DAG

DERIVATIVES ADVISORY GROUP

White Paper

Choosing a Swap Rate: Swaps vs. the True Cost of LIBOR

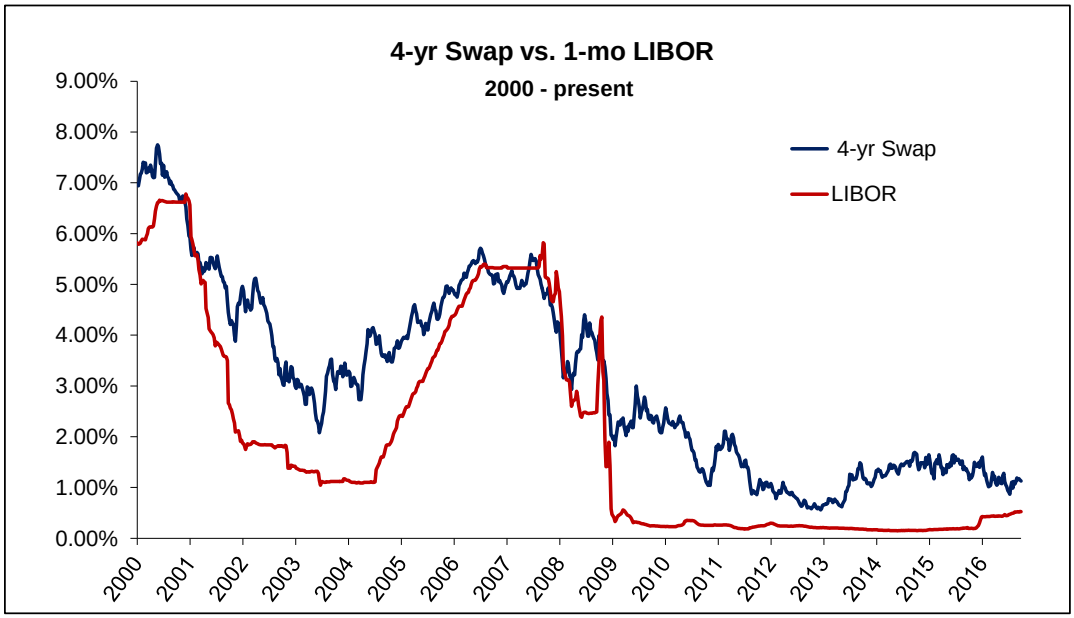
Swaps vs. the True Cost of LIBOR

When comparing fixed swap rates to LIBOR, we should compare swap rates with the historical *average cost of LIBOR* over the same term of the swap in order to make an apples-to-apples comparison.

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, from 2006 on, 4-year swap rates had either only a slight premium to LIBOR, or below LIBOR, appearing quite attractive relative to LIBOR.

Exhibit 1



The problem with this graph though is that it compares two rates with vastly different maturities, 1 month vs. four years! 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.

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Average LIBOR

The Exhibit 2 below compares the swap rate vs. the *average LIBOR rate* over any particular four-year period, showing that most of the time, *LIBOR has averaged much lower than the swap rate*.

