

**CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE?****ELLIOTT JONES****Executive Director  
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My topic is swaps and capital markets transactions. A colleague of mine in New York has commented about swaps "he who knows, does not speak, he who speaks, does not know". Having given you that perspective I will now try to give a brief review of how swaps are used in capital markets transactions and you can judge where I fit on my colleague's spectrum.

I would like to define two common types of swaps. First is an interest rate swap. In an interest rate swap agreement, two parties agree to exchange interest rate payments. Most commonly one party agrees to exchange a stream of fixed rate payments in return for receiving a stream of floating rate payments. The stream is calculated by reference to a notional principal amount and is paid periodically, normally semi-annually. Importantly, an interest rate swap does not involve an exchange of principal but only a stream of payments. In US dollar interest rate swaps the fixed rate amount is specified for the life of the contract and the floating rate is calculated periodically by reference to an index such as LIBOR, the London Inter Bank Offered Rate, or for Australian dollars in reference to the Australian bank bill rate.

A currency swap is an agreement between two parties to exchange obligations of interest from currency A to currency B and when done in conjunction with a new capital raising an initial exchange of principal also occurs. Because explaining the concept in words was difficult for me, let me give you a specific example for a deal on which we quoted; a Swiss franc - Canadian dollar swap.

The company we were dealing with had a fixed rate Swiss franc liability, created through issuing a fixed rate Swiss franc bond, but wanted a fixed rate Canadian dollar liability for a period of seven years. We quoted on a swap with the company in which we agreed to the following terms.

On the effective date of the swap the company would pay us 117,000,000 in Swiss francs in return for receiving 78,000,000 in Canadian dollars. This rate of exchange was determined by the spot exchange rate for those two currencies at the date of the

exchange. On each annual payment date the company would pay us 11.23% times the 78,000,000 Canadian dollar amount and we would pay him 5.8% times the Swiss franc amount. Both these rates reflected the interest rates then current in the respective markets. At the maturity of the swap contract we would repay the 117,000,000 in Swiss francs and the company would repay us the 78,000,000 in Canadian dollars. This is the same spot rate as the initial exchange of principal. The effect of this transaction was to create for the company a Canadian dollar liability for a seven year period, which reflected rates in Canadian dollars out of what was originally a seven year Swiss franc liability.

Just to note the major differences between an interest rate swap and a currency swap - in an interest rate swap no exchange of principal occurs. In a currency swap there is an exchange of payments in two different currencies which is not the case in an interest rate swap. A currency swap may involve fixed interest payments by both parties as in the previous example as opposed to a fixed to floating payment which is the norm in an interest rate swap.

Swaps have any number of variations to them and I would just like to cite the major elements that could be varied. First, timing: Does the swap start now or at some time in the future? Two, repayment: Is the swap repaid in a bullet or does it amortise? And finally, options: Do the parties have an option to enter or not enter the swap at some future point?

Having defined swaps, how are they used in capital markets transactions? Basically they are used to take advantage of arbitrage opportunities as they exist between different markets. This arbitrage can be either credit perception and/or a market access arbitrage.

For instance, AAA borrowers have a significant advantage in the Eurodollar fixed rate market, where they may be able to borrow at a 100 basis points better for 10 years than a BAA borrower. One basis point is a 1/100th of 1%. However, for short-term floating rate paper the differential might be only 25-30 basis points. The key point is while the AAA borrower has an absolute advantage in both markets, he has a comparative advantage in the fixed rate market. And it is the presence of this comparative advantage that creates the arbitrage opportunity.

In an Australian context, AIDC is rated AAA by virtue of its Commonwealth guarantee. It needs to raise US dollars to fund its US dollar loan portfolio. It can and does raise floating rate debt, but it can often raise cheaper floating rate debt by raising a fixed rate Eurobond. For example, AIDC could issue a 10 year Eurobond at say 30 basis points over the prevailing US Treasury bond. Simultaneously, it could enter into a 10 year interest rate swap to receive a payment at 90 basis points over the same Treasury bond and pay 6 months LIBOR flat. AIDC receives a rate in a swap that is 60 basis points over the coupon

it is paying on the Eurobond. The 60 basis point saving is then notionally deducted from the LIBOR payment that AIDC has to make. Thus AIDC ends up with a cost of funds of 60 basis points under LIBOR which is probably a 40 basis points saving over its cost of funds if it had been raised simply by issuing floating rate debt.

