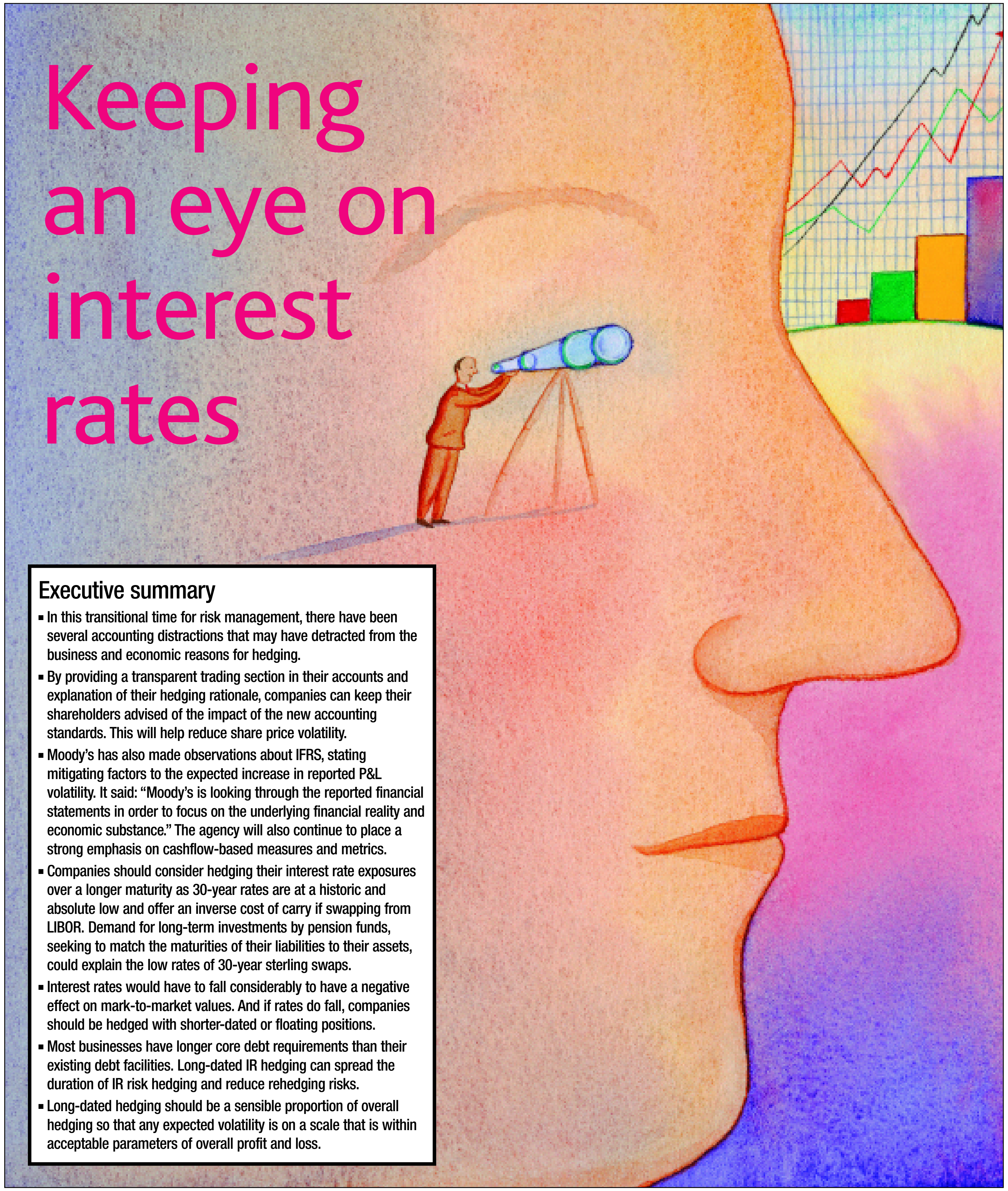
Keeping an eye on interest rates



THE NEW INTERNATIONAL ACCOUNTING STANDARDS WERE DEVISED TO MAKE CORPORATES' USE OF DERIVATIVES MORE TRANSPARENT... BUT COULD THEY RESULT IN THE 'HIDDEN RISK' OF CORPORATES NOT HEDGING AT ALL. **STEVEN MORTIMER** ARGUES THAT TREASURERS SHOULD CONTINUE TO FOCUS ON THE ECONOMIC AND BUSINESS NEEDS OF RISK MANAGEMENT, AND LOOK TO HEDGE INTEREST RATE EXPOSURES OVER A LONGER MATURITY.

There is no doubt that treasurers have not had an easy time recently. During the economic downturn, accountants compounded the problems they faced by drawing up onerous reporting requirements. As a result, pension funds (FRS 17) and derivative hedging (IAS 39) both moved on balance sheet and at mark-to-market (MTM) values.

IAS 39 in particular has presented treasurers hedging FX and interest rate risks with particular concerns. Risk management has been made so much harder by having to consider whether your hedge is 'effective' in relation to a liability – that is because there is an 80-125% correlation range.

