DAG

DERIVATIVES ADVISORY GROUP

White Paper

Loan Hedging Requirements: How to Best Deal with Them

Introduction

Often a bank will include a “hedging requirement” in a variable LIBOR rate-based loan offer, mandating that the borrower enter into an interest rate swap upon closing the loan. For example, below is the wording from the term sheet for a recent client transaction of ours:

> **REQUIRED HEDGE:**
> Borrower will be required to hedge the floating interest expense by entering into an interest rate swap ("Swap") with XYZ Bank (or other counterparty acceptable to XYZ Bank), contemporaneously with the closing of the loan (specifically Phase II), pursuant to which Borrower shall receive the amount necessary to pay the interest expense due under the loan (exclusive of default interest or other adjustments provided for in the loan documents) and shall pay the amount that would be equal to the interest that would accrue on the loan at a fixed rate. XYZ Bank's estimate on the notional amount for the Swap shall be up to $13,000,000. XYZ Bank is willing to provide this Swap to Borrower upon mutually agreeable terms. Assuming a Swap were executed with XYZ Bank at today's rate, the Swap's fixed rate would be 5.0% on up to $13,000,000.

It is important to understand the motivation and incentives of the bank regarding such a hedging requirement for a loan. This paper will “pull back the curtain” on such a requirement and discuss a borrower’s best approach to satisfying/negotiating such a requirement.

Loan Hedge Requirement

Bank Motive - Profit

A bank will say that the hedge requirement in a loan is there to indirectly protect the bank by protecting the borrower from rising rates. The fact of the matter is, the *real purpose of a hedge requirement* is to force the borrower to buy a swap from the bank *so the bank can earn a profit on the swap.*

Logic (and law) Against the Hedging Requirement

It is disingenuous for the lending bank to say that the purpose of the hedge requirement is to reduce the bank’s risk on the loan (by reducing the borrower’s interest rate risk). A bank actually takes (and internally approves) risk to enter into a swap with a borrower. If you ask a bank to produce any computations about how the swap reduces the bank’s risk, you will get a blank stare, or some double-talk.

Additionally, by law a bank is prohibited from forcing a borrower to enter into a swap with it (see the OCC’s “anti-tying” statute here https://www.occ.gov/news-issuances/bulletins/1995/bulletin-1995-20.html). Because of this prohibition, the lending bank has to word the hedge requirement to allow the borrower to enter into a swap with another bank. But this is disingenuous, because the

Copyright 2013 DAG

derivgroup.com
704-554-1160

bank knows that *in almost no case will another bank offer the borrower a swap without collateral* (and the lending bank holds all the collateral).

Negotiation Strategy

Sometimes the language the bank uses for the hedging requirement will take the form of: "the borrower must hedge the loan's interest rate risk with an interest rate protection product which is acceptable to the bank". We have seen that borrowers can typically negotiate to buy an interest rate cap instead of a swap to fulfill the hedge requirement. This is typically a much more effective and cheaper way of fulfilling this requirement, while also offering the borrower protection against a potential rise in rates.

An interest rate cap offers the borrower protection against their rate going above a pre-determined maximum level, but allows the borrower to enjoy the benefits of a low rates if they don't rise. Sort of "having your cake and eating it too". A cap also has a much lower profit margin than a swap because a cap can be purchased from a bank other than the lending bank, leading to more price competition

Copyright 2013 DAG
derivgroup.com
704-554-1160