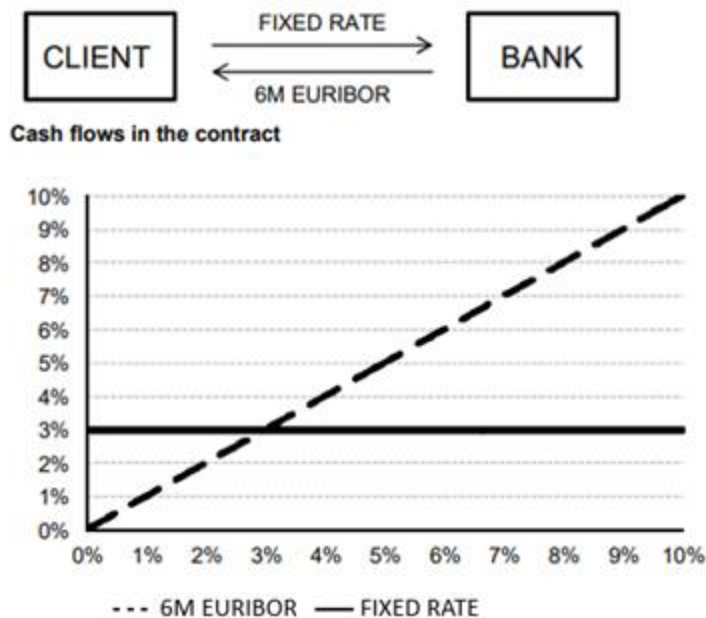
Information about interest rate swaps

Use of contracts

An interest rate swap is a contract between two parties to change the interest rate base of an investment or credit from floating to fixed or vice versa, or the interest rate base of a floating interest rate. An interest rate swap can, for example, be used to hedge against the rise of the interest rate of a floating interest rate credit by changing the rate to fixed-rate interest during the chosen period. The basis for interest payment is the notional amount of capital. No capital changes hands between the parties at any stage, the interest flows merely change owners.

Example

The client pays (the bank receives) a fixed interest rate of 3.00% under a five-year interest-rate swap and receives (the bank pays) 6-month Euribor.



If the floating interest rate is lower than the fixed interest rate, the client pays the net cash flow to the bank. If the floating interest rate is higher than the fixed interest rate, the bank pays the net cash flow to the client.

Risks

Interest rate swaps involve a market risk derived from the interest rate changes, because the parties entering an interest rate swap are obliged to pay the resulting cash flows regardless of the prevailing market conditions. If the market interest rates considerably change once the contract has been made, the interest rate swap may result in significant losses.

In addition to market risk, the interest rate swap's counterparty is subjected to counterparty risk. Counterparty risk means a risk that the interest rate swap's counterparty is not able to fulfil the obligations stated in the contract.

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Changes in an interest rate swap may cause extra expenses to the client based on contract's market values. If an interest rate swap is terminated prematurely, it may result in considerable termination costs depending on the swap's market value at the time. Clients should understand that if the swap's underlying instrument is an investment or credit and its terms are changed, for example, owing to premature repayment, it usually has an effect on the interest rate swap's character as a hedging instrument.

Fluctuation of interest rate swap's market value, and termination of contract

The market value of an interest rate swap is the net present value of the expected interest rate flows in the contract. The market quotations of interest rate swaps are determined by interbank markets, reflecting on future interest rate expectations. The pricing of interest rate swaps also takes into consideration the creditworthiness of the contracting parties.

The sensitivity of the interest rate swap's market value to interest rate changes is the bigger the longer the contract and the higher the capital.

An interest rate swap can be closed before maturity at the existing market value.

Financial commitments and obligations related to interest rate swaps

A party entering an interest rate swap is obliged to pay the resulting cash flows regardless of the existing market conditions.