

## Product Briefing - Asset Swaps

An asset swap is a combination investment package where an investor buys a fixed rate bond and simultaneously enters into a 'pay fixed' interest rate swap. Although asset swaps can be structured in one of two ways the most popular format is the 'par in, par out' (or just 'par-par') structure. Here the investor pays 100% of the face value of the bond (i.e. its par value) at the start of the transaction, holds the bond to maturity and then receives par from the issuer at maturity.

If the market value of the asset is anything other than par at the point of purchase this will create an advantage to either the buyer or seller. If the bond is trading below par this means the investor will be disadvantaged as he will 'overpay' for the bond. For bonds that are trading at a price greater than their face value this bestows a cash flow advantage on the investor (i.e. if the bond is trading at 120 the investor only pays 100).

The second element of the asset swap structure is that the fixed rate on the swap is set equal to the coupon on the bond. Again, since it is unlikely that these two parameters will be exactly equal, it will create an advantage for the one of the parties.

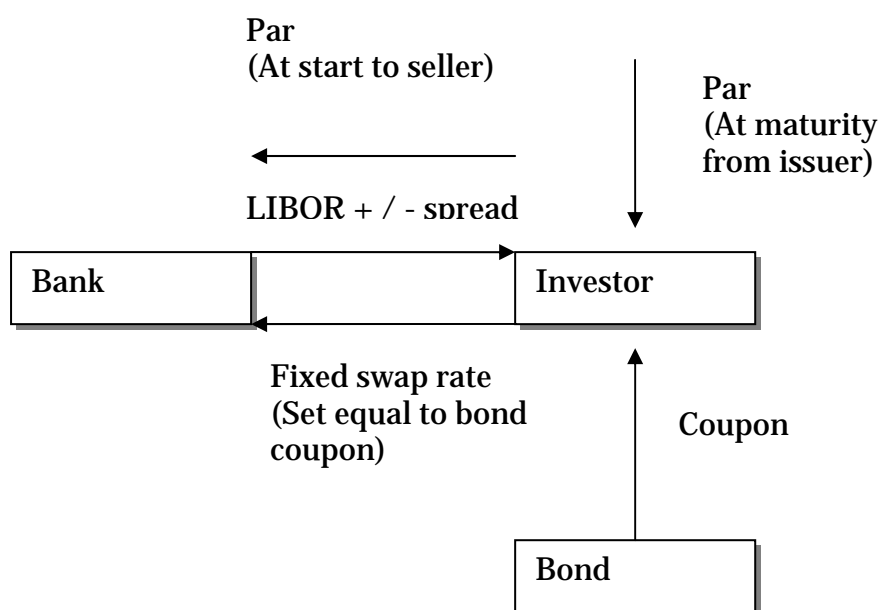


Figure 1 Asset swap package

Figure 1 shows the cash flows associated with an asset swap and gives a visual depiction of the rationale for entering into this type of transaction. Since the fixed coupon on the bond and the fixed rate on the swap are equal and opposite to

each other (and have the same maturity), the cash flows have no net economic impact on the investor. As a result, the investor owns a structure that pays them LIBOR plus or minus a spread, which makes the structure economically equal to a floating rate note.

In the asset swap package the spread to LIBOR acts as a balancing mechanism to ensure that any advantage or disadvantage incurred as a result of the investor paying par and entering into an off-market swap is returned over the life of the deal. In this way the entire package will then become an equitable exchange of cash flows.

An asset swap structure has more credit than interest rate exposure. Suppose that interest rates were to rise. The bond element of the structure would lose money but since the investor is paying fixed on a swap, this deal now becomes a more attractive transaction and will therefore increase in value. As a result the two elements more or less cancel each other out. The same effect in the opposite direction would happen for a fall in interest rates. However, if interest rates remain unchanged but there is a perception that the issuer is more likely to default, then the bond element will lose value with no offsetting profit on the swap. Overall there will be a net loss.

There are a number of reasons why an investor may wish to enter into an asset swap package:

- They may wish to reduce the market risk of holding a fixed rate bond (bond market risk will be covered in chapter 3)
- Since floating rate notes offer an investor credit exposure rather than interest rate exposure the investor may wish take a view on how this component will evolve
- The corporate entity to which the asset swap is linked does not have any floating rate debt in issue and so the investor may have to create this synthetically using the asset swap
- If the fixed rate bond is trading cheap to its fair value, then asset swapping the asset will create an attractively priced FRN
- It is possible to buy a fixed rate bond say in USD and asset swap it using a currency swap, where the fixed rate is also USD but the LIBOR cash flows are denominated in say, EUR.