

# Bond Swaps

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## Abstract

Paper provides evidence about Bonds Market and bonds portfolio management strategies explaining Bond Swaps as a one of the major and important tools of active management strategies of bond portfolios; different types of bond swaps and their using techniques and rules according given circumstances based acquired market data. Bonds swapping strategies and their benefits in portfolio management, as well some recent trends concerning bonds swaps. The general purpose of the paper is to provide reader basic information about bond swaps, how to use it and place and time of its usage.

**Keywords:** bond swaps, diversification, swapping strategies, wash sale

**JEL:** G1, G12, G24

## 1. Introduction

The bond market is by far the largest security market in the world, providing investors with virtually limitless investment options.

The precise size of the global bond market is difficult to pin down because of the market's rapid growth and increasing diversity. For example, Merrill Lynch's "Size and Structure of the World Bond Market: 2004" estimates that there were about \$45 trillion in global bonds outstanding at the end of 2003, while a recent study by the McKinsey Global Institute, "\$118 Trillion and Counting: Taking Stock of the World's Capital Markets", estimated the size of the global bond market at about \$51 trillion in 2003. For comparison, the same McKinsey study estimated the size of the global equity market was \$32 trillion, not quite two-thirds of the size of the global bond market.

Many investors are familiar with aspects of the market, but as the number of new products grows, even a bond expert is challenged to keep pace. Before discussing economic forecasts and how those forecasts may affect unique sectors of the bond market, there is need to answer the most basic question: What is a bond?

First and foremost, a bond is a loan that the bond purchaser, or bondholder, makes to the bond issuer. Governments, corporations and municipalities issue bonds when they need capital.

Investors have traditionally held bonds in their portfolio for three reasons: income, diversification and protection against economic weakness or deflation.

Investors have several options for adding bonds to their portfolio. One option is to invest with an "active" bond manager that will employ various strategies in an effort to maximize the return on a bond portfolio and outperform the market's return as measured by a selected benchmark. A second option is to invest with a "passive" manager whose goal is to replicate (rather than outperform) the returns of the bond market or a specific sector of the bond market. A third option is to invest in a "laddered" bond strategy, in which maturing bonds are passively reinvested in new bonds without any attempt to maximize returns (Adams, 2010).

Stock market investors will choose a particular risk level on the SML and invest at this point, choosing only those securities that lie on the SML (or above it). Stock investors have dif-

ferent levels of risk/return requirements Bond investors will do the same thing. A young, aggressive bond investor may choose a high risk bond and is willing to risk his principal investment. A retiree may not be willing to take a risky bond investment and may, instead invest in conservative bonds.

Individual investors choose to invest in bonds. As well, pension funds, banks, insurance companies and other institutions invest in bonds. At any rate, all investors are interested in a bond investment strategy. There are three major types of strategies:

1. passive portfolio management strategies
2. active portfolio management strategies
3. matched-funding strategies

In the 1950s the bond market was considered a safe, conservative investment. At that time a buy-and-hold strategy was sufficient. However, times changed, in the 1960s inflation increased, and interest rates became more volatile. Thus, with more volatile interest rates, there was a great amount of profit potential with bonds. Not all investors viewed the rise in interest rate volatility as a good thing. The pension fund and insurance companies that invest in bond found their job much more difficult. Thus, strategies based on duration were developed to aid pension fund managers to match their liabilities with properly constructed bond portfolios.

### *Passive Bond Portfolio Strategies*

There are two major passive strategies:

- buy-and-hold
- indexing

### *Active Management Strategies*

These strategies require major adjustments to portfolios, trading to take advantage of interest rate fluctuations, etc. There are five major active bond portfolio management strategies:

- Interest rate anticipation
- Valuation analysis
- Credit analysis
- Yield spread analysis
- ***Bond Swaps***

In each strategy, the manager hops to outperform the buy-and-hold policy by using acumen, skill, etc (Reilly, 2005, p. 634-636).

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## 2. Bond Swaps

One of the tool of active bond portfolio management strategy is bond swaps. Bond swaps involve liquidating a current position and simultaneously buying a different issue in its place with similar attributes but having a chance for improved return.

