Interest Rate Swap Agreement

The key parts of the product:

An interest rate swap (IRS) is a hedging instrument that allows you to manage interest rate risk beyond one year. It involves the exchange of future interest payments on a predetermined principal amount.

The types of interest rate swaps can be:

- fixed rate to variable rate
- variable rate to - fixed rate
- variable rate to variable rate with a different basis (e.g. 3-month BUBOR to 6 months BUBOR)

We recommend this product to:

The exchange might have several purposes depending on the tendency of changes in the interest rates expected and on the debtor's or investor's position of the company:

- In the case of a debtor position, interest rate swaps can be used to hedge against the increase in costs resulting from a rise in interest rates.
- In the case of an investor position, an interest rate swap can be used to obtain a higher interest rate than falling interest rates.

Benefits:

- Interest rate swaps allow to quickly and flexibly build up an interest rate risk position in line with our expectations of changes in market interest rates, without changing the existing structure of loans and deposits.
- By entering into a swap agreement, you can hedge against future interest rate movements.
- Uncertainty arising from the existing interest rate position can be managed, making future cash flows from the exposure predictable.
- For asset-liability management, interest rate swaps help to change the repricing mechanism of the interest rate risk position by matching the maturities of revenues and liabilities.
- An interest rate swap can be terminated any time with an opposite transaction.
- In an interest rate swap, the principal amount is only used as a basis for the calculation, there is no exchange of principal. If both parties have an obligation to pay in the same currency on the same day, only the difference is settled (netting).

Risks:

- In the case of falling interest rates, the party paying the fixed interest rate in the interest rate swap - the swap buyer - may incur a financing cost above the market rate, or in the case of rising interest rates, the seller of the interest rate swap earns less interest than the market rate.
- Terminating an interest rate swap before maturity can result in a significant loss or gain depending on current market conditions

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Key elements of the interest rate swap agreement

Currency pair:	Currency element of the transaction
Reference Amount:	The amount used as the basis for calculating the interest exchanged. Minimum of EUR 1,000,000 or equivalent in another currency.
Amortization:	If the Reference Amount changes during the term, it is necessary to fix the Reference Amount for each interest period
Start date:	The starting date of the first interest period, which may be the second business day after the conclusion of the transaction or a later date
Maturity:	The duration of the transaction, which usually starts from 2 years to 10-15 years depending on the currency.
Length of interest period:	The period after which interest rate swaps take place is typically 3, 6 or 12 months
Method of calculating interest	When calculating both the interest paid and the interest received, the method of calculating the interest, which can be a fixed rate or a variable rate, must be fixed. In the case of a variable (floating) rate, the parties agree on a reference rate, typically a market benchmark of the given currency, such as 3-month EURIBOR.
Interest calculation convention:	The convention used to calculate accrued interest (such as ACT/360, ACT/ACT, ACT/365, etc.)

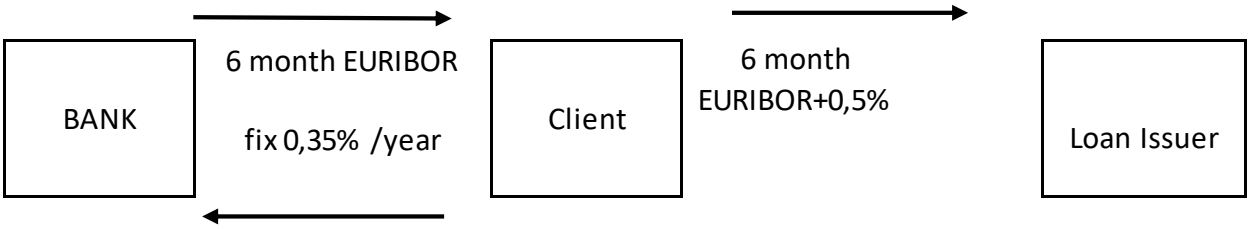
Conditions for concluding an interest rate agreement

- Master Agreement for entering into derivatives contracts outside an exchange or other regulated market
- MIFID suitability and appropriateness test and EMIR related statements
- valid LEI code
- HUF account
- Freely available treasury limit and collateral according to the initial margin requirements of the master agreement and general terms of business.
- Minimum amount of EUR 1 000 000 per transaction

Example – Borrower perspective

- To finance a project, the company has taken a loan of EUR 1,000,000 at variable interest rates with a remaining term to maturity of 3 years. The interest on the loan is paid semi-annually afterwards. The interest rate on the loan is EURIBOR 6 months + 0.5% p.a.
- The company treasurer is afraid of a rise in EURIBOR and decides to fix the interest rate for the remaining term at a level that is favorable to the project and that the project can bear, as a protection against a possible rise in interest rates. The euro 3-year swap rate is 0.35%.
- The company thus buys a 3-year interest rate swap from the bank, under which it pays a fixed interest rate of 0.35% and receives a variable interest rate - EURIBOR - every six months, in line with the interest rate setting dates of the loan.

The company will use the interest rate swap to transform its floating rate loan into a fixed rate loan at 0.35%+0.5%.



The following table shows the cash flow of the interest rate swap, assuming that the 6-month EURIBOR is -0.50% at the time of the loan and increases in following periods.

	Swap				Credit		Payable	
Periods	EURIBOR (%)	Change	FIX	Swap Result	Loan Interest	Net cost of credit	Without swap	With Swap
1	-0,50	-2 500	1 750	-4 250	-1 750	2 500	0	4 250
2	-0,20	-1 000	1 750	-2 750	-250	2 500	1 500	4 250
3	0,35	1 750	1 750	0	2 500	2 500	4 250	4 250
4	0,70	3 500	1 750	1 750	4 250	2 500	6 000	4 250
5	1,10	5 500	1 750	3 750	6 250	2 500	8 000	4 250
6	1,50	7 500	1 750	5 750	8 250	2 500	10 000	4 250
Total				**4 250**	**19 250**	**15 000**	**29 750**	**25 500**

The table shows that if an increase in interest rates were to occur, the client would be forced to pay a higher interest rate on its floating rate funds, but the cash flow from the interest rate swap - which it receives from the bank under the transaction - would compensate for the additional costs of the interest rate increase.

In the hedge, the counterparty foregoes the cost reduction resulting from a possible fall in the 6-month EURIBOR and fixes its interest costs at 0.85% through the interest rate swap (the example uses an actual/360 basis)

Example - From an investor's perspective

- The minimum expected return on a HUF investment portfolio is 2.0%. The portfolio manager invests HUF 200,000,000 in a variable yield linked to 6-month BUBOR. The portfolio manager is concerned about a decline in short-term yields and therefore wishes to hedge the interest rate risk of the investment.
- The 2-year swap rate is 2.00% and the 6-month BUBOR at the time of the transaction is 1.35%.
- The portfolio manager sells a two-year interest rate swap to the bank, under which it pays a floating interest rate of 6 months BUBOR and receives a fixed interest rate of 2.00%.

The portfolio manager transforms its investment into a fixed annual return of 2.00% through an interest rate swap.