

“On the same day, two borrowers closed loans and fixed their rates using identical interest rate swaps. It will cost one borrower \$63,000 more than the other... and he’ll never know the difference.”

INTEREST RATE SWAPS A BORROWER’S WHITE PAPER

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- If purchased correctly, a swap should be a borrower’s most effective method of fixing a loan rate to hedge against interest rate exposure.
- The reporting of swap contracts is uncontrolled and the profits are unknown to the borrower. Banks often take advantage of these facts to maximize their income.
- Borrowers can take measures to assure fair pricing when purchasing and unwinding swaps.

WHAT IS A SWAP?

An interest rate swap is a way for a borrower to fix the rate of a floating rate loan. When a borrower enters into a swap, he is essentially buying a “futures” contract. The price of the swap is a calculation of the market’s anticipation of 30 day Libor over the swap term. The borrower agrees to pay that fixed rate during the term of that swap rather than paying 30 day Libor. It’s like buying a futures contract on orange juice with one big difference. Your orange juice futures trade is reported to you. You know at what price that contract was executed and how much you paid to the broker for that execution. With a swap, the bank’s trade information is not reported to the borrower who cannot verify cost and profit.

THE FIXED RATE DIFFERENCE

If purchased correctly, a swap should be a borrower’s most effective and fair way to hedge interest rate exposure. It has a distinct advantage over a bank fixed rate with a prepayment penalty because it has a “two way” make-whole provision. In other words, if you pay your loan ahead of schedule, the bank will make a unilateral determination of the value of the remaining swap contract. If rates have declined, you will owe money, but if rates have increased, you will receive money. With a bank fixed rate, you will pay the penalty defined in your loan documents regardless of rate movement. That is known as a “one way” make-whole. In fact, many banks will enter into a swap contract to hedge the loan without the borrower ever knowing. The bank then writes the prepayment language so that the borrower pays even if rates increase, and the bank keeps the upside for itself.

THE BANK’S PROFIT

When a bank books a swap, it is entitled to a profit. First of all, it has to pay for the department that performs that function. Moreover, there is a credit risk that the bank is assuming with that contract and they must be compensated for that risk. The problem is that the profit that the bank takes is completely discretionary and, without a Hedge Advisor, the borrower is unaware of what profit was added by the bank.

A BASIS POINT IS A TERRIBLE THING TO WASTE

It is not unusual to have a difference of 30 to 40 basis points in the pricing between identical swaps priced for different borrowers. In the case mentioned at the start of this paper, a borrower on a loan of \$6 million paid 14 basis points more on a 10 year swap than the other borrower. The net present value of each basis point is roughly \$4,500. In this case, the one borrower paid \$63,000 more for his swap than the other. It is particularly easy for the bank to hide this because the market may fluctuate by as much as 20 basis points or more on any given day and several basis points in the span of a minute. If the market moves in favor of the bank while the trade is being executed, it is commonplace for the bank to keep the additional profit for itself. However, when the market moves against the bank during the time of execution, the bank will advise the borrower and the additional basis points will be added to the swap rate. Unless a Hedge Advisor is on the phone and monitoring the market, the borrower will never be sure of the bank's profit level.

COMING AND GOING

In addition to making a profit when the swap is booked, the bank will seek to make additional profit if a loan is prepaid. When a borrower pays a loan early, the swap language will generally require that the swap be terminated. The bank will determine the value of the swap in the market; this is known as "marking to market". Let's say that the market for that swap is positive by \$120,000. This is how much the borrower should be paid by the bank. However, the bank may decide to take whatever profit it deems reasonable and tell the borrower that its market value is \$85,000. In this case, the borrower would have paid another \$35,000 to the bank and never realized it. This is particularly unfair to the borrower because there is no justification for this extra profit. Any cost of the trade has been more than offset by the bank's being relieved from the risk for which they had been compensated when the swap was purchased.

