GANYMEDE CAPITAL

Thought leadership series: Managing interest rate risk for Private Credit GPs

Very much like our previous paper on the hidden costs to hedge (or not hedge) FX exposure, interest rate hedging is far more common in public market funds than in their private market equivalents. In this paper, we explore what hedging solutions are available for Private Credit funds.

Why would a Private Credit fund want to hedge interest rates?

One example is when a fund has lent out capital with a mixture of fixed and floating rate terms. Interest rate hedging allows it to manage the risks of falling reference rates (if it is lending floating and wants to offer its LPs a minimum return), or rising reference rates (if it is lending fixed and wants to remain competitive through cycles).

Hedging back-leverage, or leveraged share classes or whole funds, is another example. As fund finance debt advisors, we have arranged a lot of leveraged share classes for private credit funds, as well as loan-on-loan or NAV facilities. The back-leverage (or NAV) facility is almost exclusively floating rate.

However for funds that primarily lend with fixed rates, this exposes them to the risk of rising reference rates. GPs often want (and their lenders often demand) that the fund protects or hedges itself against rising reference rates.

Overview of Interest Rate Options

Interest rate risk is typically managed using swaps, futures, or options. In this paper, due to the potentially lower cost in terms of margin requirement, we focus on Interest Rate Options—specifically **Caps, Floors, Collars, and Swaptions**—as hedging tools for private market funds.

> "A Cap provides protection against rising benchmark interest rates."

Interest Rate Options are analogous to buying an insurance policy: they allow a fund to pay an upfront premium, and receive a payout (to limit its exposure to) rising or falling interest rates.

They provide flexibility over traditional Fixed vs Floating Interest Rate Swaps ("**IRS**") and can be structured to match the specific risk profile and tenor of the underlying asset with potentially a reduced cost to protect against large movements in the floating Reference Rate in return for accepting the risk of a small amount of movement.

Margin - still the big problem

Like FX forward transactions, some interest rate derivatives require management of margin. **Margin calls may occur at short notice**—often with just two days' lead time, and holding sufficient cash in the fund to cover potential extreme moves is a drag on investment performance.

Even on a simple fixed floating IRS, where as an example a fund receiving

Reference Rate	Region / Country	Type	Description
EURIBOR	Europe	Market	Euro Interbank Offered Rate
ESTER	Europe	Market	European Short Term Rate
ECB	Europe	Central Bank	European Central Bank Refinancing Rate
SONIA	United Kingdom	Market	Sterling Overnight Index Average (This replaced LIBOR)
BoE	United Kingdom	Central Bank	Bank of England Refinancing Rate
SoFR	USA	Market	Secured Overnight Financing Rate
FED	USA	Central Bank	Federal Funds Rate

floating (benchmark linked) payments on an underlying loan "swaps" them for fixed payments, the counterparty is going to need to make margin calls.

Although this might appear counter-intuitive, margin calls (in this case if swap rates are rising) reflect the credit risk the counterparty faces should the fund not be able to make the net payment.

"What happens if you can't meet a margin call? Legally this is serious, you have defaulted on your ISDA Master Agreement"

Making margin calls is challenging for illiquid portfolios.

If cash is not posted in time, the counterparty may close out the position and as is often the case this would likely be at times of greater market volatility, leaving the fund exposed to fluctuations in the very interest rates that the fund had attempted to hedge against.

Solutions to Margin

The use of Options can lower or remove entirely the need for margin compared to using Interest Rate Swaps. Private market managers may therefore explore the following:

1. **Upfront Premium Options**: Some interest rate options (Caps, Swaptions) require only a one-time premium and no variation margin if structured as non-collateralized bilateral contracts.
2. **Margin Facilities**: Securing a committed margin line from your product provider to meet potential margin or premium payments. Non-bank providers can be particularly strong here.
3. **Credit Facilities**. Whilst it is unlikely a fund would source a specific credit facility just to hedge interest rates (although combined with FX hedging it might make sense), subscription lines and leverage facilities if they have headroom can be good sources of liquidity to make margin calls.
4. **Pre-funded Hedging Accounts**: Setting aside capital to cover premium/margin ahead of investment.

Cost of hedging

All option-based hedging comes with trade-offs:

- ◊ Caps and Swaptions require premiums
- ◊ Collars reduce premium but cap the upside/downside
- ◊ Custom structures add complexity and require negotiation

