Porter, White & Company

The Value of Transparency in Swap Pricing

Derivatives White Paper, JULY 2009, Number 6

I. Introduction

One of the most important services we provide in our assignments as swap adviser is transparency in pricing, which means that we provide our clients with an estimate of how much a bank is going to charge on a proposed swap. Banks tends to cut their spread (or gross profit), which is often not disclosed prior to our involvement, by the mere fact that they know that some-one has been hired by the client to look over the shoulder of the bank. In one of our assignments, the implied reduction in fee on an interest rate swap as a result of our involvement was almost 38%. We refer to this savings, brought about by our mere presence in the deal, as "implicit sav-ings."

II. Transaction Costs and Implicit and Explicit Savings

The transaction cost in a simple fixed rate swap transaction is the difference between the fixed swap rate that a bank is offering a borrower and the swap rate that is available in the market place for the bank. This is measured by the "spread from mid-market," and includes compensation for the bank to cover items such as its own transaction costs, credit risk on the borrower with respect to the swap, and profit on the swap transaction. For example, if the bank can enter into a fixed rate swap,[1] with another bank, at a rate of 5.00%, [2] it may offer its borrower a fixed rate of 5.20%. The difference of 0.20% (20 basis points), would be referred to as the spread from mid-market and is the gross income to the bank to cover the items listed in the previous sentence. (A small bank, or a bank with questionable credit might have to pay more to "lay off" a swap.)

The spread from mid-market is the transaction cost of entering into the swap and the present value of this spread is the immediate liability that a borrower takes on by entering into the transaction. A borrower has an incentive to minimize this spread, assuming they know what it is, and the swap dealer has an incentive to maximize the spread since it represents income for the bank.

Explicit savings from a negotiation of the spread is easily identified if the bank initially asks for a 20 basis point spread but after negotiations with the borrower agrees to 15 basis points instead. The borrower explicitly saved 5 basis points through the negotiations

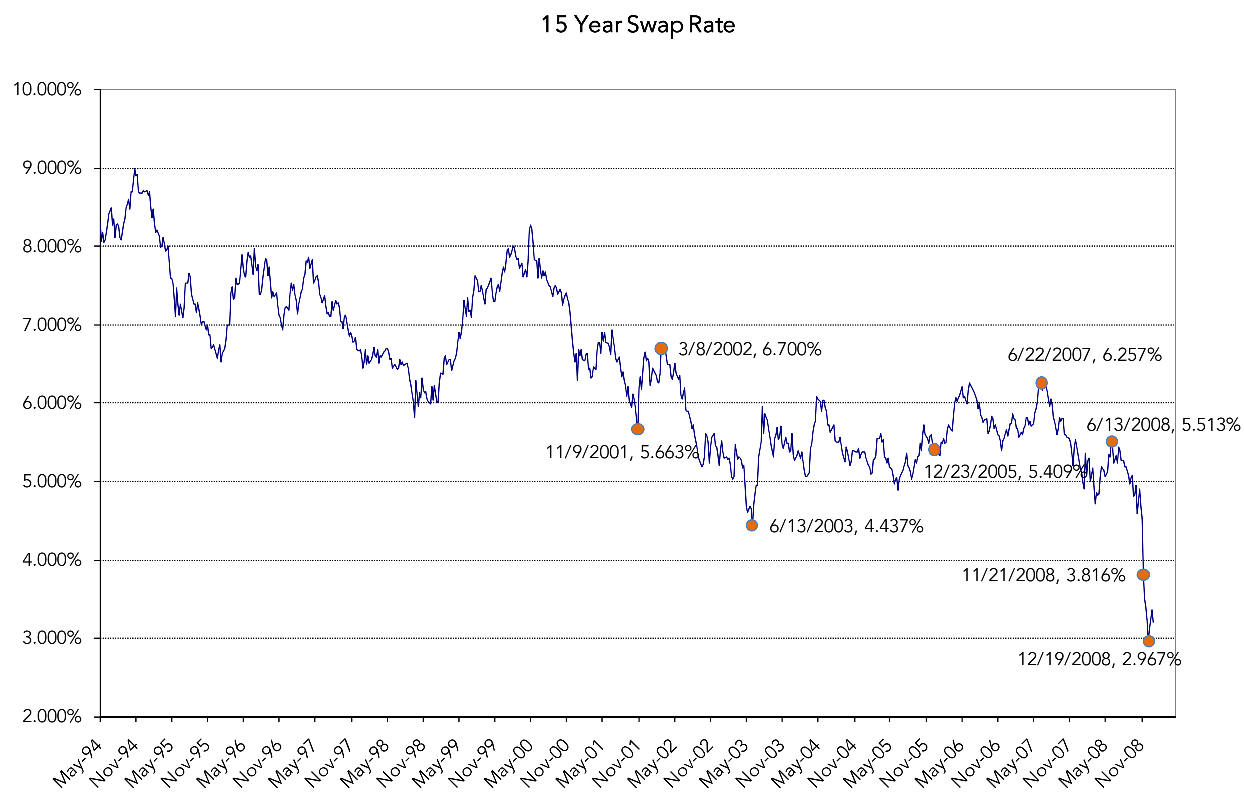
[1] Or otherwise hedge the transaction in another market, such as the futures market.
[2] Plus/minus bid-ask spreads in the dealer swap market, which tends to be low relative to "end-user" spreads.

