



# Hedging Against Interest Rate Movements

The stability of low variable interest rates is about to end—is your business prepared?

by Michael T. Newsome

**H**edging against interest rate fluctuations is not a matter of guessing the market's movements. If the movement of interest rates affects the earnings and stability of the business, then a hedge is appropriate regardless of market timing. We see two concerns. First, businesses have grown accustomed to ultra-low rates and are operating on the hope that hedging can be deferred for the moment. Second, long rates appear to be on the brink of an upward move, although timing is indeterminate. As Keynes once observed, "It is better to be roughly right than precisely wrong."

On June 19th, Chairman Bernanke spoke before the usual assemblage of Fed watchers and suggested the time is near to gradually curtail the Fed's massive bond purchase program, signaling that the program would end in 2014. His comments set off gyrations in both the bond and equity markets. In a span of three days, 10-year swap rates ran up 50 basis points. This brief episode prompted a clamor of concern for the fragility of the economy and peril to the housing recovery. In response, the Federal Reserve quickly reversed course. Equity markets rallied and money rates stabilized. Most importantly, it confirmed the obstacles to returning to market determined rates without triggering financial turmoil.

As the financial crisis of 2008 and 2009 gathered steam, economic activity and credit demand ebbed, leading the Fed to push rates lower to spark economic growth. The success of this policy remains the subject of much debate, but in a practical sense, it doesn't really matter. The 10-year swap rate bottomed out at 1.54% just about a year ago. Within the past 45 days, that rate increased 125 basis points to 2.8%. This jump adds \$1.25 million to the cost of credit on a \$10 million loan over the span of ten years. This should be a wake-up call for borrowers.

## HEDGING ALTERNATIVES

There are several techniques to hedge against interest rate movements allowing customization to specific situations.

**1. Fixed Rate Loans** were the standard approach to hedging prior to derivative contracts. We have recently seen an uptick in fixed rate loan proposals. Our reticence towards fixed

loans is based on the lack of both flexibility and reciprocity:

- The hedge cannot be customized—it is either all fixed or all variable;
- Changing the hedge means replacing the loan; and
- If rates decline and the loan is terminated early, the borrower is on the hook for a breakage fee to compensate the lender for a loss of

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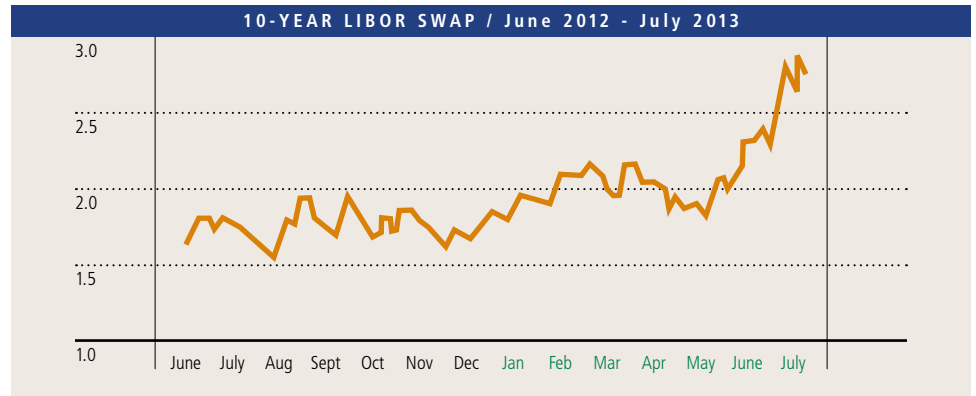
value based on the movement of rates over the remaining term. Conversely, if rates move higher, the lender is not obligated to compensate the borrower for the gain in value. In the past, there was wide variation in breakage formulas, in some cases downright punitive.

**2. Interest Rate Swaps** are the most prevalent hedging tool, where the borrower exchanges its floating rate index (i.e. three-month Libor) for a longer duration Libor swap rate over a specific term. To the extent that underlying rates change, either the swap provider or

the borrower earns a gain.

As the typical intermediaries for middle market hedges, banks tend to favor swaps. The appeal of swaps to bankers is twofold. First, accounting rules permit swap dealers to recognize all of the swap income when the contract is booked, rather than over the multi-year life of the transaction. Second, swaps are independently priced products, where similar contracts (in terms of amount, expiration, and amortization) might have very different pricing. Credit risk, liquidity risk, and/or the borrower's limited insight into market pricing typically account for this variation. Swap spreads are fairly opaque, posing a challenge for borrowers to ascertain whether a market price has been achieved.

Following our last issue of INSIGHT, a few of our banker friends pointed out that implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act addressed pricing transparency concerns. Under Dodd-Frank, swap providers are obliged to provide a point of pricing comparison by disclosing the swap dealer's spread over its pre-trade mid-market mark (PTM), which is intended to serve as the unbiased raw cost of the swap, excluding markups for profit, credit exposure, and other factors. Their point is well taken. However, the PTM reflects the mid-point between the bid and ask in swap transactions at a given point in time and is a subjective internal calculation for a specific institution, rather than the broader market. It does not pinpoint the market for a given transaction.

