A HEDGING STRATEGY TO MANAGE INTEREST RATE RISK

Interest rate swaps have become an essential tool for many types of line-of-credit borrowers. In today’s market, a ladder-of-maturities swap strategy is an approach borrowers should consider to hedge against interest rate volatility.
For organizations that prefer the flexibility of line-of-credit or multi-disbursement loans but also want to manage floating-rate interest risk — a company in commercial real estate or construction for example — these arrangements can be highly effective.

In practice, leading commercial banks with strong credit ratings provide interest rate swaps, offering important risk management tools to their clients. Through the interest rate swap, the client company pays a fixed rate to the bank in exchange for the company to receive a floating rate based on its floating-rate loan. The parties do not exchange the underlying principal amounts of the hedged loan, only the streams of interest payments.

This strategy can work to the advantage of both parties to the agreement.

How does an interest rate swap work?

In the Middle Market, most interest rate swaps transacted for floating rate borrowers exchange fixed-rate payments from the borrower for floating-rate payments from the Bank based on LIBOR (London Inter-Bank Offered Rate), the interest rate benchmark frequently used for short-term financing.

The “swap rate” is the fixed interest rate that the receiver of the payment (normally the Bank) asks for (from the borrower) in exchange for the uncertainty of having to pay the short-term LIBOR floating rate over time. At any given point, the market’s forecast of what LIBOR will be in the future is reflected in a calculation called the forward LIBOR curve.

Over time, interest rates implied by the curve change and cause swap rates to fluctuate.

Three reasons a company might want to enter into an interest rate swap:

1. **To hedge against volatility.** First and foremost, the interest rate swap is a strategy for hedging the risk of unfavorable interest rate fluctuations. If a company has a loan with a floating interest rate and the company expects the floating rate to rise, then that company can enter into an interest rate swap to switch its floating rate for a fixed rate. Generally, with line-of-credit or multi-disbursement loans interest rate risk can be managed by transacting one or more interest rate swaps to hedge a portion of the core balance of the debt.

2. **To reduce uncertainty.** If a company has a floating rate loan, it is almost impossible to determine the dollar amount of interest payments it will be making throughout the duration of that loan. Whether the floating rate rises or falls, the change will affect the company’s finances. To eliminate that uncertainty, the company can enter into an interest rate swap that enables it to make fixed payments instead of variable payments.

3. **To shrink the cost of a loan.** Depending on the specifics of the transaction, a company might be able to enter into an interest rate swap that allows it to pay a lower fixed interest rate to the receiver than it would have had to pay for a fixed interest rate loan.
A passive hedging strategy for any market

No one knows, of course, when tops and bottoms will occur in the interest rate market.

A well-designed ladder of maturities swap strategy helps reduce interest rate volatility and takes some of the guesswork out of where interest rates are heading.

Here’s how the approach works for a typical line-of-credit balance:

• The laddered strategy targets a hedged position of between 30% and 50% of the core balance.

• The hedged position is divided evenly between two-year and three-year interest rate swap contracts, thereby creating three rungs of the ladder: the unhedged rung that remains floating, the two-year rung of hedged debt and the three-year rung of hedged debt.

• As the swap contracts mature, they are replaced with current contracts to maintain the hedging strategy.

The principal advantage of the ladder approach is its ability to achieve lower volatility in the interest rate (as measured by the resulting weighted average rate) of a portion of the debt, while maintaining flexibility in the projected debt that remains unhedged.

As an additional benefit, when the two- and three-year swap rates are lower than the one-month LIBOR rate — as they are currently — the “cost” of the hedging strategy (as measured by the lower weighted average compared to the unhedged floating rate) is an initial reduction in interest expense.

As the chart shows, the two-year Treasury has only recently fallen well below the one-month LIBOR line, indicating a building expectation of rate cuts. From a hedging perspective, a firm entering into this strategy today would not only be reducing risk, it will likely be reducing its current interest expense from day one. It’s also important to note that LIBOR is expected to be phased out across the world by the end of 2021 in exchange for a new reference rate (Secured Overnight Financing Rate, or SOFR), so any company executing on this strategy should work with a commercial bank that is prepared to manage this important transition.

The bottom line is that a ladder-of-maturities swap strategy may seem complex at first, but when a company works with an experienced commercial bank counterparty, this approach to reducing interest rate risk and expense can be as straightforward as paying a fixed amount each month.

Questions? We’re here to help. Call 1-410-244-4256 or your M&T Relationship Manager or visit us at mtb.com/commercial.