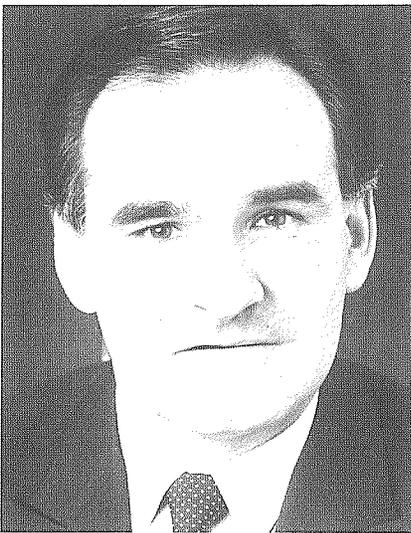


SWAPS, CAPS AND COLLARS

FLEXIBILITY THE FINANCING KEY



by KEVIN G. OSBORN

Swaps, caps and collars have earned their places in the new language of corporate funding. They are among a growing range of instruments enabling companies to insure against risk and to take advantage of moving markets.

At a recent function, a client reminded me that the market was made up of bankers all working on the 3-6-3 rule. I sat back in amazement, thinking this chap was quoting the latest Aussie dollar price, but what he meant was that bankers had traditionally borrowed at 3 per cent, lent at 6 per cent and hit off the first tee at Kooyonga at 3pm.

That is not the case any more, as corporations, merchant and investment banks have developed new products that have proved to be more competitive than the trading bank overdraft facility.

One area of debt planning corporations often overlook is the method in which funds are raised. In many instances companies are concerned with supply and price, and not form.

Too often a company offers one bank the total security for a transaction, and then at a later date may need to introduce a specialist lender for a specific situation. Problems arise because the first lender has the first call on all the assets of the borrower, and the specialist lender has nothing.

Corporations should look to raise debt by providing a group of bankers with a security pool, thus not favouring the first bank or the traditional overdraft lender. This situation is known as *pari passu* — i.e. equal position for all. Healthy competition can be stimulated in this manner.

The other popular method is to arrange debt funds through a negative pledge over the assets of the company.

In this situation, the borrower signs a legal agreement not to create a lien on any asset of the company without the specific approval of the lending banks.

The negative pledge is often combined with financial covenants that control the company in regard to continuing profits, overall leverage and ownership. Negative pledges allow companies to raise debt without paying large amounts of stamp duty, and allow a borrower to have multiple lenders providing competition on loans which, overall, lowers the borrower's cost of funds.

Having looked at the structure of the debt, we can now look at getting the most out of the market itself. This can be achieved by using the following instruments:

Forward Rate Agreement (FRA): An FRA is an efficient and simple instrument to protect companies against adverse interest-rate movements. Some of the advantages of an FRA are: ■ a corporation is guaranteed a rate and therefore is insured against interest rate movements; ■ an FRA is totally flexible and can be tailored to the individual's needs; ■ the bank or merchant bank with whom you write the FRA need not be the same bank you borrow from or deposit funds with.

The following example (A) of documentation shows the major components of an FRA transaction.

Kevin Osborn, Managing Director of Michell NBD Limited, also addressed the Institute of Chartered Accountants on aspects of innovative financing.

On June 12, 1987, if the Reuters BBSW reference page quoted 180-day bank bills at 16.05 per cent, then Michell NBD would pay ABC Company Ltd \$A26,289.25 to compensate ABC for the rate rising to 16.05 per cent. This amount is arrived at by using the discounted proceeds formulae. Conversely, if the 180-day bill rate had fallen to 13 per cent by June 12, ABC Company would pay Michell NBD approximately 1 per cent p.a. for 180 days, or \$13,005.30.

A major point to remember with FRAs is that you can speculate in the market-place if company policy allows you to do so: i.e., you don't need an underlying borrowing or deposit to trade an FRA.

For example, a company that has a *net borrowed position* in the cash market and believes interest rates will fall, could arrange a "deposit FRA" on the basis that at settlement date interest rates will be lower, and it will profit by trading the market correctly.

Interest Rate Swaps: Swaps are an integral tool for managing assets and liabilities and thus have increased the range of options corporate treasurers have for raising funds and hedging exposure in the volatile interest-rate market.

A swap evolves where two parties have equal, but opposite needs. The participants in an interest-rate swap exchange their *form* of borrowing or investing

without an exchange of principal.

The single currency rate swap is a longer-term version of the FRA. Example (B) shows that ABC Company has borrowed fixed date for three years at 13.5 per cent, with settlement every 90 days to adjust its bill rollovers which would be done at market price, back to the 13.5 per cent.

On the settlement dates, Michell NBD will compensate ABC for the difference; conversely, if rates fall, ABC would compensate MNBD for the differences.

The advantage of an interest-rate swap is that it allows corporations to finance longer-term assets or investments and be assured of the funding cost.

