

Swap agreements – the impact on farmers

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There has been considerable publicity recently surrounding interest rate swap agreements entered into by farmers with their bank. These swap agreements were typically sold by banks between 2007 and 2008, prior to the global financial crisis, when interest rates were high and there were fears that floating rates could rise. However, as a result of the global financial crisis, there was a significant drop in interest rates. As a consequence, farmers who had entered into swap agreements considered themselves locked into a high interest rate in an economic climate where the benefits of significantly lower interest rates were being enjoyed by many others.

The purpose of this article is to consider the function and purpose of swap agreements, issues that have arisen with farmers, and whether the banks have a case to answer.

What is a swap agreement?

While swap agreements can involve the exchange of the cash flows of various financial instruments, this article focuses on interest rate swaps that were sold to farmers.

An interest rate swap is an agreement between two parties where one party agrees to pay the other a stream of future interest payments calculated on a fixed rate set at the outset and the other agrees to pay interest on the same principal amount at the floating rate reset every, say, 90 days for the term of the agreement.

Who might enter into an interest rate swap? There are two common examples. First, a borrower which has a loan with a floating interest rate cost might be worried that interest rates are going to rise. By entering into a swap (separate from the loan agreement) where the borrower receives a floating interest rate and pays a fixed interest rate, that borrower can enjoy more certainty in its interest cost. The borrower pays a floating interest rate on the loan, and in the swap receives a floating interest rate payment (which effectively cancels out its floating rate payment for the loan) and makes a fixed interest rate payment - these payments see the farmer paying the fixed interest rate, and swapping the uncertainty of floating interest rate fluctuations with the certainty of a fixed interest rate.

Secondly, a saver who has invested money at a floating interest rate might be worried that interest rates are going to fall. The saver might want to enter into a swap whereby they pay a floating interest rate and receive a fixed interest rate. The saver would receive a floating interest rate payment on the investment, and on the swap would pay floating and receive fixed - the two floating payments would cancel each other out, and the saver would receive a fixed interest payment by virtue of the swap.

Most swaps are entered into with a bank, and the bank will only enter into swaps with counterparties whom it thinks will honour their side of the agreement. The banks essentially make a market between the sellers and buyers of swaps, and make a margin on every swap transaction (which is the bank's incentive to develop the swaps market).

When swap agreements were sold by banks to farmers, the typical arrangement was that the bank had loaned or was about to loan the farmer money on a floating interest rate. There is a benchmark market interest rate at which banks are prepared to trade with other banks, known as the wholesale bank bill interest rate and which is referred to as the "BKBM". The BKBM sets out the rate for different terms every day.

The bank sets the interest rate to be paid by the farmer on the loan at a fixed margin over the BKBM - the size of the margin reflecting the bank's assessment of the relative credit-worthiness of the farmer. There are two reasons why the farmer might have entered into a swap agreement. First, the bank may have encouraged or required the farmer to hedge his/her risk against rising interest rates as a term of the loan. The lending manager of the bank would have introduced his bank's risk manager (really the swaps salesman) to facilitate the transaction. In practical terms, the farmer can only enter into a swap with his/her lending bank.

Secondly, the farmer may have been independently concerned that interest rates might rise. S/he might have known about the use of swaps as a risk management tool, and asked his/her bank if it could assist.

If the New Zealand experience has been similar to what has been discovered in official banking enquiries in the United Kingdom, then it is likely that the former situation was much more common than the latter, with the banks effectively imposing swaps on their customers.

In either case, the farmer learns that the bank can sell a product that takes away the risk of interest rates rising. This product is an interest rate swap. The farmer and the bank will agree that for a fixed term (usually corresponding to the term of the loan) and based on a fixed amount (usually the amount of the loan) every quarter, the bank will pay the farmer interest at the BKBM rate reset at the start of the quarter, and the farmer will pay the bank interest at the fixed interest rate which has been set at the start of the quarter. By convention, the swap flows are netted out each quarter.

It is important to understand that the bank is not betting against the farmer as to what the future direction of interest rates will be. The bank will immediately go to the market and buy the opposite swap to hedge its position. In practice, the bank will base the terms of its swap with the farmer on what it knows the market to be. If the wholesale market price for a five year swap is 8%, then the bank will have priced its swap to the farmer at a margin over 8%. In this way, the bank immediately locks in a profit on the swap as soon as the farmer signs the agreement. Overseas, the rationale for banks promoting swaps to their small to medium enterprise ("SME") customers was to establish another profit source for the bank.

A swap is not a lending facility and does not alter the terms of the underlying loan agreement. An interest rate swap (receive floating/pay fixed) is an interest rate management tool that can be used in conjunction with a variable rate lending facility i.e. where interest is paid at a base floating interest rate plus a margin.

