Over the past year and a half, we have seen dramatic evidence of the damage that excessive or unmanaged risk can do to businesses and the economy. Yet taking on risk is unavoidable if you want to grow your business and improve your bottom line. I’m Edwin Martinez, Managing Director in PNC’s Derivative Products Group. The answer to this dilemma is to address and actively manage the risks you can control to maximize the value of your business.

Interest rate derivatives can help you mitigate the risk of unpredictable interest rate swings. By adding certainty around this expense category on your income statement at a time when improving margins is critical, you can ensure that more of each revenue dollar drops to the bottom line.

Yet you may be hesitant about this strategy because interest rate derivatives, like interest rate swaps, appear too complex and their benefits may seem unclear. In some cases you may be taking advantage of the simplest kinds of swaps when a more sophisticated approach would serve you better or would be more consistent with your outlook on interest rates in general.

Let’s take a high level view of how interest rate swaps work and then discuss a more targeted strategy.

Interest rate swaps are contractual agreements between the bank—and a client like you—who agree to exchange different forms of interest payments through a stated maturity date. In one of the most popular versions, they effectively convert a floating rate on a loan to a fixed rate.

To visualize how an interest rate swap works, take the situation of the floating rate borrower who feels that rates will rise over the term of a loan, significantly increasing interest costs and potentially eroding already strained operating margins.

This client enters into a swap agreement with the bank, whereby the client receives a floating rate, such as LIBOR, that offsets the interest on its underlying loan agreement and pays a fixed rate.

The payment of LIBOR from the bank to the client offsets the client’s LIBOR payment to the lender. After the LIBOR payments cancel each other out, the client is left with an effective all-in fixed rate consisting of the swap rate plus the
spread over LIBOR.

While this approach is common, there are many variations of interest rate derivatives you might want to consider, depending on your current debt structure and your outlook on interest rates. Let’s discuss one in more detail.

If you believe that rates will remain low for the near term and would like to take advantage of the floating rate environment while still protecting against too much risk, you may want to consider an Interest Rate Cap.

Interest rate caps provide protection should rates rise above a pre-specified rate, offering essentially an insurance policy against a large or unacceptable increase. As a client, you choose the acceptable level of risk by choosing a strike rate that corresponds to a manageable worst-case scenario.

In this scenario, companies can actively manage their interest rate exposure within their acceptable risk threshold rather than eliminating it entirely.

In addition to managing risk and ultimately increasing business value, derivatives like interest rate swaps and caps deliver other benefits, including flexible terms. You can also customize derivative structures to meet your timing and cost needs. You can choose the index you want to base the derivative on. Derivatives can be structured based on various indices such as Prime, Commercial Paper, Fed Funds, SIFMA and others, as well as LIBOR.

A derivative can be terminated at its market value at any time.

And a derivative is entirely separate from the underlying credit agreement. Derivatives such as interest rate swaps and caps are powerful risk management tools that can help you create value in your business. Other strategies that you may want to consider include floors, collars and swaptions.

I hope you will explore this topic further by getting in touch. My contact information appears on the previous page.

Thank you for your time and attention.