

# Declining interest

IN THE FACE OF HISTORICALLY LOW INTEREST RATES,  
TREASURERS FACE NEW RISK CONUNDRUMS.  
PAOLO ESPOSITO REVIEWS THE OPTIONS

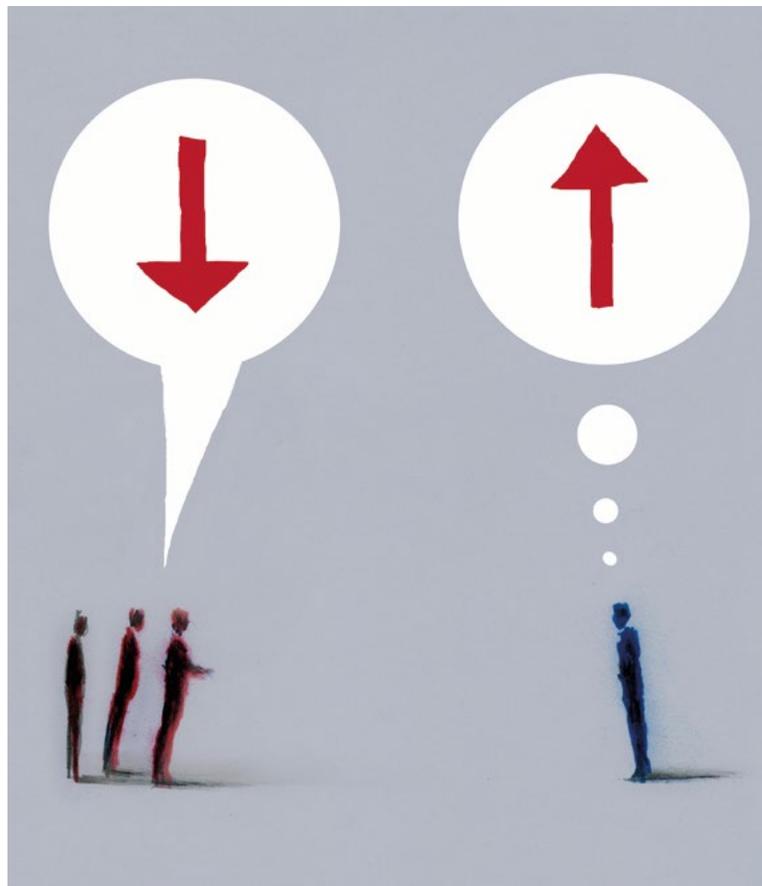
Global interest-rate markets are experiencing unprecedented conditions. In addition to issues such as the potential impact of Brexit, currency wars, de-pegging and devaluation over the past year, we have also seen a great deal of debate around quantitative easing, timing of interest-rate hikes or cuts, and monetary policies.

In April 2016, there were roughly \$7 trillion of government bonds (about one third of the Bloomberg Global Developed Sovereign Bond Index), offering negative yields, which is just one example of the peculiarities of today's situation. This is the case for the euro, Swedish krona, Swiss franc, Danish krone and Japanese yen. And it seems likely there is yet more uncertainty to come. It is expected that the volatility around interest-rate and monetary policies that characterised 2015 and this year to date will continue.

The following are some of the new challenges corporate treasurers face when it comes to managing interest-rate risks for their companies. This is particularly relevant today, as many corporates have a variety of currency exposures to manage and diversified funding sources.

## Negative rates

From a cost of borrowing perspective, negative rates should be good news, reducing the overall funding



cost companies pay. Most commercial loan agreements, however, now include the so-called 'zero-rate' provisions as standard, ie clauses that, when rates go negative, set the rate to zero. These provisions are clearly a cost for the corporate borrowers, as they prevent them from receiving the benefits of negative rates. From a financial standpoint, these provisions constitute floors that the borrower has 'sold' to the lender (notably,

without receiving the corresponding market value).

Under the current market conditions, these floors can cost the affected corporates several millions: on a €100m, three-year facility on the Euro Interbank Offered Rate three-month index, the missed benefit in funding savings is today in the region of €700,000. Corporates need to correctly assess their future cost of funding, especially those that are highly leveraged

or cyclical businesses that require the full cost benefit of falling rates to compensate for lower economic performance during downturns.

The cash cost of the 0% floor in presence of negative rate (some of which are shown on the opposite graph), however, is not the only issue: the floors create an extra set of complications from a risk management standpoint.

## Hedging challenges from negative rates

About two-thirds of UK listed companies actively manage the interest-rate risk associated with their debt, and the most common way to achieve this, historically, has been by entering into a swap. Normally, this provides very suitable hedging results as the floating flows on the swap perfectly match and offset the floating flows on the debt, leaving the company with a synthetic fixed debt and removing undesired earnings volatility.

In an environment of negative rates, however, the company would not end up with a fixed rate. If a company elected to enter into a swap when the loan includes a 'zero-rate' provision, then the negative floating flows on the swap would not be matched by offsetting negative flows on the loan, since the 0% floor removed this benefit.