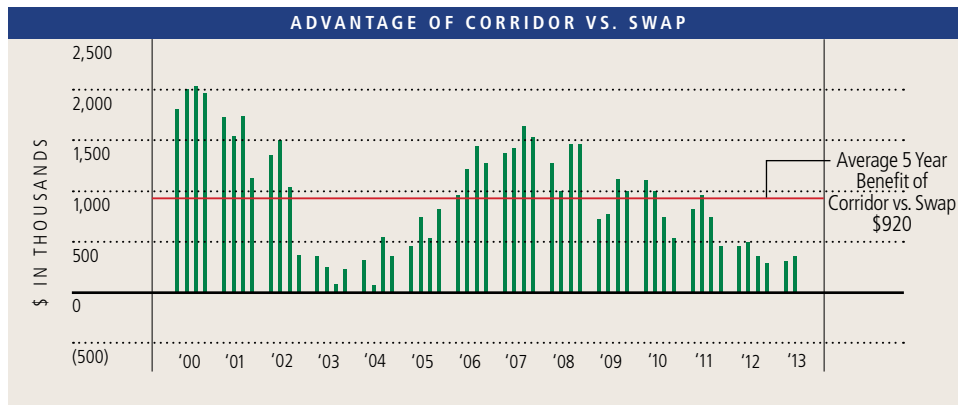
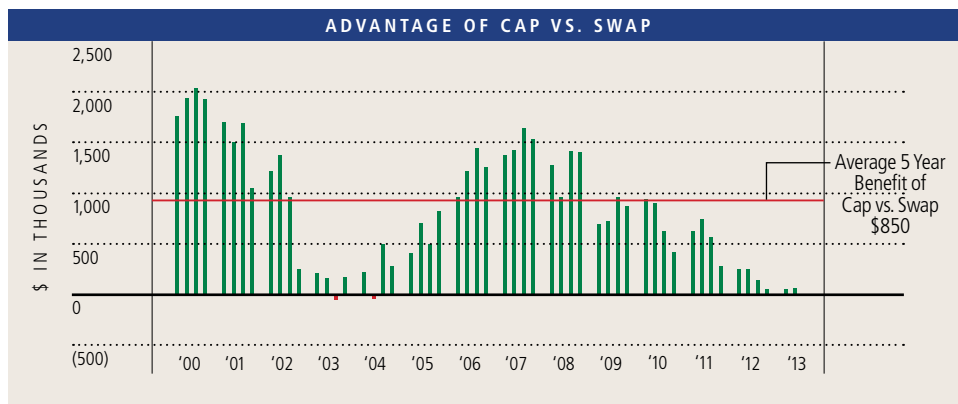


**3. Option Products** provide an array of customized contracts that can be used to fully or partially hedge interest rate risk. Unlike a swap contract, where the two counterparties agree to exchange fixed and floating cash flows over a period of time, an option is analogous to an insurance policy where counterparty 1 agrees to pay counterparty 2 in the event that X occurs. The cost of the option is paid up front and the contract can be sold at a gain if rates exceed the strike price. Here are several common hedging contracts:

- Interest Rate Caps create a ceiling on floating rate interest costs. When market rates move above the cap rate, the seller pays the purchaser the difference. The cap ensures that the borrower's interest rate does not exceed the cap rate.
- Interest Rate Corridors are a long interest rate cap coupled with a short interest rate cap. The buyer of the corridor purchases a cap with a lower strike while selling a second cap with a higher strike. The premium earned on the sold cap then reduces the cost of the purchased cap. The buyer of the corridor is protected from rates rising above the sold cap's strike, but exposed again if they rise past the purchased cap's strike price.
- Interest Rate Collars combine the purchase of an interest rate cap and the sale of an interest rate floor. The cap protects against rising rates and the sale of the floor reduces the cost of the cap by foregoing the benefits of rates that fall below the floor.

**OPTIONS VS. SWAPS**

Comparing the performance of these hedging strategies under different interest rate environments is useful. The above charts compare the benefits of a 5-year swap relative to 5-year cap or a 5-year corridor for each quarter between 2000 and 2013 based on a notional loan amount of \$10 million. In each case, the strike price of the cap was set 1% over the fixed swap rate and the corridor has a 2% band. In all quarters but two (the two downward red columns



in 2003 and 2004), the cap was the lowest cost alternative. The corridor strategy was superior

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to the swap in all instances. The average benefit over five years was \$850,000 for a cap and \$920,000 for a corridor.

The alternatives available to borrowers are complex, but a few basis points mean real money. An independent derivatives advisor provides knowledge and access to all alternative hedging techniques, evaluates the implications in the specific situation, offers unbiased insight into market pricing, and engenders competition among market providers to insure competitive pricing.

Given current circumstances, the failure to hedge interest rate risk is comparable to not buying insurance until an accident occurs. The stable low interest rate environment of the past few years is not guaranteed to continue. **ZS**



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