Stand your ground

Executive summary

- Beware the treasury analyst who insists there is always some clever game to be played with a derivative transaction. Stand your ground and demand the proof.

The word hedging evokes concern over the changing nature of interest and foreign exchange (FX) rates. Some treasurers also consider the price volatility of air fuel, energy and metals. Others wish they had concerned themselves earlier in the current economic cycle when those commodities were considerably less in demand. One smug chap can even remember trying to excite an earlier employer's interest in metals hedging when copper was about a third of its current price but to no avail.

This article concentrates on interest rate hedging because it is the most common form of hedging decision which UK companies need to consider in an economy in which interest rates are one of the few financial controls remaining in government hands (if only through an agency), and are high and volatile relative to our competitors' in an economy which often suffers an inverted yield curve.

This article considers why hedging may or may not be appropriate, why some corporates need to use derivatives, and the disciplines and processes required to implement a hedging strategy.

REMEMBER THE ECONOMICS Most businesses can access floating-rate debt (that for which the interest rate refixes, typically quarterly, regardless of the term of the debt). These short-term interest rates are, in general, a factor of inflation rather than the market distortion witnessed during late 2007, which saw rates out to nine months rise heavily in response to liquidity problems in the banking market.

The levels and volatility of both inflation and short-term interest rates tend not to correlate closely in the UK economy because rates move either in anticipation of inflation or as a result of it. However the relationship holds over time, corporates have to think in longer time scales than politicians and central bankers tend to consider. We need to consider how adversely exposed our underlying businesses are to inflation before committing to exchanging the interest rate exposure between floating to fixed.

It is this form of analysis which moved housing associations and utilities towards funding with index-linked debt: their revenues are linked to the retail prices index (RPI), parts of their cost base move with RPI, and utility regulators use current cost accounting to measure performance and set the rate of return which drives the tariffs. In parallel, the form of pension regulation in the UK has stimulated demand for index-linked debt to enable pension administrators to match income to the cost of the index-linked payments which residents of an inflation-volatile economy prefer.

Before getting excited about rising short-term interest rates, consider that the upside of inflation is probably the ability to raise prices despite competition. The other side of this simplistic statement is that changing to fixed interest rates may mean living with a fixed finance cost when inflation is falling, the yield curve is normalising, and competitors are adjusting prices downwards in real terms.

WHAT CHOICES DO YOU HAVE? The choice is simple: borrow in the chosen interest rate structure, or borrow at the best margin and fees and switch using derivatives to the chosen profile.

Remember that the first 'cost' to manage is the margin, the second is the fees. Borrow debt with the right interest rate profile for your business and any accountant's wittering about IAS 39 can be dismissed because derivatives are not involved. Derivatives come into play only when the corporate cannot, or cannot cost-effectively, achieve its desired interest rate profile through its source of debt.

In summary: all businesses can borrow at a floating rate either by borrowing from a bank or by selling commercial paper (CP).

Because small and medium enterprises (SMEs) are usually restricted to floating-rate debt loans, they need to consider derivatives to enable them to change their interest rate profile to fixed. However, operating leases and hire purchase agreements are often fixed rate and are one of the means by which an SME may be able to achieve fixed interest rates.

Larger businesses can also access fixed-rate term debt, usually in the form of listed bonds.

A MATTER OF DEGREE Recent times have seen commercial enterprises gear up to levels previously considered suitable for project finance only, as investment bankers redefined gearing as a percentage of enterprise value rather than of balance sheet value. This greatly increased the volume of debt which they could justify being issued by their corporate clients.

In parallel, the explosion of UK government-sponsored single asset

TO HEDGE OR NOT TO HEDGE?, ASKS **STEVE BASEBY**.

financing under the banner of PFI/PPP (private finance initiative/public-private partnership) and the income certainty of UK utility regulation have led to the creation of many companies with levels of gearing which make a first-time UK mortgage borrower look overly cautious. However, the degree to which a business should divert resources for analysing interest rates depends on the level at which rate movements affect profitability and cashflow covenants. The trend to gearing up suggests most medium and large enterprises need to monitor interest rates. How actively is a matter of arithmetic.

