INTEREST RATE SWAPS

10 Myths and Misconceptions

Derivative Logic

The professionals at Derivative Logic have 60 + years combined experience on the trading floors of four major derivative dealers. During our countless discussions with clients from a myriad of industries over the years, we've seen a common set of falsehoods come up regarding interest rate swaps over and over again. In the following 2-minute read, we'll take a quick wade through interest rate swaps: 10 myths and misconceptions.

#1: "The bank is betting against me"

We hear this one all the time. The fact is the bank is mainly interested in earning fee income, not making bets. Think of it in this way: Is your stockbroker making a bet against you if they sell you a stock or bond? Of course not. The bank selling you the swap operates in the same way. One of their main motivations is to earn a fee or commission. They have no risk (unless you default on the loan and hence the swap) if the stock, bond or swap fall in value.

#2: "When unwinding a swap, the negative termination value isn't really a loss to the bank"

Part of this is true. When you refinance your floating rate bank loan and simultaneously terminate your swap prior to its maturity, it's just another opportunity for the bank to make money. When you're having to write a check to get out of an interest rate swap (in general, when current swap rates are lower than the fixed rate in your swap) the bank often charges you more than the true negative termination value of the swap. The same is true if a swap's termination value is positive and they are paying you to unwind it; they may pay you less than it's actually worth. However, if the swap value is negative and terminated at fair market value, it is a real loss to the bank, and they will expect you to make them whole.

For example, an investor buys a fixed rate bond for $1,000 with a 3.00% coupon and then has to sell the bond before it matures. Now assume, at the time of sale, that the same bond has a yield of 5.00%. Who would buy the 3.00% bond for $1,000 if they could buy the same bond yielding 5.00%? The seller of the 3.00% bond compensates the buyer for the existence of the higher yield by selling it at a lower price, below $1,000. The same concept is true with a swap, only in reverse.

#3: "The bank is earning more in interest because I have to write a check every month on the swap"

What if the bank was paying you because your fixed rate is lower than LIBOR, does that mean the bank is losing money? No. Simply put, if you are paying the bank on the swap, the bank is also paying someone on the other side of the transaction.

#4 "The ISDA is non-negotiable"

This is partially true. The swap contract between you and the bank is called the ISDA and comes in two parts: 1) The Master Agreement and 2) the Schedule. While the ISDA Master Agreement isn't negotiated – its sort of like a Webster's dictionary for derivatives – the Schedule should be, but often times is not out of sheer ignorance of the hedger. The Schedule is where the agreement gets "customized" to you as a hedger and your particular interest rate swap. If the bank ever tells you the ISDA isn't negotiable, is "standard" or "boiler plate", a siren should go off in your mind. You always have an opportunity to negotiate the Schedule and level the contractual playing field. Is it worth the effort? Absolutely, as banks typically offer ISDA agreements that, out of the box, are overwhelmingly in their favor.

#5 “Derivatives are risky”

You may recall Warren Buffet’s quote “Derivatives are financial weapons of mass destruction.” While certainly noteworthy, Mr. Buffet wasn’t referring to a borrower executing a derivative to manage interest rate risk when he made that statement. Employing a swap to fix a floating rate loan is no riskier than a fixed rate loan that includes make-whole provisions and/or pre-payment penalties.

Your risk is simply opportunity risk – you may have been better off floating. Among other benefits, interest rate swaps offer the hedger flexibility – a key feature in today’s economy – to diversify their floating rate debt by hedging an amount less than their full loan obligation or for a shorter term than the loan term*. In fact, for many borrowers, we would venture to say that a traditional fixed rate loan can be riskier than a floating rate loan fixed with a swap.*

#6 “Swap rates are transparent; anyone can find them”

Thank goodness for Dodd-Frank legislation. Now swaps are transparent because banks must quote mid-market and disclose their fees. What does the legislation say about how much a bank *can charge* in fees? Bottom line, it doesn’t. This isn’t so transparent and, in most cases, is quite difficult to quantify.

#7 "A pay-fixed Swap is the best method to hedge floating rate debt"

Banks tend to favor interest rate swaps because the fee income can be substantially higher than other hedging alternatives (i.e. rate caps, corridors, swaptions etc.). For some borrowers, a swap may not be the best solution to mitigate interest rate risk, and there can even be scenarios where a swap *adds risk, not reduces it*.

#8 "My bank is giving me a competitive rate"

How do you know? There is no way to verify that statement unless you can calculate risk exposure, credit value adjustment, and credit costs. Simply comparing the rate you're being offered to other lender's offers isn't enough. Knowing the lender's cost of funds and true risk in making the loan is the real way to negotiate.

#9 "I'm concerned if I hire an Independent Derivative Advisor, I may lose some negotiating power"

Would you feel the same way about hiring an attorney or accountant? The bank may say "You don't need to hire an independent advisor because that is what we do for our clients". Would the bank say the same thing about hiring an attorney?

#10 "Why hire an Independent Derivative Advisor when the bank can offer the same service"

Problem with this statement is that you are not receiving independent advice from the bank. Simply put, *the bank is trying to sell you something and it is your job to understand it*. Read the non-reliance clause in the last few pages of that snappy swap PowerPoint presentation the bank sent you, or in the ISDA Schedule. What do they say? They spell out in black and white that the bank does not have your interests at heart, that they are acting in their own interests and suggest you seek independent advice. Also, are you truly receiving the best hedging strategies available and at pricing appropriate based upon your credit profile or the risk of the swap? In these credit challenged times, what about your risk to the bank? What happens to your interest rate swap or rate cap if the bank goes under and the hedge has positive market value? How will you realize that gain if the bank no longer exists?

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Confused? Don't know where to start? Need more information? Get the edge you need by contacting us. We analyze swap requirements and perform pre- and post-LIBOR sensitivity analyses routinely to gauge the affects on your cash flows.

Interest rate swap strategy is often misunderstood. Despite what you may have been told, swaps are flexible ***and*** negotiable. Because Derivative Logic has mastery of theory and practical market realities, we insure you receive the most favorable terms for your situation.

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