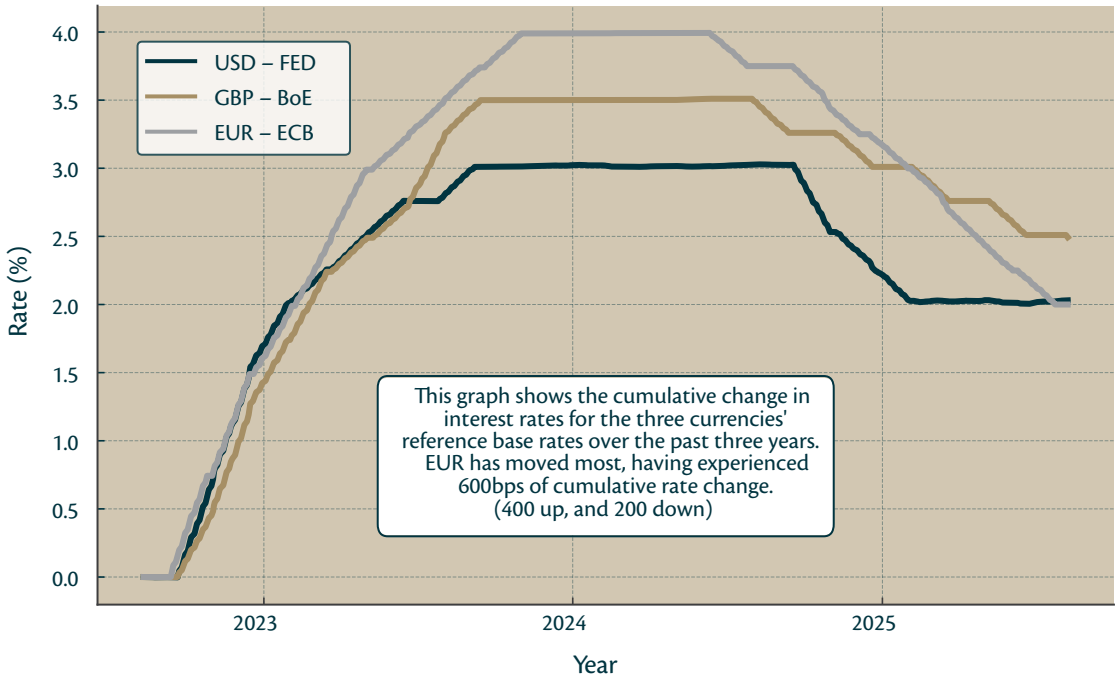
The decision must weigh the cost of hedging (upfront premiums, performance drag) versus the cost of not hedging (exposure to rising rates, reduced distributions).

In periods of rate volatility, effective interest rate hedging has moved from an operational decision to an investment-critical one.

Interest Rate Caps and Floors

A **Cap** provides protection against rising reference rates. The buyer receives a payoff when the reference rate (e.g., SOFR or EURIBOR) exceeds the agreed strike rate ("**Strike**") on a given Strike Date.

For example, if the Strike is 5%



Comparison - hedging a benchmark rate increase

Cap

Purchased upfront as a strip of options, one for each interest payment date.

Typically protection sought at a higher level (the Strike) than prevailing benchmark rate, to avoid cost being too high

Payout whenever the benchmark rate exceeds the Strike, by the amount of the excess.

Apart from finding upfront cash to purchase the options, no liquidity or cash management needs.

Collar

A strip of Caps is purchased upfront for each Strike Date at a Strike above the Reference Rate, but you also sell a strip of Floors at Strike below the Reference Rate.

This provides protection from rate rises above the Cap Strike, and the cost or purchasing the Cap is subsidised by selling the Floor. However, you will lose the benefit of rate falls below the Floor Strike because you are paying that away.

The upfront payment for the combined premium would be reduced compared to a Cap, maybe even zero so little to no upfront cash is needed.

However, there maybe an ongoing Margin requirement arising from the Floor option that was sold.

Swaption

For a known or expected income stream that starts in 6 or 12 month time, a Payer Swaption is purchaed.

The buyer of a Swaption would need to pay the upfront premium, buy but over the duration of the Option Period no margin should be needed, as when purchasing a Cap.

The higher the strike (the fixed leg of the IRS), the lower the upfront premium.

It will be exercised (into an IRS) if broadly the swap rate is higher than the strike on the fixed exercise date.

If exercised, the fund is committed to exchanging the floating benchmark rate for this fixed strike.

and the Reference Rate reaches 5.25% then the fund will receive compensation for the 0.25% the Strike has been exceeded by.

Who would buy a Cap?

A debt fund that had borrowed (for leverage / enhanced returns) at a floating rate, and its income stream, the loans it has made, are primarily fixed rate.

Or a debt fund that was lending at a fixed rate, but to offer investors extra returns should floating rates rise.

The higher the Strike is above where the Reference Rate is at the time of purchase, the less protection is obtained (in that it kicks in on a higher Reference Rate), but the lower the upfront cost. Deciding on an appropriate Strike is a key consideration for GPs.

A **Floor** conversely provides protection against falling reference interest rates. The buyer receives a payoff when the reference rate drops below the strike rate.

Who would buy a Floor?

A debt fund that had lent at a floating rate, but had promised its investors a minimum targeted return.

In the same way as a Cap, the lower the "strike", the less protection but at a lower cost.

Cash & Margin Considerations for Caps and Floors.

In each case, practically, the fund will purchase upfront a strip of options, one for each interest payment date they are seeking to hedge.

For a GP buying these Options for their fund, they will pay an upfront premium payment for each such option. Apart from finding the cash to buy these options, there are no liquidity needs to manage.

Interest Rate Collars

A **Collar** involves buying a Cap and selling a Floor (or vice versa). This limits both upside and downside, often at a reduced or zero net premium.

