



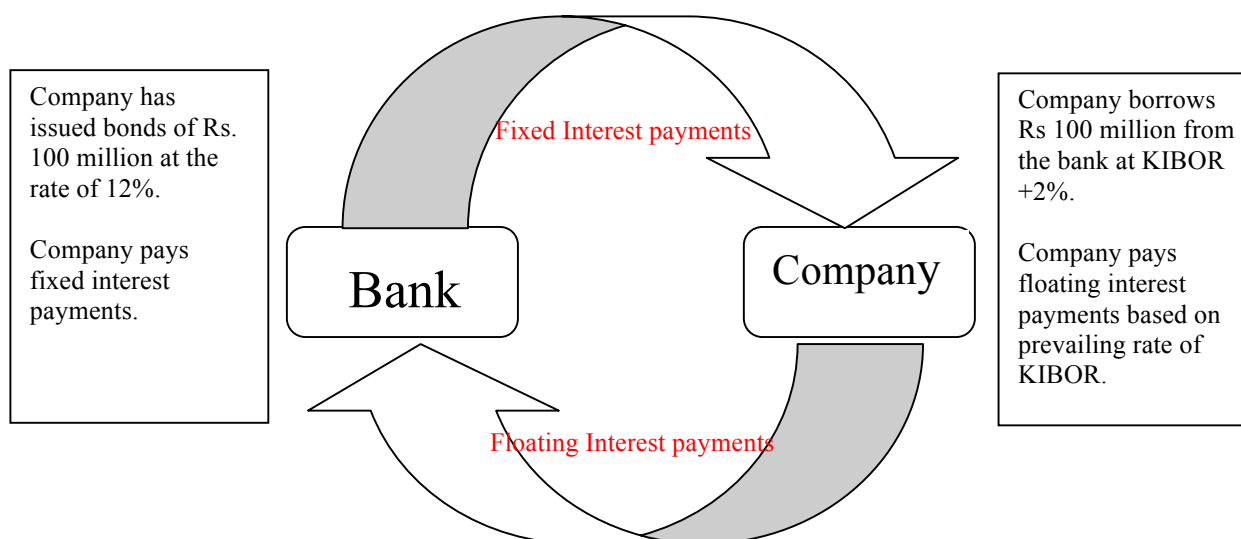
Interest Rate Swap

5 Jan 2013

Definition

Interest rate swap (IRS) is an exchange of two streams of cash flow.

A floating interest rate is one which keeps changing i.e. KIBOR, LIBOR etc. A fixed interest rate is one that remains unchanged over the tenor of the loan.



Why is KIBOR decreasing

KIBOR was at 14% in July 2011. Since then, it has come down significantly. KIBOR on Jan 2 was at 9.36%

Factors in decreasing trend:

1. Declining inflation
2. Incentive for Government of Pakistan (GoP) as servicing cost of government borrowing goes down.
3. Lower NIM (Net Interest Margin) of banks encourages them to lend money to the private sector. Increase in private sector lending at cheaper rates should boost growth.

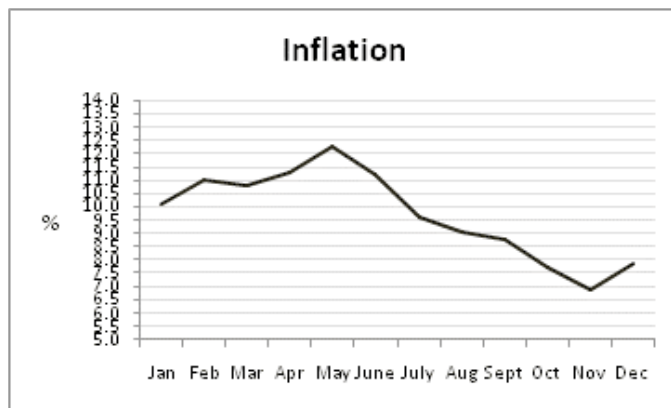
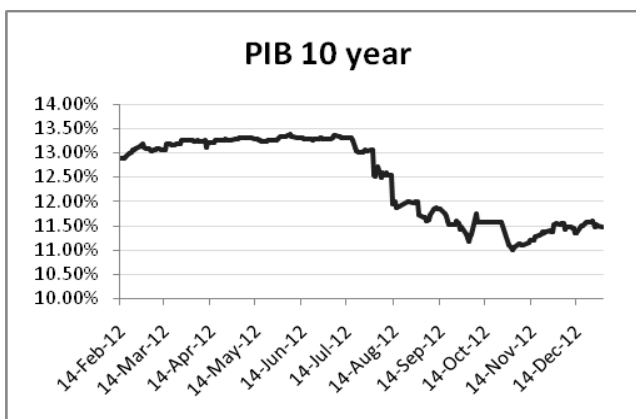
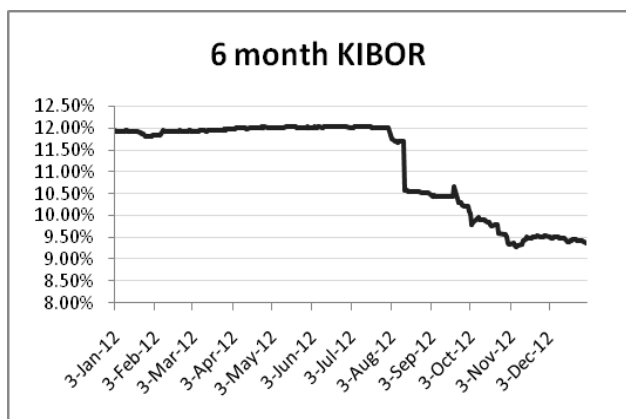


Interest Rate Swap

4. GoP anticipates that lower interest rates will mean less financial cost for the Government, which is currently the biggest borrower. Less financial cost will in turn reduce the fiscal deficit.

