interest rates

Interest rate hedging strategies are tailored to reflect a business's particular interest rate views, risk appetite and need for flexibility.

contact us

Dublin
tel: +353 1 790 0040

London
tel: +44 207 560 8680

Stamford, US
tel: +1 203 391 5555

Cliona Coakley
Interest Rate Derivative Specialist

This case provides an example of a structured liability hedge.

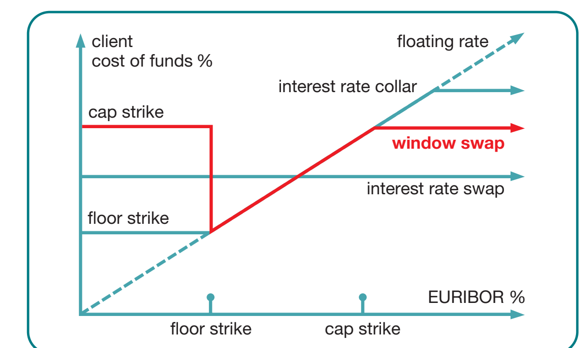
Our client's loan covenant stipulated that they must hedge their debt for a 3 year period. They believed that interest rates would not rise at the rate predicted by the market, and so did not view entering into an interest rate swap as good value. The thought of paying upfront for an option did not appeal either, and the cap level derived from a zero cost collar had to be struck so high as to not provide a meaningful hedge. After reviewing a number of possible solutions proposed by Bank of Ireland Global Markets, the company decided that a window swap best suited their hedging requirements.

A window swap is similar to an interest rate collar, except that the cap level is struck at a lower rate than that in a comparable vanilla interest rate collar. Similarly, it can provide a floor level below that of a comparable vanilla interest rate collar in order to allow the customer to benefit more from a favourable downward move in interest rates. At the outset of the trade, a cap/floor range or 'window' is agreed, inside which the client pays a floating reference rate. Outside the 'window', a pre-agreed fixed rate is payable for that period, so in the event of the floor level being breached, the client pays the higher pre-agreed fixed rate for that period. The window swap resets at every rollover.

By combining a series of interest rate derivatives in order to construct the window swap for the company in question, we were able to structure a 3 year hedge which provided a cap level and a floor level that was 25bps lower than the corresponding interest rate collar. (This was the benefit at the time of hedging for this particular client; it is subject to change due to market changes). During the life of the deal, in the event of the floor range level being breached, the client pays the higher fixed rate for that period. As the rate payable under the window swap resets each period, the client has the chance to pay a lower floating rate on their debt if rates reset again above the floor level.

The outcome was that the client was hedged at zero upfront cost and was able to benefit from a favourable move in interest rates while knowing their maximum cost of funds.

The diagram below illustrates a stylised example.



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