August 2010 Newsletter

Amend and Extend

The Boost.

After a soccer game, my daughter often asks for a Jamba Juice. I, of course, tend to enjoy one as well because of all the sweating I have done on the sideline. On my first visit to Jamba Juice, I was asked what kind of boost would I like. I had this puzzled look on my face and my daughter gave me her "my dad is clueless" look. The person said "It's free!" so I asked my daughter which boost I should get, and she immediately suggested the one that increases your brain function.

We've recently seen many of our clients approached by their banks with offers to lower their existing swap rate by extending the maturity and/or adding to the notional. For some reason, the Jamba Juice anecdote springs to my mind as I think about these restructure ideas as enhancing the swap by giving it a boost of lowering your rate and freeing up some cash. The only difference is that this boost isn't free.

In the Blender.

Typically, these restructures are called "amend and extend" or 'blend and extend." The idea is rather simple; however determining true cost is more complicated. A hedger with a $10mm interest only 5-year pay fix swap executed 3 years ago would have a rate of about 5.05%. The current 5-year swap rate is now approximately 1.70%. How to combine the two and average down, you ask?

Rate Reduction.

How does the swap rate get reduced and what happens to the negative market value? In our example, the swap has a negative market value based upon today's 2-year swap rate. This means that if LIBOR follows the expected future path (we know that is unlikely) the hedger will pay the mark to market over the next 2 years.

Maturity Extension.

If a new 5-year swap rate is 1.70%, then it makes sense that one could lower the swap rate maturing in 2 years by extending the maturity date for 3 years. Given that we can't make the negative mark to market ("MTM") go away, it needs to be included in the amended swap rate. Therefore, we need to calculate how much the rate needs to be marked up in order to cover the negative MTM. If we take the MTM and divide by the value of one basis point we come up with how many basis points the MTM represents. By simply adding this to the 5-year swap rate you come up with the blended swap rate which would be 1.70% + 1.83% = 3.53%. That's a monthly cash flow reduction of 152 basis points or $12,666 per month for the next 2 years.

Easy in Theory, Pricing Somewhat More Complicated.

As most people know, derivatives aren't transparent and once you start restructuring them it gets even more opaque. When extending the maturity date of a swap there are several moving pieces. For instance,

calculating the market value of the existing swap and adjusting the longer dated swap rate to take into account the MTM is not easy unless you have a pricing system and live market feeds.

One also needs to consider that the bank had made fee income on the original swap. Any bank swap fees should only be measured on the extended portion of the swap and not on the 2 years remaining on the old swap (we call this double dipping). This is important considering that the value of one basis point on a 2-year forward 3-year swap is much lower than the value of one basis point on a 5-year swap.

Is This Strategy Right For You?

This can be a very effective strategy for a number of reasons. It can lower, in the short term, interest payments and provide interest rate protection beyond the original maturity date of the swap. Economically, extending the maturity date of the swap and lowering the rate is equivalent to executing a 2-year forward starting swap for 3 years. The only difference is that the original swap rate remains the same and the new forward swap rate is lower than the extended swap. One needs to keep in mind that the reduction in monthly cash flow doesn't come without a price—it's not savings.

We can help you decide if it's worth pursuing a restructure and analyze the additional risks you are taking by extending the maturity date. There may be more effective alternatives and less expensive structures than extending the life of a swap. If your bank has proposed restructuring your existing interest rate swap, please give us a call and we can help make sure that the restructure meets your needs and is priced appropriately. We will also suggest alternative strategies base upon your firm's cash flow and goals.

Market Benchmarks

Treasuries			
	Current	Month Ago	Year Ago
2 Yrs	0.53%	0.64%	1.18%
3 Yrs	0.78%	1.01%	1.70%
5 Yrs	1.55%	1.80%	2.66%
10 Yrs	2.90%	2.96%	3.63%
30 Yrs	4.04%	3.91%	4.41%

LIBOR			
	Current	Month Ago	Year Ago
1-Month	0.30%	0.35%	0.28%
3-Month	0.43%	0.53%	0.47%
6-Month	0.65%	0.74%	0.90%
9-Month	0.82%	0.94%	1.22%
12-Month	1.02%	1.16%	1.48%

FWD Implied	
3ML Rate	
Dec. 10	0.43%
Dec. 11	0.92%
Dec. 12	1.69%
Dec. 13	2.48%
Dec. 14	3.29%

SIFMA: Tax-Exempt Rates			
	SIFMA Setting		SIFMA Swap[1]
Current	0.28%	3 Yrs	0.82%
Last	0.29%	5 Yrs	1.43%
52 Wk Avg	0.27%	10 Yrs	2.46%
% 1-ML	93.33%	15 Yrs	2.95%
% 3-ML	64.41%	20 Yrs	3.18%

Spot Starting LIBOR Swap[2]			
	Current	Month Ago	Year Ago
2 Yrs	0.59%	0.84%	1.44%
3 Yrs	0.92%	1.21%	2.09%
5 Yrs	1.62%	1.95%	2.90%
10 Yrs	2.78%	2.92%	3.77%

Forward Starting LIBOR Swap[2]			
(FWD Premium bps)	3 Yrs	5 Yrs	10 Yrs
6 Mos Fwd	32.0	32.8	20.8
12 Mos Fwd	67.0	65.8	41.1
18 Mos Fwd	105.0	99.8	62.0
24 Mos Fwd	142.0	130.8	82.0

OIS	
Rate	
3M	0.18%
6M	0.18%
12M	0.22%
24M	0.45%

% of LIBOR Swap[2]			
	67% LIBOR		70% LIBOR
3 Yrs	0.62%	3 Yrs	0.64%
5 Yrs	1.09%	5 Yrs	1.14%
10 Yrs	1.86%	10 Yrs	1.95%
15 Yrs	2.23%	15 Yrs	2.33%

Note: If amortizing, the SIFMA swap rate or % of LIBOR swap rate is lower.

5/25 yr[3]	7/25 yr[3]	10/25 yr[3]	15/15 yr[3]
1.59%	2.16%	2.67%	2.71%

Fed Funds	Prime	JPY	Eur
0.25%	3.25%	85.81	1.3235

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