There has been little to no guidance on how to model this effectiveness and auditors will face a challenging time verifying the infinite variations of internal bespoke, effective testing models. Opinions also vary as to whether a number of hedge instruments will qualify for 'hedge accounting.' This has happened because IAS 39 is accountancy-focused. Although understandable from a theoretical standpoint, the practical end-user considerations could be better.

Neil Cotter, Treasurer of Logica, says: "My major criticism [of IAS 39] is that there are an awful lot of words but very few examples."

How many corporate treasury specialists were consulted before IAS 39 was introduced? Judging by the amount of adverse reaction it has received, both from the corporate and banking community, it clearly could have been handled better. At a roundtable discussion on the subject in May 2004, Peter Zeggar, Treasurer, Parent & Holding of Unilever, commented on a private meeting the International Accounting Standards Board (IASB) held with fellow corporate treasury representatives.

"We all explained our risk management policies and why we have them and we explained that most counterparties would share these issues with us," said Zeggar, "and basically their reply was 'sorry, your risk management policies unfortunately do not fit into our rules.' And that was that."

Paradoxically, just when most treasurers may want to lock into interest rates in what are more uncertain times, the latest standards may actually steer people away from hedging and result in companies taking more interest rate risk.

BUSINESS RATIONALE FIGHTING BACK. After the initial panic, changing requirements on shadow accounting and adverse reactions, the dust is settling on IAS 39 in the UK. After concerns over the accounting treatment of individual derivatives, companies are sensibly considering their derivative portfolios as a whole – where there are often offsetting hedges mitigating the potential MTM moves.

Executive summary

- In this transitional time for risk management, there have been several accounting distractions that may have detracted from the business and economic reasons for hedging.
- By providing a transparent trading section in their accounts and explanation of their hedging rationale, companies can keep their shareholders advised of the impact of the new accounting standards. This will help reduce share price volatility.
- Moody's has also made observations about IFRS, stating mitigating factors to the expected increase in reported P&L volatility. It said: "Moody's is looking through the reported financial statements in order to focus on the underlying financial reality and economic substance." The agency will also continue to place a strong emphasis on cashflow-based measures and metrics.
- Companies should consider hedging their interest rate exposures over a longer maturity as 30-year rates are at a historic and absolute low and offer an inverse cost of carry if swapping from LIBOR. Demand for long-term investments by pension funds, seeking to match the maturities of their liabilities to their assets, could explain the low rates of 30-year sterling swaps.
- Interest rates would have to fall considerably to have a negative effect on mark-to-market values. And if rates do fall, companies should be hedged with shorter-dated or floating positions.
- Most businesses have longer core debt requirements than their existing debt facilities. Long-dated IR hedging can spread the duration of IR risk hedging and reduce rehedging risks.
- Long-dated hedging should be a sensible proportion of overall hedging so that any expected volatility is on a scale that is within acceptable parameters of overall profit and loss.

More importantly, more and more corporates are realising the need to base their hedging decisions on economic and business rationale, as opposed to accounting treatment.

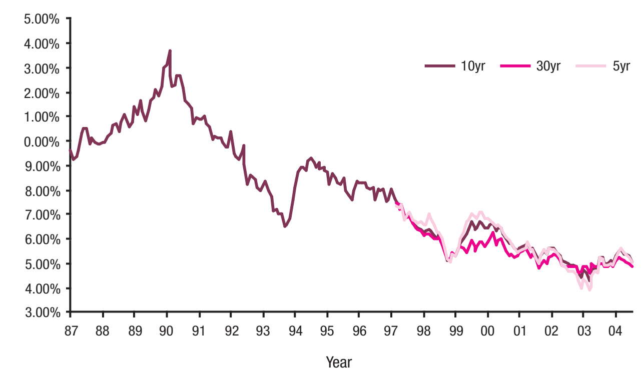
For example Nestlé, which reports under IAS, uses a 'trading' statement in its accounts with an accompanying note that states: "Some derivatives, while complying with the group's financial risk management policies of managing the risks of the volatility of the financial markets, do not qualify for applying hedge accounting treatments and are therefore classified as trading."

Siemens is an example of a company that takes a 'macro portfolio approach' to hedging. In its notes to the consolidated financial statements, Siemens, which reports under US Generally Accepted Accounting Principles (GAAP), says: "The company manages risks associated with fluctuations in foreign currency denominated receivables, payables, debt, firm commitments and anticipated transactions primarily through a company-wide portfolio approach. This approach concentrates the associated company-wide risks centrally and various derivative financial instruments, primarily foreign exchange contracts. To a lesser extent, interest rate and cross-currency interest rate swaps and options are utilised to minimise risks. Such a

