

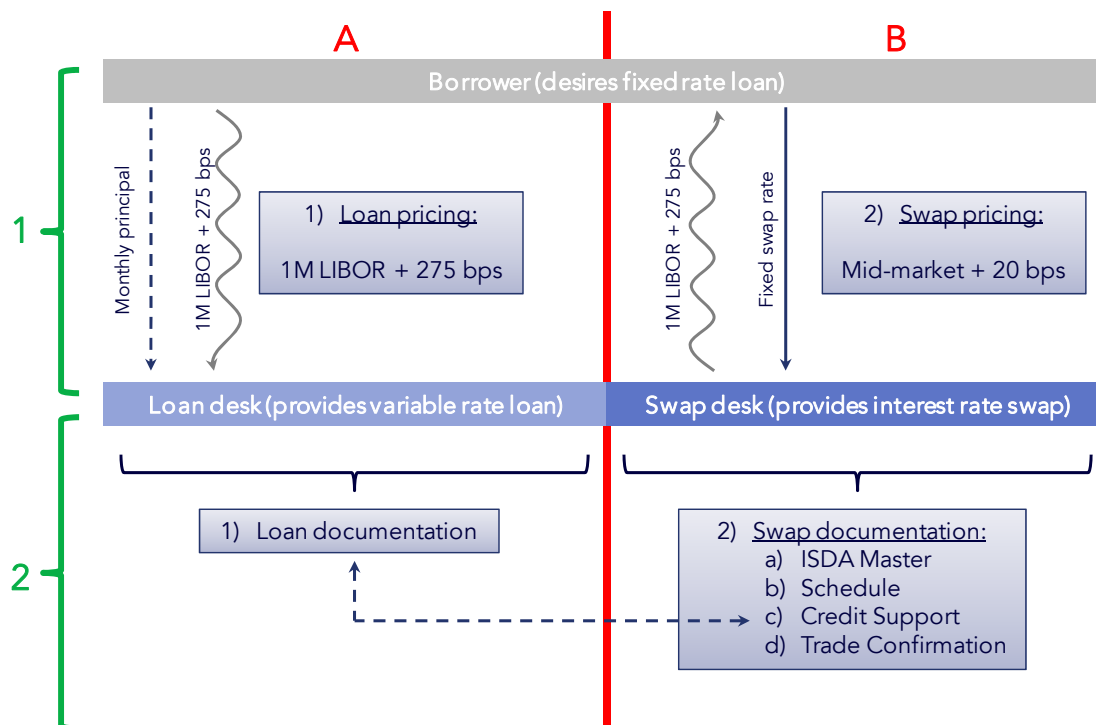
Porter, White & Company

Negotiating Synthetic Fixed Rate Loans

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I. Introduction

Despite the unanticipated disasters that have occurred with complicated swap transactions, synthetic fixed rate loans relying on interest rate swaps have become customary in middle market bank lending, as well as for much larger loans. Explaining a synthetic fixed rate loan is almost impossible without a chart. The chart we use for this purpose is shown below.



II. Negotiating a synthetic fixed rate loan

A synthetic fixed rate loan is very different from a traditional fixed rate loan where there is (a) a loan document and (b) a principal and interest payment schedule. Fixed rate loans today are offered as a combination of (i) a variable rate loan and (ii) a swap. The process of negotiating and pricing loans has changed and unless borrowers and their professionals understand the new negotiating dynamics, they will not be able to compare different loan offers, pricing terms will not be transparent, and negotiating leverage will be lost.

The chart above can be thought of as a 2x2 matrix, where the columns (A and B) specify the products that are combined and the rows (1 and 2) specify how they should be negotiated. Column A (on the left) is the loan itself including the pricing terms of the loan and the documents securing the loan with specifications of collateral. Column B (on the right) is the fixed to floating swap. The swap converts the variable rate of the loan to a fixed rate for the borrower. The swap has two important components: pricing terms and security terms. Often, the collateral underlying the loan will secure the swap as well.

To repeat, while it is natural to divide this transaction into its “product” components (the loan and the swap), once a borrower commits to one of the products (often the loan), he generally gives up negotiating leverage on the other product. It is therefore better to negotiate the loan and the swap simultaneously.

The top row (1) specifies the pricing terms for the loan and the swap. The bank frequently separates negotiation of the spread over LIBOR (on loan) from negotiation of the spread over mid-market (on swap).¹ To the borrower, it is the total spread that is relevant [spread over LIBOR (loan) + spread over mid-market (swap)]. The two spreads should be negotiated simultaneously. The spread over mid-market on the swap is almost never disclosed during negotiations unless someone like PW&Co is on the borrower’s team.

The bottom row (loan and swap documentation) specifies the security and collateral for the loan and swap. For most bank loans, the collateral securing the loan and the swap will be the same. The documents for the loan and the swap should therefore be negotiated simultaneously, keeping in mind that the swap’s value can vary substantially, sometimes in favor of the bank and sometimes in favor of the borrower.

Given that the structure of the ISDA² form documents used to negotiate swaps are different from traditional loan documents, understanding the interaction and overlap between the loan and swap agreements is of great importance in documenting agreed terms. Loan and swap documents are usually initially drafted by the bank and should be negotiated by borrower’s counsel to ensure that they are consistent with agreed terms. Borrowers should not accept blindly the documents offered by the bank.

III. Conclusion

While it is natural to think of, and negotiate, a synthetic fixed rate loan in its “product” components, loan first and then swap, this is not the correct approach. The loan and the swap share security and market characteristics that are best negotiated simultaneously.

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¹ Mid-market means the midpoint between the bid and the ask fixed swap rate for a given set of terms and high credit counterparties. It may be viewed as the “whole-sale” rate. ² International Swaps and Derivatives Association.

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