APPLYING THE BEST STRATEGY

THE NEED FOR A WELL THOUGHT OUT INTEREST RATE RISK STRATEGY IS GOING TO BE OF INCREASING IMPORTANCE OVER THE NEXT COUPLE OF YEARS AND BEYOND, SAYS **NICK DOUCH**.

At its simplest level, interest rate risk is the adverse effect that rate changes can have on a company's profitability. The bigger picture is more complex, though, and includes the impact interest rate changes can have on the financial structure of a company and the knock-on effect – for example, the possibility of breaking loan covenants or lowering credit ratings – this may cause. It can also encompass changes in a firm's competitiveness caused by interest rate changes – strictly, this will ultimately show up in the profitability of the organisation, but it deserves special mention.

Over the past few years the fall in inflation in many countries has meant that interest rates have gone down – a trend exacerbated by growing fears of global recession. Not only have interest rate levels fallen, but also the yield curve has tended to flatten. In these circumstances, it is all too easy to reduce interest rate risk management to a much lower status than it was accorded when interest rate levels were higher, movements were more volatile and yield curves could be both steeply negative as well as positive. Easy to do, but wrong.

Perhaps the concept of interest rate risk is wrong – maybe the concept of interest rate exposure is the right one. This may be little more than a semantic distinction but it does illustrate the real problem. That is that, although interest rate risk may seem to be lower at the moment, companies are still exposed to the possibility of violent interest rate changes, even though the possibility of a sharp movement seems less.

No matter what your view on interest rate changes in the future, it is still imperative that a well thought out strategy of interest rate risk management is in place.

WHAT ARE THE ALTERNATIVES? There are three alternatives when it comes to interest rates: either they can be floating (and this category includes interest rates that can only change at rollover dates which are several months apart); they can be fixed; or there can be an option (in the case of a loan, an interest rate cap and, in the case of a deposit, an interest rate floor). All other examples are nothing more than mathematical manipulation of these alternatives. Therefore, the underlying tools are simple ones and do not require a deep level of understanding. What is far more difficult is to decide the mix of these three.

At the most simplistic level, a company will borrow floating when it expects interest rates to fall further than the fixed rate suggests, and will borrow fixed when that is not the case. The third alternative, options, can be used in circumstances where there is some uncertainty. The two most obvious of these are the uncertainty that the borrowing/deposit will actually arise or uncertainty about the future course of interest rates. In reality, there is always uncertainty about where rates are going and interest rate strategies need to take this into account. However, an option may be a good alternative if, for example, in the case of a borrowing, there is a strong conviction that interest rates will fall, but the cost of being wrong is too high to risk.

The problem with options is that there is some premium that has to be paid. That may be embedded in the rate in some way, or it may reduced – even to zero – by giving up some of the optionality (as in a collar) but the premium is still being paid even if the payment is not explicit.

LIQUIDITY AND INTEREST RATE RISK MANAGEMENT. Before looking at ways of establishing the correct strategy for a company, it is worth diverting to an area where interest rate risk management can become confused with a different objective.

It is clearly important that a company should arrange its borrowings to ensure it has sufficient liquidity now and in the future. That invariably means that the maturities of at least some of the borrowings need to be of a medium to long maturity. For example, a project that will not be re-financed for five years would ideally be paid for out of a five-year borrowing. For larger companies, that usually means bond finance – which, of course, is associated with a fixed interest rate.

However, the fact that the bond has a fixed interest rate does not mean the company has to pay a fixed interest rate either now or in the future. It is entirely possible to switch the interest rate liability to that of a floating rate or even a capped rate for all or part of the life of the bond. In other words, borrowings taken for liquidity purposes need to be assessed separately for interest rate management, and that means they need to be looked at in the context of all borrowings and deposits and as part of an overall interest rate management strategy.

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DETERMINING THE RIGHT INTEREST RATE STRATEGY. There is no obvious strategy that produces what could be described as a neutral stance in terms of interest rate risk. However, what is certain is that any strategy (or non-strategy) that automatically has all exposure on a floating or a fixed basis is far from neutral. Either is a huge gamble on the future course of interest rates. In the case of floating rates, the bet is that interest rates will fall or stay stable over the life of the borrowing. In the case of fixed, the bet is that interest rates will be higher than the fixed rate. That is slightly simplistic because a fixed rate does give certainty of repayment amount. While that might be a desirable attribute when it comes to an individual repaying a mortgage, it is not really an adequate reason when it comes to a company, where exposures are far more complex.

