

Options on Interest-Rate Swaps (Swaptions) for borrowers

The situation

Your firm has a loan of \$500,000 in USD and this is on a floating-rate basis. People are uncertain about what interest rates will be in the future. Some people think rates will be higher, others feel they will be lower. You want to protect your firm against the risk of higher borrowing costs. In the past you have used Interest-Rate Swaps but you know that if you use an Interest-Rate Swap now, you may give up the possible benefit of lower interest rates.

The product

A Swaption is another product, which can be very useful in these circumstances. Basically, it is an option on an Interest-Rate Swap. It gives you the chance to use an Interest-Rate Swap at a certain fixed rate, but you do not have to do so. In this way it protects you against an increase in rates while giving you the freedom to enjoy cheaper borrowing costs if rates fall. If you enter into a Swaption you will need to pay us an up front cash premium.

A Swaption gives you a period of time when you can take advantage of a fixed borrowing cost. You might do this if this guaranteed rate is a better rate than would be available in the market.

The solution

You have borrowed \$500,000 in USD for a 3-year period. You want to protect your firm against rising interest rates and guarantee a maximum cost of funds of 5.5%. At the same time you want to be able to take advantage of any possible fall in interest rates. You buy a Swaption from us at a rate of 5.5% for a 3-month period. Let us see how the product would work.

Two examples

- In 3 months' time the Interest-Rate Swap rate for 3 years is at 6.0%. You make use of your Swaption and ask us to provide you with an Interest-Rate Swap for this period at the agreed rate of 5.5%. We do this and your 5.5% cost of funds for the period is protected. As an alternative you could ask us to pay you compensation equal to a margin of 0.5% on the amount for the rest of the loan.
- In 3 months' time the Interest-Rate Swap rate for 3 years is at 5.0%. You do not want to take up your Swaption and instead you will borrow at the cheaper rate of 5.0%. In these circumstances the Swaption protected you against a higher borrowing cost and also allowed you to take advantage of the fall in rates.

The benefits

- The Swaption will give you full protection against rising interest rates.
- The Swaption will give you freedom to benefit if rates move lower.
- You can sell the Swaption to us at any time and you may receive some value back depending on prevailing rates and the time left to maturity.

Features

- We can provide Swaptions to meet your needs.
- We provide Swaptions for borrowers in all major currencies and for a wide range of maturities. The option period can last for any length of time, but generally no longer than 12 months.
- You can negotiate a Swaption with any bank. It does not have to be the bank who lent you the money.
- You should pay us a premium beforehand,
- The premium you pay will depend on:
 - the guaranteed rate compared with the Interest-Rate Swap rate;
 - how long you want the Swaption for; and
 - how interest rates may do in the future.