Swaps can be executed to increase current yield, to increase yield to maturity, to take advantage of shifts in interest rates or the realignment of yield spreads, to improve the quality of a portfolio, or for tax purposes. Some swaps are highly sophisticated and require a computer for calculation. However, most are fairly simple transactions with obvious goals and risk (Kruger, 2000).

The swaps market has grown very rapidly over the past twenty years and has become highly liquid and flexible. The birth of swaps in the early 1980s can be traced to the financial turbulence at that time and the resulting high volatility of interest rates. High volatility led many borrowers to value more than ever the stability and security of fixed-rate debt, at a time when the capital markets offered it only at an increasingly high premium; this spurred a variety of financial innovations (Shen, 2009).

Swaps have grown explosively in the last decade. At the end of 1982, the aggregate of contracts outstanding was \$5 billion. By the end of 1991, contracts outstanding exceeded \$4.6 trillion (Simons, 1993, p.23).

There are various types of different swaps our topic consider three of the more popular bond swaps:

**Pure Yield Pickup Swap** The pure yield pickup involves swapping out of a low-coupon bond into a comparable higher-coupon bond to realize an automatic and instantaneous increase in current yield and yield to maturity. Your risks are (1) that the market will move against you and (2) that the new issue may not be a viable swap candidate. As well, because you are moving to a higher coupon obligation, there could be greater call risk.

An example of a pure yield pickup swap would be an investor who currently holds a 30-year, Aa-rated 10 percent issue that is trading at an 11.50 percent yield. Assume that a comparable 30-year, Aa-rated obligation bearing a 12 percent coupon priced to yield 12 percent becomes available. The investor would report (and realize) some book loss if the original issue was bought at par but is able to improve current yield and yield to maturity simultaneously if the new obligation is held to maturity.

The investor need not predict rate changes, and the swap is not based on any imbalance in yield spread. The object simply is to seek higher yields. Quality and maturity stay the same as do all other factors except coupon.

**Substitution Swap** The substitution swap generally is short term and relies heavily on interest rate expectations. Therefore, it is subject to considerably more risk than the pure yield pickup swaps. The procedure assumes a short-term imbalance in yield spreads between issues that are perfect substitutes. The imbalance in yield spread is expected to be corrected in the near future. For example, the investor might hold a 30-year, 12 percent issue that is yielding 12 percent and be offered a comparable 30-year, 12 percent bond that is yielding 12.20 percent. Because the issue offered will trade at a price less than \$1,000 for every issue sold, the investor can buy more than one of the offered obligations. You would expect the yield spread imbalance to be corrected by having the yield on the offering

bond decline to the level of your current issue. Thus, you would realize capital gains by switching out of your current position into the higher-yielding obligation (Wraith, 2002).

**Tax Swap** The tax swap is popular with individual investors because it is a relatively simple procedure that involves no interest rate projections and few risks. Investors enter into tax swaps due to tax laws and realized capital gains in their portfolios. Assume you acquired \$100,000 worth of corporate bonds and after 2 years sold the securities for \$150,000, implying a capital gain of \$50,000. One way to eliminate the tax liability of that capital gain is to sell an issue that has a comparable long-term capital loss. If you had a long-term investment of \$100,000 with a current market value of \$50,000, you could execute a tax swap to establish the \$50,000 capital loss. By offsetting this capital loss and the comparable capital gain, you would reduce your income taxes.

Municipal bonds are considered particularly attractive tax swap candidates because you can increase your tax-free income and use the capital loss (subject to normal federal and state taxation) to reduce capital gains tax liability.

### 2.1. Bond Swapping Strategies

A bond swap is a technique whereby an investor chooses to sell a bond and simultaneously purchase another bond with the proceeds from the sale. Fixed-income securities make excellent candidates for swapping because it is often easy to find two bonds with similar features in terms of credit quality, coupon, maturity and price.

In a bond swap, you sell one fixed-income holding for another in order to take advantage of current market and/or tax conditions and better meet your current investment objectives or adjust to a change in your investment status. A wide variety of swaps are generally available to help you meet your specific portfolio goals.

#### **Why You Would Consider Swapping**

Swapping can be a very effective investment tool to:

- increase the quality of your portfolio;
- increase your total return;
- benefit from interest rate changes; and
- lower your taxes.

