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SWAPS VERSUS FIXED RATE LOANS

Comparing proposals of a fixed rate financing from a bank, insurance company or conduit to that of an offering of a fixed rate Swap include a look at two important components. Swaps are often more competitive than that of a fixed rate loan when considering pricing and prepayment terms.

PRICING COMPARISON

Borrowers comparing pricing of fixed rate loans to fixed rate Swaps should be aware that banks typically price fixed rate loans based on the Federal Home Loan Bank, (FHLB) advances often resulting in higher rate quotes for borrowers. The FHLB rates are posted online at www.fhlbboston.com. The FHLB uses the swap market to quote their rates which are considered the cost of funds for the bank. Both the FHLB and the bank have costs imbedded in their fixed rates, so the borrower is left with having to pay both the funding provider and the bank a margin. Pricing fixed rate loans based on FHLB rates usually results in a higher fixed-rates for the borrower. For example, a 10-year fixed rate loan based on the FHLB rate is typically 75 basis points higher than a Swap offering. Borrowers should factor in the price advantage available by hedging with Swaps.

PREPAYMENT TERMS: SWAPS VS LOANS

Swap prepayment terms offer a two-way valuation which often results in a gain for borrowers upon an early termination in a rising rate environment while conventional fixed rate loans from banks, conduits and insurance companies do not allow for a gain upon termination should rates rise. When rates have dropped when a borrower terminates a fixed rate Swap a “make-hold” or penalty will be assessed by most finance providers. For Swaps, the market value is determined by a comparison of the existing fixed rate on the swap to a new market swap rate for a term with equal remaining years at the time of the prepayment. Terms for prepayments are standard in the industry as defined by the International Swap and Derivatives Association, ISDA. However, it is recommended that a borrower hire a consultant to check the pricing to make sure the cost or gain is set at a fair market level. A consultant can also arrange alternative unwind strategies such as an assignment to ensure a borrower is sure to receive a fair market value.

SAMPLE PREPAYMENT RESULTS FOR A $10 MILLION LOAN

Rate Change	SWAP TERMINATION VALUES 10 year Swap AFTER YEAR 3	AFTER YEAR 5	AFTER YEAR 7
Up 1.00%	$516,230.31	$395,946.33	$245,176.42
Up 0.50%	$262,310.43	$200,445.13	$123,544.00
No change	$87,916.35	$62,797.39	$43,958.17
Down 0.50%	($270,993.25)	($205,520.05)	($125,486.99)
Down 1.00%	($550,972.04)	($416,249.57)	($252,948.91)

NEW ADDITIONS TO THE TEAM!

Harbor Derivatives is pleased to announce two excellent additions to the team allowing us to provide enhanced service to our clients. Please email or call the office to welcome Tim and Mairead

Mairead Anderson

Mairead is an intern at Harbor Derivatives. Her responsibilities include analyzing new and existing hedges, providing marketing support and producing the weekly rate sheet. Mairead graduated from Thayer Academy and is currently enrolled at the College of the Holy Cross. She is a member of the lacrosse team and is an economics major.

Tim Weiss

Tim is a Sales Executive and Trading Consultant. He has over 25 years of experience in capital markets in Chicago, New York, London and Boston. His experience includes sales and trading of swaps, futures, bonds and equity derivatives at Citadel Investment Group and Societe Generale. He holds several industry licenses including Series 7, 4, 3, 24, 55 and 63. Tim graduated with a B.A. from St. Michael’s College.

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