Fixed Income - Derivatives
Information sheet

Financial instruments are all types of instruments that are intended to be traded on the securities market. They can be divided into complex and non-complex instruments. Before you trade in a financial instrument, we are required to ascertain whether you have sufficient knowledge and experience to understand the properties and risks involved in trading in financial instruments. Below is some information about the most important qualities and risks associated with a type of instrument in which you have shown an interest. If you do not have sufficient knowledge and experience, we recommend that you do not trade in this instrument.

Introduction

Fixed income derivatives are a collective term for instruments such as options, forwards and swaps relating to interest. They are classed as complex financial instruments. Among other things, fixed income derivatives may be used to change or protect the interest on a loan, without needing to change the terms of the underlying loan, or for exposure in a fixed income asset.

Derivative instruments vary in regard to their risk level and the factors that affect the financial outcome. It is therefore important that you understand what applies to the derivative you intend to trade in.

How fixed income derivatives work

One characteristic of derivatives is that they are linked to events or conditions at a specific time or period in the future.

The value of the derivative is based on the underlying asset, e.g. interest rates. The market value of a fixed income derivative may vary during the term of the derivative, depending on movements in the market interest rates.

Fixed income derivatives enable the interest risk in a portfolio to be adjusted depending on the prevailing economic circumstances. For example, a loan portfolio can be adapted to exploit an advantageous interest rate situation or to stabilise the interest rate risk in times of high uncertainty. With the help of fixed income derivatives, the borrower can (for example) easily switch between fixed and variable interest, or limit the interest rate risk by protecting against interest rate increases.

A fixed income derivative is a separate contract, which does not control or influence the contractual provisions of any underlying loan contract.

Transactions in certain fixed income derivatives may require you to pledge collateral for the derivative, particularly if the derivative is subject to clearing via a clearing house. The collateral requirement may also change in line with changes in the price of the underlying asset.

For whom are fixed income derivatives suitable?

Fixed income derivatives are particularly suitable for companies and other debt managers who want to deal with the interest rate risk in their loan portfolio – i.e. the risk that interest rates will go up (in a loan with variable interest) or down (in a loan with fixed interest) – in order to have more control over future interest costs.

Fixed income derivatives are an alternative to binding interest on a loan in the traditional manner when you want to create room to manoeuvre in risk management. Fixed income derivatives come into their own when there is a need to change the loan portfolio.

Trading in fixed income derivatives

Fixed income derivatives are generally unlisted instruments that are not traded on a stock exchange. A fixed income derivative is tailored to the customer's need, and is usually traded OTC (Over The Counter), i.e. directly between the customer and the bank. A limit is required in order to trade in fixed income derivatives with SEB.

Types of fixed income derivatives

There are various different types of fixed income derivatives. The most common variants available for trading at SEB are reviewed below.

Fixed income swaps

A fixed income swap is an agreement between two parties (e.g. you and the bank) to exchange interest payments with each other for a set time.

Fixed income swaps allow you to switch between fixed and variable interest without needing to change the underlying loan.

In a fixed income swap, someone with a loan with variable interest (e.g. Stibor 3 months) can switch to fixed interest to protect against rising market interest rates. This avoids binding the interest on the loan itself, which would bind up capital. Conversely, someone with a loan with fixed interest can switch to variable interest to benefit from falling market interest rates.

Fixed income swaps can also be used to actively take up positions according to a specific belief in the interest rate. In these cases, fixed income swaps operate as a form of investment.

A fixed income swap is a flexible instrument that can be tailored to the buyer's needs. This solution usually results in a lower interest cost than binding the loan itself to a fixed interest rate. The alternative (swapping to fixed interest) produces a more stable interest cost.

It is easy to close a fixed income swap early, for example by calculating the net present value on all future interest rate payments. Closing a swap early may incur a cost or revenue, depending on how the market value of the fixed income swap has changed.

Fixed income options

A fixed income option is a right or an obligation to buy or sell an interest rate product at a predetermined price (redemption price).

The holder of the option is entitled to buy (call option) or sell (put option) an interest rate product at a set price at a set time. The issuer of an option is obliged to buy (put option) or sell (call option) an interest rate product at the set price at a set time. The holder of the option pays a premium to the issuer for this right.

An option solution is flexible, meaning that as the buyer you can choose whether or not to exercise the option. Depending on the market interest rate, you can use the option if the agreed interest is advantageous, let it lapse or sell it back to the bank.

Fixed income cap

A fixed income cap is a series of fixed income options that a borrower can use to ensure a maximum interest rate cost for a variable interest loan. The fixed income cap entitles the holder to receive payment whenever the reference rate (for example Stibor) exceeds the interest cap (the redemption price). Payment amounts to the difference between the reference interest rate and the redemption price, calculated for the nominal amount. If the reference interest rate is lower than the redemption price, no payment is made for the relevant interest period.