An acid test is whether an adverse rate movement in the accounting periods under review, by both the bank and the equity markets, would cause the earnings per share (EPS) targets and cashflow covenants to be missed. For the UK, I would suggest using 0.5% either way as the benchmark for testing. But this is a subjective test for each business to consider when deciding how much of its interest rate exposure should be fixed. Remember that the same inflation assumptions underlying your interest rate assumptions need to be those used to value the non-financial revenues and costs.

If you have managed to get your shareholders to concentrate on a performance measure other than EPS, then, of course, you will need to look to the effect of changing interest rates on that – and congratulations for having managed to divert their attention.

Large corporates also need to consider the cashflow metrics of credit rating agencies.

BASIS RISK AND IAS 39 Accounting standards are everywhere in the world of finance. Even taxation qualifications now require knowledge of accounting standards. Treasurers should feel blessed that they largely need only to be concerned with a few, one of which is IAS 39 *Financial Instruments: Recognition and Measurement*.

Many UK companies are not required to account to IAS yet. It is this yet which requires companies to be vigilant about long-term financing arrangements lest interest rate moves result in erratic changes in profitability and distributable reserves.

BEFORE GETTING EXCITED ABOUT RISING SHORT-TERM INTEREST RATES, CONSIDER THAT THE UPSIDE OF INFLATION IS PROBABLY THE ABILITY TO RAISE PRICES DESPITE COMPETITION.

Discussion prior to the implementation of IAS 39 suggested a draconian enforcement policy, which would make it difficult for any derivative-backed transaction to achieve hedge accounting – that is, for the underlying balance sheet transaction and the derivative to be regarded, in substance, as one transaction. Although auditors have been pragmatic, the essential requirement remains, which is that there must be close correlation between the two transactions.

Basis risk for treasurers is the gap between the structure of the loan and that of the derivatives used to modify its interest rate. In theory, treasurers should be as concerned about correlation between debt and the derivative as accountants. In practice, they are tending to be more concerned than accountants. There is no value in getting excited over a swap into a low fixed rate if the periodic refix of the floating rate occurs at a different date to the refix date on the corporate's term facility while short-term rates move materially between the dates. So the rollover dates must match. For an illustration of the potential risks, consider the day-to-day changes in short-term interest rates which occurred during autumn 2007. A few days' gap and the result could have been to inflate the net fixed rate in excess of 25 basis points.

DERIVATIVES (SWAPS/FRAS AND OPTIONS) This brief summary of the derivatives is not intended to do any more than help with the setting. Further details are the realm of the technical committee.

Forward rate agreements (FRAs) are short-term swaps. Interest rate swaps are agreements to exchange the basis (fix or float) of the interest rate, nowadays for up to 30 years.

Old lags will regale you with tales of the original swap between the World Bank and IBM; in fact, it was a cross-currency swap to enable each to exchange both currency and interest rate liabilities. Not so old, then. The swap was made in 1981. Hence the concern of modern central bankers and financial regulators that their processes forged in the financial crises of the 1890s and 1930s may not be identifying the risks of the 21st century.

The fixed-rate leg of swaps is priced at a risk margin over the relevant government bond which reflects approximately an AA-rated credit risk of the corporate side of the deal. The smaller the business, the more likely it could be asked to provide additional margin quoted as a broader spread on the swap price. More important is the degree of security which the bank could seek, usually by linking the swap to the security of the underlying debt.

Options are more flexible because the borrower can defer the decision, or structure the option so that a decision is only made if trigger rates are achieved in return for paying a premium. This is more in line with an insurance policy. Combining two opposite options creates a collar – a range within which rates float, but otherwise are fixed, or vice versa – and can give rise to a zero premium. Care needs to be taken to understand the option structure and to monitor the markets to understand when the triggers are met.

Even greater care needs to be exercised by companies accounting under IAS to understand and monitor the potential effect of mark to market on annual profit reporting.

THE ISDA The International Swaps and Derivatives Association's membership is made up of institutions which deal in derivatives, FX, interest and commodity. It provides standardised documentation on which interested parties such as the ACT comment. The agreement comprises two parts: a hard-coded agreement, and a schedule in which the parties to the agreement customise the terms to reflect their individual circumstances and their relationship.

