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Interest rate swaps as a mechanism for managing risk: background and current issues - by Sam Nagler

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As a borrower, you may have heard of interest rate swaps as a mechanism for managing the risk of interest rate fluctuations. In a swap, the borrower essentially trades the floating rate provided by its lender for a fixed rate of interest. This is achieved by the borrower entering into a separate transaction with a “swap counterparty”. The swap counterparty is often, but not always, the lender itself.

The swap is documented by a set of agreements, which normally includes:

• an ISDA (International Swap Dealers Association, Inc.) Master Agreement, a rather dense document which is generally considered to be non-negotiable;

• a Schedule to the Master Agreement, which is negotiable as to “deal points” but generally non-negotiable as to boilerplate; and

• a Confirmation, which sets forth the actual fixed interest rate following a recorded call in which the interest rate is established.

Like lenders in commercial transactions, swap counterparties generally require a legal opinion from the borrower’s attorney and borrower certificates as to adoption of the necessary votes to authorize the swap transaction and the execution of related documents.

For its own protection, a lender will sometimes require that its borrower retain a swap advisor, sometimes referred to as an Independent Registered Municipal Advisor (IRMA). This eliminates any possibility that the lender itself can be deemed to be advising the borrower on the swap. An IRMA must be registered with the United States Securities and Exchange Commission (SEC) pursuant to a rule adopted by the SEC as mandated by the 2010 Dodd-Frank Act. Although the SEC rule only applies to state or local governments issuing municipal securities, swap advisors may be utilized in any transaction involving a swap.

From my experience, retaining a swap advisor is advisable even when it is not required. Swaps are complicated transactions, and the risks may not be apparent. The primary risk is that if the swap needs to be terminated (or is unilaterally terminated by the lender due to a default) prior to the expiration date, a substantial termination payment may be due. This would occur if the prevailing interest rates decline between the time of the swap and the time of its termination. (On the other hand, if interest rates have risen, the borrower would be entitled to a payment from the swap counterparty.)

Swap advisors can also help borrowers understand risks that are not hedged by the swap. For example, in tax-exempt bond financing transactions, the interest rate is generally around 65% of what it would be using conventional financing, because the bondholder does not pay tax on the interest payment and passes along that benefit to the borrower. However, in light of the current discussions regarding a possible decrease in the corporate tax rate, bond documents now frequently provide that if the corporate tax rate is decreased, the borrower will be required to make the bondholder whole for the loss of what had been the full anticipated benefit of not paying tax on the interest. This would be a separate payment obligation of the borrower which is not hedged by the swap. Such an unhedged risk may not be readily apparent to the borrower.

The primary benefit of the swap advisor, however, is in negotiating the swap interest rate. A qualified swap advisor is intimately familiar with what is “market” for swap rates and spreads, and can advise the borrower and negotiate with the lender at all stages of the transaction, up to and including the recorded phone call on which the rate is set. For substantial loans, even the saving of a few basis points will generally justify the swap advisor’s fee.

In summary, interest rate swaps are an integral part of the fixed income market, but should be entered into cautiously, and with proper counseling.

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