A swap only affects the base rate (BKBM) applicable to the underlying loan agreement. The credit margin and any applicable fees under the loan agreement are still charged. They may still be subject to change in accordance with the conditions of the underlying loan agreement.

By way of example:

A farmer borrows \$1,000,000 at a floating base rate of BKBM plus a 2.5% margin.

The farmer agrees with the bank to swap for the next five years the BKBM floating rate for a fixed rate of 8%.

Under the loan agreement, each quarter, the farmer makes an interest payment. The payment is calculated on the basis of the BKBM (90 days) as at the start of the quarter plus the 2.5% margin.

Under the swap, for the next five years, each quarter the net position of the swap cashflow is settled between the farmer and the bank.

If at the start of a quarter, the BKBM rate is 10%, the farmer will make an interest payment under the loan agreement at 12.5% (being the BKBM index rate of 10.0% plus the 2.5% margin). However, under the swap, the bank will pay the farmer 2.0% (the difference between BKBM and the fixed rate) so that the net interest paid by the farmer is 10.5% (being the fixed BKBM rate of 8% plus 2.5% margin).

If at the start of another quarter the BKBM rate is at 6%, the farmer will make a payment under the loan agreement of interest at 8.5% (being the BKBM index 6.0% plus 2.5%). However, the farmer will need to pay the bank an additional 2.0% under the swap because the fixed rate is 2% higher than BKBM so that the total interest paid by the farmer is still 10.5%.

In practical terms, under the loan plus swap in this case the farmer has actually agreed to pay to the bank a fixed rate of 10.5% p.a. on the loan.

The farmer is protected against his/her interest rate rising above 10.5%. However, if the rate on the loan agreement falls below 10.5%, the farmer does not benefit at all – irrespective of the floating interest rate, the farmer will still pay 10.5%.

This is one area where difficulties have arisen between banks and customers. As a result of the global financial crisis, interest rates have fallen markedly. The bank bill rate has fallen to under 3%, meaning that under the loan agreement above, the farmer would be enjoying paying an interest rate of less than 5.5% on the loan. However, under the swap, the farmer is required to make an additional payment of more than 5%, bringing the total cost back to 10.5%.

Customers have gone to their banks to see if they can get out of their swap contracts so that they can enjoy the lower floating rates under their loan. They have then been told that they will have to make "penalty" payments to exit the swap agreement. Some of the amounts quoted have been substantial, and many farmers have cried "foul".

The only practical way for a farmer customer to close a swap is to go back to the lending bank and ask to cancel it. Remember, at the outset, the bank entered into two swaps - one with the farmer (to pay floating and receive fixed) and the other with the market the other way round (to pay fixed and receive floating). To close a swap with the market, the bank has to go to the market and buy a receive fixed/pay floating swap for the remainder of the swap term.

If interest rates have fallen, the bank will incur a loss which is why it wants to charge the customer a penalty. If we use our previous example, imagine after two years, the three year swap rate is 4%. The bank will have to pay the market 8% under the original swap, but will receive only 4% on the new swap. On a \$1,000,000 notional amount, the bank will lose \$40,000p.a. for the next three years. The bank will require the customer to cover this loss. The calculation of the exact amount will be opaque to the farmer, because these future losses will be

discounted at a discount rate determined by the bank, and the bank might want to add another profit margin on the transaction.

This article has dealt only with a plain swap. However, official enquiries in the United Kingdom have thrown up a whole range of more complicated arrangements - caps, collars and another arrangement which goes under the wonderful name of asymmetric leveraged collars. There are believed to be over 40,000 swap transactions with SME customers, and the regulator found that on a small pilot study, over 90% of transactions may have involved some regulatory breach.

Several big issues which have come to light include:

- The imbalance of knowledge between the banks and the customers.
- The banks not explaining the risks properly to the customer (e.g. marketing material showing what the effects of rises or small falls in interest rates were, but not the effects of large falls in interest rates and/or covering all of the benefits but only a small proportion of the risks).
- Overhedging (either taking out swap contracts for longer terms than the underlying loan, or for larger amounts than the loan amount).
- The banks taking advantage of the captive arrangement with their customers where the only practical swap counterparty was the lending bank, with the lending bank taking pricing advantage.
- Long complicated legal agreements putting into effect the swaps (in one case it was reported that a finance expert took two days to properly disentangle the agreement).

Issues that have arisen with farmers

The Commerce Commission is currently investigating in New Zealand the promotion and sale of interest rate swaps marketed by various banks to rural customers¹. The Commission is conducting the investigation under the Fair Trading Act 1986 and is primarily considering whether interest rate swaps were marketed in ways that may have misled customers as to their true risk, nature and suitability.