The terms of the agreement need to conform with the corporate's other financing agreements. The terms need to be recognised as having the same consequence as similar terms in loan agreements. For example, default on a loan will cross-default the derivative transaction and vice versa. So put as much care into negotiating these slender agreements as in negotiating the 120-page term-loan facility.

One major point is that the ISDA should be in place before a deal is done. Bank compliance officers will be chasing for execution, at worst, soon after the first transaction. This requires that the corporate has appropriate dealing mandates ready: board-authorised appointees to execute ISDAs, deal and confirm deals with financial limits. Boards of all but the smallest businesses tend to meet occasionally and with fixed circulation periods for board papers, and FDs do not like being asked to fill out the any other business with last-minute papers about complex financing issues. So plan ahead and get the authorities in place before the first deal is done.

REMEMBER THE RELATIONSHIPS We all write treasury policies and procedures which set out to spread business and counterparty risk across relationship banks and seek maximum pricing tension by pressing banks to compete. This fine theory is tempered first by the need for smaller businesses to grant security to get any debt, and second by the fact that the smaller the loan business the smaller the number of bankers. In reality, derivative business is often linked to the providers of debt. At the SME level of business the term loan will come with a hedging agreement, often politely called a hedging letter, which both commits the corporate to a hedging strategy and to transacting that strategy with the lenders.

Larger corporates will be able to detach the two transactions but the relationship card remains to be played. Fail to pass the derivative business to your lenders and their cost will be higher next time.

WATCH OUT FOR FALSE MOTIVES

▪ **Value shifting** The easiest false motive for entering into derivative transactions is value shifting between accounting periods. The UK's chronic inverted yield curve tempts value shifting with short-term hedges. A two-year swap to fixed can often create cheaper borrowing costs in year one at the theoretical expense of year two, but only if the implied base rate reductions do not occur. An even cruder means of value shifting is to collapse a derivative position which is either in or out of the money and crystallise a profit or loss to massage the current accounting period's result. However, this leaves future years re-exposed to whatever exposure the derivative closed out.

▪ **Following the marketing** Bankers tend to market five-year floating-rate debt with heavy handed suggestions in order to fix the rate through derivatives (which, in turn, results in the hedging letter). Investment bankers tend to market fixed-rate bonds with fixed/floating derivatives as a means of achieving long-term floating rates. Both give themselves a double helping of margin.

The tenor of floating-rate borrowings has increased over the past 15 years and for a while covenants in the bank and bond markets nearly converged. But don't dismiss long-term floating-rate borrowing if a floating rate is your target. Look to the all-in cost, the IAS 39 workload of the derivative-based alternative, the formal credit ratings and level of public disclosure required to issue fixed-rate bonds, and whether those covenants are the real threat which the lawyers believe them to be. Covenanting not to do something you probably dare not do is not a burden.

Ensure you review all the alternatives and not just those of your competitors, or those of the latest banker who visited the FD.

A note on disclosure. Listed companies will have no problem with the content of the disclosure statements required to issue listed debt but may have trouble with the timing relative to their normal reporting cycle. Project finance special purpose vehicles, including PFI and PPP structures, will be less comfortable having their contracts aired publicly which has been one of the attractions of issuing wrapped bonds. Ensure the directors understand the disclosure requirements of any debt strategy.

▪ **History is not certainty** Rates and markets change. Whether they are high or low is a relative statement. Base rate of 5.25% and gilts at 4.5% give an extraordinarily low interest rate scenario for folk who entered this trade in the early 1980s (respective comparators were 15% and 13%), but UK base rates remain high relative to the more recent history of the euro into which sterling may yet be folded, while long-term UK interest rates have been forced down by pension funds' appetite for long-term fixed income (which may eventually become exhausted).

There is no absolute target rate, fixed or floating. Any rate strategy needs to be forward-looking and justify itself against a forecast of what could happen rather than what has happened.

And one for our own trade: watch out for the techy (your own or the bank's) with the spreadsheet who insists there's some clever game to be played with a derivative. Stand your ground and demand convincing arguments on why a transaction would make sense.

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