Don't drop your guard on interest rate risk

LOW INTEREST RATES DO NOT MEAN THAT RATE RISK HAS DISAPPEARED. COMPANIES SHOULD USE THIS OPPORTUNITY TO ENSURE THAT THEIR HEDGING IS ALIGNED WITH THEIR AIMS, SAYS **NICK STADTMILLER**.

Interest rates in developed economies around the world are at historic lows, an effect of central bank policies to stimulate growth in those countries after the financial crisis in 2008. Benchmark policy rates are near zero in the US and Japan, and at record lows in the UK and euro zone. In the US, the Federal Reserve has even announced that it does not intend to raise interest rates before the end of 2014 at the earliest. The so-called communication strategy is intended to keep medium-term interest rates low by anchoring the market's expectations for Fed policy.

With short-term rates unlikely to rise for more than two years, many corporate treasurers are probably not very concerned about interest rate risk. Medium- and long-term interest rates are low, and short-term interest rates are even lower. While the five-year dollar swap rate was just above 1.10% at the time of writing, the three-month dollar LIBOR rate was near 0.47%. Thus floating-rate loans linked to LIBOR offer a significant cost advantage over longer-term, fixed-rate arrangements.

A QUANDARY Treasurers who want to take advantage of low term rates are faced with a quandary. Locking in very low term rates comes at the cost of forgoing even lower short-term rates. A treasurer who takes a floating-for-fixed interest rate swap for five years starts off losing over 0.60% in "carry" – the difference between the five-year fixed rate paid and the LIBOR rate received.

Nevertheless, companies with floating-rate liabilities do have interest rate risk, even if that risk is not apparent at the moment. Trading in futures contracts indicates that the market expects LIBOR to rise by roughly 65 basis points per year in 2015 and 2016. Assuming that LIBOR rises in tandem with increases in the Federal funds rate, this implies that the market is predicting that the Fed will raise rates much more slowly than it has during previous periods of rate hikes. Historically, the Fed raises rates by around 200 basis points a year during a tightening cycle. Even though the Fed may not be as aggressive in increasing policy rates during this cycle, there is a strong possibility that rate hikes will be faster than the market currently expects.

If the Fed ends up raising rates faster than the market expects, future LIBOR-linked interest payments would be higher than current expectations. Before the Fed actually begins raising rates, if the market begins pricing in a more aggressive hiking cycle, longer-term interest rates would rise in response. In that case, corporates that had decided not to hedge would have lost the opportunity to lock in low rates.

NOW MORE COMPLICATED Hedging interest rate risk in this environment is, in some respects, more complicated than in the past. For this reason, it is useful for corporate treasurers and managers to review their overall approach to interest rate hedging decisions.

Corporates assessing their hedging policy should first examine their interest rate exposures carefully. Some risks are obvious, such as floating-rate loans. Others may not be immediately apparent as "risks", such as interest-earning assets, or planned future borrowing. A good way to gain an intuitive feel for net interest rate risk is to test the company's profit and loss projections under alternative interest rate scenarios.

Clearly articulating the company's objectives for hedging is also an integral part of the overall approach to making hedging decisions. For some, the goal is to minimise variation in cashflow – in other words, to fix future costs. This is the rationale for entering into fixed-for-floating interest rate swaps. For other hedgers, the purpose is to limit their exposure to adverse market scenarios. For example, a corporate may be comfortable with the risk of floating-rate payments, but might want to limit its downside if rates rise substantially. In this case, purchasing options such as interest rate caps may be more appropriate. Still others may be willing to take near-term interest rate risk but prefer to hedge exposure further along the curve; forward-starting swaps can be used in this situation.

Different entities faced with similar risks may decide to manage them in different ways, reflecting their risk appetite and objectives. It may be tempting to side-step hedging decisions when short-term rates seem set to remain low for some time. But low interest rates do not mean that interest rate risk is gone. Companies should use the opportunity of low interest rates to rethink their approach to managing rate risk and ensure that their hedging decisions align with their objectives.

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