Section 9 of the Fair Trading Act 1986 prohibits misleading or deceptive conduct in trade. Liability for misrepresentations can also arise under the Contractual Remedies Act 1979 or under the tort of negligent misstatement.

When considering any legal claim the general elements that need to be determined are:

1. Whether there is any contractual or other legal obligation/duty owed?
2. Whether there is a breach of any such obligation(s)?
3. Whether there was any reliance placed on the advice received?

¹ <http://www.comcom.govt.nz/interest-rate-swaps-2/>

4. If so, what is the loss (if any) suffered as a result of the breach(es) and the reliance on such advice?

Complaints have been raised that swap agreements were sold to farmers as if they were “the same as” or “better than” a fixed rate loan agreement. If this is what occurred, then the product may have been mis-sold.

A swap agreement works in conjunction with a variable rate lending facility and does not affect the obligations owing under the underlying loan agreement.

However, swap agreements that run to maturity operate by effectively “fixing” the rate under an existing floating rate loan agreement. In practical terms, this means that the swap agreement often operates to provide the same benefit to the farmer as a fixed rate loan agreement. And just as additional costs would apply in respect of any early termination of a fixed rate loan agreement, early termination of a swap agreement can also incur additional costs.

Accordingly, while the swap agreement may not have been marketed accurately and farmers may not have understood the particular issues involved, if the alternative was a fixed rate loan agreement, and the swap agreement operated as such in any event, the adverse consequences may be minimal, or non-existent. In such a case, while there may be a complaint that the swap agreement was misrepresented, it might be difficult to establish loss.

Of course, it was most unfortunate that farmers were left with high interest rates under swap agreements when interest rates fell dramatically. However, similar consequences would have flowed if a fixed rate loan agreement had been entered into instead. In hedging against increasing interest rates by using a plain swap, the farmer also assumes the risk that if interest rates fall, the higher effective rates would be locked in until the end of the fixed term.

Issues will arise, however, where the underlying loan agreement provided for the ability for the bank to increase the margin on the floating loan rate during the term. In some cases where the farmer comes under financial pressure, the bank may increase the margin because of a perceived increase in risk exposure, thereby increasing the total interest payable under the term loan agreement.

By way of example (using the above figures):

The bank increases the margin to 5%.

If at the start of another quarter, the BKBM rate is at 6%, the farmer will now make a payment under the loan agreement calculated on the basis of interest at 11% (being the BKBM index rate plus 5% margin). However, the farmer will also need to pay the bank another 2.0% under the swap so that the total interest paid by the farmer is now 13% (being the fixed rate agreed of 8% plus 5% margin).

Using this example, where the farmer may have thought that s/he was fixing the interest rate at 10.5%, being the fixed BKBM rate of 8% plus the margin at the time of 2.5%, the ability of the bank to increase the margin has meant that a much higher interest rate was charged, notwithstanding the existence of the swap agreement.

In such circumstances, the floating rate loan plus a swap agreement does not operate the same way as a fixed rate loan agreement (unless the bank retained an ability to increase the margin in that fixed rate loan agreement). If the farmer was encouraged to enter into a swap agreement

on the advice that it was the same as a fixed rate loan, and the bank subsequently increased margins, then a claim may be able to be made against the bank. With high levels of borrowing, the recoverable loss could be significant.

Other issues and potential claims may also arise where the bank provided advice to farmers as to the suitability of swap agreements, the risks and advantages of swap agreements, or the role that the bank would take in the administration of the swap agreements, and that advice was wrong.

Each case would need to be considered on its particular facts and circumstances. Consideration also needs to be given to limitation periods. Civil proceedings for breach of the Fair Trading Act 1986 must be filed within three years from the date the loss or damage (or the likelihood of loss or damage) was discovered or ought reasonably to have been discovered. Proceedings for breach of contract or in negligence must be filed within six years from the date the cause of action accrued.

Legal advice ought to be sought to determine the application of any limitation periods.

Conclusion

The investigation by the Commerce Commission into concerns about the mis-selling of swap agreements by New Zealand banks comes on the heels of a similar investigation by the Financial Services Authority in Britain into concerns over the practices adopted by banks in respect of the sale of interest rate derivatives. While it is encouraging that the Commerce Commission deemed the concerns raised serious enough to warrant an investigation, the investigation is expected to take some months to complete and, even if the banks are held to be at fault, it is unlikely that the farmers will be compensated for their losses.

Farmers who have concerns in respect of the mis-selling of swap agreements ought to seek legal advice. Lawyers advising farmers ought to give careful consideration to limitation periods.



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