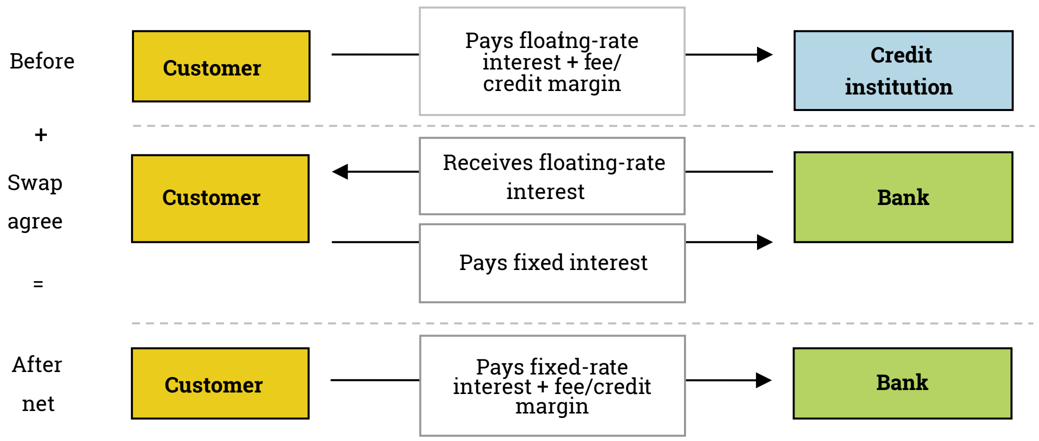
What is an interest rate swap?

An interest rate swap is a financial instrument under which two counterparties swap interest payments for a period of time. You could say that an interest rate swap is an agreement to swap interest for an agreed period of time.

For which investors are interest rate swaps relevant?
Interest rate swaps are relevant for investors who want to keep an existing loan, but want to change interest payments on the loan from, e.g., fixed rate payments to floating rate payments or vice versa.

From floating to fixed rate or vice versa
The scenario may be that you have one or more floating rate loans. However, your assessment is that the current fixed interest rate is attractive and that you generally expect rising interest rates. Although fixed interest rates are higher than floating interest rates, you would like to receive the current fixed financing rate.
You have two options:

- to refinance your entire loan to a fixed rate loan with the Bank or with a mortgage credit institution;
- to keep your floating rate loan and supplement the loan with an interest rate swap (see figure).



Keep the loan, but swap payment flow
If you opt for an interest rate swap, your old loan continues with the existing instalment and interest conditions but you swap interest payments with the Bank. The interest rate swap offsets more or less precisely the interest payments on existing loans against new interest conditions and payments. Completely hedging your fundamental interest payments is not always possible since you cannot always hedge the specific basis rate on the loan. It may be that you pay interest based on an overnight rate on your loan, but you receive interest based on a three-month rate in the interest rate swap. Moreover, the credit margin and/or the fee may change on the existing loan. Payment flows under an interest rate swap alone consist of the regular interest payments.

Also for loans provided by other lenders Since the loan itself is not changed, the Bank also offers interest rate swaps for loans provided by other lenders including lease financing.

When should you do what?
Of course, the spread is important when you decide whether you want to enter into a swap agreement, but it is equally important to consider how you expect interest rates to develop:

- if you expect interest rates to fall, you should choose a floating rate loan;
- if you expect interest rates to increase, you should choose a fixed rate loan.

The above assumes a normal interest rate structure. When the interest rate structure is normal, it means that fixed interest rates are higher than floating interest rates.

What happens in practice?
- your loan continues;
- you enter into an interest rate swap agreement with the Bank which runs concurrently with your loan;
- The Bank confirms all agreements by sending the agreement to you which you must accept by your signature and return to the Bank;
- you need not sign any new loan agreement as you would have had to do if you were refinancing an ordinary loan.

