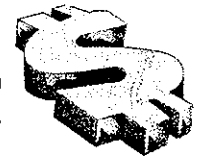



# Weekly News & Comment

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## MONEY MATTERS



### The development of the swap market

By **Deborah Hicks Midanek**, a turnaround manager active in the financial services sector who heads the New York office of **Glass & Associates** and founder of the interest rate swap desk at **Drexel Burnham\***

**Editor's Note:** Over the past year, a number of judges — even those with a substantial financial background — have commented to us about the increasing difficulty of understanding all of the new financial instruments and creative financing arrangements that come before the court. We decided to help. This is the second in a series of occasional articles in which financial experts from Wall Street and other arenas will take us all through a crash course in finance. If you have specific topics you would like to see covered or areas in which you consider yourself to be an expert, please call BCD Managing Editor **Michelle Laque Johnson** at (800) 860-5086, ext. 301 or e-mail her at [mjohnson@lrp.com](mailto:mjohnson@lrp.com).

The last 10 years of strong momentum in the equity markets and relatively low volatility in the bond market have provided a fertile environment for the feverish growth of ever more exotic "derivative" instruments. Swaps of interest rate risk, equity and currency risk, disaster and credit risk have become commonplace, expressed in various forms as collars, corridors, floors and so on. The pace of innovation has been staggering, and the legal and accounting professions, though laboring mightily, are by definition behind the curve.

Indeed, bank regulators and economic policy pundits have become increasingly concerned as this shadowy world creates an invisible network of global connections. With increasing volatility in all financial markets, the impact these murky instruments can have on companies and economies needs to be more broadly understood. Leaving the legal interpretation of individual contracts aside, this article seeks to provide an intuitive framework for understanding what's going on.

When these instruments were first introduced in the early 1980s, they were a response to the genuine needs of different categories of borrowers and investors. They represent a textbook case of financial intermediaries filling the role they were intended to play. At its most basic, the swap contract allows players in the financial markets with different advantages in their own markets to pool their advantages and each improve its position as a result.

As an example, the first participants were banks. A small bank with an advantage in its local deposit market, an ability to raise low cost long-term floating rate liabilities, might need to match fund a term

ing. The size of the loan and of the bank itself might make the cost of fixed rate borrowing prohibitive. A large bank might have access to attractively priced fixed rate funds but instead need the lowest possible floating rate cost of funds to match the interest rate risk of its large floating rate corporate loan book.

In order to share their respective advantages and achieve their goals, the two parties, brought together by the financial intermediary, would enter into an agreement, in effect estimating the value of their advantages and apportioning them. The small bank would pay the big bank a stream of fixed rate payments and receive from the big bank a stream of floating rate payments.

Initially, the two parties, introduced by the intermediary, would be the parties to the contract, and the intermediary would simply take a fee for its services as marriage broker. Each contract would be individually negotiated, taking into account the timing of payments due, the damages on liquidation, netting possibilities, credit, tax and cross border issues. Advantages were shared based on the average performance over some period of time of a floating rate index. Since so many of these early transactions were driven by low fixed rate financing available in the Euro markets, most of the early deals used easily observable LIBOR to denominate the floating rate side of the deal.

In the early days, intermediaries would receive a telex from the end user, setting forth the terms of the desired deal, and generally have an exclusive mandate for a period of months to find the counterparty. Clearly, these transactions were off the balance sheet and there were no public disclosures required on anybody's part. Fees were substantial, and the intermediary with the best net-

work of counterparties and, especially, access to borrowers in the Euro markets, had a major advantage.

As long as these deals were negotiated one by one, however, there was a limit to activity, and the intermediaries active in the market knew they had a limited period of time in which to enjoy the benefits of relatively little competition. The next step was, in retrospect, predictable.

Intermediaries began to "warehouse" deals. To avoid the need to scramble to find a counterparty deal by deal, where timing, credit concerns and transaction size were difficult to match even if pricing was acceptable, the intermediaries would enter into a swap contract as principals, laying off the other side over time, and piece by piece.

This development increased swap activity substantially, and fueled further evolution. The intermediaries, now dealers, had to learn to manage the interest rate risk associated with their warehouse positions, and, with the significant increase in volume as well as the intermediaries' own exposure, documentation had to be standardized.

While initially the province of the investment banking side of the house, when intermediaries became dealers, responsibility for the hedging function moved to

the trading desks. Master agreements with repeat users were created, early termination penalties were made consistent and the **International Swap and Derivatives Association** was born to help develop market standards.

In other words, swaps became tradable instruments, and borrowers and investors could effectively separate the source of funding from the nature of the interest rate risk they were willing to accept. Once this paradigm was established, and mechanisms were in place to evaluate and trade risk per se, the range of applications naturally began to proliferate. Any aspect of risk that could be measured could be swapped for a price.

As swaps began to trade, rather than remaining with one counterparty for the life of the deal, conventions surrounding value developed as did secondary market liquidity, to the point where dealers today consult screens showing current activity in order to value many different kinds of swaps in an instant.

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