PW&Co Investment Banking

Implicit savings, on the other hand, is less easily defined but can be thought of as the difference between the spread the bank would charge if a borrower had no insight into the market versus full insight into the market. For example, the bank may offer a borrower a fixed rate of 5.30% and if the borrower has no insight into the market he does not know that he is being charged 30 basis points for the transaction. In this case, if the borrower obtains insight into the market and subsequently is only charged 20 basis points, the implicit savings would be 10 basis points. In other words, the bank would never state that they would charge 30 basis points unless asked, and then they would only charge 20 basis points.

Implicit savings are therefore very hard to calculate since no swap dealer would publicly say what they would charge if they know that the other party had no insight into the market and most estimates are based on anecdotal evidence.

In one of our assignments, however, our client had been provided with interest rate information prior to our involvement. The rate information provided by the swap dealer is shown in the picture below. We randomly picked eight data points and added labels (red dots).



Comparing the eight random data points to the closing mid-market rates reported by Bloomberg for the same dates, shown in the table below, it appears that the bank embedded a charge of 40 basis points for presentation purposes when marketing swaps. However, after our involvement and when asked for their proposed spread, the bank offered 25 basis points.

	Rate (%)		
Date	Graph	Bloomberg	Difference (Basis Points)
11/9/2001	5.663	5.263	40.0
3/8/2002	6.700	6.300	40.0
6/13/2003	4.437	4.037	40.0
12/23/2005	5.409	5.009	40.0
6/22/2007	6.257	5.857	40.0
6/13/2008	5.513	5.113	40.0
11/21/2008	3.816	3.416	40.0
12/19/2008	2.967	2.567	40.0

This means that the implicit savings by having transparency in pricing on the client's side when negotiating with a swap dealer may be worth as much as 15 basis points.

On several occasions we have experienced similar reductions in spread once the counterparties know that a party with market insight is involved on behalf of the client. For example, we have been involved in terminating transactions where termination amounts, apart from market movements, have almost doubled to the benefit of the client as a result of us bringing transparency and our clients have received fixed rate swap offers that have included spreads of an estimated 45-50 basis points before concrete discussions about compensation for executing swaps.

III. Dollar Value of Implicit Savings

The actual dollar value of the implicit savings depends on the size and term of the transaction and the value of 15 basis points may range from, say, $25,000 on a $2 million swap to several hundred thousand dollars on a $50 million swap.

To calculate the dollar value of the implicit savings, we begin by calculating the present value of a basis point for the life of the swap. For example, the present value of one basis point (0.01%) on a $10 million 15-year swap, given a 4.00% LIBOR swap rate, is $11,200, which means that saving 15 basis points would be worth $168,000 (15*$11,200).

IV. Conclusion

The advent of interest rate swaps used in conjunction with variable rate borrowings in middle-market corporate finance, in contrast to traditional fixed rate loans, has provided banks and borrowers with a whole set of new tools in managing interest rate risk. However, with these new often complex tools, comes the ability for the more informed to take advantage of the less informed, and unless the playing field is leveled there is a substantial chance that the parties at an advantage will make excess profits to the detriment of the less informed. It is important to keep in mind that the swap desk is a separate profit center for dealers and each basis point gained by the bank is paid for by the borrower.

As we have shown here, the cost of informational disadvantage may be substantial and is likely to far outweigh the cost of professional advice when executing derivatives. We are in the business of leveling the information playing field when it comes to derivatives. While we often provide our clients with alternatives that provides more flexibility or save explicit costs, when compared to the deal they are being pitched, our greatest value may be just showing up at the meeting with the bank.

C. Johan Grahs
July 1, 2009

Porter White and Company
15 Richard Arrington, Jr. Blvd., N. • Birmingham, AL 35203-4103 • P.O. Box 12367 • Birmingham, AL 35202-2367
205/252-3681 • FAX 205/252-8803 • www.pwco.com