USING YIELD CURVE EFFICIENT INTEREST RATE SWAPS TO MANAGE RISK

New Federal Reserve Chairperson, Janet Yellen, appears committed to continuing to reduce asset purchases over the coming months. What does this mean for long term and short term rates in the United States, and what are financial managers and business owners currently considering to protect their margins and manage risk?

Recognizing the potential impact on intermediate and long term interest rates, business owners and corporate treasury teams are carefully reviewing their projections for funded debt levels over the next several years and actively managing their mix of fixed and floating rate debt.

INTEREST RATE DERIVATIVES PROVIDE FLEXIBILITY

One benefit of interest rate derivatives is that they are completely customizable. Their flexibility allows financial managers and treasury teams to fine-tune their interest rate profiles and maturities according to their risk tolerance and cash flow needs. Cancelable hedges, forward starting hedges, swaptions, collars and partial hedges are just a few of many examples of customized hedging solutions that suit specific financing needs.

YIELD CURVE EFFICIENT INTEREST RATE SWAP

Another hedging solution that can mitigate interest rate risk is the yield curve efficient interest rate swap.

Like traditional interest rate swaps, this strategy involves an exchange of payments. The client pays a known, fixed (constant) rate of interest in exchange for a floating rate index (for example, LIBOR).

However, with a yield curve efficient interest rate swap, the fixed rate paid changes at pre-determined points in time, more closely following the expected future path of interest rates. Similarly, the frequency and timing of the increases can be tailored to meet specific cash flow needs.

For example, if a non-amortizing five-year floating to fixed rate swap rate is approximately 1.75%, under this contract, the client would pay 1.75% monthly and receive one month LIBOR (currently 0.15%). Thus the “premium” to convert from a monthly floating rate to a five-year fixed rate is approximately 1.60%.

EXAMPLE

Client pays the following fixed rates and receives one month LIBOR:		Similarly, under a five year non-amortizing Yield Curve Efficient Swap, the company would pay the following fixed rates and receive one month LIBOR:	
Year One:	0.30%	Year One:	0.30%
Year Two:	0.80%	Year Two:	0.80%
Year Three:	1.85%	Year Three:	1.85%
Year Four:	2.80%	Year Four:	2.80%
Year Five:	3.50%	Year Five:	3.50%

Given the shape of the yield curve and the nature of the structure, the yield curve efficient interest rate swap is most attractive with limited or no reduction of principal. Essentially, the net present value of the cash flows of a constant fixed rate swap and a yield curve efficient swap are the same over the life of the hedge. However, the yield curve efficient swap enables companies to enjoy lower known fixed rates in the initial years of the hedging agreement.

TWO RECENT SCENARIOS

A growing industrial manufacturing firm was expanding its primary operating facility and also adding machinery and equipment. This manufacturing firm was concerned about their interest expense but, given the increased required debt service, was not comfortable "paying up" to lock in a fixed rate swap. The yield curve efficient swap enabled the borrower to protect their interest expense while minimizing the initial premium until the expanded facility and new equipment were in place and in production to meet growing demand.

An innovative technology company was making an acquisition to enhance its capabilities. Again, said company was focused on the acquisition and integration but wanted to protect their interest expense on the acquisition financing. The yield curve efficient swap allowed management to keep their interest expense down initially while they focused on integration and recognizing the companies' synergies. Management's forward projections showed that the combined company could easily absorb the higher back end interest expense once those synergies were absorbed and integration complete.

RISKS AND REWARDS

There are both risks and rewards associated with implementing a yield curve efficient swap.

The primary benefits of implementing a yield curve efficient swap include:

- The ability to achieve fixed rate protection on a portion of your debt portfolio and more closely align the fixed rate with projected changes in the floating rate
- A reduced initial premium to move from a floating rate to a fixed rate in the early years of the hedge (initially 0.85% in this example)
- An effective way to manage interest expense and align the cash flows with expected revenue growth

As with any interest rate hedge, there are a few potential risks to consider:

- Should fixed rates for the remaining term be lower and you choose to terminate the hedge, the cost will be higher relative to an interest rate swap with a constant fixed rate to maturity
- Typical with swaps, should floating rates over the life of the hedge average less than the effective fixed rate, in hindsight, you would have paid less interest if you remained floating

As mentioned earlier, in addition to the Yield Curve Efficient Swap, there are many other custom tailored hedging solutions to meet your needs and risk management objectives. I recommend that you carefully consider your company's potential financing needs over the next several years and projected debt levels and consult with your Relationship Manager and Derivatives Specialist to assess your alternatives.

For more ideas, insight and solutions to help your business thrive, please contact your Relationship Manager or visit pnccapitalmarkets.com.

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