

November 2012

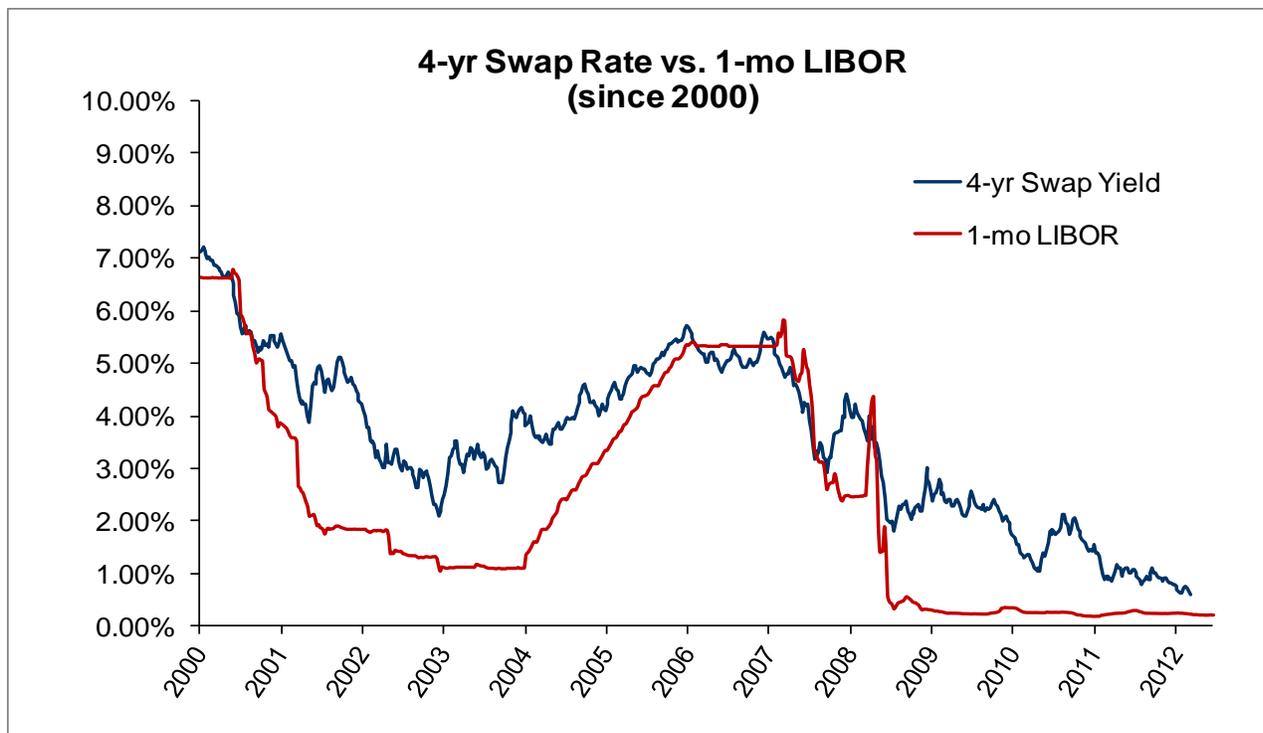
Swaps vs. the “True” Cost of LIBOR

When comparing fixed swap rates to LIBOR, one should compare swap rates with historical *average cost of LIBOR* over the same term of the swap in order to make an apples-to-apples comparison. When swap rates have appeared most attractive relative to LIBOR is when LIBOR was momentarily elevated, and the worst time to have chosen a fixed rate.

Background

Borrowers typically compare the current fixed swap rates to LIBOR, when making hedging decisions to protect themselves against the risk of rising interest rates. As shown in Exhibit 1 below (a graph of 1-mo LIBOR versus the 4-year swap rate), from 2006 on, Swap rates had either only a slight premium to LIBOR, or, were below LIBOR, appearing quite attractive relative to LIBOR.

