

INTEREST RATE SWAP

By Marijean Stallings*

In a commercial mortgage setting, the lender may insist on the borrower entering into an "Interest Swap" or "Swap Agreement" along with the mortgage loan agreement. The *Interest Swap* agreement is an additional contract that is highly speculative and rather risky for the borrower in almost all cases. The lender is insuring its adjustable interest rate to the borrower at the additional cost and exposure to the borrower. A church, Christian school, or other nonprofit organization should rarely consider a loan agreement where the lender includes an *Interest Swap* and only after clearly understanding the serious potential downside of such an arrangement.

What is an "Interest Swap"?

Simply put, an *Interest Swap* is the exchange of one set of cash flows (streams of payment) for another. The most common type of interest rate swap is the exchange of fixed rate flows (from the purchase of a derivative) for floating rate flows (the rate the mortgage customer has agreed to pay on its mortgage). **In simple terms**, the lender is taking out a contract on your adjustable rate mortgage loan in a fixed rate commodities market (usually overseas) to "hedge" against an upturn in interest rates during the pendency of your commercial loan. For example, in the United States, a lending institution may believe that long-term interest rates are going to rise, causing it to seek protection against the impact of higher interest rates on its balance sheet.

One solution for the lender is to enter into an interest rate swap. In exchange for receiving payments tied to the floating rate index the lender uses for borrowing in the short maturities (with payment dates corresponding to the dates the lender must reset its short-term borrowing), the lender would pay a

fixed rate index, all on the same notional (predetermined index for determining the interest rate) amount as its total outstanding borrowings. With the swap, the managers of the lender have closed out the company's exposure to changes in short term rates and they have taken on an exposure to long-term a rate that more closely corresponds to the lender's long-term assets.

Just like a commodities' option, a swap can be high, low or pretty much on target. Most swaps are priced to be at par with the floating rate at inception meaning that the value of the floating rate cash flows is exactly the same as the value of the fixed rate cash flows at the inception of the deal. Naturally, as interest rates change, the relative value may shift. Receiving the fixed rate flow will become more valuable than receiving the floating rate flow if interest rates drop or if credit spreads tighten.

Investment banks and commercial banks are the market makers for most of these swaps. Most lending institutions warehouse the risk in portfolios, managing the residual interest rate risk of the cash flows. As you can imagine, the management of these risks can be very complex with swaps maturing on a daily basis and the difficulties of managing a variety of similar but not identically matched products. Most local branch bankers have no idea what the "breakage fee" on your contract is should you ask them to explain it. Indeed, often, experts from the "home office" must make the calculations at any given time.

The "swap rate" is the difference, whether positive or negative, between the forward exchange rate and the spot rate for a given commodity (a foreign currency), usually expressed in "points". The "forward exchange rate" is set at the time of contract for a foreign currency transaction with payment or delivery at some future date. The "spot

rate" is the theoretical yield on a zero-coupon Treasury note. The commodity in context of commercial mortgages and *Interest Swap* rates is generally British currency as expressed on the London Currency Exchange. In the case of an interest rate swap, the "swap rate" is the market interest rate paid by the party responsible for the fixed payments. In general, a well-defined rate exists for this payment, and when a swap is initiated, the fixed rate paid is usually quite close to the market swap rate. However, as the swap matures the fixed rate paid on the swap stays constant, while the swap rate might change, and these two rates can diverge.

Why interest rate swaps are usually a bad deal for small and medium size business organizations

But why are interest rate swaps a poor deal for most borrowers? As long as the borrower makes its timely mortgage payments, has no significant growth issues, and has no need to refinance during the term of the mortgage, the interest rate swap will have little impact on your organization. However, should your organization experiences significant growth and needs to refinance and get more money, or simply wish to refinance to take advantage of shrinking interest rates, the business will immediately be confronted with an unexpected dilemma: To grow or to refinance the current mortgage shall require the payment of a "breakage fee" on the *Interest Swap* contract. This amount dwarfs most prepayment penalties—generally breakage fees run about 12% of the mortgage balance at the time of breakage! The amount is so substantial that it generally locks the borrower into the current loan, prohibiting expansion, and forcing the commercial borrower to endure the higher interest rates when there is a significant downturn in the market.

These contracts are extremely complex and few attorneys have ever encountered them. Further, the contracts are so convoluted and deceptive in language that most attorneys simply "pass" on the mortgage based upon the interest rates and more identifiable standards. If the borrower does not refinance during the term, there is no problem. If it needs to grow and refinance before the term expires, the borrowing company is in crisis.

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Platinum's recommendation to business and nonprofit organization clients with respect to mortgages tangled with interest rate swap contracts

It is our general counsel to avoid interest rate swap and derivative-backed mortgage loans for your organization. The benefits to the business or nonprofit organization are negligible at best and the downside can actually destroy your organization in many scenarios. If your banker has convinced you to enter an interest rate swap mortgage arrangement, ask the question: "What is the breakage fee should we need to refinance or secure more money prior to the expiration of the mortgage term?" In most cases, you will be amazed with the creative explanations that fall far short of an answer to your question. Chances are quite good that your bank representative has no idea what is the true answer to your question. In many cases, the bank representative will acknowledge he or she cannot answer the question honestly because he or she does not know the answer and has no meaningful way to calculate the answer until "you decide to refinance". ■

About the Author

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