

Risk Management Advisory Services

Interest Rate Hedge Consultants

Structuring, Pricing, Valuation and Education



June 3, 2008

BACK TO FLOATING? Everyone should be familiar with the plain vanilla fixed rate swap or “pay-fixed swap”. Most people think about swaps as a means to fix floating rate debt. However, swaps can be used to synthetically convert fixed rate debt to floating. This is called a reverse interest rate swap or “receive-fixed swap”.

Many corporations that issue fixed rate bonds, utilize reverse swaps to convert fixed rate debt to floating. Often times this strategy is used to simply diversify one’s capital structure. Too much fixed rate debt creates opportunity risk (lower floating rates versus fixed rates), while too much floating rate debt puts the borrower at risk in a rising interest rate environment.

Let’s assume you’ve fixed everything for 5 or more years sometime last year. Long-term fixed rates looked attractive then, however, with the slowdown in the economy and the Fed lowering interest rates, long-term rates are lower in some cases by over 200 basis points.

During times like this it’s always a good idea to see if you can re-adjust your hedge structure. Just like one would review their 401K investments, we recommend doing the same with your interest rate hedges. As we’ve said in the

past, hedging is a dynamic process and not static.

This doesn’t mean we would recommend a reverse interest rate swap for 5 or more years. That fixed rate you currently have may come in handy in the future. While we don’t expect LIBOR rates to return to 5.00% anytime soon (levels last seen October 2007), there could be an opportunity to convert some fixed rate debt to floating for a much shorter period of time.

For example, the 2 year swap rate is currently 3.20% and 1M LIBOR is 2.45%. That’s a difference of 75 basis points. With a reverse interest rate swap, you receive 3.20% and pay the floating rate. This means that you would immediately lower your cost of funds by 75 basis points. If we introduce some optionality with a structured reverse swap, we can increase the positive carry by as much as 15 to 25 bps. 1M LIBOR does have the potential to go lower, even if the Fed doesn’t lower interest rates again because there still is a credit premium of about 30 basis points implied in the 1M LIBOR rate. Over the past couple of weeks, the implied credit premium (see our March 2008 newsletter) has fallen as the credit crises appears to be easing.

To the swap provider of the pay-fixed swap, this is a risk reducing or risk neutral trade. What this means is that pricing

(swap fee) a reverse interest rate swap doesn’t have credit exposure; therefore the swap provider should price the derivative as a transaction and not include a fee for credit exposure.

Let’s assume the Fed kept rates on hold for the next 12 months. What would 1M LIBOR have to average for the last 12 mos to be indifferent? The answer is ~ 3.95%. Keep in mind that you have been receiving 75 bps of positive carry for 1 year. The last year you would be giving this back. Of course, we don’t expect the Fed to raise the Fed Funds rate to 3.75% or 4.00% all at once at the end of 12 months, but it does provide an idea of how much the Fed would have to raise rates the longer the Fed Funds target rate remains low. And if you introduce some optionality, you could be looking at a Fed Funds rate of 4.25%. Remember too, that after 2 years, you are back to your fixed rate, be it for the next 3 yrs or longer.

In summary, interest rate derivatives can be used not just to fix floating rate debt, but to create floating rate debt from fixed rate debt obligations or pay-fixed interest rate swaps. It’s another tool to manage risk. Keep in mind, there is risk to being 100% fixed or 100% floating. The tricky part is to manage the best mix depending on your business and where we are in the current interest rate cycle.

MARKET BENCHMARKS

Treasuries				LIBOR				SIFMA: Tax-Exempt Rates			
	Current	Month Ago	Year Ago		Current	Month Ago	Year Ago		SIFMA Setting	SIFMA Swap ⁽¹⁾	
2 Yrs	2.44%	2.47%	4.85%	1-Month	2.45%	2.70%	5.32%	Current	1.62%	3 Yrs	2.62%
3 Yrs ⁽²⁾	2.70%	2.70%	4.86%	3-Month	2.67%	2.77%	5.36%	Last	1.70%	5 Yrs	2.93%
5 Yrs	3.21%	3.18%	4.90%	6-Month	2.88%	2.87%	5.38%	52 Wk Avg	3.10%	10 Yrs	3.39%
10 Yrs	3.92%	3.87%	5.00%	9-Month	2.99%	2.93%	5.39%	% 1-ML	66.09%	15 Yrs	3.67%
30 Yrs	4.63%	4.57%	5.10%	12-Month	3.10%	2.99%	5.39%	% 3-ML	60.60%	20 Yrs	3.81%

