Basis Swap

A basis swaps is an interest rate swap that involves the exchange of two floating rates, where the floating rate payments are referenced to different bases. Both legs of a basis swap are floating but derived from different index rates.

Basis swaps are settled in the form of periodic floating interest rate payments. They are quoted as a spread over the reference index. For example, 3-month LIBOR is frequently used as a reference. Spreads are quoted over it.

A basis swap can be used to limit interest rate risk that a firm faces as a result of having different lending and borrowing rates. Basis swaps help investors to mitigate basis risk that is a type of risk associated with imperfect hedging. Firms also utilize basis swaps to hedge the divergence of different rates.

Basis swaps could involve many different kinds of reference rates for the floating payments, such as 3-month LIBOR, 1-month LIBOR, 6-month LIBOR, prime rate, etc. There is an active market for basis swaps.

Reference:

https://finpricing.com/lib/EqAsian.html