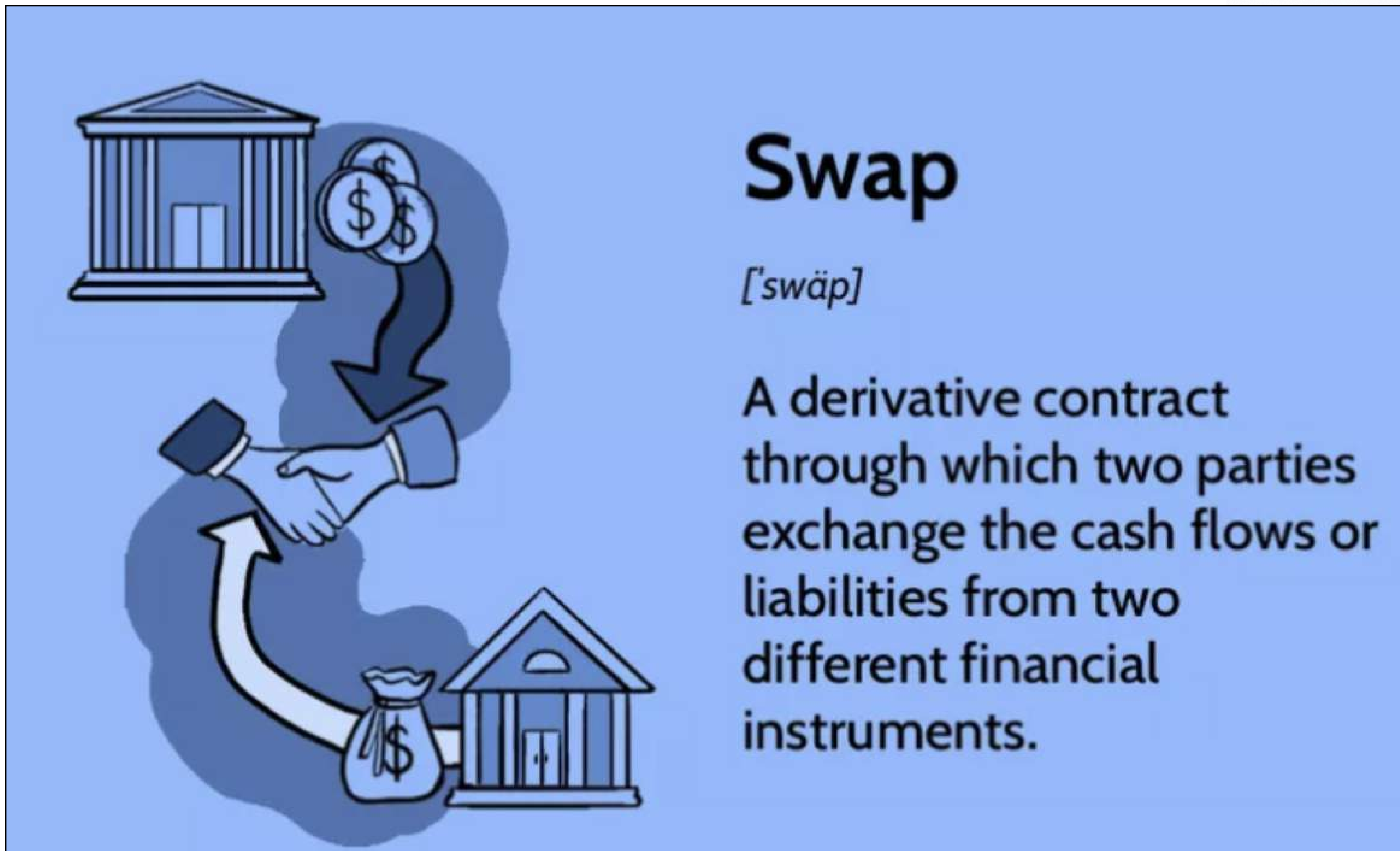
1. What Is a Swap?

A swap is a derivative contract. This financial agreement takes place between two parties to exchange assets that have cash flows for a set period of time. At the time the contract is initiated, the value of at least one of the assets being swapped is determined by a random or uncertain variable, such as an interest rate or a commodity price.



2. What Is the Swap Market?

Swaps are unlike most standardized options and futures contracts, which means most individual investors aren't really familiar with them or how they work. These financial instruments are customized contracts that trade on the over-the-counter (OTC) market between private parties. As such, they can't be traded easily over an exchange. This means there is always some degree of counterparty risk involved.

But don't be fooled. Just because they trade OTC doesn't mean the swap market is illiquid or lacks enthusiasm. In fact, the opposite is true. It is one of the largest and most liquid markets in the world, and there are plenty of knowledgeable traders who want to take part as either buyers or sellers.

The market was introduced in the 1980s to help traders lock in prices for various assets, including commodities, foreign exchange rates, and interest rates.1 The notional value of outstanding contracts in the global OTC derivatives totaled $632.2 trillion by the end of June 2022, which was an increase of 3.6% from the same period in 2021. The gross market value for interest rate derivatives jumped 32.2% to $18.3 trillion by June 30, 2022.2

The first interest rate swap occurred between IBM and the World Bank in 1981.3 However, despite their relative youth, swaps exploded in popularity. In 1987, the International Swaps and Derivatives Association reported that the swap market had a total notional value of $865.6 billion.4 By mid-2006, this figure exceeded $250 trillion, according to the Bank for International Settlements.5 That's more than 15 times the size of the U.S. public equities market.

