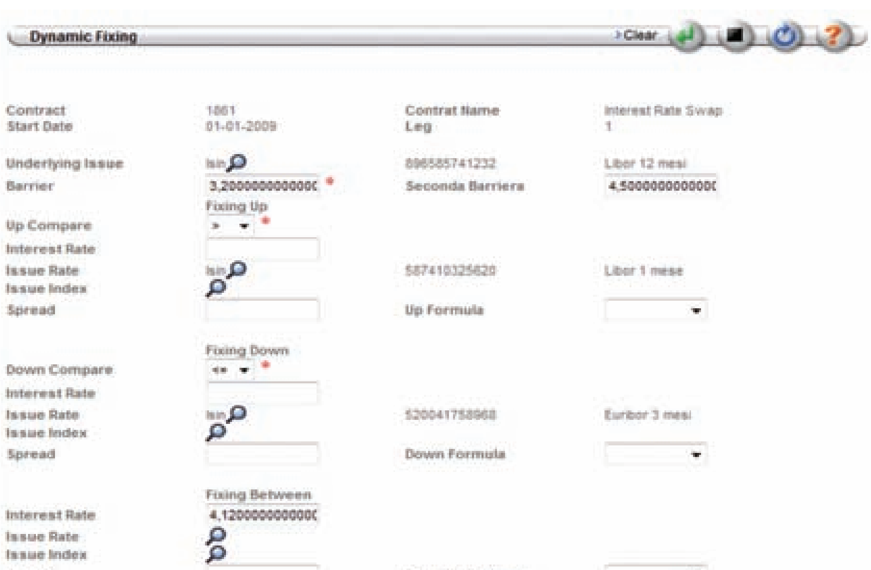
In the current economic climate, in which the focus is on either the variability of market rates and/or on saving financing or hedging costs, more and more financial market participants make use of ad hoc OTC hedging derivatives, which, given the effectiveness of their particular structure, solve the problem of protecting against market volatility in a cost-effective way.

Among these, the Barrier Swap, a structured OTC derivative, for which the profile of the periodic cash flows is the sum of standard financial instruments, is an example of a product for the management of hedging interest rate risks.

The Barrier Swap and, more generally, the swap with dynamic fixings, allows the transformation of fixed interest rates to variable (floating) rates (or vice versa) depending on the needs of the Asset Liability Management Policy. The hedge is activated upon the occurrence of certain conditions prevailing in the market of floating interest rates in exchange for a price lower than the swap under standard conditions (plain vanilla).

The financial player who resorts to the use of such an instrument exchanges the variable rate for a fixed rate lower than the prevailing market rate of a plain vanilla IRS contract of equal duration. Against such a reduction, the possibility is accepted that the hedging is suspended for one or more periods, if the fixing of the variable reference rate exceeds the specified levels set.

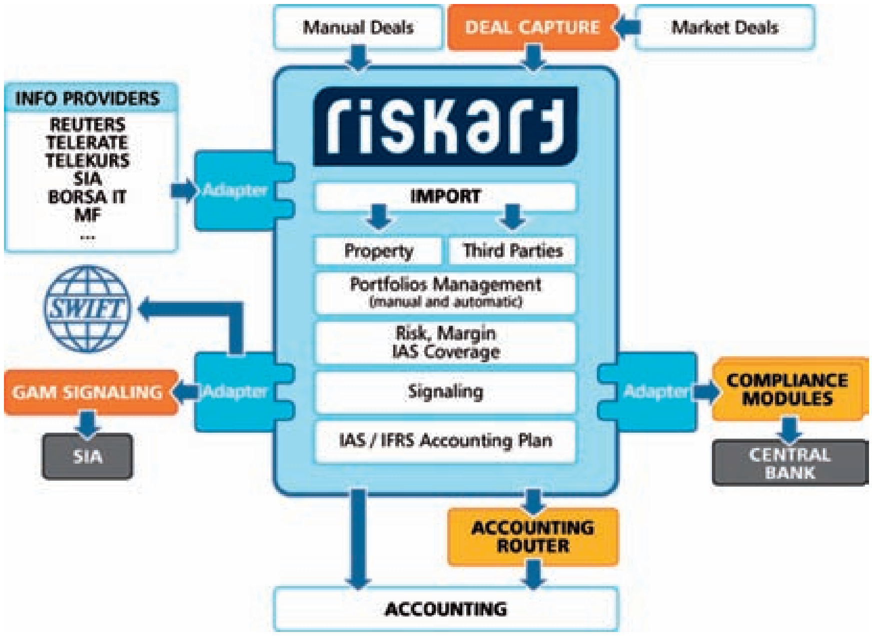
Such a result is achieved through a standard interest rate swap contract



combined with one or more embedded interest rate options (cap or floor) that, properly structured, contribute to shaping the financial risk profile that best fits the needs of the user, thus activating the hedge only if adverse fluctuations in interest rates are experienced.

The presence of options, standard or with barrier, defines the reference variable rate range; in some cases the use of options with a double barrier or digital makes hedging effective upon various levels, depending on the strategy chosen by the holder.

Another hybrid instrument, with more complex indexing rules than the Barrier Swap, is the Equity Linked Swap, used mainly by issuers of structured bonds who intend to hedge against the risk of embedded options. In its most common



form, such an instrument may be broken down into a plain vanilla IRS in which the parties exchange a fixed rate for a variable rate, and in one or more call options with underlying the reference index of the options embedded in the structured bond. The strike price of these options is reset at the end of each period .

The financial player who acquires such a contract achieves the objective of making a perfect hedge for the structured bond, making sure that the index value fluctuation of the equity linked component does not negatively impact the overall cost of financing.

Whatever the requirement of the financial player, from reducing interest or market risk or maintaining hedging costs as low as possible, the examples described show how the newly structured derivative products, while extremely flexible and adaptable to manage risk, contain highly complex features. <

The riskart solution

The riskart solution dedicated to operational support of derivative products offers itself as a tool designed to manage increasingly sophisticated structures available in the financial market place. The riskart approach provides the necessary flexibility through the use of specific parametering menues made accessible from the application itself. By minimising, or in many cases, removing the need to modify the programming code, it is possible to build structures for the management of cash flows generated by complex instruments.

Within the domain of swaps with dynamic fixing, riskart today is equipped with specific operating functionalities that allow to insert fixing contractual terms at the opening stage of each contract and subsequently fully automate the calculation of periodically exchanged cash flows, with the possibility of verifying market conditions to determine the applicable rate.

The main requirement dictating the implementation of these integrations has been the ease of use by end users: user-friendliness and intuitiveness of the applications are essential features when dealing with such complex instruments.

With these recent innovations, riskart is equipped to manage in an integrated manner Barrier Swaps, Equity Linked Swaps and other possible forms of dynamic fixing, including cases in which the determination of the applicable price to each individual cash flows depends on the use of more complex algorithms determining the activations of the barriers.

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