



Fisher Funds

Investor Education Centre

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Swap rates made simple

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My initial response to a reader's request for an explanation of *swap rate* was one of apprehension, because it is a term that is often accompanied by financial jargon, and I knew that it would be a challenge to make it interesting. However, having thought about it, I realise that it is an important term, it affects all of us who have anything to do with mortgages or currencies, and we should try to understand what swap rates are.

We all know what it means to swap – we exchange something of ours with something someone else has, hoping that we both benefit. In financial markets, the simplest type of swap is an interest rate swap, where people swap their floating interest rates for fixed interest rates.

Imagine a room of home-owners with mortgages. Half of the room have fixed rate mortgages and half have floating rate mortgages. All of the people in the room have interest rate risk. The fixed-rate mortgagees worry that if interest rates fall, they will end up paying too much for their mortgage, whereas the floating-rate mortgagees have the opposite worry - that if interest rates rise, their total cost will rise.

Now imagine that each group takes half their mortgage and swaps it with the other group, agreeing to pay the other group's rates. This swap will have diversified their mortgage and lowered their interest rate risk overall. This swap is not as straightforward as swapping a blue marble for a red marble, because the interest rates vary for fixed and floating mortgages – one is a fixed rate of interest (as the name suggests) whereas the other is a rate that changes regularly and is based on an underlying interest rate - in New Zealand, the Official Cash Rate.

Every day banks are faced with the opportunity of effectively swapping interest rates with each other, just as described above (imagine a room full of bankers rather than home-owners ... or maybe not!) The rate that they agree to swap interest rates for is known as the swap rate. This swap rate is determined by where they think interest rates might be heading, how long they need to swap for, and how they feel about the other party they are swapping with.

Although interest rates have been trending down over the last year or so, swap rates haven't fallen to the same extent ... much to the disappointment of home-owners whose mortgage rates are based on the banks' swap rates. The reason for this is that banks, like most of us really, don't know what to expect for the year ahead in terms of economic growth, inflation and therefore interest rates. They have also become more wary of each other following the collapse of the US financial system, so are not as willing to swap with other banks on generous terms.

New Zealanders, and Australians for that matter, borrow more than we save, so our banks need to borrow money from overseas to be able to lend it out. Overseas banks would normally lend to our banks at the swap rate. Not any more. They are demanding much higher interest rates to be prepared to lend to our banks. All of this adds up to mortgage rates that haven't fallen by as much as we would have expected given the reductions in the OCR.

I don't subscribe to the conspiracy theory that says that banks are deliberately not lowering mortgage rates so they can make profits. They, like us, are paying the price for bad lending practises in the US. There will come a point when the global banking industry starts to "play nicely" again and as uncertainty recedes, we home-owners should feel the benefit.

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