AND EVERYTHING IN BETWEEN

Any time there is any modification to the terms of a swap there is a trade, which provides an opportunity for the bank to take additional profit. Banks will often say to borrowers who would like to extend the term of their loan that they can "blend and extend" the swap. Once again, the borrower assumes that there is no cost when, in fact, the bank often uses the trade to increase the profit once again. CMAC recently requested a Hedge Advisor value a swap that was executed by a medical group in Tennessee. The swap had been booked to start at the estimated time of the completion of the project. The Hedge Advisor determined that the bank made a sizeable profit on that initial swap. When the project was delayed, the bank suggested that the swap be reset and, without any knowledge of the client, added additional profit of \$50,000 to a swap only a few months old.

OUTFOXING THE FOX

There are borrowers who feel that they have a good understanding of the swap market and will refer to sources such as Bloomberg to "keep the bank honest". In truth, once the bank knows that the borrower is following a reporting service, they know that they can charge a higher profit, because Bloomberg rates are based on un-amortizing semi-annual coupons which have a higher price. The borrower does not see that a larger than normal profit was added for the bank.

CHOICES

Understanding the importance of swap revenues to the bank will also help the borrower to understand that the bank is not necessarily providing the best advice in terms of hedging strategies. The longer and larger the swap, the more money that is made by the bank. That is hardly a recipe for objectivity. It may be best to hedge only a portion of the debt, to ladder the swaps or to combine a swap and a cap. There are many

alternatives and the right choice should involve an analysis by an expert acting only on behalf of the borrower... an independent Hedge (swap) Advisor.

ANYTHING BUT BOILERPLATE

When selling a swap, the bank will routinely send a set of documents described as “boilerplate” to be signed by the borrower. These are as important as any loan document and they are anything but boilerplate. Unfortunately, there are few attorneys with expertise in derivatives contracts and so these swap documents, like the swap pricing, are accepted as a matter of trust. That is a mistake. The swap “schedule” is an essential document that contains crucial terms that can control every aspect of your contract. It may specify the process and conditions for unwinding your swap, define conditions of default and termination, as well as conditions under which the swap could be transferred or assigned. These and many other terms could translate to hundreds of thousands of dollars. A Hedge Advisor will negotiate these terms and have his own attorney review the borrower’s swap documents to assure equanimity in the contract.

THE EQUALIZER

Hedge or Derivative Advisors are people in the financial sector that represent borrowers in these transactions. An independent Hedge Advisor has the expertise and tools to ensure that the borrower is employing a hedge strategy that will most likely achieve his objectives and make sure that the costs and profits of all transactions are completely transparent. The Hedge Advisor employs the same computer models and receives the same ongoing market information as the banks themselves. A good advisor will also provide ongoing services such as swap valuation during the life of the contract.

WHO ARE THESE PEOPLE?

Just as many of the best defense lawyers probably started out their careers as DA’s, the best swap advisors often came from the bank’s derivatives area. They know the ins and the outs and, quite often, they know one another. Although the borrower is most often in a position where the swap can only be purchased from the lending bank, the mere presence of an advisor will result in that bank behaving more responsibly. With an Advisor, acceptable profit margins will be negotiated beforehand and the advisor will monitor the trade by telephone during execution to confirm the cost and profit. The advisor will assure that there will not be additional profits taken at the time of modification and that valuation will be determined by a bidding process rather than a unilateral decision of the bank. Advisors are very inexpensive compared to the value that they bring and there are typically no out of pocket costs, as they are generally built into the rate and paid by the bank. As with any service provider, the borrower should always request and check references of any advisor.

THE BOTTOM LINE

Swaps can be a borrower’s most effective tool in hedging interest rate exposure by replacing floating rate debt with fixed rate debt. They have an advantage over a fixed rate from the bank because the bank fixed rates generally carry a prepayment penalty no matter if rates rise or fall, while a swap would pay the borrower if rates rise. However, because of the hidden nature of the costs and the complexity of the documents, the expertise of a Hedge Advisor is needed to assure agreed pricing at execution and that those other advantages will not be diminished by the terms of the swap schedule.