# GETTING READY FOR WHAT'S NEXT: HEDGING SOLUTIONS FOR A SLOW-MOTION ECONOMY

**In the face of moderate economic growth in the United States and overseas, short- and long-term interest rates remain at historically low levels.**

Long-term rates have edged slightly higher since December of 2012, and many forecasts have been calling for higher longer-term yields toward the end of 2014 and into 2015 in line with expectations about when the Federal Reserve may change its policies.

Many companies have been managing their near-term debt portfolios on a floating rate basis even though locking in longer-term rates has been an attractive option. The duration of the traditional bank debt facility and the liquidity in the market for bank debt at pricing that is attractive to borrowers have contributed to this trend.

In the past five years, many companies that had previously elected to hedge with an interest rate swap — but are now in a position to refinance or significantly pay down the debt facility — will be faced with the early termination or make whole of their current interest rate swap.

Since interest rates have declined, the interest rate swap's value is negative or a liability and must be considered as a cost in any refinancing or restructuring.

## THE ROLE OF CANCELLABLE INTEREST RATE SWAPS

Companies that are trying to manage this duration or tenor mismatch between a facility's maturity and a paydown or refinance event are finding that a "cancellable or callable" interest rate swap can provide more flexibility.

In its simplest form, the cancellable interest rate swap combines a vanilla interest rate swap with an embedded option purchased by the client. It gives the company the right to terminate the interest rate swap on an agreed-upon date with no make whole due to the bank if the interest rate stays low.

For instance, if the stated maturity on the debt facility was seven years and the client wanted a fixed rate for seven years, they would execute a seven-year interest rate swap mirroring their debt facility. A five-year option or one-time right could be purchased by the client to terminate the swap at the mutually agreed upon five year date.

The option is paid for in additive basis points above the current vanilla swap rate, essentially embedding the option in the swap. When the determination date of the option arrives five years from now, the client would have the flexibility to either terminate the interest rate swap at no cost or let the option expire and remain in the interest rate swap for the last two years.

This one-time right to exit the interest rate swap provides flexibility as long as there is a defined view that there will be an event at the five-year time frame. Added flexibility can be structured by embedding multiple rights to cancel the interest rate swap on a quarterly or monthly schedule.

This cancellable interest rate strategy can be employed as a hedge against a specific debt facility or as a part of a larger strategy to manage duration of a debt portfolio. Further, many companies use the cancellable interest rate swap in conjunction with other hedging tools such as caps, collars and forward starting interest rate swaps.

There are many flexible and creative hedging solutions available. You should review the expected duration of your debt portfolio and consult with your capital markets profession to discuss your options.

**For more information, contact your Relationship Manager or visit pnc.com/ideas.**



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