Reverse Interest Rate Collar

What is a Reverse Interest Rate Collar?

The Reverse Interest Rate Collar is a financial instrument for protection against decreasing floating interest rates or for a fixed interest rate in combination with other derivative instruments. The reverse interest rate collar has two key fixed levels – interest rate cap level and interest rate floor level. In case the floating interest rate is above the level of the interest rate cap, the client pays the difference between the two, and in case it is below the level of the interest rate floor – it receives the difference between the floor and the current level. When the floating interest rate is between the two levels, the two parties to the transaction do not owe anything to each other.

Who is the Reverse Interest Rate Collar intended for?

The Bank offers the reverse interest rate collar as part of an interest rate swap, in order that the clients receive a lower fixed interest rate and remain protected from interest rates falling below a certain level. The reverse interest rate collar can also be used to hedge exposures to securities or other floating rate assets.

How the Reverse Interest Rate Collar works?

In case a client of the Bank wishes to fix an interest rate on a credit linked to a floating interest rate, the client may enter into a transaction with an interest rate swap and a reverse interest rate collar. Under the transaction, the client will pay the fixed interest rate agreed in the swap and will receive a floating interest rate, limited by the level of the interest rate floor to the level of the interest rate cap.

In short, the terms of the transaction can be formulated as follows:

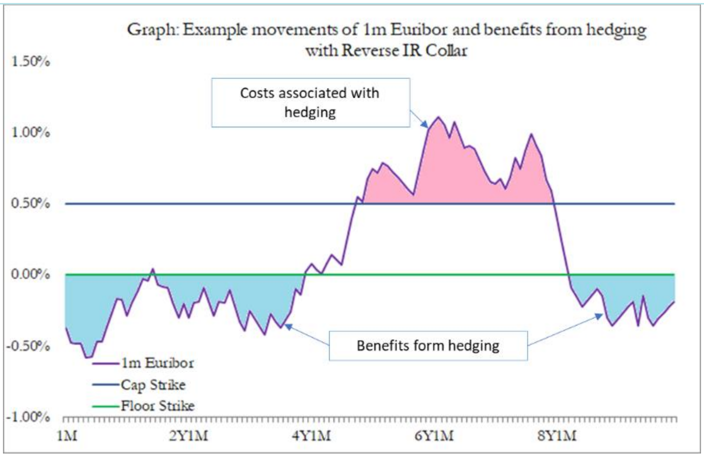
- The client pays a fixed interest rate
- The client receives a floating interest rate, but not less than the level of the interest rate floor and not more than the level of the interest rate cap.

Example 1:

The company has entered into a loan agreement, the interest rate of which is formed as 1m Euribor + spread of 3.00%, but not less than 3%. To hedge the interest rate on its loan, the company may enter into an interest rate swap transaction at a fixed interest rate of 0.40% with a reverse interest rate collar with an interest rate cap of 1.00% and an interest rate floor level of 0.00%. The client always pays a fixed interest rate of 0.40%, receiving 1m Euribor, but not less than 0% and not more than 1%.

The combined interest rate on the hedged exposure is:

- **3.40% when 1m Euribor is lower than 1% and**
- **3.40% + (1m Euribor – 1%) when 1m Euribor is higher than 1%**



Example 2:

A client hedges a floating interest rate on securities through a reverse interest rate collar. The interest on the securities is 1m Euribor + margin of 3.00%. The interest rate is below 0.20% and the interest rate cap is 0.80%. After hedging, the combined interest rate is not higher than 3.80% and not lower than 3.20%.

Main advantages:

- **Protection** – The clients might use the Reverse Interest Rate Collar in combination with an interest rate swap for fixing of an interest rate or for interest rate risk management for fixed income securities or another floating rate asset.
- **Cash flow management** – The Reverse Interest Rate Collar gives an opportunity for cash flows management according to client's expectations.
- **Flexibility** – The Reverse Interest Rate Collar is an OTC instrument and its parameters are negotiated between the counterparties of the deal.
- **No premium** – For the Reverse Interest Rate Collar, the parties to the transaction do not pay a premium in advance.

