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TAKING STOCK



HEDGING YOUR BETS WITH SWAPS

Everybody in the business world has heard of "hedging." It sounds great, but what does it really mean? A "hedge" is a protection against future risk. In a perfect "hedge" the party involved completely eliminates the potential for future gain or loss (e.g. the status quo is maintained). In the financial world, interest rate swaps are the most popular tool available for "hedging" against future movements in interest rates. Given the popularity of interest rate swaps in financial management today, it is hard to believe that this derivative did not exist as a tool until the early 1980's. Today, however, interest rate swaps are the most commonly used financial derivative and account for more than \$165 trillion in transactions according to figures maintained by the International Swaps and Derivatives Association.

An interest rate swap is only one of many types of swaps that are available in the financial world. Other types of swaps include currency swaps, commodity swaps, and equity swaps. All swaps, however, have in common the agreement to exchange one cash flow stream for another, e.g., "I'll agree to pay you X, if you agree to pay me Y". This article is intended as a primer on how these rather recently developed financial tools work.

PLAIN VANILLA SWAPS

An interest rate swap is a contractual agreement between two parties under which each agrees to make periodic interest payments to the other for a specified period of time at varying rates based upon an agreed upon notional principal amount. The most common form of interest rate is a fixed-for-floating interest rate swap. In a plain vanilla fixed-for-floating swap, one party – the fixed rate payor - agrees to pay interest at a fixed rate for a specified period of time to the other party, and the other party – the floating rate payor – agrees to pay interest at a floating rate (e.g. based on floating LIBOR or Treasury rates) over the same period of time. Normally, neither party will make the gross payments to the other – but rather the payments streams are netted periodically with the party owing the larger sum paying the excess amount to the other.

Fixed-for-floating swaps are useful for many reasons; however, one easy to understand use is where a borrower subject to a floating rate under a credit facility buys a swap to protect itself against a potential rise in rates. The borrower may "swap out" a portion of its floating rate interest payments for a fixed stream of interest payments. In such a transaction the borrower will be the fixed rate payor and will receive a floating rate stream equivalent to the floating rate it pays under its debt facility. In the event rates rise, the borrower has protected itself by capping the interest payments due on the portion of swapped debt. It should be noted that if rates stay low or decline and the swap is terminated, a payment may be due from the borrower upon termination (since there will be value attributable to a fixed rate

payment in excess of the current floating rate payments).

Alternatively, if floating rates rise during the term of the swap, the borrower will not only have capped its interest exposure on the swapped debt, but would also be entitled to a payment upon termination of the swap (since the floating rate payments will have greater value).

OTHER SWAPS

In other interest rate swap transactions, parties may exchange fixed for fixed rates or floating for floating rate payments or a party may lock in a forward interest rate in anticipation of a future debt issuance. A forward rate agreement is essentially an interest rate swap for one specified period of time of predetermined length (i.e., lock-in at six months forward for a period of one-year). This type of instrument can be used by a company with seasonal borrowing needs or a company that knows it has an upcoming capital projects that it will fund with debt. If the company believes interest rates will rise during this period (or wants to protect itself from potential rising rates), it can essentially buy a swap where it will be the fixed rate payor commencing in the future period of time and the counterparty will be a floating rate payor for the same period. If interest rates rise as expected, the value of the agreement increases for the company and it will have essentially locked in its borrowing cost at the lower fixed rate amount.

In addition, interest rate swaps may be structured in conjunction with currency swaps utilizing different foreign currencies in order to take advantage of fluctuations and rates in various foreign markets. Interest rate swaps may also be structured with various features that increase their utility, including "caps" or "floors" whereby a counterparty to the swap is guaranteed a maximum limit or minimum amount with respect to a floating rate (and the other party would pay the difference), and "swaptions" which gives the holder an option to purchase a swap at a future time.

HEDGE FUNDS AND SWAPS

While banks are the largest participants in swap transactions, hedge funds have now become the second largest user of swaps. Hedge funds are attracted to the swap markets by the leverage made possible by swaps and the ability to lock-in higher investment returns for specified risk levels. Hedge funds, which basically pool money from wealthy individuals and institutional investors in order to invest in stocks, bonds, foreign currency and derivatives, generally seek higher rates of return for the capital they have under management. Various types of hedge funds will take down swaps to make directional bets based on movements of interest rates or enter into forward rate agreements to take advantage of perceived pricing or irregularities in the market, all for the purpose of increasing the returns on their managed portfolios. Swaps are also widely used by pension managers, insurers and corporate treasurers to hedge against rising rates, match fund asset and liability positions, and to otherwise manage risk. Swaps are also entered into purely for arbitrage by those familiar with or wishing to exploit variations in different financial markets.

STANDARD FORM OF SWAP AGREEMENT

The International Swaps and Derivatives Association, formerly known as the International Swap Dealers Association (ISDA), was formed in 1985 to promote uniform practices in the writing, trading, and settlement of swaps and other derivatives. One of its most important accomplishments was the development of the standard Master Agreement for use in swap transactions. The utilization of a single form of Master Agreement allows parties to conduct multiple swaps without re-negotiating terms and allows swap transactions to be consummated in an expedited manner. The ISDA Master Agreement was most recently updated in 2002 and includes updated provisions dealing with events of default and a single method for calculation of payments upon early termination.

THE UNAVOIDABLE RISKS

While interest rate swaps are all about managing risk, there are certain risks that are inherent in any swap transaction. These risks include (a) the market risk of the transaction – e.g. the value of the swap based on the movement of forward rates and whether the swap will be "in the money" or "out of the money" in the event of termination of the swap, (b) credit risk in the transaction based upon the creditworthiness and ability of the counterparty to any swap to be able to satisfy resulting obligations – which risk can be mitigated by collateralizing the swap, (c) managerial risk in the ability to timely monitor and administer swap transactions, and (d) legal risk in the event of the incapacity or lack of authority of a party to a swap or the default or breach by a counterparty to the transaction. All of these risks must be considered and managed as part of a swap transaction.

As interest rates continue their upward movement, the use of financial derivatives will continue to be a necessary tool in corporate treasuries and financial institutions worldwide in order to provide a hedging mechanism against the movement of such rates. It is a certainty that the volume of interest rate swap transactions will continue to grow in the years ahead. An understanding of the uses and issues involved in utilizing this important tool is an imperative for any company competing in the global marketplace.

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