بنك الامارات للاستثمار
EMIRATES INVESTMENT BANK

Understanding Leverage & Interest Rate Risk

Leverage Risk

Adding leverage to any portfolio increases the potential risks that you may face as an investor/ client. It is important that you understand these risks and how these might impact you. You should consider carefully if the risk of leverage is appropriate for you.

Illustrated below are some examples of how negative movements in market values are magnified when a portfolio incorporates leverage. Please consider how similar scenarios may impact your portfolio.

Illustration of a portfolio with 1:1 Leverage, (or 50% LTV)	
Your original equity into a portfolio	**$ 1,000,000**
Loan facility taken to leverage the portfolio	**$ 1,000,000**
Total available funds you invest in the market	**$ 2,000,000**
The market declines by 10%	**$ 200,000 reduction in the market value of your invested funds**
Your funds in the market are now worth	**$ 1,800,000**
Your loan value remains at	**$ 1,000,000**
After deducting the loan, your equity is worth	**$ 800,000**
Your equity has reduced by 20% or double the market movement because your portfolio was leveraged by 1:1	

Illustration of a portfolio with 2:1 Leverage (or 66.67% LTV)	
Your original equity into a portfolio	**$ 1,000,000**
Loan facility taken to leverage the portfolio	**$ 2,000,000**
Total available funds you invest in the market	**$ 3,000,000**
The market declines by 10%	**$ 300,000 reduction in the market value of your invested funds**
Your funds in the market are now worth	**$ 2,700,000**
Your loan value remains at	**$ 2,000,000**
After deducting the loan your equity stake is worth	**$ 700,000**
Your equity has reduced by 30% or triple the market movement because your portfolio was leveraged by 2:1	

Interest Rate Risk

Should you use leverage to invest in a product, then you may be at risk from rises in Interest Rates. An increase in interest rates may result in the return you expect to receive from your investments being less than the amount you are paying for the leverage. The higher the proportion of the leverage employed in the product, the greater your exposure to Interest Rate Risk.

Both below illustrations assume an initial investment of $ 1,000,000 into a Bond portfolio. The 'cost of funds' increases in stages to show the Net effect on the return you make from the investment. Various costs and margins have been assumed for the sake of this illustration.

Illustration with 1X leverage						
Loan Amount	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00
Loan Interest margin (spread)	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%
Reference Rate (Index Rate)	**0.25%**	**0.50%**	**1.25%**	**2.00%**	**2.75%**	**3.50%**
Total Interest Rate	**1.50%**	**1.75%**	**2.50%**	**3.25%**	**4.00%**	**4.75%**
Amount of debit interest	15,000.00	17,500.00	25,000.00	32,500.00	40,000.00	47,500.00
Total Investment in Portfolio	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00
Expected Net Return	2.25%	2.25%	2.25%	2.25%	2.25%	2.25%
Gross Return	45,000.00	45,000.00	45,000.00	45,000.00	45,000.00	45,000.00
Net Return	**30,000.00**	**27,500.00**	**20,000.00**	**12,500.00**	**5,000.00**	**-2,500.00**

Illustration with 2X leverage						
Loan Amount	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00
Loan Interest margin (spread)	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%
Reference Rate (Index Rate)	**0.25%**	**0.50%**	**1.25%**	**2.00%**	**2.75%**	**3.50%**
Total Interest Rate	**1.50%**	**1.75%**	**2.50%**	**3.25%**	**4.00%**	**4.75%**
Amount of debit interest	30,000.00	35,000.00	50,000.00	65,000.00	80,000.00	95,000.00
Total Investment in Portfolio	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00	2,000,000.00
Expected Net Return	2.25%	2.25%	2.25%	2.25%	2.25%	2.25%
Gross Return	67,500.00	67,500.00	67,500.00	67,500.00	67,500.00	67,500.00
Net Return	**37,500.00**	**32,500.00**	**17,500.00**	**2,500.00**	**-12,500.00**	**-27,500.00**

Note: These illustrations assume there is no change in Loan Amount, Loan Interest Margin, Total investment in Bond portfolio and Expected Net return.

Additional Important Considerations

- Any securities used as collateral for a loan will become subject to interest rate risk when previously they may not have been otherwise exposed.
- You will be liable to pay the total amount of interest due on any loan balance at the rate set out in your Facilities Letter regardless of whether the income from any asset or investment you may have earmarked for the purpose of covering the interest is sufficient.
- You will be liable to repay or settle your liabilities in respect of all drawings under your loan facility even if the value of any asset or investment you may have earmarked for the purpose of repaying or settling those liabilities is insufficient. In both these circumstances you will be liable to make up any shortfall from your other resources.
- Both the level of income (if any) from any asset or investment and the value of any asset or investment may fall. Furthermore, the amount of interest payable on your loans may increase. In a worst-case scenario, an asset or investment you have earmarked for funding your liabilities under a loan agreement may become worthless, leaving you liable to fund all interest on any loan, and repay any loan balance from your other sources.
- Where minimum collateral values apply to a facility agreement you may be required to provide additional collateral or even repay a loan if the collateral value has decreased beyond specified levels.