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Isolating the Effect of Day-Count Conventions on the Market Value of Interest Rate Swaps

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Abstract


Day-count conventions are a ubiquitous but often overlooked aspect of interest-bearing investments. While many market traded securities have adopted fixed or standard conventions, over-the-counter agreements such as interest rate swaps can and do use a wide variety of conventions, and many investors may not be aware of the effects of this choice on their future cash flows. Here, we show that the choice of day-count convention can have a surprisingly large effect on the market value of swap agreements. We highlight the importance of matching day-count conventions on obligations and accompanying swap agreements, and demonstrate various factors which influence the magnitude of day-count convention effects. As interest rate swaps are very common amongst municipal and other institutional investors, we urge investors to thoroughly understand these and other 'fine print' terms in any potential agreements. In particular, we highlight the ability of financial intermediaries to effectively increase their fees substantially through their choice of day-count conventions.

Keywords: Day-Count Convention, Interest Rate Swaps

JEL Classification: E4, P43

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