These are just a few reasons why you might find swapping your bond holdings beneficial.

#### **Swapping for Quality**

A quality swap is a type of swap where you are looking to move from a bond with a lower credit quality rating to one with a higher credit rating or vice versa. The credit rating is generally a reflection of an issuer's financial health. It is one of the factors in the market's determination of the yield of a particular security. The spread between the yields of bonds with different credit quality generally narrows when the economy is improving and widens when the economy weakens. For example, if you expect a recession you might swap from lower-quality into higher-quality bonds with only a negligible loss of income.

Standard rating agencies classify most issuers' likelihood of repayment of principal and payment of interest according to a grading system ranging from, say, triple-A to C (or an equivalent scale), as a quality guideline for investors. Issuers considered to carry good likelihood of payment are "investment grade" and are rated Baa3 or higher by Moody's Investors Service or BBB- or higher by Standard & Poor's Ratings

Services and Fitch Ratings. Those issuers rated below Baa3 or below BBB- are considered “below investment grade” and the repayment of principal and payment of interest are less certain. Suppose you own a corporate bond rated BBB (lower-investment-grade quality) that is yielding 7.00% and you find a triple-A-rated (higher-investment-grade quality) corporate bond that is yielding 6.70%.<sup>1</sup> You could swap into the superior-credit, triple-A-rated bond by sacrificing only 30 basis points (one basis point is 1/100th of one percent, or .01%). Moreover, during an economic downturn, higher-quality bonds, which represent greater certainty of repayment in difficult market conditions, will typically hold their value better than lower-quality bonds.

### ***Swapping to Increase Yield***

You can sometimes improve the taxable or tax-exempt returns on your portfolio by employing a number of different bond-swapping strategies. In general, longer-maturity bonds will typically yield more than those of a shorter maturity will; therefore, extending the average maturity of a portfolio's holdings can boost yield. The relationship between yields on different types of securities, ranging from three months to 30 years, can be plotted on a graph known as the yield curve. The curve of that line is constantly changing, but you can often pick up yield by extending the maturity of your investments, assuming the yield curve is sloping upward. For example, you could sell a two-year bond that's yielding 5.50% and purchase a 15-year bond that is yielding 6.00%. However, you should be aware that the price of longer-maturity bonds might fluctuate more widely than that of short-term bonds when interest rates change.

When the difference in yield between two bonds of different credit quality has widened, a cautious swap to a lower-quality bond could possibly enhance returns. But sometimes market fluctuations create opportunities by causing temporary price discrepancies between bonds of equal ratings. For example, the bonds of corporate issuers may retain the same credit rating even though their business prospects are varying due to transient factors such as a specific industry decline, a perception of increased risk or deteriorating credit in the sector or company. Suppose you purchased in the past (at par) a 30-year A-rated \$50,000 corporate bond with a 6.25% coupon. Assume that comparable bonds are now being offered with a 6.50% coupon. Assume that you can replace your bond with another \$50,000 A-rated corporate bond having the same maturity with a 6.50% coupon. By selling the first bond and buying the second bond you will have increased your annual income by 25 basis points (\$125). Discrepancies in yield among issuers with similar credit ratings often reflect perceived risk in the marketplace. These discrepancies will change as market conditions and perceptions change.

### ***Swapping for Increased Call Protection***

Swaps may achieve other investment objectives, such as building a more diversified portfolio, or establishing better call protection. Call protection is useful for reducing the risk of reinvestment at lower rates, which may occur if an issuer retires, calls or pre-refunds its bonds early. Call protection swaps are particularly advantageous in a declining interest rate environment. For example, you could sell a bond with a short call, e.g., five years, and purchase a bond with 10 years of call protection. This will enable you to lock in your coupon for an additional five years and not worry about losing your higher-coupon bonds in the near future. You may have to sacrifice yield in

exchange for the stronger call protection.

### ***Anticipating Interest Rates***

If you believe that the overall level of interest rates is likely to change, you may choose to make a swap designed to benefit or help you protect your holdings.