The end result is not only that swaps no longer provide certainty of interest expense when rates are negative,

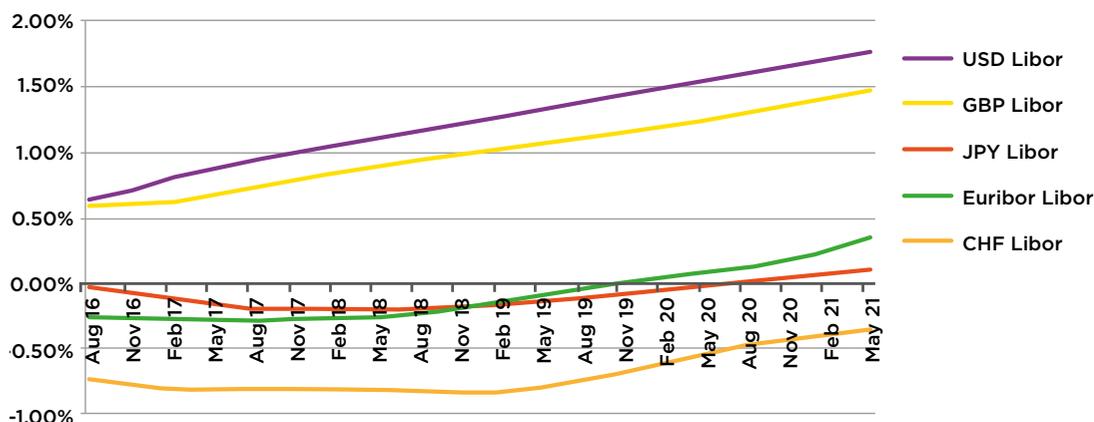
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but also that the company would then pay the fixed rate on the swap plus a floating rate (corresponding to the negative level). The presence of floors on loans and the current interest-rate environment have therefore introduced inconsistency and asymmetry between the debt's and the hedge's flows, resulting in hedge ineffectiveness and in additional costs.

So, what are the solutions for companies that are sensitive to earnings volatility and do not want or can't ignore this issue? Companies can buy a 0% floor (effectively 'buy it back', since they initially 'sold it' to their lender) and embed it into the swap. These 'swaps plus floors' are, however, not considered as a standard product and the assumptions used to calculate their price differ significantly from bank to bank; they also come at a significant cost, even if they are not in the money, or if they have no intrinsic value. Consequently, the pricing of 'swaps plus floors' should be carefully monitored, as they can be very expensive if priced inefficiently. This is especially the case when longer maturities are required.

Alternatively, for companies that are reluctant to (over) pay to buy back the floor, some good results can be achieved by structuring the hedge with a 0% cap. The idea is that the 0% cap, together with the 0% floor on the loan, creates a synthetic swap (at a rate given by the cost of the cap deferred over time). This solution solves the issue of the embedded floors from a risk management point of view (ie obtaining an effective hedge, which fixes the interest expense of the debt), and is also very efficient in terms of pricing (usually cheaper than a swap plus floor for indices with a liquid option market). However, given the peculiarity of its structure,

## INTEREST RATE FORWARD CURVES ON MAJOR INDICES



this strategy requires some expert support in derivative negotiation and structuring.

### Basis differential

Another issue that is compounded by the current situation is the difference in rates between the various maturities, ie one month versus six months, on the same index as, say, GBP Libor: the so-called 'basis'. After the crisis of 2008, this difference has increased and reached historically high levels. The

The only additional consideration is that, when looking at hedging derivatives, swaps or options on shorter maturity indices (such as one month if compared with six months) could be a bit more complicated to structure, as they are less liquid. Pricing of derivatives based on one-month Libor indices should therefore be discussed in greater detail with the hedging bank(s), or with the support of a hedging adviser,

pricing models for options, and it directly affects the derivative's price.

In recent months, we have seen a switch away from options, as they've become relatively more expensive to account for the high volatility of the market. There are, however, companies that have a preference, or a need, to hedge with options, for example, companies that can't take the settlement risk for a swap terminated early on refinancing, or highly cyclical companies that need to reduce their interest costs when the economy slows down (hence usually opting for caps). In these cases, treasurers need not despair: there are still ways to optimise the risk management strategies in view of a company's specific requirements, by selecting the hedging strategy (such as product, index or maturity) that is most appropriate for the current market conditions. ♥

## Treasurers need not despair: there are still ways to optimise the risk management strategies

basis differential effectively reflects the preference, from a bank's point of view, to lend money for shorter maturities and their willingness to charge less in comparison with longer maturities.

In practical terms, it means that companies that have a choice (usually determined in standard facility agreements) could take advantage of the basis by switching their loans from semi-annual to monthly periods. This simple election reduces immediately the rate companies pay on their borrowings by up to 23 basis points, which on a £100m, five-year loan equates to savings on interest of more than £1.1m.

to ensure that corporates receive the full benefit of the current basis differential.

### Interest-rate volatility

The volatility of rates has been historically high across currencies, geographies and maturities. While market turbulence puts hedging policies to the test and makes it more difficult for a company to make risk management choices, it also makes some hedging products more expensive than others. This is the case for derivatives, which include optionality (such as caps, floors and swaptions), as opposed to swaps. Volatility is in fact one of the inputs of the

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