INTEREST RATE SWAPS

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Recent developments in international financial management techniques enable borrowers with less than the highest credit ratings to access medium-to-long term fixed rate international capital markets. The technique — known as interest rate swaps — may also enable some borrowers to minimise the cost of borrowing in such markets. The article outlines the interest rate swap concept and examines the advantages and disadvantages associated with the technique. The article also examines potential use of interest swaps by Australian organisations.

BACKGROUND

Volatility in short term interest rates in recent times has served to highlight the need for corporate treasurers worldwide to lock in medium to long term debt at fixed rates. But even as corporate borrowers look increasingly to obtain long term fixed rate debt funding to protect corporate profits from fluctuations in short term interest rates, the international bond markets, as a part of what commentators have dubbed “the flight to quality”, are rejecting all but the highest quality borrowers.

However, recent developments in financial management techniques make it possible for corporations with less than the highest quality credit ratings to raise long term fixed rate funds through a complex mechanism known as the Interest Rate Swap. The concept, which derives from the now familiar technique of currency swaps allows companies with less than the highest quality credit ratings to take advantage of international bond markets to raise long term fixed rate finance which would not otherwise be available to them.

Where access to international bond markets is available to the particular borrower the use of interest rate swaps would normally enable the borrower to obtain funds at a rate somewhat below that it would have had to pay had it assessed the market directly. A corporate borrower with the highest quality credit rating may also utilise the technique to obtain a better deal on interest rates than it could obtain through a normal fixed rate bond offering.

THE INTEREST RATE SWAP CONCEPT

In its simplest form, the interest rate swap involves two parties in search of funds; one a corporate borrower with a mediocre credit rating (the equivalent of a double or triple B rating from any of the major US rating agencies) and the other a borrower — almost invariably a non-US bank in need of dollars to fund Euro-dollar loans — with the highest quality credit rating (a triple A rating is obligatory). The parties to the swap are generally brought together by an investment or commercial bank which acts as a broker to the transaction.

The lower rated company borrows from a bank or consortium of banks on a standard Euro-currency “roll-over” loan at a floating rate usually set at a margin over the London Inter Bank Offered Rate (LIBOR). At the same time, the higher rated borrower — the bank — issues a fixed rate bond offering. The broker then matches the two loans and arranges for the two borrowers to swap loans and interest payments.

Under the terms of the swap, the lower rated company usually pays the fixed rate of the bond offering together with the margin over LIBOR on its loan. The higher rated company is left paying only LIBOR, saving it the spread over the Inter Bank Rate it would normally have had to pay.

Borrowers on both sides of the swap generally have separate contracts with the broking bank, which for a fee, guarantees that the interest charges, although not always the principal will be paid. The swaps may be anonymous and the partners to the swap may only be known to the broking bank.

† The views and opinions expressed in the article are those of the author and do not necessarily reflect the views and opinions of the Commonwealth Banking Corporation.
1. **AN EXAMPLE**

Let us assume, for example, that Company A wishes to obtain $50 million in fixed rate funding for seven years from the Euromarket. However, the company because of its credit rating either does not have access to the international bond market at this time or that it could only have access at a rate which it considers prohibitive. In these circumstances, Company A decides to enter into an interest rate swap.

The Company borrows $50 million from a group of banks for seven years at LIBOR plus 5/8 per centum by way of a normal syndicated Euro-currency loan. Simultaneously a non-US bank, Bank B, borrows $50 million in the Euro-bond market paying a fixed rate of 14.25 per cent per annum. A swap is then arranged by the broker. The transaction leaves Company A to pay as interest the fixed 14.25 per cent per annum on Bank B's bond plus the 5/8 per cent margin on its own floating rate loan for an effective fixed cost rate of just under 15.00 per cent.

In addition, both parties in the swap pay a one-time-only fee of around 0.5 per cent for the transaction to the broker. The less credit worthy company — Company A in our example — may in addition have to pay a negotiated fee of between 0.25-0.50 per cent to the broker giving an effective cost of funds to it of just over 15.00 per cent. If Company A was a double B or triple B rated borrower, given the usual margin of 1.5-2.0 per cent between triple A companies and double B or triple B borrowers, the company will have effected a cost saving of at least 0.5 per cent per annum.