Exhibit 2

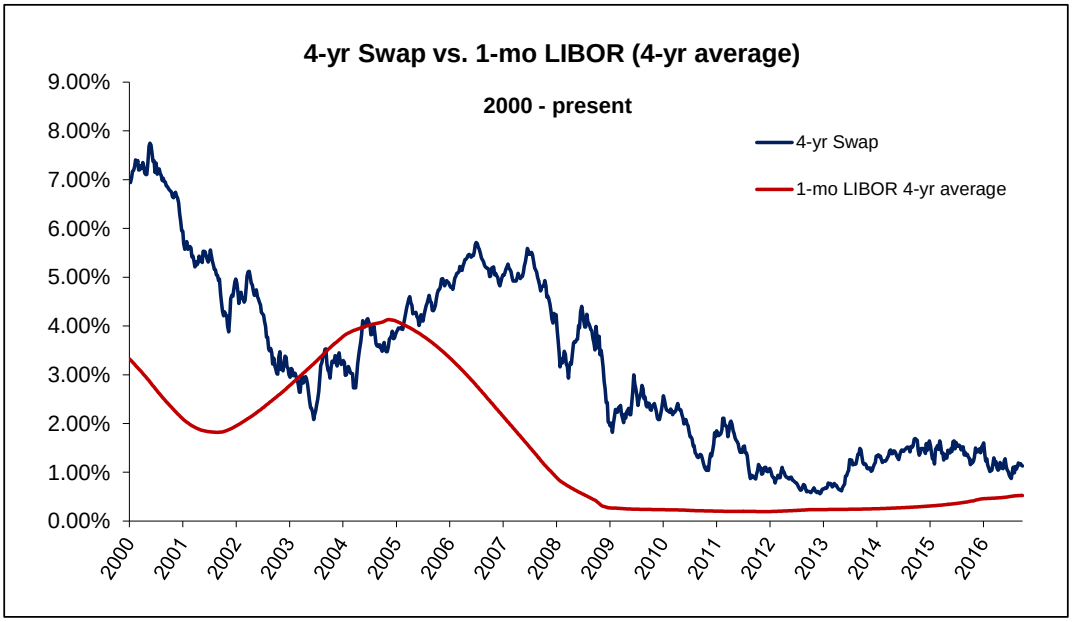
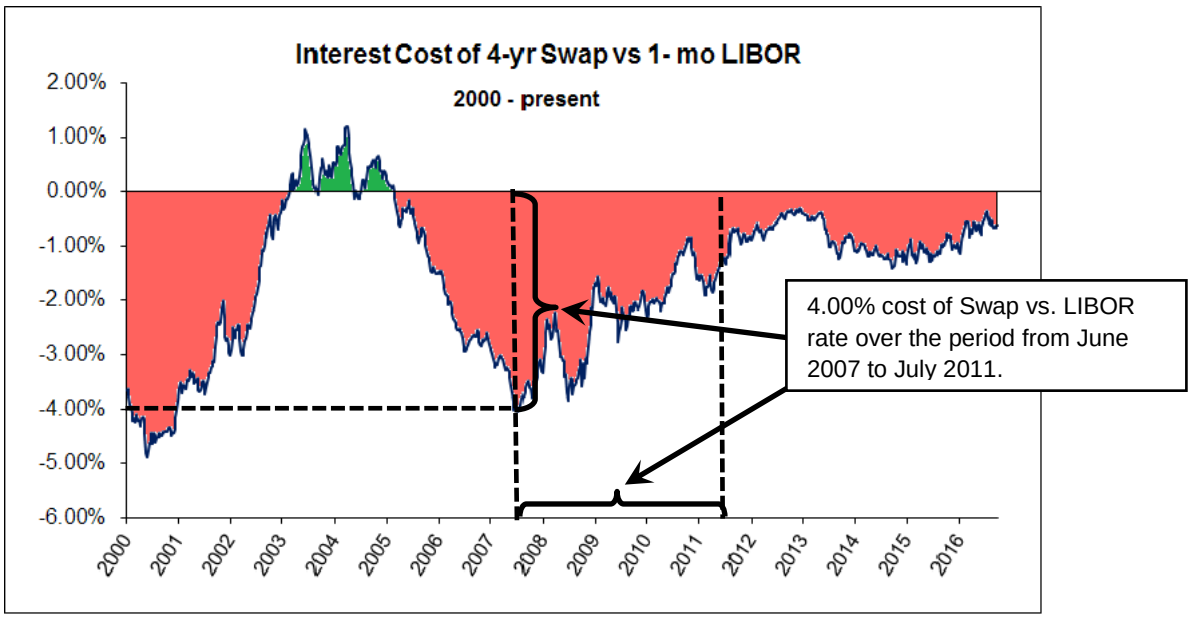


Exhibit 3 below graphs the difference between the two lines in the graph above. The red areas represent the cost of the swap vs. LIBOR on any date for the subsequent four years, and the green area the savings.

Exhibit 3



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As it turns out, there have been very few periods over the last 20 years when 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 pronounced with longer-term swaps (vice versa with shorter swaps).

During those periods when swap rates were lower than LIBOR and looked particularly attractive (i.e. the yield curve was inverted), 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 the biggest, longest swap a borrower can use. 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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