If you believe that rates are likely to decline, it may be appropriate to extend the maturity of your holdings and increase your call protection. You will be reducing reinvestment risk of principal and positioning for potential appreciation as interest rates trend down. Conversely, if you think rates may increase, you might decide to reduce the average maturity of holdings in your portfolio. A swap into shorter-maturity bonds will cause a portfolio to fluctuate less in value, but may also result in a lower yield.

It should be noted that various types of bonds perform differently as interest rates rise or fall, and may be selectively swapped to optimize performance. Long-term, zero-coupon and discount bonds perform best during interest rate declines because their prices are more sensitive to interest rate changes. Floating-rate, short- and intermediate-term, callable and premium bonds perform best when interest rates are rising because they limit the downside price volatility involved in a rising yield environment; their price fluctuates less on a percentage basis than a par or discount bond.

However, you should remember that rate-anticipation swaps tend to be somewhat speculative, and depend entirely on the outcome of the expected rate change. Moreover, shorter- and longer-term rates do not necessarily move in a parallel fashion. Different economic conditions can impact various parts of the yield curve differently. To the extent that the anticipated rate change does not come about, a decline in market value could occur.

### ***Swapping to Lower Your Taxes***

Tax swapping is the most common of all swaps. Anyone who owns bonds that are selling below their amortized purchase price and who has capital gains or other income that could be partially, or fully, offset by a tax loss can benefit from tax swapping.

You may have realized capital gains from the sale of a profitable capital asset (e.g., real estate, your business, stocks or other securities). Or you may expect to sell such an asset at a potential profit in the near future. By swapping those assets that are currently trading below the purchase price (due to a rise in interest rates, deteriorating credit situation, etc.) you can reduce or eliminate the capital gains you would otherwise have paid on your other profitable transactions in the current tax year.

The traditional tax swap involves two steps: (1) selling a bond that is worth less than you paid for it and (2) simultaneously purchasing a bond with similar, but not identical, characteristics. For example, assume you own a \$50,000, 20-year, triple-A-rated municipal bond with a 5.00% coupon that you purchased five years ago at par. If interest rates increase (such that new bonds are now being issued with a 5.50% coupon), the value of your bond will fall to approximately \$47,500. If you sell the bond, you will realize a \$2,500 capital loss, which you can use to offset any capital gains you have realized. If you have no capital gains, you can use the capital loss to offset ordinary income. You then purchase in the secondary market a replacement triple-A-rated 5.00% municipal bond (from a dif-

ferent issuer), maturing in 15 years, at an approximate cost of \$47,500. Your yield, maturity and quality of bond will be the same as before, plus you will have realized a loss that will save you money on taxes in the year of the bond sale. Of course, if you hold the new bond to maturity, you will realize a \$2,500 gain in 15 years, taxable as ordinary income at that time. By swapping, you have converted a “paper” loss into a real loss that can be used to offset taxable gain.

### ***Some Important Rules for Tax Swapping***

Under current tax law, the maximum tax rate on long-term capital gains is lower than the maximum rate on short-term capital gains. In order to be entitled to the lower long-term capital gains rate, a taxpayer must hold the asset for more than one year. Because of ongoing discussions concerning possible changes in the tax treatment of capital gains, investors should consult their tax advisor for up-to-date advice.

If you have short-term or long-term capital gains, the losses from the swap transactions will offset these gains first—long-term losses will offset long-term gains, and short-term losses will offset short-term gains; net losses in either category will then offset gains in the other category. If the net result is an overall capital loss, the excess loss can be used to offset ordinary income dollar-for-dollar (up to a maximum of \$3,000). If an investor has both net short-term and net long-term capital losses, the ordinary income is first offset by the short-term capital losses, then by the long-term losses. Excess capital losses can be carried forward indefinitely to reduce capital gains liability and ordinary income in future years.

The tax basis of the new bonds will be their cost (the price paid for the bonds). If the new bonds are bought at a discount and held to maturity, or are sold at a price higher than their cost, a taxable gain will often result, unless also offset by losses. To the extent such gain represents accrued market discount, it will be taxed as ordinary income, with the balance treated as capital gain.

Changes in the tax laws always present an opportunity to review your bond holdings.