Terms and conditions
When you trade financial instruments like interest rate swaps with the Bank, you always sign a **service agreement** in which the Bank stipulates how the Bank manages /monitors the risk you assume. The service agreement entitles the Bank to close the interest rate swap or demand security if the **market value** of the interest rate swap moves in negative direction and exceeds certain agreed and granted credit limits.
The market value expresses the value of the interest rate swap relative to current market rates and time to expiry. Please be aware that a traditional interest rate swap is non-callable which may be a disadvantage compared with a callable mortgage loan which can be paid off at par.

The service agreement will contain 'amber' and 'red' alerts, indicating a negative net market value. The current market value appears from a special account which can be viewed in the Netbank. You may close the swap early at market value which is calculated on the basis of the current interest rate market. In the event of special, extreme market conditions, without current market prices, the Bank may not be able to offer you to close the transaction, which may lead to losses.

In addition to the basic service agreement, an interest rate swap agreement **may** in some situations include your or the Bank’s right to end the agreement early also known as a **break clause**.

For further information please see the individual fact sheets "Calculation of risk on derivative financial instruments" and "About break clauses". They are available on request from your relationship manager.

Costs and market value
The margin, which the Bank charges for the transaction, is included in the calculation of the market value. Therefore, the market value will generally be negative from the start of the swap because all future payments are discounted back to the present time at an interest rate corresponding to the market rate.

About risk
If you pay fixed rate interest and receive floating-rate interest, the market value will become negative if interest rates decline.
It is important that you have sufficient financial strength when you use financial instruments. You should be able to withstand any negative consequences of changes in interest rates and market risk even in case of extreme swings in interest rates. This means that your position may be less favourable, both with respect to credit conditions and borrowing opportunities.

You should be aware that you are buying a derivative financial instrument and will be in a different position than if you had refinanced the underlying loans by traditional means.

When using benchmarks (e.g. interest rate benchmarks) in swaps, you must be aware of the risk that these benchmarks are or can be subject to national, international or other initiatives, which may mean that the composition of the benchmark is changed or that the benchmark completely disappears.

Further information is available at:

trustednovusbank.gi/general-terms/fallback-plans

An interest rate swap is a financial product classified as red according to the risk classification.

Read more about the risk classification of investment products at:

trustednovusbank.gi/investmentinformation

We recommend that you seek advice from professional advisers about any accounting and tax consequences before entering into interest rate swaps.

What you should know before trading
If you wish to receive personal advisory services in connection with the establishment and the ongoing development of the interest rate swap, a suitability test must be performed allowing the Bank to assess the suitability of the interest rate swap relative to the purpose and the time horizon. Your financial strength, risk tolerance and knowledge of and experience with interest rate swaps will be included in the test. We recommend that you contact your relationship manager if you have any questions in relation to anything described in this fact sheet, or if, generally, you would like to have some points clarified.

Tax
We do not give advice on tax issues in connection with specific transactions.

If you wish to learn about the specific importance of the tax rules for you, we recommend that you consult your accountant.

Pros and cons

YOU PAY INTEREST AT A FIXED RATE AND RECEIVE INTEREST AT A FLOATING RATE	YOU PAY INTEREST AT A FLOATING RATE AND RECEIVE INTEREST AT A FIXED RATE
Pros • You hedge the risk of general interest rate increases; • If interest rates increase, the market value of your interest rate swap will increase, and the swap may be closed early at a gain.	**Pros** • The interest you pay is typically lower given the interest rate structure; • You benefit if interest rates fall; • If interest rates fall, the market value of your interest rate swap will increase, and the swap may be closed at a gain.
Cons • You will not benefit if interest rates fall; • If interest rates fall, the market value of the interest rate swap will fall and the swap cannot be paid off at par like, for instance, callable mortgage bonds. This may lead to demand for additional security or demand to close early at a loss; • Fixed interest rates are typically higher than floating rates assuming the interest rate structure to be normal. You will pay this extra cost until the floating rate has risen to the level of the fixed rate in the swap; • A traditional interest rate swap is non-callable.	**Cons** • You do not know your interest during the agreed term; • If interest rates increase, the market value of the interest rate swap will fall, which may lead to demand for additional security or demand to close early at a loss; • A traditional interest rate swap is non-callable.