19BAE710-FINANCIAL DERIVATIVES

Swaps are financial derivatives that involve the exchange of cash flows or other financial instruments between two parties over a specified period. These agreements are typically used to manage risks, alter cash flow structures, or take advantage of comparative advantages in borrowing costs. Here's a brief overview:

1. **Definition:**
   - A swap is a financial contract between two parties to exchange financial instruments, cash flows, or other obligations over a predefined period.
2. **Parties Involved:**
   - There are usually two parties involved in a swap transaction: the "fixed-rate payer" and the "floating-rate payer." Each party commits to making certain payments or providing specific financial instruments to the other.
3. **Types of Swaps:**
   - Interest Rate Swaps (IRS): Involve the exchange of fixed-rate and floating-rate interest payments.
   - Currency Swaps: Involve the exchange of cash flows in different currencies, helping to manage currency exposure.
   - Commodity Swaps: Involve the exchange of cash flows based on commodity prices.
   - Credit Default Swaps (CDS): Provide protection against credit risk by compensating the buyer in the event of default.
4. **Interest Rate Swaps (IRS):**
   - The most common type of swap.
   - One party pays a fixed interest rate, and the other pays a floating interest rate based on a reference rate (e.g., LIBOR).
5. **Currency Swaps:**
   - Used to hedge or speculate on currency exchange rate movements.
   - Each party borrows in one currency and lends in another, exchanging interest payments and principal amounts.

6. **Commodity Swaps:**
    - Involve exchanging cash flows based on commodity prices, such as oil or agricultural products.
    - Used for hedging against commodity price fluctuations.
7. **Credit Default Swaps (CDS):**
    - Provide insurance against the default of a borrower.
    - The buyer pays a premium to the seller in exchange for protection in case of default.
8. **Objectives of Swaps:**
    - Risk Management: Swaps are commonly used for hedging against interest rate, currency, or commodity price risks.
    - Cash Flow Management: Swaps can be structured to alter the cash flow profile of debt obligations.
    - Speculation: Traders may use swaps to speculate on market movements.
9. **Counterparty Risk:**
    - As with any derivative contract, swaps carry counterparty risk. If one party defaults, the other may face financial losses.
10. **Notional Amount:**
    - The notional amount is the reference amount on which the swap payments are based. It is used to calculate the cash flows, but the parties do not exchange the notional amount.
11. **Termination and Settlement:**
    - Swaps typically have a fixed maturity, but they can be terminated early through mutual agreement or triggered by specific events. Settlement involves exchanging the final cash flows or market values.

In summary, swaps are versatile financial instruments that allow parties to customize their exposure to interest rates, currencies, commodities, and credit risks. They are widely used in financial markets to achieve specific financial objectives and manage risk exposures.