Investors who expect their tax rate to increase will frequently swap taxable bonds for tax-exempt (municipal) bonds. This is done with the expectation that tax-exempt bonds will become relatively more desirable in the marketplace than fully taxable bonds and will benefit from price appreciation.

Remember that Prudential Securities is not a legal tax advisor, and you should consult with your tax advisor before making any tax-related investment decisions (Chang, 2002).

### ***How to Avoid a Wash Sale***

An important caveat is that you cannot swap identical issues (such as selling the New York 7s to establish a loss and then buying back the same New York 7s). If it is not a different issue, The Internal Revenue Service (IRS) will not recognize a tax loss generated from the sale and repurchase within 30 days before or after the trade or settlement date of the same or a substantially identical security—typically called a “wash sale.” While the term “substantially identical” has not been explicitly defined in this context, two bonds have generally not been considered substantially identical if (1) the securities have different issuers, or (2) there are substantial differences in either maturity or coupon rate (Kadlec, 1999).

Most swaps involve several different types of risk. One obvious risk is that the market will move against you while

the swap is outstanding. Interest rates may move up over the holding period and cause you to incur a loss. Alternatively, yield spreads may fail to respond as anticipated. Possibly the new bond may not be a true substitute and so, even if your expectations and interest rate formulations are correct, the swap may be unsatisfactory because the wrong issue was selected. Finally, if the work-out time is longer than anticipated, the realized yield might be less than expected. You must be willing to accept such risks to improve your portfolio.

## **3. For a Personal Appraisal**

To learn more about what bond swapping may mean to you, consider your objectives and discuss them your financial consultant.

### ***Swap Objectives and General Information***

1. Do you wish to establish a tax loss or realize a gain?
2. Do you wish to improve quality?
3. Do you wish to increase yield?
4. Do you wish to increase call protection?
5. Is there a change in your tax status?
6. What is your tax bracket?
7. What type of bond are you swapping?

### ***How to Use Bond Swaps***

Some investors take their money out of the market when one of their investments posts a loss. Other investors view losses as a new opportunity to reinvest money into better performing funds. One way to preserve your financial investment on a bad day is to use a bond swap to reallocate your funds.

### ***Instructions***

Things You’ll Need:

- Money invested in at least 1 bond
- Investment broker
- Software to buy and sell bonds

#### **Step 1**

Look through your investment portfolio to find any underperforming or high maintenance bonds. These securities could be longer-term bonds that are getting close to maturity, bonds with high taxes or bonds with interest rates that have dropped significantly. These bonds are the ones that you will be swapping out.

#### **Step 2**

Talk to your broker or look online for a similarly priced bond that has a better credit or interest rating, even if in a different industry sector. This is the bond that you will be swapping for. You should as well consider using bond swaps to switch to bonds that were issued recently and still have many years until they mature.

#### **Step 3**

Contact your broker or use your trading software to sell one bond and buy the other. In a perfect bond swap, you will be using all of the money from the sale to fund the purchase so your total invested income remains the same after the swap.

#### **Step 4**

Check to see if you sold your bond at a loss. Many investors use a bond swap to avoid paying capital gain taxes. If

you're selling your bond for less than you paid for it, you're receiving a financial loss which will help decrease the taxes you have to pay on gains or income in that tax year.

#### Step 5

Report your loss on Schedule of your tax return. If you held the bond that you swapped for at least 1 year, you can report it as a long-term loss and it will count against your long-term gains. Remember that if you hold the new bonds until they mature or sell them at a profit, you will have to pay taxes on that income.

#### Step 6

Continue to do your homework. Just because you've swapped out your bonds doesn't mean you are done with your bond portfolio. Keep on top of current market trends and changes. If you don't, it could cost you quite a bit of money (EBSCO host 2009).

## 4. What Professionals Must Know to Tax-Manage Bonds

Investors generally view the volatility of interest rates and bond prices as an unfortunate but inevitable aspect to fixed-income investing. A comprehensive grasp of newer tax laws can leverage the ability of an investment manager to harvest the unrealized fluctuations in bond prices and enhance the after-tax returns of bond portfolios without creating undesirable tax consequences in the process. Realizing long-term capital gains and losses are both beneficial techniques, and their success will depend on the particular circumstances.