2. **ADVANTAGES OF INTEREST RATE SWAPS**

Interest rate swaps have significant advantages for all parties involved. For the lower credit rated company, the interest rate swap provides access to fixed rate long term funds which it previously may not have enjoyed.

Where the lower rated borrower enjoyed access to the international bond markets, the interest rate swap would normally provide it with funds at a cheaper rate than if it had tapped the market directly. With the flight to quality in the international bond market gathering momentum, the spread between borrowers with the highest quality credit rating and borrowers with lower rating (between for example a triple A and a triple B borrower), is considerable — in the order of 1.5-2.0 per cent — and interest rate swaps can effect savings in the order of 0.5-0.75 per cent per annum.

For the higher rated participants in interest rate swaps — generally as noted earlier, non-US international banks — such transactions can provide funding at extremely competitive rates. Interest rate swaps generate money for banks at or slightly below LIBOR. In fact there have been instances where interest rate swaps have generated funds for banks a full 0.25 per cent below LIBOR.

In view of the narrow margins at which banks lend in the syndicated Euro-credit market the funding advantage provided by participating in swaps is important to the profitability of non-US banks without a natural dollar deposit base. The higher rated borrowers' only risk in an interest rate swap is the unlikely possibility that LIBOR will average more than the interest rate on the fixed rate bond offering for the full term.

For the investment bank or commercial bank acting as a broker to the deal, such transactions are an important new source of fee income. The major US money centre banks and investment banking firms are particularly prominent in this field. For the banks the fee income is especially welcome as it does not generate balance sheet assets and assists the banks to lift their return-on-assets ratios.

The major drawback to interest rate swaps is the amount of time it takes to complete a transaction. Legal documentation in respect of interest rate swaps is complex and must generally be tailor-made to the individual transaction. The complexity of these transactions results often in delay and in swiftly moving international money markets the delay can impact unfavourably on a transaction.

3. **SIZE OF THE MARKET**

While the concept is still in its infancy, market estimates suggest that approximately $1 billion in interest rate swaps have been completed. This estimate includes only known public issues and must be regarded as conservative as a significant but unknown number of private transactions are also thought to have been completed during the period. Another market estimate puts the size of the total market at around $5 billion.

Participants in interest rate swaps seeking fixed rates have typically include US utilities, financial, and oil and gas companies. The main participants seeking a
floating rate have, as noted earlier, been foreign banks although US banks such as Citibank, Bankers Trust and Morgan Guaranty, as well as some industrial companies, are also understood to have been active.

The major Japanese banks, including Long Term Credit Bank of Japan, the Nippon Credit Bank and Sumitomo Bank, are among the organisations that have participated as the higher rated party in interest rate swaps. The Japanese banks have emerged as particularly good candidates for the fixed-rate side of interest rate swaps, being attracted to the prospect of obtaining floating rate funds at or slightly below LIBOR, as traditionally the Japanese Ministry of Finance has discouraged banks from taking on fixed-rate commitments in foreign currency and the banks have often tended to pay a slight premium when refinancing variable rate borrowings.

Others are thought to include Banque Indosuez, Bank of Montreal, Toronto Dominion Bank and Deutsche Bank. These banks which have been infrequent borrowers in the fixed rate market in the past are regarded as extremely good credits and are entitled generally to favourable rates for seven year fixed rate funds. This enables them, even after taking into account the spread on LIBOR paid by the lower rated party to the swap, to provide funds at a rate which is extremely competitive when compared to the rate that the lower rated borrowers would have had to pay had they accessed the bond market directly.

As interest rate swaps have become more commonplace, several variations of the concept have evolved. In one variation, no new money is raised at all and both sides to the swap use existing debt. In another variation, banks have funded the fixed rate portion of the swap by private issues of long dated certificates of deposit. Another possibility involves the corporation swapping fixed rate money against fixed rate money if one side no longer needed old debt and wished to fix the rate of cash invested short term thereby locking in a rate on investments.

The interest rate swap concept can also be extended to encompass exchanges of fixed rate debt in one currency for floating rate debt in another currency. For example, fixed rate Swiss Francs may be swapped for floating rate US dollars. This action may be used to effectively alter the currency denomination of a borrower's exchange rate exposure. In this form, an interest swap may be combined with a long term currency swap.

