Banc one corporation (interest rate yield curve and how banc one's interest swaps...

Munaf Usmani Academia Research 1st March Interest Rate Yield Curve and How Banc One's Interest Swaps Impact the Curve When we’re talking about the interest rate yield curve for Banc One Corporation, we imply the realized rate of return it is generating from net investments. All banks have a target to earn a substantial spread between their assets and liabilities. In the case of Banc One Corporation, it was given the mandate by its management to reduce the interest rate risk which was associated with its investments. For this purpose, they heavily engaged in the use of Interest Rate Swaps (IRS). These swaps had a significant impact on their portfolio. Initially, they engaged in fixed-receiving IRSs’ which provided them with an above-market return or implied yield. In this case, swaps assisted them in generating higher returns, and thus its yield curve witnessed an upward shift. However, this yield curve would be flat as the rate is fixed. Also, it is shift in the implied yield rather than a rising slope because the tenure of the investment remained the same. After this, Banc One changed gears and opted for investing in short-term floating rate instruments and then entering into medium-term receive-fixed swaps. This again boosted the yield for the corporation, and at the same time provided liquid investments. The advantages of this structured product greatly outweighed the disadvantages. As part of its ongoing strategy to invest in CMOs’, the bank began to consider the development of a synthetic swap which would cater to the CMO investments which Banc One had made. Amortized Interest Rate Swaps were introduced. In this derivative, the bank was receiving a fixed rate and paying a floating rate. However, there was a risk of prepayments of the mortgages in which the bank had invested in. If the interest rates were to fall, the amortization of the CDOs’ would increase rapidly and the bank would find itself with funds to reinvest in a depressed market. The yield curve of the bank would be downward sloping after the prepayments are fully made. Similarly if the market rose, it would find itself stuck with a below market yield which it had locked in. Luckily for Banc One, they were earning a lot on the AIRS derivative as prepayments tend to give higher returns in the amortization schedule. This again prompted for higher returns, and hence the yield for the bank was again positive as interest climate remained stable. Another type of swap which the bank engaged in was the Prime-Libor swap. If the condition of interest rate climate remained constant, the yield curve would remain flat for the bank as it would receive a fixed rate. However, if the Libor would increase, then the yield curve would witness a decline as the effective return of the fixed rate would be reduced due to the increase in the floater. The opposite applies for a decline in Libor. Work Cited Yield Curve Implications of Interest Rate Hedges, http://www. kawaller. com/pdf/Yield_curve. PDF, N. D., Web, March 01 2011.