Nurturing Markets,
Widening Horizons

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MANAGING DERIVATIVE RISKS

THE TEN COMMANDMENTS

Before considering a derivative transaction:

1. **FORECAST:** Have a view on the markets.
   Build a credible scenario.
   Compare it with market consensus.

2. **ANALYSE:** Work out your cash flows and your risks under various scenarios.
   Determine your target cash flows if you are right and how much you are willing to lose if you are wrong.

Reviewing the derivative transaction:

3. **REPLICATE:** Reverse engineer the transaction by decomposing it into its basic building blocks. De-leverage it if necessary.
   Understand its implied trading strategy.
   Understand which variables have the greatest impact on the value of the transaction

4. **SIMULATE:** Compute the transaction's break-even and its evolution with the passage of time and under different scenarios.
   Compute the leverage over time and under changing scenarios.

5. **SCALE:** Determine the optimal size and leverage of the transaction.

6. **COMMIT:** Tie your dealer down to a maximum bid/ask spread, quote frequency and dealing size. What does his price represent – a dealing price or a theoretical mid-market valuation.
   Check his pricing methodology, his credit standing and check prices with other market makers.

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Approving the derivative transaction:

7. **AUTHORISE:** Who can commit the firm to a transaction, what and how much can he commit to, and with whom.
   Under what conditions can he commit the firm to a transaction especially new structures with which the firm is not familiar.

8. **LIMIT:** Determine the acceptable overall risk profiles over time. For markets risk, this includes risk limits for the "Option Greeks" i.e. separate limits for delta, Gamma Vega. For credit risk, there should be counterparty and concentration limits, collateral triggers and other sorts of credit enhancements in place.

9. **ESTABLISH:** Ensure that the appropriate systems, procedures, accounting, documentation and people are in place and able to keep abreast with the changing dynamics of a derivative transaction.

Entering into the derivative transaction:

10. **MONITOR:** Set individual adjustment points in advance: for e.g. stop-loss limits or profit lock-ins which trigger an automatic close out of a transaction once they are breached. Establish procedures and the people who have authority to override these automatic close-out triggers.

(Source: "Managing Derivatives Risks – The Use and Abuse of Leverage by Lillian Chew Checklist development with the help of the Finance Department of the University of Lausanne, Switzerland")