Who would buy a Collar?

Let's go back to the debt fund that has borrowed (for leverage / enhanced returns) at a floating rate, and its income stream, the loans it has made, are primarily fixed rate.

The Cap ensures that if the Reference Rate rises, it receives a payout to offset its extra finance costs. But this time having sold a Floor, if the floating rate falls, it no longer benefits from cheaper financing against its fixed rate income stream – it has to pay away this saving.

It has however reduced the NET Cost of the premium arising from purchasing one option by receiving premium from selling the other.

Cash & Margin Considerations for Collars.

Generally structured to be cost-neutral or low-cost on upfront costs. For example the premium received from selling a Floor may offset the cost of buying a Cap. This can be a big benefit as more of the fund's capital can be used for making loans, not hedging them.

However the sold leg of the Collar introduces **potential liability**. As such, the fund may need to meet margin calls if structured under ISDA/CSA agreements. Whilst this could create short term liquidity issues for a fund, it must be remembered that typically it comes at a time of cheaper cost of borrowing.

Interest Rate Swaptions

A **Swaption** is an option to enter into an interest rate swap (**IRS**) at a fixed future date.

As a reminder, an IRS is an exchange of interest payments, where one party agrees to pay a series of floating payments (over say a 2 year period) and the other party agrees to pay a series of fixed payments over the same period. The party paying the fixed rate and receiving the floating rate is deemed to be the **Payer**, and the party receiving the fixed rate is deemed to be the **Receiver**.

The fixed rate (the **Contractual Fixed Rate**) is set at the start of the IRS. For example in a 2 year duration IRS, the fixed rate will reference the prevailing market defined 2yr Swap Rate at the point of execution. The floating rate will be linked to the 3 month Reference Rate (e.g. EURIBOR) published at the start of each 3 month period. An IRS on day one is typically designed such that the discounted present value of both the floating and fixed legs offset each other to give a NET value of Zero.

A Swaption is the option to enter into an IRS set to start in the future, say 6 months or 1 year from now with the Strike being the Contractual Fixed Rate and being compared the prevailing Swap Rate at that time.

The Fund may elect to execute the option and enter into the terms of the IRS, or decline to execute and therefore NOT enter into the terms of the IRS.

Put simply, if the Fund was looking for protection from rate increases in the future then they would purchase a Payer Swaption, if they wanted to protect themselves from rate decreases then they would purchase a Receiver Swaption.

Furthermore, a Swaption contract can either be Cash Settled or Physically Settled. When the Swaption is contractually "Physically Settled" and the option purchaser elects to execute the option then the actual IRS is entered into and both parties need to commence payments of their part of the agreement. Whereas, if the Swaption contract is defined a "Cash Settled" then the NET value of the whole IRS is agreed upon and that single cash amount is paid, the IRS is not started, and none of the future cashflows of the IRS are paid, and no further obligation exists.

While an IRS would be valued to roughly NET zero at day one, and also a Forward Starting IRS, a Swaption would generate an Option Premium to purchase

the option because of the Value of that Optionality. As such premium is paid by the purchaser upfront.

Swaption Collars can be constructed by Purchasing a Swaption with a High Rate and selling a Swaption with a Low rate to reduce the Option Premium but this could become Margin generative, and we will maybe look at these more interesting strategies in a later paper.

Cash & Margin Considerations for Swaptions.

For a GP buying these Swaptions for their fund they will pay an upfront premium payment for each such option. Apart from finding the cash to buy these options, there are no liquidity needs to manage.

If the option is exercised, the fund will receive cash each month that the reference is above the strike, but should it fall back below the strike, the fund will need to make monthly payments, but this should be fully offset by cash interest from underlying loans (assuming they are not PIK).

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> Are independent and solely represent the interests of our clients in seeking and negotiating innovative financing structures to meet requirements;

> Utilize the breadth of our network to seek the most cost effective and streamlined solutions for our clients;

> Promote competition amongst providers to ensure that our clients can duly claim to have fulfilled their fiduciary responsibilities of seeking the most appropriate terms with respect to a given financing and hedging situation; and

> Work with our clients at all stages of the process – seeking appropriate counterparties, negotiating terms, running competitive bid processes, executing a structured transaction and helping clients navigate the post execution landscape.

Gareth James

- Former Global Head of Fund Derivatives and Finance at Deutsche Bank.
- Former Global Head of Alternative Asset Solutions at UBS Investment Bank.
- Founder and CEO of Trium Capital, a multi-strategy private markets asset manager.
- Qualified Solicitor, practiced securitisation and structured finance with Lovells.
- MA in Mathematics from the University of Cambridge.

Ken Goldsbrough

- Former Head of European Debt Advisory at Duff & Phelps, Houlihan Lokey and Greenhill.
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- Former Chairman of the Trustees of the Paribas Limited Pension Fund.
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- Former Director at Deutsche Bank, running delta-one flow fund derivatives trading desk, and traded collateralised hedge fund trading facilities and proprietary CTA replicating index strategies.
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