Cancellable Swap

What is a Cancellable Swap?

It is a Swap that may be cancelled at an agreed date in the future by the Borrower at no cost. It is constructed by the combination of a Swap embedded with the cost of purchasing a Receiver's Swaption where the embedded Swap rate is set at the same rate as the Swaption strike rate.

Objective

It enables the Borrower to protect its borrowing costs for a defined period of time whilst retaining the opportunity to cancel it on an agreed date or dates in the future without the potential burden of penalty costs.

How does it work?

The Borrower has a contractual requirement to pay a fixed rate of interest and receive the floating rate (three month LIBOR). The Receiver's Swaption provides the Borrower with the option to enter into a Receiver's Swap to negate the effect of the Payer's Swap thus enabling the whole structure to be terminated at no cost to the Borrower.

Advantages

- It provides the Borrower with a known fixed rate of interest.
- It provides the Borrower with the opportunity to cancel the contract on a future date at no cost.
- No upfront cash premium is required.

Disadvantages

- A Cancellable Swap rate will be higher than the market rate.

Note

The benchmark for the floating rate has been shown as three month LIBOR but this may be six month or one month LIBOR or even base rate according to the terms of the underlying loan.

Caution

Cancellable Swaps are also provided where the Bank has the right to cancel the Swap at no cost. In this case, the Borrower will have sold the Payer's Swaption in exchange for a lower embedded borrowing cost. In effect, the Borrower will have surrendered control over the hedge to the Bank. It is inevitable that the Swap will be cancelled just when rates are rising.

TRADE DESCRIPTION	
Instrument:	Cancellable Swap
Fixed Rate Payer:	Borrower
Floating Rate Payer:	Bank
Option Holder:	Borrower
Trade Date:	23-Sep-11
Effective Date:	23-Sep-11
Maturity Date:	23-Sep-21
Cancellable Date:	23-Sep-16
Embedded Swap Rate:	2.45%
Principal:	£50,000,000
Premium Payable:	Nil

Scenario	Conditions at time of Swaption expiry	Result
1	Swap fixed rate is ***above*** the market rate.	Exercise Swaption thereby cancelling Swap.
2	Swap fixed rate is ***equal*** to market rate.	The client would be indifferent about cancelling Swap.
3	Fixed rate is ***below*** the market rate.	Do not exercise Swaption as Swap holds intrinsic value.

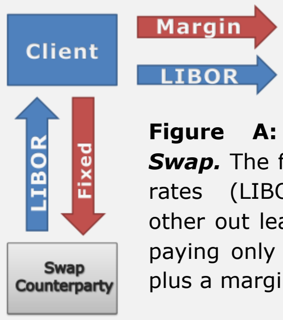

Figure A: *Interest Rate Swap.* The floating benchmark rates (LIBOR) cancel each other out leaving the borrower paying only a fixed Swap rate plus a margin.

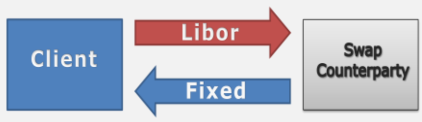

Figure B: *Receiver's Swaption.* Gives the client the right, not the obligation, to enter into a Receiver's Swap.

Figure C: If the Swaption is exercised, then the hedge contract between the Borrower and counterparty is cancelled leaving conventional debt cash flows: floating LIBOR plus Margin.