Help for hedgers

JAMES DUCKER CONSIDERS THE INDEPENDENT ADVICE TREASURERS NEED TO ASK FOR WHEN HEDGING.

Hedging in the financial markets has become more common across industries and asset classes over the years as businesses have better recognised their exposures. The markets have opened up to customers of all sizes, enabling almost any company to hedge.

The biggest issues are foreign exchange and interest rates. Any business buying or selling outside the UK has an FX exposure and should be actively considering how to mitigate that exposure. And any business borrowing money should be considering how to manage potential interest rate fluctuations in the future.

Derivatives to address these risks can be extremely effective when used correctly. However, if used incorrectly, they can cost users substantial sums of money. Successful derivative transactions require significant analysis, understanding, judgement and an appreciation of the motivation of the counterparty. It is therefore important to examine derivatives in great detail before entering any contract. Advice, suitability and pricing are the three main areas to explore.

ADVICE All the banks have set disclaimers around "non-advice". In effect, if any customer purchases hedging, then they are doing so on their own information and cannot rely on any information provided by the bank. It's a real buyer-beware scenario.

It is important that businesses take informed decisions and understand the risks inherent in derivatives. A customer must either decide whether to proceed using their own knowledge or look for advice from a third party. When obtaining advice, it is important to look at any relevant experience and qualifications. For example, there are FSA regulated advisers able to advise corporates on derivatives.

Any external adviser will (or should) be working with their client and have no vested interests.

SUITABILITY It may seem obvious but any derivative entered into should be suitable based on the underlying exposure. Thousands of structures can be used, but more than likely only a few will be suitable, as every company has different exposures, different goals and different risks. It is not often easy to understand how all these risks interact and thus arrive at suitable hedging strategies.

It is equally important to understand all the risks of the potential hedging strategy before concluding whether the hedging is truly suitable or perhaps simply shifting misunderstood risk from one area to another (of the business or of the financial markets).

PRICING How does anyone know what a good or bad price is with hedging instruments? Pricing for a simple spot or forward contract in an FX or interest rate swap is generally available on the internet or the financial pages of newspapers, but hedging usually involves more complex structures or specific notional flows. The pricing of these is difficult to calculate unless you have expensive software or treasury systems with real-time market data feeds.

Any business should question the price of a structure being offered by the prospective counterparty in order to make an informed decision. If the price is too high from the outset, the risk may be skewed against alternative ideas.

Calculating breakages

The breakage of a simple interest rate swap is a straightforward calculation that should be fairly easy to work out in-house to ensure the counterparty is not taking a margin. The breakage cost for a swap is the future expected cashflows, using the implied future fixings of that specific time, adjusted for the net present value of money.

Many businesses look to see if the break cost is a good idea and then decide whether it's a good idea on the basis of the size of the fee. In fact, if the market were perfect and correct with regards to the future fixings, there would be no difference at all to break the deal, or simply pay the future cashflows over time. Therefore the important question to ask when breaking a deal is whether current market expectations are correct – if the curve used is too high, then the breakage cost will be lower than the future cashflows (ie. it would be economically good to break the deal) and vice versa.

To calculate the breakage cost of a swap, a business needs the notional flow of the hedge, the fixing dates, the implied market fixings, and the market discount factors. Breakages for more complex hedging instruments take into account more factors and once again require market data and/or treasury systems.

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