THE IMPACT OF INTEREST RATES ON A COMPANY'S UNDERLYING BUSINESS. A good starting point for a strategy is to determine how the company fares when interest rates rise or fall. An extreme example illustrates this quite well. A building company that develops new domestic properties knows that – in general terms at least – demand for new houses will tend to fall as interest rates rise, and vice-versa. There may well be a lag involved, but if rates rise or fall far enough, then the demand will follow this pattern. Therefore, it would be foolish to have all borrowings floating because the company risks a pincer on its profits from climbing interest rate costs and declining revenues from house sales. As a result, such companies are likely to look to fix (or cap) a reasonably high percentage of their borrowing.

On the other hand, retail organisations are in intense competition, and the cost of borrowing is a crucial component of this competitiveness. The ideal strategy here would be to use interest rate caps, as it would guarantee the most favourable rate. However, the cost of the option means that competitiveness is compromised anyway. As a result, retail organisations are more likely to leave themselves maximum flexibility, and that means a higher proportion of floating rate borrowing unless there is a strong belief that interest rates are going to rise.

Therefore, it is important to analyse the impact on the company's overall business (and not just borrowing costs) as a precursor to deciding the ideal mix of borrowing styles.

COVENANT CONSIDERATIONS AND CREDIT RATING IMPLICATIONS. There are times when the certainty of interest payments becomes more important and, if a company has a loan covenant that specifies some form of interest cover, that is one of those times. This idea can be extended to companies which regularly require increased borrowings for acquisitions.

Good value acquisitions could well occur when interest rates are rising (the firm being acquired may well be suffering from reduced liquidity as a result). In these circumstances, a higher percentage of fixed or capped borrowings than would usually be the case is appropriate.

High levels of interest rate expense – especially if they are rising at the same time – can be an important negative factor for credit rating agencies. Not surprisingly, this is most likely to be the case in highly geared companies, and this too is another scenario where a company may well decide that a higher level of certainty is appropriate.

WORKING OUT THE RIGHT MIX. There are three stages in this process. The first is to use the ideas we have discussed to decide what the neutral position for the company should be. For example, a building developer might believe that a mix which was 70% fixed/30% floating would be the most appropriate, whereas a business that is under constant competitive cost pressures might choose the reverse, 30% fixed/70% floating. Similarly, a company that has loan covenants based on interest costs, or feels it is particularly at risk of a credit rating downgrade if interest costs rise, might decide that it is prudent to have more than 50% of its borrowing in either fixed or capped loans.

However, this is rather a static analysis, and does not allow a company and its treasurer to express a view about where interest rates are going to go in the future. To enable this to happen, it is usual to have some band around this central point. If the view is that interest rates will definitely fall in the future, then the policy would be to have the highest level of floating borrowing possible. If interest rates are expected to rise, then it would be the high fixed rate end of the band that would be appropriate. In either case, though, the benchmark against which success or failure is measured would be the mid-point and, in that sense only, it is the neutral strategy.

The width of the band will depend on how much flexibility the company needs to run its business but should also reflect the board's confidence in those who have to take a view on interest rates. For example, as this team gains experience, it would seem reasonable to assume that the band would be widened. Different targets and bands can be set for interest rate exposures in different currencies.

Setting the appropriate timeframe for interest rate exposure management is also crucial. A 100% fixed for one year, renewed annually, may give less protection than 60% fixed for five years. Modelling of the variability of earnings and interest expense before and after tax is critical to this assessment.

The board will then be able to quantify the potential impact on both profit and covenants of a shift in the yield curve and to appreciate the value of the treasury team in interest exposure management. It will not be misled into thinking that a 50:50 fixed/floating mix is necessarily a safe bet.

TAX AND ACCOUNTING IMPLICATIONS. In an article of this length, it is impossible to do justice to either of these areas. However, that does not mean they are not important, and clearly both have to be taken into account. In particular, the introduction of new accounting standards (FAS 133 and IAS 39 and IAS 32) will mean that these decisions (or non-decisions) will be clearly exposed in annual reports. If for no other reason than this, the need for a clearly thought through interest rate risk strategy is going to be of increasing importance over the next couple of years and beyond.

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