

Affordable Housing Finance

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The Ins and Outs of Swaps

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For the past several years, interest-rate swaps have been widely available to affordable housing borrowers as a method to fix the interest rate on a loan.

Under the swap structure, a borrower closes on a variable-rate loan with a lender and enters into a separate interest-rate swap with a "swap provider." Until recently, the swap provider would typically be a financial institution other than the lender.

Swaps are attractive to a borrower when the cost of a variable-rate loan with a swap is less than the cost of a traditional fixed-rate loan. If the borrower is not comfortable with the additional complexity and risk of a swap, the borrower may prefer to obtain a traditional fixed-rate loan and not take advantage of any of the cost savings that come with a swap.

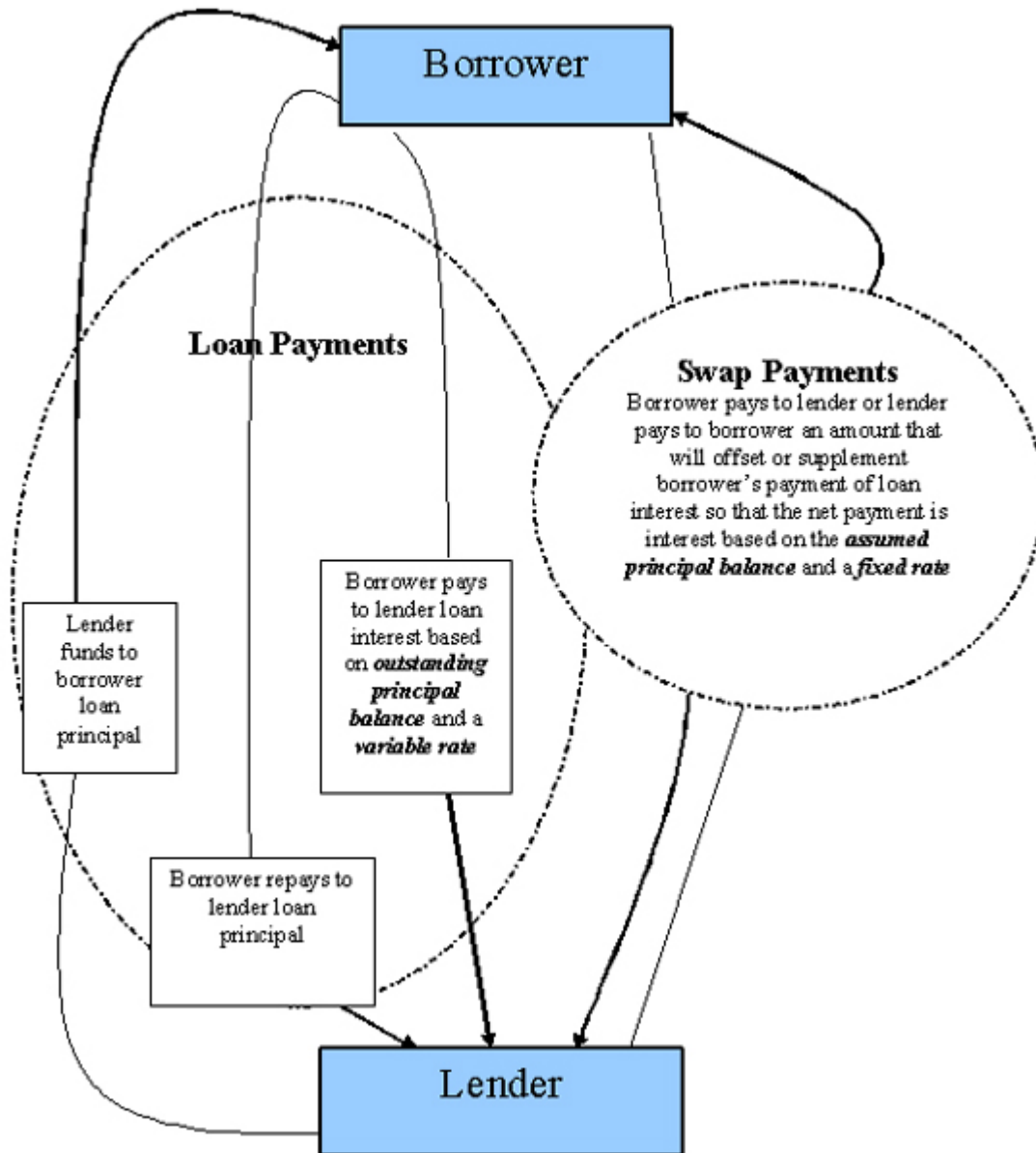
In recent months, borrowers have had less flexibility to determine the method of fixing the interest rate on their loans. In lieu of traditional fixed-rate loans, lenders are increasing their use of interest-rate swaps as the preferred method to achieve a fixed interest rate. This article describes the structure of this product, which is referred to here as a "synthetic fixed-rate loan." This article also explores the benefits and drawbacks of synthetic fixed-rate loans, and offers some thoughts as to why lenders offer it as a preferred product.

Synthetic fixed-rate loan

The primary difference between the synthetic fixed-rate loan and prior swap structures used for loans is that with a synthetic fixed-rate loan

the same financial institution acts as both lender and swap counterparty. The following chart illustrates this new structure.