The holder of the fixed income cap pays a premium for this interest rate protection, determined on the basis of the term and redemption price, among other things. fixed income caps for longer terms are more expensive, since the holder is protected for a longer period of time. The lower the redemption price, the more expensive the fixed income cap, since this increases the probability that the reference interest rate will exceed the redemption price.

An fixed income cap can be used as protection from rising interest rates, but also enables the holder to take advantage of falling interest rates.

As with a fixed income swap, a fixed income cap can be closed early, which may result in a revenue, a form of premium repayment if so desired. This revenue depends on how the market value has changed in regard to (for example) investment term, redemption price, reference interest and volatility. You should be aware that the market value of an fixed income cap during the investment term may be zero.

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Risk

In the context of investment, the term "risk" denotes the probability that the invested capital will decline in value. A higher risk often means a greater opportunity for a high return, but at the same time the risk of losing money increases.

Risk varies substantially from one derivative to the next. Derivatives can be used to both increase and reduce risk. Using a fixed income derivative for speculative purposes raises the risk.

Trading in fixed income derivatives always carries a counterparty risk, i.e. the risk that the counterparty will not fulfil its commitments, which can affect the price of the derivative during its term. Redeeming a contract early also carries a risk.

Fixed income derivatives allow investors to avoid uncertainty relating to future interest levels and interest costs. However, it is never possible to know in advance whether the strategy will pay off.

Swaps

It is possible to switch to both higher and lower risk via a swap.

Options

The maximum the buyer of an option can lose is the premium paid. On the other hand, the loss can be unlimited for the issuer of an option. Price movements for the option may be greater than for the underlying asset.

Fixed income cap

There is a risk that the holder of a fixed income cap is paying a premium for something that will not be used.

More information

Companies or sole proprietors trading in financial instruments are covered by the European Market Infrastructure Regulation (EMIR). Among other things, this means that you must sign the contract named "Agreement regarding portfolio settlement" in order to trade in these instruments at SEB.

As a company or sole proprietor, you are also obliged to report your transactions to a transaction register, which requires you to have a LEI-code (Legal Entity Identifier). This can be obtained from various issuers, such as Nordlei (www.nordlei .org) and GMEI Utility (www.gmeiutility.org). You must have a LEI-code in order to trade in these instruments at SEB. You can also transfer the task of reporting your transactions to SEB. We will do this on your behalf.

Things to remember:

- The historical return of a financial instrument is not a guarantee of future return. The value of financial instruments can rise or fall, and it is not certain that you will get back all the capital you have invested.
- In order to trade in these instruments, you must familiarise yourself with the terms and conditions that apply to trading in financial instruments. The contracts that apply depend on the instrument you are trading in.
- Certain instruments require you to be liable to make payments in future. It is important that you are prepared to comply with your undertaking.
- Check the information on the statement and other reporting relating to your holdings, and inform us immediately of any errors.
- Regularly monitor changes in the value of your holdings and positions.
- You are responsible for taking any action necessary to reduce the risk of losses.
- Always ask for supplementary marketing material or further information with more details about the financial instrument you are interested in.

Check your experience

How long have you invested in this type of instrument?	What is the average amount of money you have invested in this type of instrument?	How many times per year have you traded in this type of instrument?
☐ No experience	☐ Up to 50 000	☐ Up to 2
☐ Less than one year	☐ Up to 100 000	☐ Up to 5
☐ 1 to 5 years	☐ Up to 250 000	☐ Up to 10
☐ More than 5 years	☐ Up to 500 000	☐ More than 10
	☐ More than 500 000	

Check your knowledge

1. What does a fixed income swap involve?

A) ☐ Exchanging interest rate payments with one another
B) ☐ The interest rate changes regularly
C) ☐ Switching between interest and a share

2. If you have a fixed income cap...

A) ☐ ... you are entitled to compensation if the reference rate is lower than the redemption rate
B) ☐ ... you are entitled to compensation if the reference rate is higher than the redemption rate
C) ☐ ... you are obliged to pay compensation if the reference rate is higher than the redemption rate

3. If you hold a call option...

A) ☐ ... you are entitled to buy underlying interest rate at a set price
B) ☐ ... you are entitled to sell underlying interest rate at a set price
C) ☐ ... you are obliged to buy underlying interest rate at a set price

4. If you are an issuer of a put option...

A) ☐ ... you are entitled to buy underlying interest rate at a set price
B) ☐ ... you are entitled to sell underlying interest rate at a set price
C) ☐ ... you are obliged to buy underlying interest rate at a set price

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5. A fixed income swap may...

A) ☐ ... be closed prematurely at no cost
B) ☐ ... not be closed prematurely
C) ☐ ... be closed prematurely, which may incur a cost or revenue, depending on the market value of the swap

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6. Fixed income derivatives are usually traded...

A) ☐ ... via a stock exchange
B) ☐ ... OTC
C) ☐ ... directly between customers

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7. What is the fee you have to pay when buying an option called?

A) ☐ Price
B) ☐ Premium
C) ☐ Bonus

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