

Contents

I. Feature:
"An Introduction to Interest Rate Swaps"

II: Senior Living:
"Coming Home: Recreating Evansville"

III: Health Care:
"Creating Healing Environments for Hospitals" by Kimberly Nelson Montague

IV: Affordable Housing:
"Behind the Jargon: What's Going on with LIHTCs"

V: The Nonprofit Minute:
"The Failure of Market Timing as an Investment Strategy"

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Feature

by Kass Matt

An Introduction to Interest Rate Swaps

Interest rate volatility can significantly affect an organization's cash flows and its ability to service variable-rate debt. Recent Federal Reserve actions and market instability have contributed to fluctuations in the cost of capital. When considered along with the current shape of the yield curve, they have created an opportune time for organizations seeking more control over cash flows to examine their exposure to floating interest rate risk.

Organizations with existing debt and those considering new debt should look at interest rate options as key structural considerations. Borrowers can use swaps to hedge their interest rate based upon their individual situations. As such, the main goal of a swap is to stabilize cash flow and mitigate susceptibility to interest rate swings. This is particularly desirable for nonprofit organizations that seek to maintain financial strength over the long term and fulfill their missions in perpetuity.

Additional benefits include creating a more flexible financial structure, the current ability to access fixed-rate capital at lower levels than those historically available to the borrower,

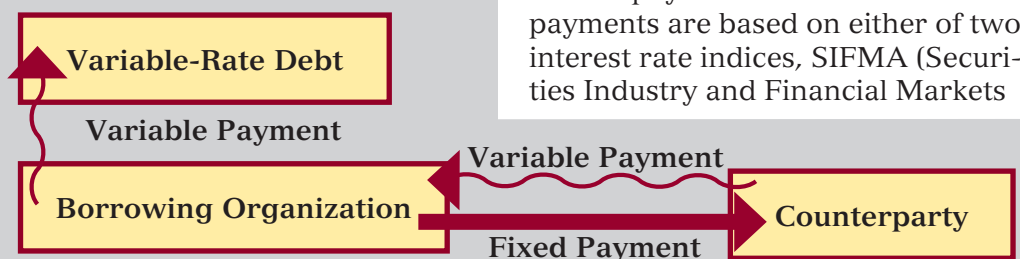
and the ability to enter into a swap at any point of a bond's amortization.

The keys to most effectively utilizing swaps are:

- Identifying variable interest rate risk exposure and determining whether, and how much, to hedge by examining all aspects of the financial profile, including operating margins, investment portfolio composition and debt structure.
- Tapping into a swap's flexibility and tailoring it to a borrower's specific cost, timing and existing debt limitations.

How Does a Swap Work?

In an interest rate swap, two parties agree to exchange interest payments based on a principal amount (the notional) over an agreed period of time (the term). An organization with variable-rate debt will pay out a different amount in interest expense each period, depending on where rates fall. In hedging the variable-rate debt, the borrower agrees to pay out a fixed amount each month to a counterparty in exchange for receipt of a variable-rate payment that approximates the borrower's debt service payment. These variable-rate payments are based on either of two interest rate indices, SIFMA (Securities Industry and Financial Markets



The Capital Issue: Feature

Association, formerly Bond Market Association) or a percentage of LIBOR (London Interbank Offered Rate). The SIFMA and LIBOR indices approximate the rates paid on tax-exempt and taxable bonds, respectively. The two variable cash flows offset each other, synthetically fixing the rate on the borrower's debt. The counterparty receives a fixed payment from the borrower. There is no exchange of principal; only payment of the loan's interest is impacted.

Fixed-rate debt vs. synthetically fixed-rate debt

The decision to issue fixed- or floating-rate debt will have significant impact on an organization's financial profile, administrative requirements and future financial flexibility. Issuing fixed-rate debt may at times be the most appropriate choice, and can often benefit borrowers. But it can also impose considerable upfront and ongoing disclosure requirements. Further, fixed-rate debt will typically be locked out from prepayment for a period of time and require upfront costs not associated with variable-rate debt.

Issuing variable-rate debt and hedging that debt with an interest rate swap will achieve the goal of predictable debt service without the additional burden of a fixed-rate obligation. A key additional benefit of this strategy is the flexibility afforded by interest rate swaps, as a borrower can fix all or only a part of the variable-rate debt, for any time period. As only a small percentage of fixed-rate obligations are carried through maturity, this flexibility can be valuable when a borrower looks to restructure debt.

How Much, For How Long?

An interest rate swap can be arranged for any term subject to the agreement of both parties; typical terms range from three to 25 years. As swap transactions are independent of the underlying debt, the structure maintains a tremendous amount of flexibility. They do not have to be tied to letter of credit enhancements, or to the banks that issue them: If a borrower has a five-year letter of credit, it can still execute a fixed-rate swap for a 20-year period. Swaps can be restructured or retired at any time to match the organization's hedging strategy, and they carry no direct prepayment penalty.

They will, however, be subject to a current termination value where either a borrower will make a payment to the counterparty to cancel the transaction, or vice versa. The termination value (often referred to as the mark to market) will depend on interest rates at the time of termination. In a swap restruc-

ture, the value of the existing swap can simply be incorporated into the new swap and reflected in the new swap rate. Alternatively, if a swap is carried through maturity, no value is exchanged and the swap simply matures.

The flexibility offered by swaps allows for very tailored hedging against market risk. Understanding how much to swap, and when, means working with an investment banker to help determine how much variable-rate risk exposure an organization has over what period of time, and at what point variable-rate levels would become too high and too risky to maintain in terms of the organization's debt covenants, operating budget and other factors.

Determining net variable rate risk exposure requires evaluating assets and liabilities in tandem. An organization with \$1 million in floating investments and \$10 million in variable-rate debt, as a simple example, potentially has only \$9 million of exposure to floating interest rate risk; the risk on the other \$1 million in debt would be canceled out by investment returns. There is no need to hedge more, or longer, than the time and amount necessary to ensure appropriate risk exposure.

Organizations have the option to issue a swap with cash flow exchanges that begin either immediately (spot start), or at a future date. In a forward-starting swap, the borrower and swap counterparty agree to a cash flow exchange in advance of the actual start date in order to lock in a current interest rate. Forward starting swaps can be used to mitigate future interest rate risk. Consider a borrower with an existing fixed rate or interest rate swap due to mature in 12 months. Concerned that long-term interest rates may be rising, the borrower enters into a forward-starting swap today, with cash flow exchanges to commence upon expiry of the existing swap.

Organizations with variable-rate debt, or those considering issuing debt, should always keep their exposure to interest rates in mind. Recent actions by the Federal Reserve, which raised its target rate 17 times from 2004 to 2006, then abruptly dropped it 125 basis points in a 10-day span in early 2008, should be additional impetus for organizations considering debt to investigate synthetic rate-lock strategies such as swaps. They remain an effective strategy to hedge against interest rate volatility and improve day-to-day cash flow stability.