Zero point

The diminishing returns on cash investments over recent months have become a serious issue for individuals and corporates alike, following a spate of cuts in base rate by the Bank of England's monetary policy committee. The first reduction, from 5.75% to 5.5%, came in December 2007, but the pace accelerated last autumn and six cuts between October and last month took the rate from 5% to an unprecedented 0.5%. As a result, returns have fallen close to zero, putting the issue of interest rate management high on the corporate agenda.

There are a range of policies that companies can adopt to deal with low interest rates, from opting for a fixed-rate loan or interest rate swap to more flexible approaches that can protect against adverse movements in rates and also provide benefits when the trend is more favourable.

Institutional investors have been moving into corporate debt, which is now viewed as cheap as credit spreads ballooned even though reference interest rates fell. For private investors, it is no longer true that cash is king.

Initially, investors were advised to switch from cash into the perceived safe haven of gilts. But with yields there so low, and with some commentators suggesting that the riskiness of corporate bonds has been overstated, there has been a massive flow of cash into relatively high-yielding corporate bonds, via bond funds.

Gilt prices have moved higher and yields have fallen, as investors seek to shift their money into safe havens and swap equity holdings for less risky asset classes. But as yields have dropped to unusually low levels, so gilts have looked even less attractive. The outlook for gilt yields must be for an increase, given the expanded government funding programme. What's more, if deflationary pressures ease off, as they are eventually expected to do, inflation will start to climb again as the economy begins to recover.

THE DEBENHAMS STRATEGY The strategy of one of the UK's major high-street names, Debenhams, is instructive. The retailer has been in the news recently after appointing Lazard as its financial adviser with the brief of reviewing Debenhams' capital structure ahead of the 2011 expiry date of its current debt deal.

As Debenhams' treasurer Ian Fleming explains, the issue of interest returns only becomes a major one for the group at certain times of the year. Most of the time, it is more concerned with interest cost. And since the onset of the credit crunch in mid-2007, the issue of returns has been eclipsed as security has become a more pressing matter. The focus has consequently swung over to the risk management side of the business.

As the credit crunch intensified, Debenhams conducted a "rigorous review" of its counterparties that significantly reduced its allocated limits. Fleming says the action created "quite a heavy additional workload" across its operations, with considerable time spent in managing the maturity and settlement risk. However, it felt like the appropriate response.

"Our company hasn't reviewed any different form of investment that wasn't already part of policy, so there has been no great change there," he adds.

On the debt side, the group's interest rate policy has been to target a 75% fixed position, primarily through a portfolio of swaps. Fleming says the group has been able to enjoy a competitive interest cost on the back of those swaps, thanks to a refinancing back in 2006. In retrospect, its timing could hardly have been better.

In the current environment of low interest rates and near-zero returns, Fleming suggests that companies have two basic approaches when reviewing their portfolio.

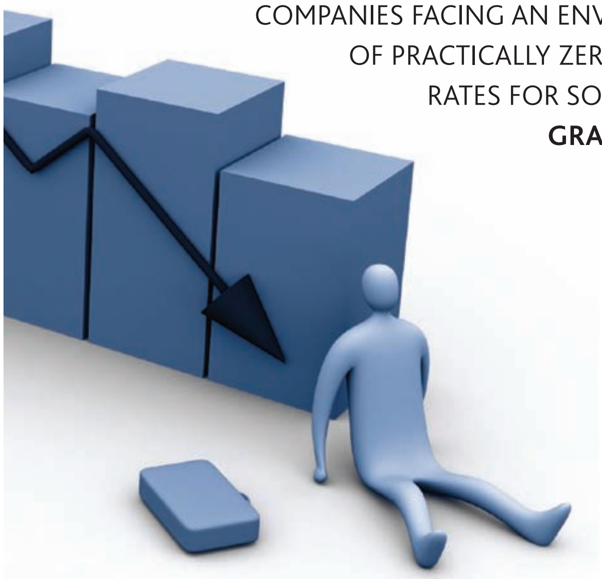
"First, what can you do to affect the rate now? You may want to restructure your swaps and take advantage of the current environment of very low interest rates. There is quite a degree of flexibility within the policy to reduce the fixed level and take advantage of a lower floating rate.

"Second, you may want to take the opportunity to fix out beyond the maturity of your current swap portfolio. For example, if it's currently three years you might want to lock out beyond the current duration. Hedging out longer will allow you to take advantage of the present regime."

Executive summary

- There are a range of approaches that companies can adopt to protect themselves against adverse movements in interest rates and also generate benefits when the trend is more favourable.

WITH THE BANK OF ENGLAND CUTTING ITS BASE LENDING RATE TO 0.5%, INTEREST RATES IN THE ECONOMY HAVE WITHERED AWAY, LEAVING COMPANIES FACING AN ENVIRONMENT OF PRACTICALLY ZERO INTEREST RATES FOR SOME TIME, AS **GRAHAM BUCK** REPORTS.



It might also be an opportune moment to ask what options are open to the company in future, so they can be used to its advantage. The policy may focus on managing interest rates over the longer term, or focusing on the current portfolio.

LOSS OF APPETITE The big question is whether the banks are still keen to assist treasurers with these options. Fleming suggests there is still some scope for shorter-term restructuring, but the past year has been marked by "a distinct lack of appetite" for longer-term fixes that is likely to persist for some time.

He explains: "For example, I might want a five-year forward start in three years' time. But as this means an eight-year exposure, the bank is unlikely to have any appetite for it, although it might make an exception if your company is top-end investment-grade. But generally they are unwilling to commit to the long term on advantageous Libor rates. There are also a lot of internal regulatory hoops that you have to jump through."

On a positive note, Fleming says that the downturn is benefiting individuals with a good understanding of risk and the ability to evaluate it, as they are the people currently being consulted.

"Within banks, these are the people who make up the credit committee; in corporations the same role is played by the treasurer, who is the individual now being asked about the risk that surrounds counterparty settlement."

Fleming anticipates that it will be some time yet before the banks are really able to understand fully where they went wrong and able to get on top of all their exposures. So there is little prospect of any early return to a more benign environment.

"We're going back to the original credit risk model all over again," he adds. "Eventually, the situation will improve, but it will take quite a while. There is an inevitable lag factor and it will only be after things have noticeably improved that the banks will regain their appetite for lending and credit-intensive derivatives."

Graham Buck is a reporter on The Treasurer
editor@treasurers.org