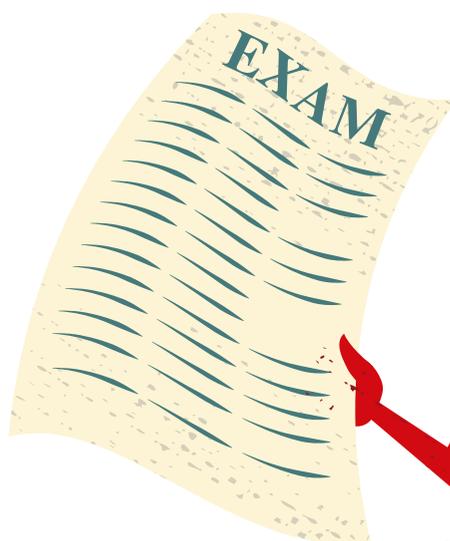


# THE DEVIL IS IN THE DETAIL



Many candidates ask how much they need to write in exam answers. Doug Williamson offers three steps to help you write enough, within limited time

Higher-level assessments such as the MCT obviously require far more in-depth detail and analysis in your responses than those that are enough at introductory and intermediate levels.

Let's review a recent question that first appeared in an article in *The Treasurer* about how to structure an answer plan (see February 2015 issue, page 52). The earlier article set out a skeleton answer plan, around which a full response would be framed. This article will illustrate the level of detailed response wanted from candidates at the senior level.

## Level up

The best guide to the expected detail in your exam answers is what a well-prepared candidate could reasonably be expected to produce:

- (1) At the level of qualification examined; and
- (2) In the time implied by the marks in the question.

The question is summarised below, to highlight the most important information needed to produce the suggested solution.

### Example exam question - extracts

Your company has just negotiated a £100m, 10-year Libor-linked credit facility. The loan amortises in equal instalments from year six to year 10. The company's policy is to swap to fixed at the outset to protect the return.

The FD favours postponing a fix. Your advice is required about whether and how to implement the FD's view without taking undue risk. Of particular concern is the need for a monitoring system to flag when action to hedge might be necessary.

#### Current data:

**Libor: Three months = 0.5%**  
**Swap rate: 10 year = 2.0%**

## Suggested solution

The issue seems to be a simple decision around whether interest rates will rise over the period of the loan, so that paying a lower floating interest rate now would be cheaper in the long run than fixing now for the period of the loan.

The magnitude of the difference is £1.5m in years one to six, shrinking thereafter until year 10.

The issues around this question are, however, wider than this.

1. Is this loan part of a larger portfolio of loans? If so, then it would seem that all of those are fixed, and so having some floating-rate debt would balance the risk better. The overall portfolio risk should be considered rather than the risk on an individual loan. It seems that there are other loans in the portfolio because of the prior policy on fixing.
2. Loans are not usually identified with particular projects and it is the overall capital structure that should be considered when evaluating projects. If the projects are non-recourse, then different approaches may be required.
3. Is company profitability affected by interest rates, which are usually set around the economy? If the economy does well, profitability might rise, thus offsetting any rise in cost on this loan. Correspondingly, the company enjoys low cost at a time of low activity.
4. What is the appetite for interest rate risk?
5. Is the company at risk of breaching covenants so that paying a higher rate may risk a default in a loan? In the same vein, are there short-term pressures on earnings that should be considered (of course, treasurers take a longer-term view)?
6. Is there any cash on the balance sheet, or might there be over the life of the loan, which might attract interest at floating rates, thus offsetting any rises in rates?

When those questions are answered, then the decision can be properly addressed.

## Interest rates

Let's suppose it comes down to a view on interest rates. In theory, the two interest rates are economically equivalent, so that the market expects rates to rise beyond 2% over the life of the fix to exactly compensate between the two choices. Therefore, any decision one way or the other hinges around whether you believe the market is right or wrong.

One question that could be posed to the FD is: "Why do you know better than the market?" Should anyone in the business be speculating?

But the market has not performed well with implied future interest rates over the last few years. The market has consistently predicted interest rate rises that have not transpired. It might be reasonable to suppose that it is also wrong now.

We could consider interest rate options, but these will include a cost beyond interest and will depend on volatility. One possibility is to mimic an option approach, which would be to fix half of the loan. In that case, however, future action to fix more or less over time, should strictly be undertaken. This is a delta hedging approach.

## Monitoring

The FD specifically asks about monitoring and monitoring resembles this delta hedging approach. It anticipates a choice of floating rate. Thus, suppose the yield curve mathematics shows that the market expects rates to rise to 0.75% after one year. So, if rates rise to 0.75% before one year, then a move should be made to fix, because the market is rising quicker than expected.

If, on the other hand, rates have not risen that far by then, floating was the right call. This monitoring and possible changes to hedging are ongoing, difficult and expensive and should be considered in the overall costs of funding.

## Recommendation

In conclusion, the wider context of the business, and perhaps peer group, should be considered before a decision is taken. But all things being equal, a postponement of hedging or partial hedging with subsequent delta hedge adjustments seems a preferred course.

## Do I really need to write all that?

That may not be realistic in practice, but write what you can in the time given. You will be able to pass with a less detailed answer, but obviously the more good points you can make, the better.

To answer well, you will need both (i) detailed understanding gained through diligent study, and (ii) a lot of practice. Answering past exam papers against the clock is the best way to practise writing incisive and succinct answers, as well as confirming and improving your knowledge and understanding. Three steps are necessary for your success.

### Three essential steps: Plan, write and move on

1. Plan time and content;
2. Write a full, rigorous answer; and
3. Move on ruthlessly.

#### (1) Plan time and content

Well before going into the exam, ensure that you know in detail the style of exam, the total marks for the paper and the time allowed. Practise working out your time plan so it is quick and easy to make. Running through a well-practised routine will also calm your nerves on the day.

#### (2) Write a full, rigorous answer

Writing rigorously, concisely and with focus under time pressure needs practice. Examiners and markers generally find candidates who have prepared well write precisely and clearly, making their points with the minimum necessary words.

#### (3) Move on ruthlessly

Stick to your time plan. As soon as you reach the end of the allocated time for each question, move on ruthlessly. You can come back to the question if you have any time left, once you have attempted all the other questions.

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*With many thanks to Will Spinney and Kerry Attwell Thomas for providing the suggested solution and for their other valued advice on this article.*



**Doug Williamson** is a finance tutor and coach, who enjoys your success