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Simple Example of Swap Terms and Flows

Terms of Swap

Fixed Rate Payer (Floating Rate Receiver)

Company A (a savings association) agrees to pay company B 10% per year for 5 years

Floating Rate Payer (Fixed Rate Receiver)

Company B (a hedge fund) agrees to pay company A at whatever the six month LIBOR rate is for 5 years

Notional Principal Amount: $50 million

Notes:

(1) Payments are scheduled every 6 months
(2) The current level of LIBOR determines the floating rate payment in 6 months
(3) The floating rate obligation is reset every 6 months
(4) LIBOR is called the referenced rate
(5) The notional principal amount never changes hands

Schedule of Obligations

Assume LIBOR = 7% on the day the swap is entered into

In 6 Months

Company A (fixed payer) pays Company B $2.5 million [= (10% x $50 million)/2

Company B (floating payer) pays Company A $1.75 million [= (7% x $50 million)/2]

In 12 Months

A pays B $2.5 million

B pays A $x, depending on LIBOR at the 6 month payment date

Questions:

(1) How might the savings association use this swap to reduce its risk exposure?
(2) What would happen to the value of the swap to the counterparties if all rates fell immediately after they entered into the swap?