Interest Rate Hedging
Market Update
July 2005
Prepaymet: Swap versus Insurance Contract

MARKET UPDATE

The yield curve continues to flatten with the spread between the 5 year swap and the 10 year at 19 basis points. Short term rates continue to be pressured from expected FOMC action. The September futures level of 3.82% indicates a 100% probability of a 25 bps rate hike at the Aug 9th Fed meeting (already priced in) and a 92% probability of an additional hike at the Sep 20th meeting. Futures indications show an expected 4.33% LIBOR level for Jul, 06.

Swap rates came close to the lows for the year in late June but are now 34 basis points higher than late June levels.

MARKET AT A GLANCE				
		Current	Last mo	Change
PRIME		6.25	6.00	0.25
LIBOR	1 mo	3.46	3.19	0.27
LIBOR	1 yr	4.09	3.73	0.36
Treasury	5 yr	4.02	3.75	0.27
Treasury	10 yr	4.21	3.96	0.25
Swap	5 yr	4.32	4.07	0.25
Swap	10 yr	4.50	4.27	0.23

Prepayment Comparison: Swap versus Insurance Contract

When deciding between a swap and an insurance contract several factors are to be considered including early termination, or prepayment terms. Depending on a client's business plans, the prepayment terms may factor more heavily on the decision than pure rate. The illustration below compares the two.

Sample financing, assumes $10 million amount, 5 year term and 20 year amortization.

Prepayment Amounts: With 3+ Years Remaining				
Market Rate Change	Swap	Insurance	Swap - Insurance	Result
+ 150 bps	351,000	-	528,000	**swap is more favorable**
+ 100 bps	234,000	-	264,000	**swap is more favorable**
-100 bps	(234,000)	(351,000)	145,200	**swap is more favorable**
-150 bps	(351,000)	(468,000)	145,200	**swap is more favorable**

Positive: Payment due to client, (negative) payment due from client.

The swap is the only product that may result in a gain on early termination in a rising rate environment. Insurance contracts do not allow a payment, or gain to the client in any rate environment upon early termination.

Both a swap and an insurance contract will generate a charge to the client during falling rates. Should there be a charge to the client the resulting charge will always be less for a swap than for an insurance contract. The reason is the reinvestment rate used in calculating the yield assessment. The swap uses the rate on a new swap with comparable terms as the reinvestment rate while insurance contracts assume a Treasury yield as the reinvestment rate for their base. Since swap rates are always higher than comparable Treasury rates the difference between the existing fixed rate and the reinvestment rate is smaller for a swap. Some insurance companies are willing to add spread to the Treasury reinvestment rate allowing for a potentially smaller cost but this must be negotiated at the time of closing of the loan.

Swaps providers are bound by terms set forth by the International Swap Dealers Association, ISDA and as a matter of procedure, the calculation of a yield assessment is similar for each provider and a payment is typically made to the client should rates rise. While most banks follow ISDA convention for most terms of their swaps this does not mean the client will always realize the best results without assistance. Derivative Advisors acts as a client advocate to ensure clients realize the best terms and results of each transaction whether it be a new position or a termination of an existing one.