Main risks and requirements:

- **Early termination** – Depending on the value of the instrument, it is possible that the client receives or pays a certain amount when the transaction is early terminated.
- **Opportunity costs** – In case the floating interest rate exceeds the level of the interest cap, the clients have opportunity costs.
- **Market risk –** The value of the instrument is affected by the market conditions, mainly by changes in the interest rate level.
- **Currency risk** – In case the payments of the Reverse Interest Rate Collar are denominated in a foreign currency, there is currency risk.
- **Collateral/ limit requirement** – Clients concluding transactions with a Reverse Interest Rate Collar must provide cash collateral or have a pre-approved limit.

What happens to the Reverse Interest Rate Collar in case of early termination of the credit or sale of the hedged asset/securities?
The Reverse Interest Rate Collar is a financial instrument separate from the credit or the securities/assets and in case of early termination/sale of the credit/securities/assets, it continues to exist.

Can the client terminate a Reverse Interest Rate Collar before its maturity?
Yes, the client can terminate his Reverse Interest Rate Collar before its maturity. At every moment of its life, the transaction has its intrinsic value. It can be positive or negative for the client, depending on the current market interest rates. For this reason, the client receives or pays a certain amount depending on its intrinsic value. In addition, the client must take into account the cost of early termination. In case the Reverse Interest Rate Collar is part of a strategy, for example with an interest rate swap, the client must terminate the whole strategy.

Collateral/ limit to Reverse Interest Rate Collar:
In order to conclude a transaction with a Reverse Interest Rate Collar, the client must provide cash collateral or be granted an investment services sub-limit. The limits for investment services are prepared and approved by the respective client service unit – Corporate Banking Directorate or the Small and Medium Enterprises and Agribusiness Department.

Collateral/ limit management:
Definitions:
- **The Principal collateral/Investment services sublimit** for the deals is the initially approved limit/ collateral for this type of deals.
- **The Initial margin** for the deal is the minimum required limit for this type of deals.
- **Variable margin** – means the negative market revaluation (from client's point of view) of all concluded and unmatured deals.
- **Coverage ratio** – the ratio of the sub-limit for investment services/ principal collateral, reduced by the variable margin and increased by the additional collateral provided by the Client, divided by the initial margin multiplied by the notional value of the concluded and unmatured transaction/s.

Collateral/ limit management process:
The Bank runs a **daily valuation of the financial instrument**. As a result of the valuation if the coverage ratio is:
- 90% or less than 90% at the date of the revaluation, the Bank shall inform the Client by telephone and/or e-mail and shall send a written request to the Client to provide additional collateral, so that the coverage reaches 100%. If the Client is unable to provide the necessary collateral, the Bank has the right to close the Client's open position by applying the current market price on the day of termination.
- 70% or less than 70% at the date of the revaluation, the Bank shall inform the Client of the decline and shall send a written request to the Client to provide additional collateral up to 100% within 24 hours of sending the written request. If Client is unable to provide the necessary collateral, the Bank has the right to close the Client's open position by applying the current market price on the day of termination.
- 50% or below 50%, the Bank closes the Client's open position by applying the current market price on the day of termination.

Documents:
- Framework agreement for FX Options (Reverse Collar) trading
- General terms & conditions applicable to agreements for the provision of investment services and activities to the clients of DSK Bank AD
- Additional Agreement to settle their relationship in relation to the fulfilment of their obligations under Regulation (EU) No 648/2012 (EMIR)
- Notification-questionnaire for client categorization under the Markets in Financial Instruments Act (MFIA)
- Product’s Target Market Compatibility Test
- Information on the nature and risks of financial instruments
- Information on costs

Key Information Document:
The financial instrument Reverse Interest Rate Collar is a combination of the instruments Interest Rate Cap and Interest Rate Floor, for which key information documents (KID) have been prepared, which every client should become acquainted with before entering into such a transaction. The KID can be obtained at the following address: 5 Georgi Benkovski str., Sofia or can be downloaded from the following web address: https://dskbank.bg/бизнес-клиенти/корпоративно-банкиране/финансови-пазари-и-инвестиции on the DSK Bank website.

Contacts:
For more information you may contact Treasury Sales at:
- **phone numbers**: +359 2 80 10862 / +359 2 93 91126/ +359 2 93 91133 / +359 293 91365 /
- **e-mail:** Treasury.Sales@dskbank.bg