PARA BELLUM ADVISORS

INFRASTRUCTURE · OPERATING PHASE

# Collateral Calls on an Operating Airport's Interest Rate Swaps

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| SCENARIO TYPE | Infrastructure, operating phase |
| ASSET CLASS | Interest rate swaps, collateral (CSA) |
| RISK FOCUS | Collateral calls on interest rate swaps, cash tied up from capex and distributions, uneven collateral thresholds |

*Illustrative case study.*

## THE SITUATION

An infrastructure fund bought a regional airport and financed it with about AUD500m of floating-rate senior debt. At acquisition the fund fixed the interest cost for nine years with interest rate swaps from two banks. That was near the top of the rate cycle, which is when fixing looks prudent, and the business itself did what the fund expected: within two years passenger numbers were at a record and earnings were ahead of plan.

The swaps sat under collateral agreements (CSAs) with cash posted daily, a zero threshold for the airport and AUD20m for each bank. The CSAs had been accepted because they brought the fixed rate down by about 0.15% (15 basis points) a year: with collateral in place, the banks no longer needed to charge much for the credit, funding and capital cost of a long-dated swap to a single-asset borrower. The numbers put to the investment committee showed a saving of about AUD0.75m a year, with the largest likely collateral call at about AUD10m.

Two years on, about AUD30m of the airport's cash was sitting with the two swap banks. The board had approved AUD60m of terminal and car park works, projects expected to return well above the cost of debt, and the airport could no longer fund them from cash flow.

## WHY A WORKING HEDGE NEEDED CASH

When the airport pays fixed and receives floating, the swap loses value as rates fall. Over the life of the swap that loss is matched by lower floating-rate interest on the debt, so as a hedge it does what it was designed to do. Under the CSA, though, the loss must be backed with cash (variation margin) as it happens, while the offsetting saving on the debt arrives a quarter at a time over the next seven years.

With about seven years left to run, a swap on AUD500m moves by about AUD0.3m for every 0.01% (one basis point) move. The fixed rate was now about 1% above the seven-year market rate, which put the swaps at about AUD30m against the airport, and with a zero threshold on its side all of it was called. The investment case had tested collateral for a 0.25% move, with nothing for 1% or 2% in either direction. Had rates gone the other way, the banks would have posted nothing until the swaps were more than AUD20m in the airport's favour with each bank.

The terms made most of the difference. With a two-way threshold of AUD10m per bank, the airport would have posted only the amount above AUD10m with each bank. With the exposure split evenly, AUD15m per bank, that is about AUD5m to each, AUD10m in total rather than AUD30m.

## WHAT THE CALLS COST THE AIRPORT

**Capex waits**

The terminal and car park works were ready to start, and the cash held by the banks was half of the cost.

**Growth stalls**

The airport bid for a nearby bolt-on business. Its lenders wanted to see about AUD40m of free liquidity, and with AUD30m sitting with the swap banks the airport couldn't show it. The deal went to another bidder.

**Distributions stop**

One of the larger calls landed in a distribution quarter, and the payout to the fund's investors was cut to nil.

**The next call is open-ended**

Nothing in the terms capped the calls: another 1% fall would have meant close to another AUD30m.

## THE OPTIONS

Each option has a cost:

- Renegotiate the CSAs: two-way thresholds, weekly rather than daily calls. Less cash posted, but the banks will want some of the 0.15% back.
- Move the swaps into the secured lending group with no CSA, as many infrastructure financings do. No collateral calls. The cost is a higher fixed rate, and the rest of the lending group must agree to the hedge banks' ranking alongside them.
- Put a liquidity facility in place to meet collateral calls, say AUD60m with AUD30m drawn. The swaps stay as they are. On typical infrastructure margins and fees, after the interest the posted cash earns, that costs about AUD0.8–1.0m a year, falling if rates rise and the collateral comes back, and it needs lender consent too.
- Hedge a smaller share of the debt. Lower collateral calls, more interest rate risk.

## WHAT THE BOARD CHOSE

The fund's asset management team favoured the liquidity facility. It left the swaps and their lower fixed rate in place, and on the numbers, it was the cheaper option. The board's concern was that the airport would be borrowing to post collateral against a hedge that was working and leaving the next call as open-ended as the last.

The board moved the swaps into the secured lending group with no CSA. Both banks were already lenders, and the rest of the lending group agreed to the swaps ranking alongside the debt. The banks priced the change at a fixed rate about 0.25% (25 basis points) a year higher, roughly AUD1.25m a year on AUD500m, more than the CSAs had saved at the start, because they were now carrying AUD30m of exposure that already existed as well as whatever followed. The AUD30m cash came back when the new terms took effect. The banks' exposure didn't go away. It now sits as a secured claim alongside the senior debt, and the airport pays for that through the higher fixed rate.

The trade-off was about AUD1.25m a year of extra interest for seven years, whatever rates do, and about AUD0.25–0.45m a year more than the facility would have cost. What the board bought for that was certainty: no collateral calls from here whichever way rates move, and no liquidity facility to refinance. It also set a rule that every future financing paper shows collateral with moves of 1% and 2% in both directions.

### THE LESSON

*The hedge worked. The collateral terms were the problem.*

## TEST IT ON YOUR OWN NUMBERS

- Revalue your swaps for a 1% fall in rates. How much collateral would you post, and from what source?
- Read your CSA thresholds in both directions. What is yours, and what is the banks', and what would a two-way threshold have changed?
- Ask your banks what it would cost to move the swaps into the secured lending group with no CSA and compare it with what the CSA saved you when the swaps were put on and with the cost of a liquidity facility.

If you pay fixed under a CSA, a fall in rates can take cash you had set aside for capex or distributions. If you don't know how much a 1% fall in rates (100 basis points) would take from yours, that's worth an exploratory discussion with Mike Duncan.

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