A second example of where swaps are used to take advantage of market opportunities is in the Australian dollar Eurobond market. The Australian dollar Eurobond market is primarily a retail market; that is, small investors rather than institutional investors buy these obligations. Recently the Australian dollar retail investor has been concentrated in Germany. Such retail investors buy names they know rather than necessarily by the issuer's credit rating. German investors have been attracted by the high coupon offered by Australian dollar bonds versus domestic DM issues or US dollar bonds, but they do not know Australian issuers, though Australian companies may be fine credit risks in their own right. Therefore, giving investors what they want, a number of German banks, well known in Germany, have issued Australian dollar bonds. Naturally they have no use for Australian dollar debt, so they swap the proceeds in a combined currency and interest rate swap with another financial institution who will pay the German bank a rate higher than the coupon on the underlying Australian bond against receiving US dollars at LIBOR. The German bank ends up with funding costs below its normal US dollar LIBOR cost and this allows it to match the basis of its US dollar assets.

The financial institution squares its position by doing another swap or two to ultimately receive fixed Australian dollars and pay LIBOR, normally with an Australian obligor who wants to pay fixed Australian dollars. The whole transaction works because the German investor will accept a rate which is lower than the prevailing fixed rates in Australia but is higher than his alternatives. And the net result is that Australian issuers are accessing the A\$ bond market through a German bank issue.

A similar market opportunity existed in the US early in 1986 when a number of investors in the US wanted high yielding securities and bought both fixed and floating A\$ denominated bonds registered with that terrible Securities and Exchange Commission. Without the swaps out of A\$ for issuers the volume of A\$ Eurobonds and Yankee Bonds would have been substantially reduced.

In the above the issuer was undertaking the swap. However, a new trend is emerging where the investors are sold not only the bond itself but a swap with it. Essentially what this attempts to achieve is to allow lower rated issuers access to the bond markets and provide investors who are credit knowledgeable with floating rate instruments. For instance, a few lower rated US corporates have issued bonds at 150 basis points over the US Treasury rates for the same maturity. Commercial banks who are satisfied with the credit risk are sold a \$10,000,000 bond and a \$10,000,000 fixed to floating swap. The overseas bank is

receiving 150 basis points over US Treasury's from the issuer but paying 90 over in the swap.

If he buys the bond with \$10 million of floating rate debt at LIBOR he is effectively making a floating rate loan at 60 basis points over LIBOR, being the 150 basis points he is receiving less the 90 basis points he is paying. By converting the bond to a floating rate asset, the swap has created investor demand for lower quality fixed rate debt by giving the investor what he wants, a floating rate and tradeable asset.

The benefit to the issuer is that although the issue cost may be higher than his alternatives, he may have received funds for a longer period of time and with less restrictive covenants than through a straight bank loan.

Swaps can also be used by investors to maintain liquidity yet, as we say, move out on the yield curve. For instance an investor might buy a portfolio of Euro commercial paper. He might then enter into a swap to pay floating LIBOR and receive a fixed rate. This allows him to increase his return by receiving the higher fixed rate (assuming a positive yield curve) yet maintain the liquidity inherent in the short-term portfolio.

The risks to be considered in a capital market transaction linked with a swap are:

1. Pricing of the underlying issue - because major financial institutions act as principals in swaps, they may be willing, because of the positioning of their swap book, to be very aggressive when offering to launch a capital markets issue. As long as the swap is "off market" this benefits the issuer. However, if the issue price is "off market", the capital market issue may get poor reception and give the issuer a bad name.
2. Timing - While not really a risk, because an issue with a swap has to be priced at the same time, it involves a commitment by Australian issuers to decide quickly on a combined package. Obviously, the issuer has to be well in tune with the market to make these quick judgments.
3. Credit risk - In a straight capital markets issue, the issuer is taking no real credit risk as investors are buying his debt. With a swap the issuer has the credit risk of a counter party to perform his side of the swap. In an interest rate swap the risk is that he ends up with a fixed or floating rate debt payment stream when he wanted the opposite. In a currency swap, like the one cited earlier, if the swap fails for any reason, the issuer ends up with a liability in currency, i.e. Swiss francs, that he didn't want initially. The resulting final cost of the issue could be substantially different than he originally estimated because of currency movements.

I hope the above has given you a feel for how swaps are used in conjunction with capital markets issues. It is difficult to say how many capital markets issues involve swaps, but enough so that most swappers would argue that the question is put the wrong way around. The question is, how many swaps involve a capital markets issue?