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Unlocking the Mechanics of Floating Rate Notes and the Swap Rate

By IAM Capital Markets

In the intricate world of finance, understanding the dynamics of various financial instruments is crucial for informed decision-making. Floating Rate Notes (FRNs) and the associated Swap Rate are integral components of the fixed income market, particularly in Australia. This article demystifies the workings of Floating Rate Notes and explores the significance of the Swap Rate in the realm of finance.

Floating Rate Notes, commonly known as FRNs or floaters, are debt securities with interest rates that fluctuate over time. Unlike fixed-rate bonds, where coupon payments remain constant, FRNs provide investors with periodic interest payments that adjust in response to market interest rates. This feature makes FRNs particularly appealing in an environment characterized by interest rate volatility.

How Do Floating Rate Notes Work?

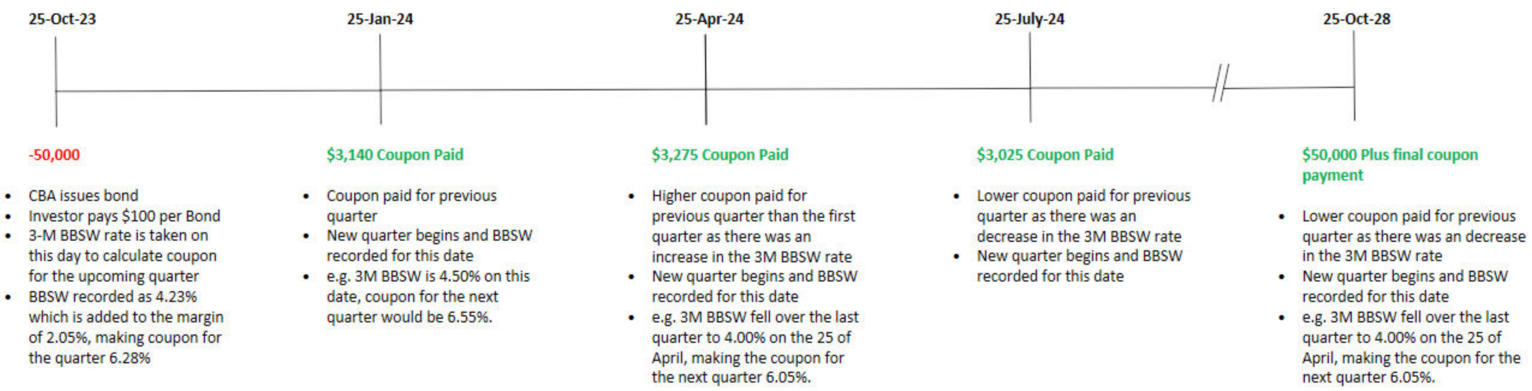
Reference Rate: FRNs are typically tied to a reference rate, such as the Bank-Bill Swap Rate (BBSW) domestically or the U.S. Treasury Bill rate. The interest rate on the FRN is determined by adding a spread or margin to the reference rate. This spread remains constant throughout the life of the FRN.

Margin: The trading margin is most relevant for bonds with floating-rate coupons. The margin describes how far above or below a bond's coupon is set from the swap rate, or the relevant benchmark being used. When calculating the yield to maturity, the current market price of a bond discounting it's current cashflows, the margin is added to the benchmark to help account for risk.

Coupon Payment: FRNs pay interest periodically, typically quarterly. The coupon payment is calculated by a predetermined coupon formula which generally is quoted at the BBSW rate plus a margin.

Floating Rate Example

In October 2023, CBA came to market with the issuance of a subordinated note with both a fixed rate tranche and a floating-rate tranche. The floating rate tranche was issued at a margin of 2.05% over the 3-month BBSW rate. Consider an investor who has bought a $50,000 parcel of this CBA FRN on the first day of issue in October with an initial outlay of $100 per bond.
On the day of issuance, the 3-month BBSW is recorded, and added to the margin of 2.05% to calculate the coupon payment that will be applicable for the upcoming quarterly coupon period. In this instance, the 3M-BBSW rate was 4.23% on the day of issuance and therefore making the coupon for the first quarter 6.28%.



Factors affecting the price of an FRN

Once issued and trading on the secondary market, the price of an FRN will fluctuate based on several factors.

1. Interest Rate Movements:

- *Benchmark Rates:* As FRNs are tied to a benchmark rate, such as the BBSW, any changes in these benchmark rates directly impact the interest payments on FRNs which is reflected in the price.
- *Inverse Relationship:* FRN prices have an inverse relationship with interest rates. As benchmark rates rise, the interest payments on FRNs also increase, making them more attractive to investors and leading to a potential rise in FRN prices.

2. Accrued Interest:

- *Accrual Mechanism:* FRNs pay interest periodically, and the interest accrues between payment dates. The accrued interest represents the portion of interest that has accumulated since the last payment date but hasn't been paid yet.
- *Impact on Price:* If an FRN is trading between coupon payments, the accrued interest is factored into the dirty or gross price. The higher the accrued interest, the higher the FRN's dirty or gross price is likely to be.

3. Trading Margin:

- *Spread Over Benchmark:* FRNs typically have a spread or margin over the benchmark rate. This spread compensates investors for taking on the additional risk associated with the issuer.
- *Market Conditions:* Changes in market conditions and investor sentiment can affect the perceived risk of the issuer. If market conditions deteriorate or if there are concerns about the issuer's creditworthiness, the trading margin may need to increase to attract investors. This can impact the FRN's price.

4. Economic Indicators and Creditworthiness:

- *Economic Conditions:* Overall economic conditions, including inflation and economic growth, can influence investor confidence in the issuer's ability to meet its obligations. Strong economic indicators may positively impact the FRN's price.
- *Creditworthiness:* The credit rating of the issuer is a crucial factor. Downgrades or upgrades in the credit rating can significantly affect investor perception and, consequently, the price of the FRN.

5. Market Demand and Liquidity:

- *Investor Appetite:* The general demand for fixed-income securities, including FRNs, affects their prices. High demand tends to drive prices up.
- *Liquidity Concerns:* If there are concerns about the liquidity of the FRN or the broader market, investors may demand a higher return, impacting the trading margin and, consequently, the FRN price.

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