### *Rates Are Low, So Harvest Gains*

Why would anyone harvest capital gains ?!

Many investment professionals use only *tax loss* harvesting to enhance returns through tax savings. *Tax-gain* harvesting is a twist on this technique, and it is one that can be very successful. Tax-gain harvesting offers value to investors by capitalizing on the difference between income tax and long-term capital gains tax rates. Swapping bonds with this technique will convert future income taxes into current capital gains taxes. As you will see, the tax savings will significantly compensate for the opportunity cost of paying taxes early.

While numerous studies have shown the relative superiority of tax-exempt debt in taxable accounts for investors in higher tax brackets, that is not the focus of this article. In reality, many investors hold some taxable debt in taxable accounts; an average brokerage account may have an assortment of corporates mixed in with municipals; an average bank account may have some bank certificates of deposit from the same bank; risk-averse investors may prefer Treasuries or agency notes for their direct and indirect guarantees of payment.

**Here is the scenario:** Ted bought some long-term bonds back in the early 90s. Interest rates have fallen to new lows, and many of his bonds have now increased in value by as much as 50 percent. Ted is sitting tight on his bonds, as he doesn't need the money until maturity, when he plans on putting a down payment on a retirement home. Despite the capital gains tax and regardless of his investment goals, Ted should perform a bond swap to save himself some money (taxes) in the long run.

**Here is the method:** Ted's largest position is 100 Treasury

bonds due August 2020, with a \$1000 face value, an 8.75 percent coupon rate, and bought at par in 1990. He bought them for \$100,000 and now their market value is \$147,000 at a 4.5 percent yield-to-maturity. Ted sells these bonds and incurs a capital gain of \$47,000 on his 2004 tax return, at his long-term capital gains rate of 15 percent. That will be \$7,050 in taxes. Ted then completes his "tax swap" by reinvesting the \$147,000 into a separate issue, also at an 8.75 percent coupon due in May 2020. The prices and yields for these issues are essentially identical. In terms of his investment, nothing material has changed from this transaction—the same coupons, the same face value, and an almost identical maturity. The key difference: he has now bought "premium bonds." Internal Revenue Service rules allow Ted to amortize the Premium each year and deduct this amount against interest income. The \$47,000 premium divided evenly over 16 years is 2,938 a year, which we deduct on Ted's tax return. The result is \$1,028 tax savings a year for the 35 percent federal income tax bracket. Over the next 16 years, Ted saves a grand total of \$16,450, or about \$9,350 more than the capital gains he paid in 2004.

Using a standard time-value-of-money formula, these future streams of tax savings can be converted into today's dollars for a more accurate comparison. The present value of the tax savings, discounted to the current after-tax yield-to-maturity of the same bond (3.2 percent) is \$13,081, which is a \$5,950 net savings over the taxes paid in 2004. Looked at another way, the tax swap adds a 6 percent return to Ted's initial investment, without changing any material aspects to his investment or adding any additional risk. Looked at a third way, Ted is using his existing investments to invest \$7,050 in a Treasury-based annuity for 16 years with a 14.6 percent after-tax annual payout and a 12.3 percent after-tax internal rate of return, with the full faith and credit of the U.S. government. Now that's a successful tax swap (Agrawal, 2005).

## 5. Recent Trends Concerning Bond Swaps

### *Lloyds to offer "Cocos" bond swap – report*

LONDON (Reuters) - Lloyds Banking Group (LLOY.L) will attempt to raise 7.5 billion pounds capital by offering existing bond holders the chance to exchange their bonds for riskier but higher yielding investments that could convert into equity, the Financial Times said on Monday.

As one element of the part-nationalised bank's 25 billion pounds recapitalisation programme, Lloyds is aiming to raise 7.5 billion pounds of so-called contingent convertibles or "Cocos," the FT said.

These are bond financings that would count towards core tier one capital and convert into equity if the bank finds itself in a crisis situation.

Bond holders may be encouraged to take part in the deal as the instruments would escape the bank on paying coupons the European Commission state-aid authorities may impose on the bank, which is 43.5 percent owned by the UK government.

A Lloyds' spokesperson was not available to comment.

The FT said that one person involved in the restructuring also said the bank would offer slightly more of the new securities to each bondholder, implying a yield up to 40 basis points, or 2-3 percent, higher than existing bonds.