The choice of financier is kept flexible, as the borrower is not locked into one lender for three years. The actual cash borrowings are still short-term, thereby allowing the borrower to fund himself at the lowest level in the short-term market yet still insure an overall maximum cost of funds.

Other types of swaps have become popular in the international markets in recent years including:

Basis Swaps: Companies exchange their interest forms. Say ABC has a facility that is priced at bank bills, while another corporation has, say, an investment in A\$-Eurobonds. Both could achieve savings by swapping the interest payments and receipts without upsetting their normal financing arrangements.

Cross-Currency Rate Swaps: These arise where, say, an Australian company — ABC — has surplus A\$ facilities, but needs pounds sterling for an investment in the UK. Having not operated in the UK or being concerned about withholding tax, the overall price of a pounds sterling loan may be excessive to ABC.

A merchant bank may have, via its parent, access to pounds sterling at fine rates but the merchant bank needs A\$ to fund its Australian lending book. So the two enter into a floating cross-currency basis swap. See example (C) page 11.

This way, the two borrowers have used their comparative advantages in a specialist market to obtain funds at the right price in the markets in which they wish to operate.

Interest Rate Options: An emerging market in Australia is the use of interest-rate options to reduce the effects of interest-rate changes, and the derivation of options, namely interest rate caps, collars and floors.

An interest-rate option is a right to

EXAMPLE (A)

FORWARD RATE AGREEMENT (FRA) CONFIRMATION NOTICE

Michell NBD Limited hereby confirms entering into a Forward Rate Agreement (FRA) made between ABC Company Limited (the Borrower) and Michell NBD Limited on 15th May 1987 with the following details.

AMOUNT:	\$3,000,000
CURRENCY:	Australian Dollars
TYPE:	Loan FRA
GUARANTEED RATE:	14.00% per annum
CONTRACT PERIOD:	12th June 1987 to 9th December 1987 (180 days)
SETTLEMENT DATE:	12th June 1987
SETTLEMENT RATE:	The mean of the bank bill rates (except the highest and lowest) quoted by specified reference banks for the relevant period (180 days) at 10.00a.m. E.S.T. on the settlement date and quoted on AAP Reuters Page BBSW.

SETTLEMENT INSTRUCTIONS:	Cash settlement to take place on settlement date.
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EXAMPLE (B)

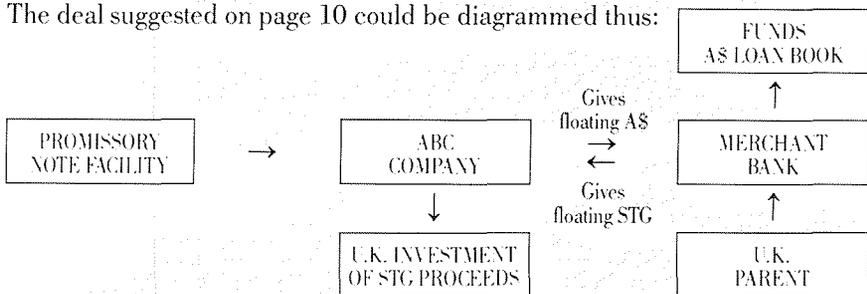
CONFIRMATION OF SINGLE CURRENCY FIXED/FLOATING INTEREST RATE SWAP AGREEMENT

We hereby confirm particulars in respect of the following Australian dollar fixed/floating Interest Rate Swap Agreement entered between us subject to the General Terms and Conditions ("AIRS Terms") dated 1987 which are hereby incorporated into this Agreement.

CONTRACT DATE:	15th May 1987
FIXED RATE PAYER:	ABC Company
FLOATING RATE PAYER:	Michell NBD
COMMENCEMENT DATE:	15th June 1987
MATURITY DATE:	14th June 1990
NOTIONAL PRINCIPAL:	A\$5,000,000
FIXED REFERENCE RATE:	13.5% p.a.
FIXED RATE PAYMENT DATE(S):	15th September, December, March, 14th June 1987, 1988, 1989, 1990
FLOATING RATE PAYMENT DATE(S):	15th September, December, March, 14th June 1987, 1988, 1989, 1990
TENOR OF BILLS:	90 days
VARIATION OF AIRS TERMS:	Nil
FIXED RATE PAYER'S ACCOUNT:	ANZ Adelaide
FLOATING RATE PAYER'S ACCOUNT:	CBA Adelaide

EXAMPLE C

The deal suggested on page 10 could be diagrammed thus:



(Initial exchange and reversal is done at predetermined exchange rates; each party incurs delivery risk on exchange transaction.)

borrow or lend at a pre-determined price, not an obligation to do so. Therefore a corporate treasurer, believing interest rates may fall, but concerned about his bottom line and his job if his crystal ball is wrong, can buy an interest-rate option to protect the corporation from major losses if rates go higher.