**INTEREST RATE SWAPS: AUSTRALIAN POTENTIAL**

There is considerable potential for Australian borrowers to use interest rate swaps.

Access to the international bond market has traditionally been available only to federal and state governments, major semi-government bodies and the largest Australian companies. Other borrowers have borrowed off-shore by way of medium term “roll-over” Euro-currency loans generally at margins over LIBOR. Such variable rate borrowing carries with it an element of interest rate risk.

Interest rate swaps would allow these borrowers traditionally without access to the international bond markets to obtain significant amounts of fixed rate debt funding, cushioning them from wide swings in short term interests rates, in off-shore money markets. Even where international bond market access is available, the lower cost of interest rate swaps makes this technique attractive to Australian borrowers. In addition, a borrower who does not wish to go through the lengthy “introduction” process necessary as a prelude to an international bond offering for all but the best known names in the market, may find the speed and anonymity of interest rate swaps advantageous.

Semi-government bodies with their preferences for fixed rate funds may find interest rate swaps particularly attractive. The semi's who are increasingly borrowing in overseas markets, could use swaps to obtain medium to long term fixed rate debt funds in international bond markets at very competitive rates without the need to make a public debt offering.

The major Australian trading banks are also potential participants as the higher credit rated party to such swaps. The banks who have become increasingly active in international lending are likely to use swaps to obtain US dollars to fund Euro-currency loans at a significant cost advantage.

The banks which lack a natural US dollar deposit base generally fund their syndicated international lending in the interbank money market. Given that they must pay a margin of around 1/8 per cent over LIBOR together with assorted commissions and fees, syndicated loans at margins as low as 3/8 per cent to 0.5 per cent are only marginally profitable. Interest rate swaps, by enabling these banks to obtain funds at or slightly below LIBOR, can provide a sizeable funding advantage for the banks.
In theory, there is potential for the use of swaps within the domestic Australian market. However, the absence of a significant long term fixed rate bond market for non-governmental debt, means that such swaps are unlikely.

The interest rate swap concept seems likely to remain a part of the international money market as long as attractive arbitrage opportunities exist in interest rates and such swaps represent an important additional funding option that Australian treasurers in both the private and public sectors will have to seriously consider in the future.

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SELECTED BIBLIOGRAPHY


BOOK REVIEW

"GOLD: World Supply and Demand"
by

M.H. Govett and M.R. Harrowell

Australian Mineral Economics Pty Ltd

Gold is big in the investment picture, and this large volume matches that description in every way: 480 pages, 171 separately cited references, 8 appendices, hundreds of tables, 14 flowsheets, and 45 other figures.

A compendium of useful gold facts, statistics and opinions, copies of this work will be well-thumbed by investment managers, analysts, cost engineers, geologists, speculators and perhaps even national governments. This is a book which readers will have to learn how best to use. One of its best values is as gold reference work, and it will be prized by analysts accordingly.

In international terms, AME’s gold work may be one of the best such volumes ever commercially available, even though critics may claim that very much of the data is otherwise available and already to hand: yes, but probably on not such a cost-effective basis. Though international, it has a good deal of Australian content.

Given the manner in which such a book will be used, the absence of an index is a pity, and this could well detract from even wider purchase of the volume, for example by institutional share-dealers in addition to their research colleagues.

The work is entirely relevant to the fundamentals of gold, gold mines, and gold share analysis. Readers will hope for occasional sectional or comprehensive updates, and possible expansion. Whereas the Consolidated Gold Fields study “Gold 1972”, and its updates may have been the standard work of the 1970’s, AME Gold could be its replacement of the 1980’s. It is much more practical than the esoteric September 1981 H.W. Brock study sponsored by Anglo American Corporation on “The Future World Price of Gold”, largely because source data is so freely provided and detailed.

The conclusions appear fairly and usefully drawn, even though they come at the end of 17 very detailed summary pages. Examples of useful presentations included relate to cost-competitiveness, future world projects and production, detailed marketing arrangements, and even speculative projects.

“GOLD: World Supply and Demand” is a helpful volume that many JASSA readers will want to keep either under lock and key, or open at their fingertips.

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This publication is available from Australian Mineral Economics Pty Ltd, G.P.O. Box 3602, Sydney, N.S.W. 2001. Price A$275, including airmail postage.