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Hedging interest rate risk - Part II: The benefits of swaps, early termination and exotic swap structures

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The floating rate loan/interest rate swap combination has become an increasingly widespread financing structure in commercial real estate transactions. In its simplest form, this structure involves a floating rate loan coupled with a separate contractual arrangement between the lender and borrower in which the party having fixed-rate liabilities, the lender, agrees to "swap" interest payments with the party having floating-rate liabilities, the borrower, thereby allowing the borrower to synthetically fix its interest expense on the loan.* This financing structure affords a number of possible advantages to real estate borrowers and lenders alike.

Foremost is access to competitive fixed-rate financing. A real estate borrower desiring to obtain fixed-rate financing, may not, due to credit rating or special purpose entity status, have access to favorable fixed rates. As well, due in part to the special purpose entity status of many real estate borrowers, and in part to the relatively short term nature of the debt issued in real estate financing transactions, banks often cannot compete with the fixed-rate proposals of insurance companies, pension funds and other long term lenders. By combining a floating rate loan and interest rate swap, each party not only obtains the desired fixed-rate financing, but does so at more an attractive rate.
Moreover, this financing structure affords greater flexibility when compared to a fixed rate loan, particularly in connection with prepayment. Prepayment of a fixed rate loan, if permitted at all, typically results in a premium or yield maintenance payment regardless of rate changes. A floating rate loan, on the other hand, typically contains no prepayment prohibitions or penalties. The only costs associated with such prepayment are those required to terminate the swap early. Early termination costs typically consist of a net payment that reflects the fair value of the remaining cash flows on the swap as of the termination date. Though such costs may be substantial if rates have fallen, if rates have risen, the borrower may receive the net payment.
Notwithstanding, since the loan and swap remain separate transactions, voluntary prepayment of the loan does not compel early termination of the swap. The borrower may retain the swap to hedge the interest cost on a different loan. If, at some future date, the terms of the swap become increasingly unattractive due to rate changes or if the underlying asset or liability for which the swap was retained has been sold, settled or extinguished, the borrower may then terminate the swap.

A variety of more exotic swap structures have developed to meet the diverse financing needs of real estate borrowers. A simple variation of the "plain vanilla" interest rate swap is one in which the notional amount changes over the life of the swap. A swap in which the notional amount decreases over time is called an amortizing swap; a swap in which the notional amount increases over time is called an accreting swap.

More complex swap structures include the forward-start swap and swaption. A forward-start swap is a swap structure wherein the parties agree to enter into an interest rate swap at some future date under terms negotiated today. The swap contract will specify the effective date, maturity date, and fixed rate of the swap. Upon the effective date, the forward-start swap is identical to the plain vanilla swap. A swaption, on the other hand, is the option, rather than the obligation, acquired through the payment of an upfront option premium, to initiate an interest rate swap under specified terms at any time until the expiry of the option. If the swaption holder does not initiate the swap prior to the swaption's expiry, the swaption will simply expire worthless.

Interest rates have risen steadily in the wake of the current economic crisis. Such uncertain and volatile economic times only enhance the difficulty banks face in competing with fixed-rate proposals of long-term lenders. Through a carefully structured floating rate loan/interest rate swap combination, real estate borrowers and lenders alike can attain their financing needs and goals now and in the future.

* For a discussion of the mechanics and documentation of interest rate swaps please see Part I of this article in the September 19-25, 2008, issue of this publication.

An article including citations may be obtained by contacting the author.

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