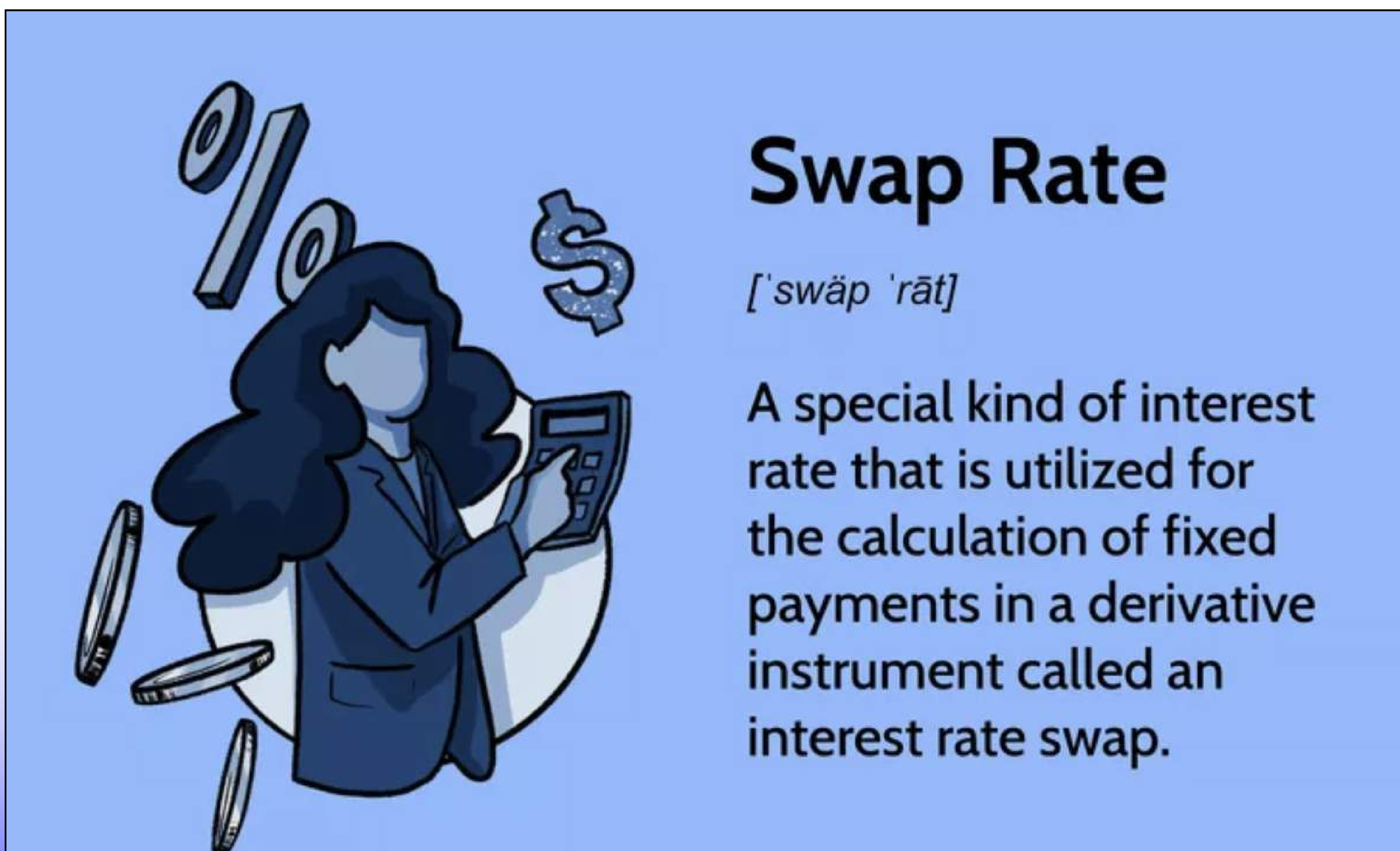
3. Players in the Swap Market

Swaps can be fairly complex, which means they're unlike stocks and bonds. They require a deeper understanding of how the markets work. As such, this isn't a market meant for your average investor. Instead, some of the key players in the swap market include banks and other financial institutions, governments, institutional investors, hedge funds, and corporations.

These entities often turn to the swap market for two main reasons: commercial needs and comparative advantage. The normal business operations of some firms lead to the exposure of certain types of interest rates or currencies that swaps can alleviate.

Consider a bank that pays a floating rate of interest on deposits and earns a fixed rate of interest on loans. This mismatch between assets and liabilities can cause tremendous difficulties. The bank could use a fixed-pay swap (pay a fixed rate and receive a floating rate) to convert its fixed-rate assets into floating-rate assets, which would match up well with its floating-rate liabilities.

In other cases, companies may get financing for which they have a comparative advantage, then use a swap to convert it to the desired type of financing. For instance, a U.S. firm may try to expand into Europe, where it is less known. It will likely receive more favorable financing terms in the U.S. By using a currency swap, the firm ends up with the euros it needs to fund its expansion.



4. The Bottom Line

Many small investors have some basic knowledge of stocks and bonds. But they may be unfamiliar when it comes to more complex securities like swaps. A swap is a financial contract between a buyer and seller who agree to exchange assets that come with cash flows for a specified period of time. But the cash flow comes with a catch: one is fixed while the other is variable. Traded over the counter, swaps are commonly used by banks, financial institutions, and institutional investors.