Introduction to interest rate swap

JYSKE BANK

An interest rate swap is an agreement between two parties to exchange interest payments over a specified time period. An interest rate swap always contains:
- a payer leg (you either pay fixed or floating interest)
- a receiver leg (you receive the opposite type of interest)

The swap determines whether you pay or receive fixed or floating interest, the frequency at which it is calculated and the duration of the contract.

The purpose is to change ones interest rate risk without refinancing a loan.

Opportunities associated with interest rate swaps!

You can use interest rate swaps if you want to keep your existing loan, but want to change the type of interest on the loan - e.g. from fixed to floating interest or vice versa. In this way, an interest rate swap allows you to hedge and assume interest rate risk, depending on how you use it.

From floating to fixed interest - or vice versa
A typical scenario is that you have a loan with a floating rate, but find that a fixed interest is more attractive at the moment. The reason being that you anticipate interest rates to move higher or want to reduce your interest rate risk.

In this case, you have two options:
- Refinance your entire loan into a fixed-rate loan
- Keep your floating-rate loan and supplement it with an interest rate swap

Keep the loan, but swap payment flows
If you opt to supplement your existing loan with an interest rate swap, your repayment and interest terms on the loan remain the same. At the same time, you enter an interest rate swap, which allows you to:
- receive floating-rate interest
- pay fixed-rate interest

This swap offsets the floating interest payments on your loan, to make your total payment flow corresponds to a fixed-rate loan.

However, it is not always possible to fully hedge a position. The reason being that e.g.:
- the swap and the loan are based on different interest rates (for instance, overnight rate on the loan vs. 3-month interest rate in the swap)
- the margin or contribution rate may change on the loan

It is also important to note that a traditional interest rate swap is uncallable, as opposed to a callable mortgage loan, which is callable at par.

An interest rate swap only involves the exchange of interest payments - not an exchange of repayments.

Framework agreement with the Bank
When you trade interest rate swaps with the Bank, you always enter into a framework agreement. This framework agreement details:
- how the Bank manages and monitors the risk that you assume
- the fact that the Bank may close the interest rate swap or require collateral, if the market value moves in a negative direction that exceeds any pre-arranged credit limits.

Market value
The market value of an interest rate swap is calculated as the present value of all future payments in the agreement. This is how the calculation is made:
- if the payments are not known at the balance sheet date, they are determined on the basis of market estimates
- each future payment is discounted to a present-day value
- the market value is the sum of these present values

Extreme market conditions
Under special and extreme market conditions, market rates may not be available. In this case, the Bank may not be able to facilitate your closing the position, which might increase your risk of incurring a loss.

1. Benefits and drawbacks!

You pay fixed and receive floating interest

Benefits	Drawbacks
You protect yourself from interest rate increases.	If the interest rate decreases, the swap depreciates.
The value of the swap appreciates, if the interest rate increases.	This may result in a requirement of collateral.
	The swap is not callable.
	Fixed interest rates are typically higher than floating rates.

You pay floating and receive fixed interest

Benefits	Drawbacks
You will typically have a lower interest rate in the beginning and will benefit from decreasing interest rates	You do not know the future interest rate.
If rates decrease, you can close the swap at a profit.	The risk of incurring a loss, if the interest rate increases.
	May trigger a requirement of collateral.
	The swap is not callable.

2. Returns!

Returns in an interest rate swap is dependent on changes in interest rates. If you pay fixed-rate interest and receive floating-rate interest, you will typically profit from any interest rate increases. Conversely, if you pay floating-rate interest and receive fixed interest, you will profit from any interest decreases.

3. About risk!

The market value of an interest rate swap may become negative, if interest rates move against your position. This means that, as a customer, you must be able to tolerate interest rate increases as well as decreases, as the changes may affect your credit terms and your borrowing capacity.

It is important that you have sufficient financial strength to cope with major interest rate fluctuations.

As the product is a derivative financial instrument, we recommend that you consult your advisor, if you have no experience with derivatives.

Jyske Bank A/S · Vestergade 8-16, DK-8600 Silkeborg
Tel. +45 89 89 89 89 · Fax. +45 89 89 19 99 · jyskebank.dk

SWIFT Code JYBADKKK
Business Reg. No. DK-17616617

4. What you should know before trading!

When trading interest rate swaps, you enter into a framework agreement with the Bank. The Bank may require collateral or opt to call the agreement, in the event of major market fluctuations. It is important that you ensure that the product suits your financial situation and risk profile.

Taxation

Tax rules vary depending on whether you are trading as a private individual, a business or a company. For a specific assessment, we advise you to consult an accountant.

Costs and expenses

Trading in interest rate swaps involves a premium or discount on the interest rate. The size of this premium or discount depends on the market conditions and the Bank's margin.

Jyske Bank A/S · Vestergade 8-16, DK-8600 Silkeborg
Tel. +45 89 89 89 89 · Fax. +45 89 89 19 99 · jyskebank.dk

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