

## INTEREST RATE SWAPS MAY BE A GOOD DERIVATIVE

There has been a lot of criticism of late about financial derivatives and how they played a role in inflicting substantial damage on the economy. There has even been legislation recently enacted back in Washington for regulating derivatives to a degree. What is a derivative? A derivative is a financial product that is said to derive from an underlying market dealing with currency, interest rates, equities and the like. Contrary to popular belief, maybe not all derivatives are bad, and some may be quite useful. We had an opportunity recently to assist a client who was concerned about rising interest rates in the future in connection with a sizable real estate loan with a variable interest rate. The client wanted some protection against a drastic rise in future rates that would negatively impact the transaction and cash flow. So the client went to its bank and in connection with obtaining the real estate loan at the going commercial rate, it also entered into an interest rate swap agreement with its lender in an effort to protect itself against future rate increases over a period of time. While the notional amount under the interest rate swap agreement often equals the principal amount under the loan agreement, there is no mandate that it must do so. And the bank's client can enter into a swap agreement for a portion of the loan balance, thereby making it partially fixed with the balance floating.

### Overview of How It Works

How does such a transaction work? Here is a very short and simple overview of what is involved and what some of the inherent risks are. The borrower goes to its bank and is offered a floating rate loan for, say, a twenty year term on a real estate project. The bank's customer is concerned that with government spending as it is and the likelihood of inflation as the economy recovers, it has financial exposure to a substantially higher floating interest rate down the road that would negate all of its cash flow projections and the economics of its deal. So in order to "hedge" its risk, the borrower asks its bank if they can offer an interest rate swap transaction on a notional principal amount that would mirror the actual principal amount borrowed under the loan documents. The bank says it can accommodate its customer's needs. This swap transaction is really an exchange of cash flows whereby the borrower agrees to pay the bank a fixed-rate interest amount pursuant to which swap agreement while the bank commits to pay its borrowing customer a floating rate on the notional principal amount. So in principle, the borrower has effectively swapped its variable or floating rate for a fixed rate. The negotiated fixed rate is going to reflect what the market expects the floating rate, on average, to be in the future. While in the beginning the net interest payable under the two transactions will favor the bank under the scenario outlined above, over time that trend would likely reverse under the rising interest rate scenario so that downstream the payments would favor the borrowing customer. The anticipated result is that over time,

the borrower will be able to average out its interest costs and enable it to have more predictable financial results.

In a simple example which assumes a lower variable rate of interest at the present time, the bank's customer pays its bank the lower variable rate of interest under its real estate loan agreement. Under the swap agreement, the customer will pay its bank additional moneys representing the difference between the higher fixed and lower variable rates of interest as long as the fixed rate exceeds the variable rate. Five years down the road and assuming that the variable rate of interest has by then substantially increased, the bank would be paying its customer under the swap agreement the difference between the then-higher variable rate and the then-lower fixed rate. So this swap transaction is really geared to enable the bank's customer to manage its interest rates.

**\$10 Million Loan Example**

**10 Year Term Swap (7.00% Fixed Rate, 25yr Amortization)**

Swap Early Termination Estimates (thousands)

Replacement Swap Rate	Years Remaining to Maturity			
	8yrs	5yrs	3yrs	1yr
8.50	820	530	330	110
8.00	560	360	220	80
7.50	280	180	110	40
7.00				
6.50	(300)	(180)	(110)	(40)
6.00	(600)	(380)	(230)	(80)
5.50	(920)	(570)	(340)	(120)

Documentation Involved

What sort of documentation is involved to do an interest rate swap agreement? In addition to the documentation for the traditional loan transaction, the swap transaction contains several well-defined components to the overall transaction. The basic document is the International Swap Dealers Association (ISDA) 1992 Master Agreement, which contains many standard and non-negotiable terms. Attached to this agreement is the ISDA Schedule to the Master Agreement, which contains more particulars to the specific transaction and which options and quotations will apply to the particular transaction. Finally there is the Confirmation of Swap Transaction which sets out specific financial terms applicable to the transaction at hand.

## Risks to the Borrower

Are there any risks for the borrower? Yes, as in any financial transaction, there are some risks to consider. One risk is whether the customer's bank will be able to financially perform its end of the bargain. If it isn't, the borrower should not necessarily expect the FDIC to pick up the terms of the swap agreement as no government entity is obligated to insure that derivative obligation. If, in the example above, the future variable interest rates go down instead of up, the borrower may wind up owing the bank more money than anticipated. Under that scenario, the bank's customer would be paying the variable rate of interest under the loan documents and also the difference between the higher fixed rate and the lower variable rates of interest. Also, following the example above, if the borrower wants to dispose of the property and pay off the loan prior to the expiration of the term, it is not relieved of its financial responsibility under the swap agreement, which will require a buyout payment under the terms of the interest rate swap agreement. Depending on then-applicable interest rates at the time of prepayment, the customer may owe the bank a sizeable fee or the customer may have an amount owing from the bank. There may also be a termination or default event which occurs, which will also mandate a calculation of the termination amount payable by or payable to the borrower. Since the interest rate swap agreement is cross-defaulted and cross-collateralized with the underlying loan transaction, a borrower needs to be aware of all possible ramifications of entering into an interest rate swap agreement.

While it is beyond the scope of this article to present a comprehensive analysis, a schedule is attached which demonstrates the implications of what might occur upon a termination of the interest rate swap agreement by the counter party because of some default or termination event that occurs. The schedule shows what cost the defaulting party would have to pay or would be entitled to receive as a termination payment depending on the replacement swap rate applicable at that time of default or termination event as compared to the fixed rate of interest and how many years until maturity. Replacement swap rates greater than the fixed rate of interest will impose an additional obligation on the borrower, while a replacement swap rate less than the fixed rate of interest would entitle the borrower (who may be in default) to receive an amount of money depending on the rate difference and the years to maturity.

## Conclusion

At the end of the day, the interest rate swap agreement can be an effective tool if used properly to even out a borrower's long term interest costs. While there are risks in any decision of this nature, if one listens to the economists, one could conclude that at some point down the road, interest rates will be going up, meaning that now may be a time to explore if this is a viable and appropriate tool to utilize. And is this tool only available for

big dollar loans? No, it can be utilized efficiently with loans amounts as low as \$1 million.

We would like to thank Andrew Tetlow, CPA, Manager of Interest Rate Risk Products at Mutual of Omaha Bank for his input and assistance. Andrew may be reached at [Andrew.Tetlow@mutualofomahabank.com](mailto:Andrew.Tetlow@mutualofomahabank.com).

*Michael W. Margrave, [mmargrave@mclawfirm.com](mailto:mmargrave@mclawfirm.com), who is also a Certified public Accountant, practices company and Real Estate law, as well as business acquisition and disposition transactions, and estate planning.*