

Interest Rate Swap

An interest rate swap is an agreement between two parties to exchange future interest rate payments over a set period of time. It consists of a series of payment periods, called swaplets.

The most popular form of interest rate swaps is the vanilla swaps that involve the exchange of a fixed interest rate for a floating rate, or vice versa. There are two legs associated with each party: a fixed leg and a floating leg. Swaps are OTC derivatives that bear counterparty credit risk beside interest rate risk.

Interest rate swaps are the most popular OTC derivatives that are generally used to manage exposure to fluctuations in interest rates. Swaps can be also used to obtain a marginally lower interest rate. Thus, they are often utilized by a firm that can borrow money easily at one type of interest rate but prefers a different type.

Swap also allow investors to adjust interest rate exposure and offset interest rate risks. Speculators use swaps to speculate on the movement of interest rates. More and more swaps are cleared through central counterparties nowadays (CCPs).

Reference:

<https://finpricing.com/lib/EqVariance.html>