Synthetic Fixed-Rate Loan



The synthetic fixed-rate loan consists of two transactions. First, the borrower obtains from the lender a variable-rate loan that requires monthly payments of interest and possibly periodic payments of principal. Second, the borrower enters into an interest-rate swap with the lender as swap provider. The swap establishes a "fixed rate" and includes a schedule of "assumed principal balances" to approximate

what the parties expect to be the outstanding principal balance of the loan over time.

Each month, either the lender or the borrower owes a payment to the other party. If the variable rate on the loan is more than the fixed rate on the swap, then the lender pays the borrower the difference between the rates times the assumed principal balance for that month. If the variable rate on the loan is less than the fixed rate on the swap, then the borrower pays the lender the difference between the rates times the assumed principal balance. The assumed principal balance may be subject to reduction for certain prepayments on the loan.

Thus, under normal circumstances, the swap payments and the loan interest payments offset each other, resulting in the borrower being obligated to pay net interest based only on the fixed rate, even as market interest rates change over time.

Benefits

The primary benefits to borrowers of the synthetic fixed-rate loan compared to a traditional fixed-rate loan are:

- Lower cost of funds. Variable-rate borrowing with a swap often costs less than a traditional fixed-rate loan.
- More choice of lenders. Because some lenders no longer offer traditional fixed-rate loans (or only offer them at a significant premium), a borrower that is open to using a swap will have more choices as to potential lenders.
- Possible lower cost of prepayment. Prepaying a traditional fixed-rate loan often requires paying a yield maintenance prepayment penalty, which can be significant even when market interest rates do not change. Prepaying variable-rate debt does not involve a material yield maintenance prepayment penalty, but prepayment may require a swap termination payment, which can be substantial if market swap rates decrease. Some borrowers prefer to take swap termination risk since it relates to market interest rate changes without an extra payment to maintain a yield. Also, if market swap rates increase, the lender (not the borrower) will be required to make the swap termination payment.

Drawbacks

The primary drawbacks or risks to borrowers of the synthetic fixed-rate loan compared to a traditional fixed-rate loan are:

- Lender failure to pay. If interest rates rise above the fixed rate set at closing and the lender fails to make payments under the swap (due to a bankruptcy or for other reasons), then the borrower still may be obligated under the loan to make payments to the lender based on the higher variable rate. Failure to make the extra payment could be an event of default under the loan, notwithstanding the lender's default under the swap. This is a concern not only for the borrower, but also for its tax credit investor, which may require some level of underwriting as to the lender. Under a traditional fixed-rate loan, the lender's ability or willingness to pay is irrelevant.
- Higher potential cost of default. A default under a traditional fixed-rate loan typically will result in a yield maintenance penalty under the loan documents. A default under variable-rate debt does not involve a material yield maintenance prepayment penalty, but the default can require a swap termination payment. Conservative borrowers may prefer not to take swap termination risk since in certain interest rate environments the swap termination payment will exceed the traditional fixed-rate loan prepayment penalty.
- Mismatch. If regulatory requirements or other industry-related events increase the lender's cost of funds, then the borrower may be obligated under the loan to make additional interest payments. Similarly, the timing of draws and payments on the loan could result in the assumed principal balance being less than the outstanding principal balance of the loan. If either of the foregoing applies, the borrower could be required to pay interest based on a rate that exceeds the fixed rate. Under a traditional fixed-rate loan, the interest rate would not increase as a result of the lender's cost of funds or the timing of draws.
- Hurdles to negotiation. The swap and the loan are often handled by different departments of the lender, which can complicate and limit the ability of a borrower to negotiate the swap documentation. A traditional fixed-rate loan does not involve documents other than loan documents.

Documenting the swap

The swap portion of the synthetic fixed-rate loan is documented by three agreements, each signed by the borrower and the lender: (1) a confirmation, (2) an International Swaps and Derivatives Association, Inc. (ISDA), master agreement, and (3) a schedule. The confirmation

often is limited to memorializing the dollar amounts and interest rates that the parties agree to at closing. The form master agreement is not edited by the parties. Instead, the schedule will modify the terms of the master agreement. ISDA publishes a form schedule, which identifies areas that the parties to a traditional swap will often negotiate. However, the ISDA form schedule is not designed for the synthetic fixed-rate loan. Thus, the schedule should be tailored to reflect the special relationship of the swap to the loan.

Swap documentation is very complicated and has traps for the unwary. Borrowers should be careful not to inadvertently agree to events of default and termination events under the swap (e.g., cross default) that are broader than events of default under the loan. For this reason, it is important that borrowers using swaps retain counsel experienced not only in affordable housing lending, but also in complex financial instruments such as swaps.

Lenders prefer swaps

Certain lenders have demonstrated a preference for the synthetic fixed-rate loan. While each lender has its own particular reasons for using the swap, there are some common factors. First, the lender may enter into a separate swap with another swap counterparty to offset the lender's obligations under the synthetic fixed-rate loan. This separate swap can reduce the lender's exposure to rising interest rates. Also, in some situations, lenders will book a profit on the swap with the borrower soon after loan closing based on the difference between the fixed-rate under the swap and the actual market rate for that swap. Finally, the loan portion of a synthetic fixed-rate loan may be more marketable to sell or participate than a traditional fixed-rate loan.

Conclusion

A growing number of lenders are offering the synthetic fixed-rate loan as a preferred product. Borrowers should be aware of its structure, benefits, and drawbacks, as well as the value of negotiating the swap documents.

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