UNIT 3- Interest Rate Swaps

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- An Interest Rate Swap is a contractual agreement between two parties who agree to exchange the future interest rate payments that they make on loans or bonds. The two parties are banks, businesses, hedge funds or investors.
- The two common Interest Rate Swap is Fixed Interest Rate Swap and Floating Interest Rate Swap. The Fixed Interest Rate Swap means where one party 'A' will make payments to the other party 'B' based on an initially agreed initially of interest, to receive back payments based on a floating interest rate index. The Floating Rate is a reference rate that is London Interbank Offered Rate or LIBOR.

For Example

Shyam owns a $200000 investment that pays him LIBOR + 1% every month.As LIBOR goes up and down so the payment Shyam receives

changes. Now, suppose Gaurav owns a $200000 investment that pays him 1.5% every month. The payment he receives never changes. Now, Shyam decides that he would rather lock in a constant payment and Gaurav decides that he would rather take a chance on receiving higher payments. So, Shyam and Gaurav agree to enter into an Interest rate Swap contract.

Advantages of Interest-Rate Swaps:

- An Interest Rate Swap helps companies to hedge against interest rate subjection by minimizing the uncertainty of future cash flows.
- An Interest Rate Swap allows companies to revise their debt conditions to take advantage of current or expected future market conditions.
- An Interest Rate Swaps are used as financial tools to lower the amount needed to service a debt.
- Interest Rate Swaps allow companies to take advantage of the global markets more efficiently by bringing together two parties that have an advantage in different markets.
- Interest Rate Swap agreement can reduce uncertainty. If a company has a floating rate loan, they may not know what sort of interest rate payments they will be paying throughout
- the duration of that loan. The floating rate could increase or decrease and it could devastate the finances of the company. In order to annihilate uncertainty, the company could
- enter into an interest rate swap agreement with a bank that allows the company to make fixed payments instead of variable payments.
- An Interest Rate Swap can also minimize the coast of a loan. A company may be able to enter into an interest rate swap that allows it to pay a lower fixed interest rate to a swap trader
- than it would have had to pay for a fixed interest rate with a lender.
- An Interest Rate Swap has more transparent pricing and has no credit risk since the exchange stands in between the counterparties.
- An Interest Rate Swap obtains a lower cost of funding.
- Swapping allow issuers to re-examine their debt profile so that advantage of current or expected future market conditions can be taken.
- If interest rate decline, Swapping from fixed to floating rate may save the issuer money.
- Interest Rate Swaps are a financial tool that has a perspective to help issuers lower the amount of debt service.

How to Invest in Interest Rates Swaps?

Interest Rate Swaps has become an prominent tool for many types of investors, as well as corporate treasures, risk managers and banks because they have ample of potential uses.

- **Portfolio Management:** Through Interest Rate Swaps the portfolio managers can regulate interest rate exposure and counterbalance the risks caused by interest rate volatility. The long-dated interest rate swaps can increase the duration of a portfolio and makes them an effective tool in Liability Driven Investing.
- **Speculation:** The Interest Rate Swaps require a little capital upfront, they give fixed-income traders a way to speculate on movements in interest rates while possibly avoiding the cost of long and short positions in Treasuries.
- **Risk Management:** Banks and financial institutions are involved in a tremendous number of transactions which involve loans, derivatives contracts and other investments. The bulk of fixed and floating interest rate exposures typically cancel each other out, but any remaining interest rate risk can be counterbalance with interest rate swaps.
- **Rate-locks on bond issuance:** When corporations or organizations decide to issue fixed-rate bonds, they usually lock in the current interest rate by entering into swap contracts that give the time to go out and find investors for the bonds. Once they actually sell the bonds,they exit the swap contracts.

What are the Risks:

- Interest-Rate Swaps involve two primary risks: Interest rate risk and Credit risk which is also known in the swaps market as counterparty risk. Actual interest rate movements do not always match expectations, swaps need interest-rate risk. A receiver(the counterparty receiving a fixed-rate payment stream) profits if

interest rates fall and loses if interest rates rise. Contrary, the payer(the counterparty paying fixed) profits if rates rise and lose if rates fall.

- Swaps are also subject to the counterparty's credit risk, the chance that the other party in the contract will default on its responsibility. This risk has been partially reduced since the financial crises, with a large portion of swap contracts now clearing through central counterparties (CCPs).

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