Figure 1. Spread (bps) between £30yr and £10yr swap rates

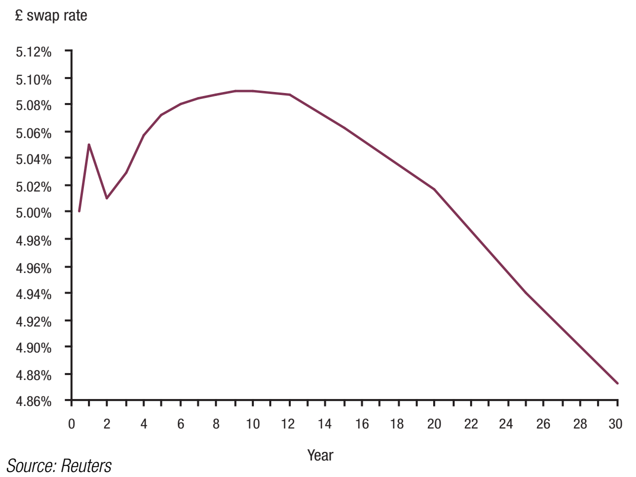
Source: Barclays Capital

Figure 2. Historic UK swap rates



Source: Barclays Capital

Figure 1. UK swap curve by maturity



Source: Reuters

Impact of interest rate moves on mark-to-market (MTM) risk

£30-yr rate (from today)	MTM	MTM impact as % of notional
4.88%	0	-
4.58% (-30bps)	- £1.1m	5%
4.28% (-60bps)	- £2.3 man	9%
4.00% (-88bps)	- £3.4mn	14%
3.58% (-130bps)	- £5 man	20%

strategy does not qualify for hedge accounting under SFAS 133. Accordingly, all such derivative financial instruments are recorded at fair value on the consolidated balance sheet."

LONG-TERM HEDGING IS A GOOD BET. For companies that decide to adopt a sensible long-term macro approach to risk management, any consequential short-term accounting volatility should not affect them materially. There are a number of additional reasons why they should feel confident executing risk management hedging strategies on the basis of sensible business and economic reasons:

- A company's hedging policy and the rationale behind it can be explained to shareholders (see *Is the UK ready for IFRS*, page 30);
- macro level hedging allows risk positions to be offset against each other;
- non-IAS hedges can be reported separately in a trading book statement;
- MTM is a non-cash item; and
- a threshold for acceptable MTM volatility can be set and the impact on the portfolio forecast accordingly.

RISK MANAGEMENT CONSEQUENCES. Due to the recent focus on arranging hedges that match companies' underlying debt maturities, there has been a lack of focus on the economic value of long-end rate fixing. This was highlighted recently by Zeggar: "I largely agree with fair value accounting; I don't agree with some of the hedge accounting rules where structures designed to manage risk 10 years out affect our current year profit and losses."

There are a number of reasons why companies should, nevertheless, consider hedging their interest rate exposures over a longer maturity. These include:

- Duration diversification – long-dated fixing spreads your interest rate maturity risk, reducing any re-hedging risks and providing an element of core rate fixing.
- A better match with business life expectancy – given that most companies' business plans span further than their fixed income debt maturity, it is prudent to consider an element of interest rate protection for the longer term. As companies always expect to re-finance their debt (business plans normally contain a core long-term, debt requirement) they can fix a proportion of interest rates beyond the current debt maturity profile. This can spread any risks associated with the timing of rehedging.
- Relative value on current day rates – risk management is not about guessing where rates will go, otherwise we would be traders. The absolute level of sterling 30-year rates – less than 4.90% – offers relative value for locking in.
- MTM risk can be quantified – it is possible to evaluate the potential MTM impact of significant rate moves (see table). For example, if £25m was fixed for 30 years at 4.88%, the worst case scenario would be if interest rates fell immediately – although this is unlikely in reality.
- MTM risks can be mitigated – this can be achieved if the scale of long-dated hedging is a sensible percentage of overall hedging, and the expected volatility is within acceptable parameters of overall profit and loss. If you have some underlying liabilities that cover part of the maturity, you will only be subject to MTM valuations on the incrementally longer maturity. For example, if you have a seven-year bank loan for £100m and you enter a £20m, 30-year fix, you could book this as two separate deals, namely a seven-year fix and a 23-year fix. The first of these deals would then be eligible for hedge accounting while the second deal would be subject to MTM.

WHY ARE LONG-DATED IR SWAPS SO COST-EFFECTIVE? In recent years, there has been an incrementally larger fall in the price of sterling 30-year swap rates than sterling 10-year swap rates. Since May 2003, there has been a relative 60 bps saving on 30-year rates versus 10-year rates.

The 30-year swap rate is low both in historical and absolute value terms. A rate of 4.88% implies a real rate of circ 2.3% (with inflation of around 2.5%), and this assumes very low growth for the economy over the next 30 years.

However, it is possible that these cost-effective, long-end rates are more the result of supply and demand than expectations. Demand for long-term investments is positive in the UK which has an advanced privatised pension fund industry that needs long-dated assets to match to its liabilities. This has been compounded by FRS 17 and the fact that more people are aware that equities do not offer the best liability match for pensions.

There is evidently a lack of fixed income assets that can satisfy both the maturity and credit quality profiles of this type of demand. Swaps being synthetic AA rated assets allows purchasers the chance to capitalise on this demand.

Steven Mortimer works in Corporate Risk Advisory at Barclays Capital.
steven.mortimer@barcap.com
www.barcap.com