Factors why interest rates seem to have bottomed out:

1. Uptick in inflation (highlighted in the diagram below)
2. Scrutiny by IMF, which expects interest rate should remain high (primarily to curb inflation and encourage saving at the national level)
3. Preserve the strength of Rupee. Lowering interest rates will remove any incentive for investors to keep their investments in rupees.
4. An uptick in the 10 year PIB, could indicate that Financial institutions have started buying PIBs as they expect that Bonds may not go down any further





Interest Rate Swap

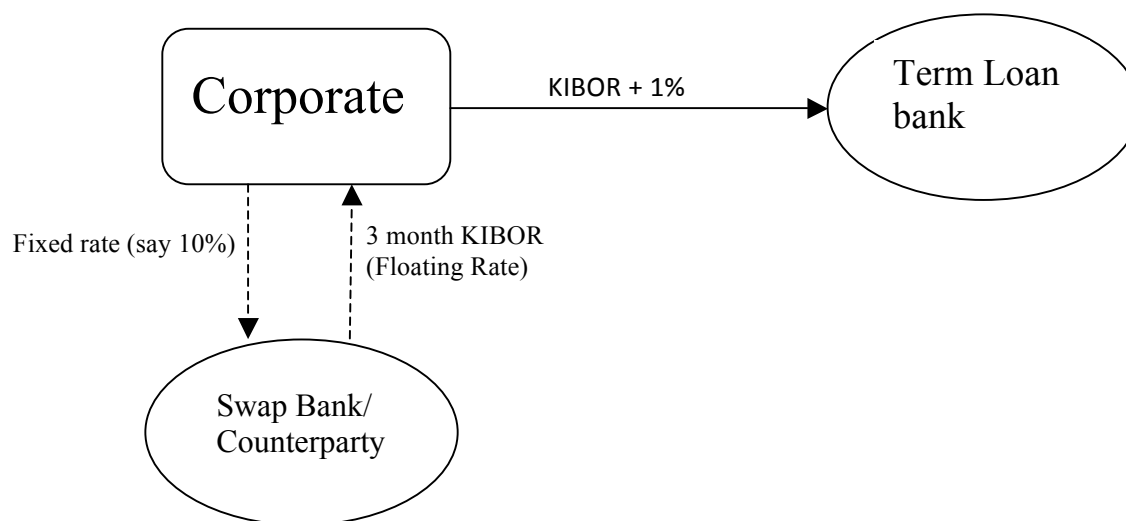
Interest rate Swap (IRS)

An interest rate swap, in its simplest form, is exchanging floating interest rate payments with fixed interest rate payments (called floating to fixed) or vice versa (fixed to floating).

If a customer agrees with the bank to fix their floating benchmark (KIBOR), they can lock KIBOR for 1 to 5 years (at a certain premium)

If interest rates go up again, the corporate will have KIBOR locked and will be indifferent to the rising interest rate scenario.

A corporate borrowed a loan at KIBOR + 1%. The interest rate swap works as follows:



In the example above, the Corporate receives the floating rate from Bank/Counterparty and pays fixed to them. The floating received is then paid to the Term Finance Bank. Therefore, the cost to the corporate is only the fixed rate payments



Interest Rate Swap

Proposal

Most analysts think interest rates have bottomed out or are near their lows. With the IMF seen to be playing a major role in the future, interest rates are likely to go up again. Keeping this in mind, (a partial/incremental) floating to fixed interest rate swap is maybe a good step to take at the moment. In this case KIBOR will be fixed.

Requirements for an Interest Rate Swap

- Loan outstanding on the obligor's books. The swap is always based on an underlying asset/borrowing.
- Approval from Board of Directors
- Approval from State Bank of Pakistan (facilitate by the Banks)
- Signing of ISDA(International Swaps and Derivatives Association) to sign with the transaction bank.

Challenges

Very few banks in Pakistan facilitate interest rate swaps hence the rates are not transparent and the terms are difficult to understand and negotiate. It also involves a good reading of macroeconomic indicators and on how& when to conduct the interest rate swap.

How do we help?

Hedging interest rates can be beneficial but a sound strategy is required. We provide a strategy by reviewing exposures and forecasting through sophisticated tools like "Boot Strapping" and "Present Values of multiple cash flows".

Strategy involves when to do it, optimal breakup of transaction, which tenor, amortizing structure or bullet etc.



Interest Rate Swap

What value can we add other than proposing a strategy?

- Help obtaining finer rates
- Help obtaining better terms and conditions
- Validating unwinding mechanism (very important, considering precedents)
- Comment on ISDA document
- Review collateral requirements

This is just an introductory paper on interest rate swaps.

For questions or discussion on interest rate swaps, please contact Komal Mansoor at 021-35202916 or email her at komal@landmark-investment.com