Swaps

A swap is an agreement between two counterparties to exchange cash flows or the liabilities from two different financial instruments over a certain period of time.

Whilst the underlying financial instruments can be almost anything, most swaps involve cash payments made to the other party at specified intervals based on a notional principal amount (i.e. face or theoretical value). Latter usually does not change hands (neither during nor at the end of the swap), unlike is the case in a future, a forward or an option contract. With each cash flow of a swap referred to as a "leg", one of them is usually fixed, the other one variable (i.e. uncertain) and based on a benchmark (e.g. interest rate, floating currency exchange rate, some index price). - However, swaps can also be used to exchange other kinds of value or risk, such as a bond potentially defaulting.

Most swaps aim at reducing losses from market fluctuations by transferring unexpected risk to a party who is ready and willing to carry the respective loss. However, swaps can also serve as tools for accessing previously unavailable markets (e.g. a foreign firm seeking exposure to a more attractive currency exchange rate by contracting with some local firm).

Swaps do not trade on exchanges: Instead, they are Over-The-Counter (OTC) contracts between businesses or financial institutions, customized to the needs of both parties. Due to their embedded risk of counterparty default, swap contracts are not eligible to retail investors.

Frequently used swap structures are, among others:

- Interest rate swap: The counterparties agree to exchange one stream of future interest payments (usually fixed) for another (usually floating), based on a predetermined notional principal amount.
- Currency swap: In this case, the counterparties exchange both, the principal amount and interest payments denominated in different currencies. Whereby, the rates in the contract are usually the same for both, the inception as well as maturity period (i.e. the principal is exchanged along with the interest obligation).
- Commodity swap: For a given period of time, the counterparties exchange floating cash flows based on a commodity's spot price for fixed cash flows determined by a pre-agreed price of a commodity (e.g. crude oil).
- Total return swap: Here, an asset is exchanged for a fixed interest rate, whereby the party paying that gets exposure to the underlying asset without having to pay the capital to hold it.
- Credit default swap: Providing insurance from the default of a debt instrument, the buyer transfers to the seller the premium payments. If the asset defaults, then the seller will reimburse the buyer the face value of the defaulted asset, while the asset will be transferred from the buyer to the seller.
- Debt-equity swap: Often applied in relocating a corporate´s capital structure in the course of a financial restructuring exercise, with the lender exchanging a credit portion for an equity stake.

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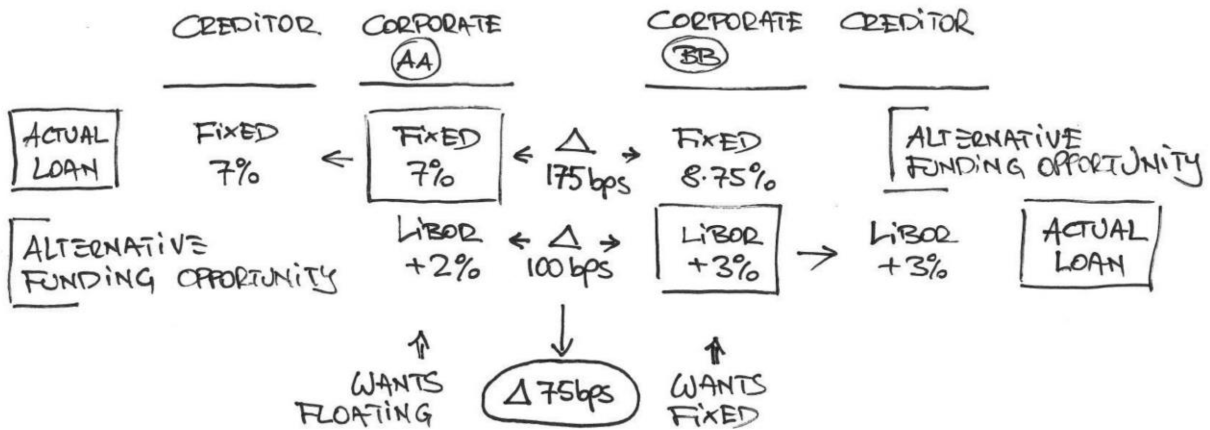
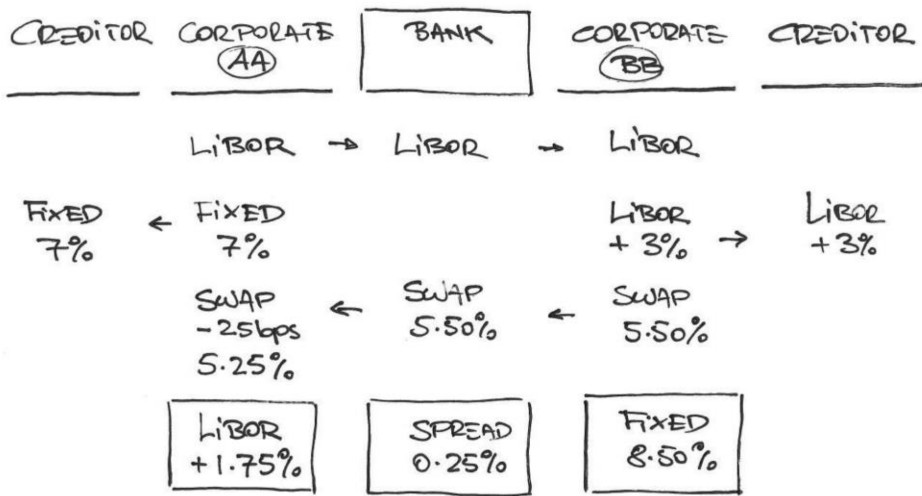


SWAP STRUCTURE



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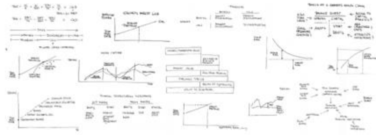

Corporate Finance Concepts

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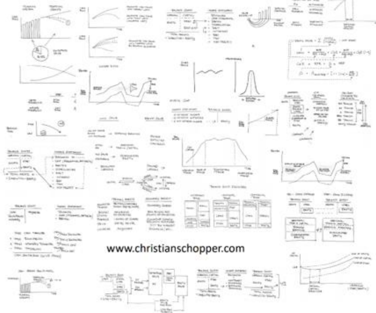

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