The paper reported one person briefed on the plan said the instruments would convert to equity if Lloyds core tier one ratio fell below about 6 percent -- under the 8-10 percent level

that the bank is expected to have after its rights issue.

Lloyds may launch one of the world's largest cash calls as early as this week after talking to shareholders on Friday to gauge their appetite for the fundraising, investor sources told Reuters on Friday.

The bank approached shareholders on Thursday to get a rights issue of 12 billion pounds done before the Christmas holiday, as soon as it gets approval from the government and regulators. Two sources close to the matter said a deal could come as early as Tuesday (Reuters, 2009, November 2, Monday).

### **Lenders Line up for Central Bank Bond Swaps**

The news that UK banks are already preparing up to £90bn of mortgage-backed bonds to send to the Bank of England will come as no surprise to some people.

The unveiling of the Bank's Special Liquidity Scheme just three weeks ago was met with estimates from securitisation analysts that banks could draw down more than £700bn of liquid government bonds in exchange for existing and newly created mortgage bonds. The European Central Bank had €150bn-€180bn of asset-backed bonds pledged in its liquidity operation at the end of December, the month for which the latest data are available. Most observers think that figure will have grown substantially as securitisation markets have stayed closed.

Comments from Yves Mersch, a member of the ECB's governing council, this week that the central bank was highly concerned about the quality of collateral it was holding, belie the fact that the biggest problem for banks remain shifting their safest, triple A rated bonds.

These bonds account for on average 70 per cent of all securitisation issuance – and therefore 70 per cent of all the funding banks raised in issuing mortgage-backed and other asset-backed bonds.

In the first half of 2007, before the credit crunch, that amounted to about \$455bn of funding in the US and about €213bn in Europe.

The problem is that buyers of this type of bond have all but vanished from the market and many of them – the leveraged off-balance-sheet investment vehicles, money market funds and banks themselves – have been forced sellers of what they previously bought.

As one senior European securitisation banker puts it: “We created a lot more triple A product than there are now buyers for it. We manufactured buyers in the form of off-balance sheet SIVs and conduits and that's the adjustment we're now going through, trying to find where to place all this stuff”.

Rick Watson, head of the European Securitisation Forum, says the biggest challenge the industry faces is in trying to restore the triple A investor base.

“This isn't just a confidence issue (although that is an important issue), but it is an institutional structure issue,” he says.

The central banks facilities that existed already at the ECB and were put in place by the US Federal Reserve and the BoE have for now, in effect, replaced the hobbled former buyers of triple A bonds.

The ECB accepts bonds backed by newly issued loans and mortgages – unlike the BoE, which will only take deals backed by mortgages that existed before the end of last year – and so has taken the place of the market for new deals.

The central bank's liquidity window has diverted supply from public markets while arguably blunting the impact of market forces on banks' wholesale funding strategies, says

Ganesh Rajendra, at Deutsche Bank.

The BoE's facility could still become very large. Analysts estimate there are about £750bn of eligible mortgage bonds outstanding, while banks have about £975bn of mortgages on their books that could be turned into eligible deals.

The amount of funding banks could need is illustrated by estimates from Deutsche Bank that total UK bank wholesale liabilities over the next 12 months are more than £740bn, with HBOS accounting for £164bn (Davies, 2008).

## **6. Conclusion**

The birth of Bond Swaps is connected and result of volatility of interest rates in past decade. It can be concluded that Bond Swaps are the least risky tools of active management strategies of bond portfolios; it allows portfolio holders to decrease riskness and improve quality of their holdings by diversifying and permanent updating their portfolios through different techniques of Bond Swaps.

The growth of swap market has been astounding. Bond Swaps became an important source of revenues for banks and other financial institutions and for individual investors; as well they are subject of- the-books transactions. Though bond swapping can be added diversity to a portfolio and potentially lower taxes, it's important to not rush into the world of bond swapping. Work with a professional financial advisor to ensure that your bond swap execution strategy helps you meet your investment goals and that you understand the tax implications of pursuing such a plan.

Bond Swaps are subject of the financial field where only highly sophisticated professionals are playing.

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