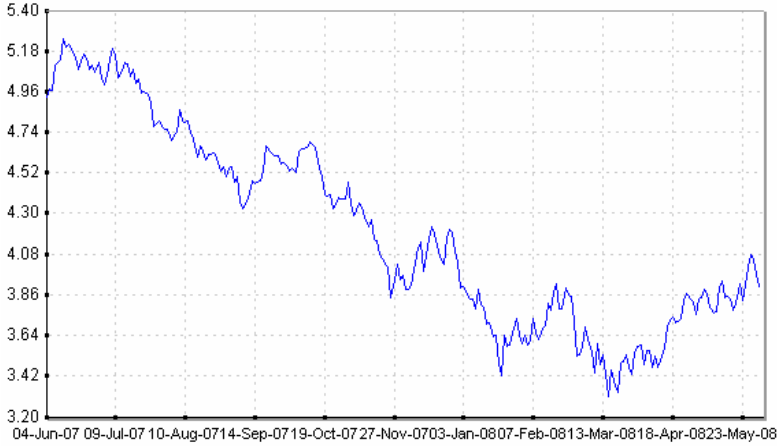
Spot Starting LIBOR Swap ⁽³⁾				Forward Starting LIBOR Swap ⁽³⁾				% of LIBOR Swap ⁽³⁾			
	Current	Month Ago	Year Ago	(FWD Premium bps)	3 Yrs	5 Yrs	10 Yrs	67% LIBOR		70% LIBOR	
2 Yrs	3.22%	3.16%	5.21%	6 Mos Fwd	25.8	19.8	13.3	3 Yrs	2.38%	3 Yrs	2.48%
3 Yrs	3.55%	3.45%	5.24%	12 Mos Fwd	54.4	41.0	27.3	5 Yrs	2.64%	5 Yrs	2.76%
5 Yrs	3.95%	3.83%	5.33%	18 Mos Fwd	75.8	57.8	38.5	10 Yrs	2.99%	10 Yrs	3.12%
10 Yrs	4.46%	4.36%	5.50%	24 Mos Fwd	93.0	71.7	48.0	15 Yrs	3.16%	15 Yrs	3.30%

5/25 yr ⁽⁴⁾	7/25 yr ⁽⁴⁾	10/25 yr ⁽⁴⁾	15/15 yr ⁽⁴⁾	Fed Funds	Prime	JPY	Eur
3.93%	4.17%	4.41%	4.43%	2.00%	5.00%	105.14	1.5460

Note: (1) Semi, 30/360 (2) Interpolated Yield (3) Monthly, Act/360 (4) Monthly, Act/360 - Mtg. Style Amortization @ 6.00%

Prices based on current market conditions and subject to change. Transaction size and structure along with credit risk considerations will effect ability to achieve market pricing.

10-yr UST: Past 12 Mos



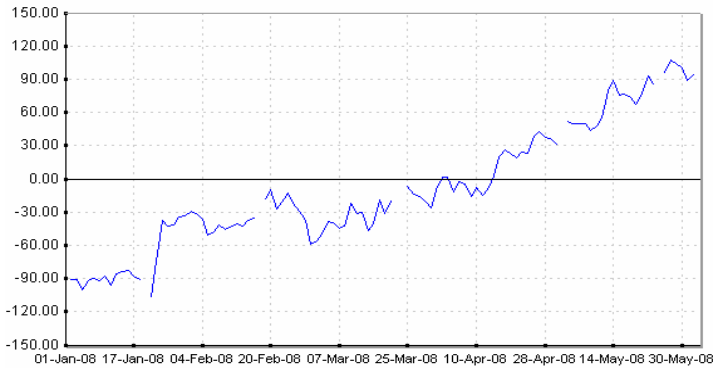
Last	Mean / High / Low	Std	1D Chg	Std of Chgs
3.906	4.211 / 5.246 / 3.312	0.534	-0.064	0.069

10-yr UST: Since 2000



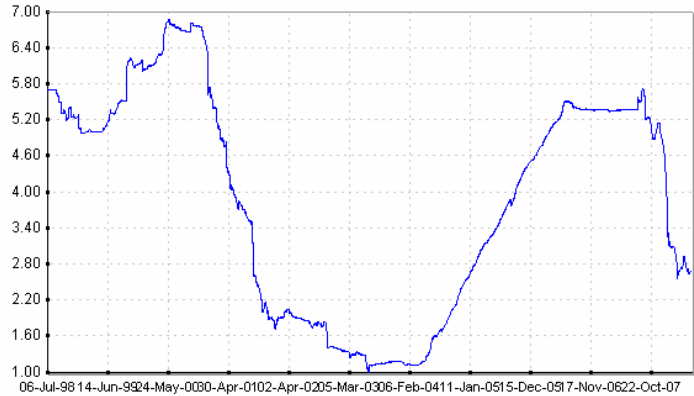
Last	Mean / High / Low	Std	1D Chg	Std of Chgs
3.904	4.645 / 6.786 / 3.102	0.696	-0.066	0.058

2-yr Swap Rate less 1ML



The spread between a 2-yr swap rate and 1ML is close to YTD highs. If the basis between Fed Funds and LIBOR "normalizes" the spread will likely move higher.

3-Month LIBOR



FOMC 2008 Meeting Dates

Jan	Feb	Mar	Apr	May	Jun
29/30		18	29/30		24/25
July	Aug	Sep	Oct	Nov	Dec
	5	16	28/29		16

Changes in the Fed Funds Rate

Apr. 30, 08	Mar. 18, 08	Jan. 30, 08	Jan. 22, 08	Dec. 11, 07	Oct. 31, 07
2.00%	2.25%	3.00%	3.50%	4.25%	4.50%
Sep. 18, 07	Jun. 29, 06	May 10, 06	Mar. 28, 06	Jan. 31, 06	Dec. 13, 05
4.75%	5.25%	5.00%	4.75%	4.50%	4.25%