He could approach a financial institution and receive a quote to take an option to borrow, say, on September 15 for 90 days at, say, 13.50 per cent which is known as the strike price. ABC would secure this option for an upfront premium of about \$1,400 per \$1,000,000.

On September 15, if interest rates are lower than 13.50 per cent, the borrower would abandon the option and borrow in the physical market. Rates would only need to fall below 12.94 per cent before the full cost of the option is offset by a lower interest cost.

Conversely, if the 90-day rate is above 13.50 per cent, then ABC would exercise the option and borrow from the option granter at 13.50 per cent, or cash in the profit on the option and use that to offset higher borrowing costs with another bank.

Options can be structured also for investors looking to insure against rates falling.

Another interesting method of operating with options is that the option taker can adjust his entry price into the market by adjusting the strike price (i.e., the exercise price of the option).

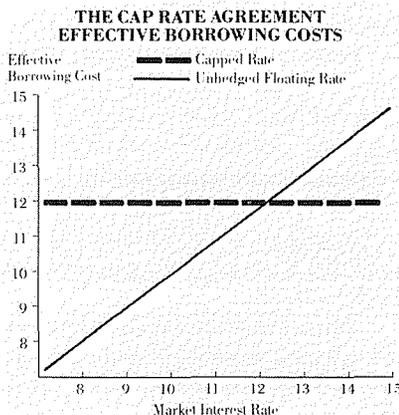
An example of this would be a treasurer who is convinced that rates will fall, but wants disaster insurance. So he arranges an out-of-the-money option (i.e., a strike price that is well away from today's prices). In our previous example, an out-of-the-money option at, say, 14.5 per cent, the upfront premium would fall to \$600 per \$1,000,000 versus the \$1,400/million to be at the money. So

our treasurer has covered the upside and now only needs rates to fall to 13.25 per cent at settlement date in September to recover the cost of the option.

A derivation of interest rate options is the interest rate ceiling or cap agreement.

Interest Rate Ceiling or Cap Agreement: An interest rate cap is an agreement between the "seller" or provider of the cap and a borrower to limit the borrower's floating interest rate to a specified level for a period of time.

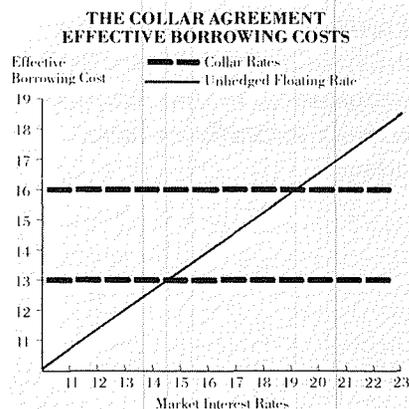
The borrower selects a reference rate to hedge (e.g. LIBOR or Bank Bill) a period of time to hedge (e.g. two years, five years) and the level of protection desired (e.g. 12 per cent, 14 per cent, 16 per cent). The "seller" or provider of the cap, for a fee, assures the buyer that its reference rate will not exceed the specified ceiling rate during the terms of the agreement. If market rates exceed the ceiling rate, the cap provider will make payments to the buyer sufficient to bring its rate back to the ceiling. When market rates are below the ceiling, no payments are made, and the borrower pays market rates. The buyer of a cap therefore enjoys a *fixed rate* when market rates are above the cap and *floating rates* when market rates are below the cap as shown below.



Caps, like an option, provide disaster insurance and hence the borrower can use the cap to insure against rising rates and take the benefits of interest-rate falls.

Interest Rate Collar Agreement: An interest-rate collar is a variation on the ceiling rate or cap agreement. The "seller" or provider of the collar agrees to limit the borrower's floating interest rate to a band limited by a specified ceiling rate and floor rate.

The borrower selects a reference rate to hedge (e.g. LIBOR, or Bank Bill) a period of time to hedge (e.g. 3 months-24 months), and the level of protection desired (e.g. 10.25 per cent to 12.25 per cent, 15 per cent to 18 per cent). The "seller" or provider of the collar, for a fee, assures the borrower that its reference rate will not exceed the specified ceiling rate nor be less than the specified floor rate during the term of the agreement. If market rates exceed the ceiling rate, the collar provider will make payments to the buyer sufficient to bring its rate back to the ceiling. If market rates fall below the floor, the borrower makes payments to the collar provider to bring its rate back to the floor. When market rates are between the floor and the ceiling, the borrower pays the market rate. The buyer of a collar, therefore has its borrowing rate confined to a band or collar, ranging from the floor to the ceiling, as shown below.



Interest-rate collars provide protection against rising interest rates without fixing rates. Taking a collar transaction will invariably cost more than the fixed-rate alternative. However, if rates fall to the bottom range of the band, there will be considerable savings compared with the fixed-rate alternatives. The obvious disadvantage of a collar from a borrower's point of view is that profit potential is limited if there is a steep decline in rates. □