Exhibit 1

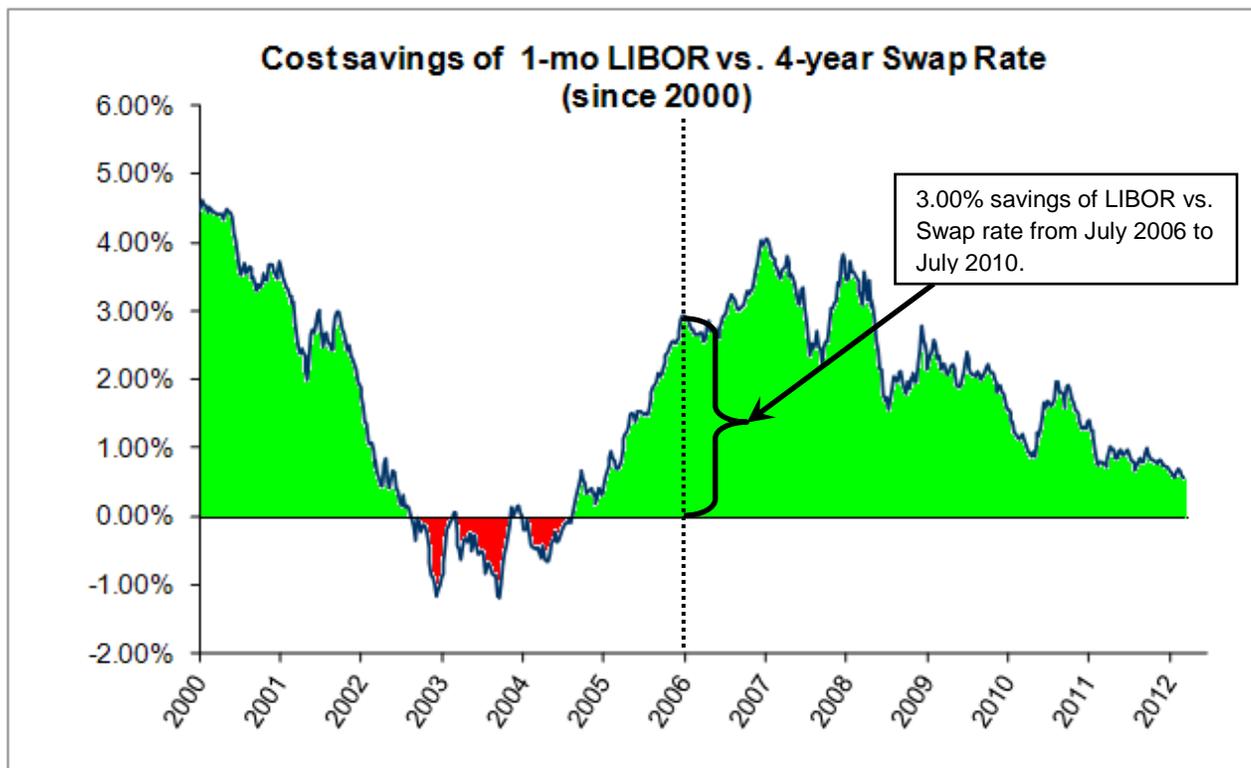


Utilizing the observations from this graph, one would erroneously conclude that during the 2006-2010 period there may have been only a slight cost advantage to LIBOR vs. the swap.

Discussion

The graph in Exhibit 2 below compares the swap rate vs. the *average LIBOR rate over any four-year period*, showing that for most of the time, LIBOR has averaged much lower over four-year periods, than the swap rate. In this graph the green areas represent the savings of LIBOR vs. the 4-year swap rate that existed on any date, for the subsequent four years (i.e. the height of the green area *at any one point*, would have been the borrower's savings rate over the next four years). The red area shows the *cost* of LIBOR vs. the swap rate.

Exhibit 2



As it turns out, there have been very few periods over the last 20 years where locking-in a 4-year swap rate would have resulted in a lower interest cost than paying a variable LIBOR rate. This phenomenon becomes even stronger with longer-term swaps (vice versa with shorter swaps).

In fact, during those periods when the yield curve was inverted (i.e. long-term swap rates were lower than LIBOR) 200, 2006-07, would have been the worst of times to have chosen a fixed-rate swap, since they represented the “top” of the market in rates.

Inverted yield curves in the U.S. have been the result of significant tightenings by the Fed, and which have in turn resulted in the economy slowing and short-term rates ultimately declining.

Summary

Since the most profitable type of hedge for a bank to sell is a long-term swap, the bank’s advice will be skewed towards convincing the borrower to implement a swap. As can be seen above though, a borrower hedging with a paying LIBOR (and hedging with a cap instead of a swap), would have saved significant interest costs. Unlike a swap, a cap allows a borrower to benefit from low LIBOR rates and still have a maximum rate (cap level).

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