Pick your options

The key to good funding and interest rate management strategies is to align the debt and interest rate profile with the objectives of the business.

A recent survey into treasury practice conducted by the ACT and Ernst & Young found that 100% of respondents had a treasury policy in place. While this implies that most (if not all) companies have funding and interest rate policies, the question remains whether those policies are robust and match their business needs.

Treasurers could be forgiven for not looking too closely at their funding and interest rate policies of late. The last few years have been characterised by liquidity aplenty, as well as low interest rates and somewhat low levels of interest rate volatility. However, if the good times stop rolling, many companies could find themselves in an adverse situation unless they have implemented a well thought out funding and liquidity policy.

Every business is different, and every company's ideal debt and interest rate profile will vary. While the first reaction may be to think "How long can I lock up financing for?" or "How low can I get my funding cost?", there should be many other considerations in formulating funding and interest rate risk policies.

FUNDING POLICY

Three key issues when designing a funding policy are: the type of instruments that provide the funding, the maturity profile of the funding portfolio, and the currency mix of the funding portfolio. All three should be considered together.

When deciding the type of instruments to use to fund the business, diversification of funding sources is key. Possible sources include letters of credit (committed and uncommitted), commercial paper, leasing structures, bank loans, private placements and bonds.

While all companies may not have access to all markets, diversification of sources is important in case one should dry up. Treasurers may also want to keep adequate amount of bank lines open in case future funding is needed quickly (i.e. for expansion).

Each type of instrument typically has benefits and drawbacks compared with other types. For example, a private placement market might currently provide cheaper funding than a bond, but it may have more restrictive covenants. As such, treasurers should consider whether the benefit of reduced funding costs outweighs the restrictions that covenants put on a business.

Treasurers should also consider the maturity profile of their funding instruments. Examples of different approaches are: matching the tenor of the financing to the assets which are being funded, locking in financing for as long as possible to manage refinancing risk, and tenor decisions based on current levels of volatility of interest rates and credit spreads.

Matching the tenor of the financing to the tenor of the assets might be the chosen approach for funding a project or purchasing long-term assets (i.e. cap-ex or PP&E).

A company may choose to lock in funding for a longer period if they do not want to risk refinancing for a longer time, or if they are trying to provide consistent funding for working capital.

When it comes to deciding the tenor of funding based on current rate levels and volatility, treasurers may want to lock in low levels of interest rates or credit spreads for a longer period of time, as when they refinance, the levels may be higher. However, many treasurers may be comfortable that rate levels will stay relatively stable, so

Executive summary

- Treasurers need to check that their funding policy and interest rate risk management guidelines are up to date and in line with current business objectives.
- Treasurers are in a position to define and manage funding and interest rate management strategies which are optimal in respect of the profile of the business.
- The last few years have seen strong levels of liquidity and a good appetite in the market for funding, so companies should look at the mix of funding options available to ensure that they are taking full advantage of current conditions.

they will fund shorter-term to take advantage of the lower credit spreads on shorter-term funding.

Businesses with international operations also need to consider the currency mix of the debt portfolio. It is considered prudent to match the currency profile of debt to the currency profile of the business. Of course, the currency profile of the debt can also be altered through the use of a derivative overlay programme.

INTEREST RATE RISK MANAGEMENT POLICY

Interest rate risk is mainly managed through the choice of the fixed-floating mix of funding (i.e. paying 50% fixed and 50% floating on funding). The precise mix is dictated by a business's risk profile.

The fixed/floating interest rate profile can be adjusted via any flexible funding structures in place or by way of derivative instruments. Interest rate swaps can convert fixed rate funding into floating, and floating into fixed. Caps, floors and more complicated options can be used to manage the interest rate risk of floating debt.

High-growth (high-risk) businesses in cyclical industries will be more suited to floating rate funding than those in low-growth non-cyclical industries because their revenues are expected to rise when interest rates rise, and vice versa. Also the leverage and risk tolerance of the business will help set the percentage of the fixed/floating mix of the portfolio. Finally, treasurers able to express a view on interest rates can tactically manage the level of floating rate funding to take advantage of expectations of rising or falling rates.

Treasurers may choose to increase the fixed proportion of their portfolio to assist in budgeting decisions, as the cost of financing for a project can be known with certainty. This way the management can run the business to generate revenues above the known costs.

Then there is the old-fashioned mixed approach, where treasurers keep a certain level of their funding fixed, a certain level floating, and a certain level fixed or floating based on perceived market movements. For example, a fixed/floating mix of 40-60% fixed could be operated, with the amount adjusted within this range. This approach is never more than half wrong, but equally never more than half right!

EXAMPLE

Let's take the treasurer of a top 30 house builder in the South East. What factors drive his decisions on funding and interest rate risk policy?

House building is a capital-intensive business. A significant time lag exists between the cash outflows at the start of the development process and receipts from the sale of a completed property. Certain factors can also exacerbate the time line. For example, it is not unusual to wait 18 months from the purchase of land to the granting of planning permission.

The size of each development also has to be considered, and whether the cost of each project is large enough for single financing amounts to be allocated to it. If the timing and size of developments are not conducive to micro or single financings, the treasurer can lock funding on a macro basis, obtaining a core level of funding for a longer period of time.

As to the interest rate risk management of the funding, the treasurer may consider matching its fixed/floating profile to match the revenues of the business. Within the housing industry, revenues can increase when interest rates fall, and decrease when rates rise because many more people take advantage of low interest rates and purchase new homes when mortgage rates are cheaper. As such, the treasurer may also consider using "inverse-floating" debt (i.e. paying a coupon of 6% - Libor), which would allow them to pay more interest when revenues are higher, and vice versa.

Or the treasurer may fix in all of their interest rates for certainty in the budgeting and forecasting process and pass on to the construction managers a known cost of financing for their development.

In the case of our house builder, the actual treasurer's strategy is to maintain a third fixed, a third floating funding, and adjust the remaining third between fixed and floating using interest rate swaps. He calls this the "good basic risk management principle of not putting all your eggs in one basket".

With rates at historical low levels, any move up has a proportionally larger effect on the total costs of doing business. Every treasurer will have a view where rates are going. It may be worth checking now how your funding is organised.

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