

A hand in a dark suit jacket is shown from the bottom right, balancing a globe on its index finger. The globe is tilted and has a large, semi-transparent percentage sign (%) overlaid on it. The background is a bright, solid yellow. The title 'Disciplined Hedging' is written in large, bold, blue letters to the right of the globe.

# Disciplined Hedging

*Controlling interest  
rate risk in an  
uncertain world*

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**W**hen the Federal Open Market Committee met on February 2, it raised the Fed funds rate by another 25 basis points, making the sixth such increase since June of 2003. Rate changes should represent a justification for re-assessing debt-related interest rate exposures and addressing perceived imbalances, but many companies tend not to take this opportunity.

Reacting to these changing conditions could take the form of restructuring funding or investment portfolios, or it could entail the use of derivative instruments to accomplish the same goal.

For many treasurers, however, derivatives use arises because their banker made derivative use a prerequisite for the extension of credit, not because of a systematic approach to managing risk. All too often, this starting point results in leaving a derivative in place for the duration of the loan, without regard to changing financial conditions.

### Getting Started

While derivatives and hedging activities may be thought of as esoteric and sophisticated, in truth, plain vanilla instruments like swaps and caps are fairly easy to understand; and textbook applications can be simple to implement. In fact, the vast majority of derivatives users rely on just these types of tools.

Even fairly junior treasury personnel should have a basic understanding of the differences among common hedging devices. Specifically, the most popular derivatives relating to interest rate exposures include interest rate swaps, which lock in interest expenses by exchanging periodic interest payments, and caps, which ensure that interest expenses won't exceed some prescribed worst-case outcome.

Even so, because of the magnitude of derivatives' potential gains or losses and the possibility of unauthorized trading activity, a passing knowledge of derivatives isn't really sufficient. Hedging transactions need to be monitored and controlled by seasoned professionals who have a reasonably high degree of authority and enough experience to be able to consider the current conditions in context. A hedge manager should be equipped to determine which of these tools to

employ, how much of the exposure to cover, and when to adjust the hedge position.

Critically, beyond concerns about the future direction of interest rates, the decisionmaker should understand the principles behind derivatives pricing. That is, when an adverse interest rate change is expected and might be incorporated in the price of a derivative, then entering into the derivative at that time might not be a prudent action.

And finally, given the potential impact that these activities may have on financial reporting, the hedge manager should have an appreciation of the accounting ramifications from entering into these types of contracts.

### The Challenge Of Uncertainty

Risk management necessarily involves judgment: No hedging strategy eliminates interest rate risk. Rather, any strategy ends up transforming the risk from one type to another.

For instance, in a low-rate environment, locking in the interest rate eliminates the risk of higher interest expenses, but it also introduces exposure to the possibility that the firm will no longer benefit if interest rates were to fall.

Adding further to the challenges of implementing a hedging program is the fact that in doing so, there is no guarantee that the activity will necessarily improve bottom-line performance in the short run. In fact, you can only discern whether hedging enhanced profitability or not, or which hedge approach would have been preferred, after the fact. Moreover, your competitive standing will depend not only on how you perceive and manage your risk, but also on how your peers perceive and manage theirs.

All of this uncertainty can cause companies to fail in their fiduciary responsibilities. That is, rather than taking the time and devoting the necessary resources to institute a disci-



plined risk management program that systematically assesses alternative hedges possibilities, they take the easy way out and either avoid hedging altogether, or simply maintain hedge positions well beyond the point where it is advisable to do so.

As an example of this latter pitfall, suppose Company ABC had entered into an interest rate swap to hedge its variable interest rate exposure on floating rate debt—either because, at the start of the hedge, the treasury officers believed that the swap's fixed rate was sufficiently attractive, or because they expected variable interest rates to rise and simply wanted to stabilize their interest expenses. Now suppose that after some time, variable interest rates did rise, consistent with initial expectations—to the point that further increases were no longer deemed to be likely, and, in fact, the weight of evidence pointed to coming interest rate declines.

Despite the lack of certainty, it would seem that both alternatives of leaving the swap in place or liquidating the swap suffer from the same shortcoming. That is, in either case, the firm is fully exposed to being right or wrong in its market judgment and to bearing the benefit or cost associated with the outcome. An alternate approach would be to employ a middle-ground solution, where some portion of the hedge would be terminated, but some portion would remain intact. Alternatively, the hedge manager might want to consider substituting a cap for the swap contract by liquidating the swap position and purchasing an interest rate cap. In either case, the idea would be to mit-

igate the risk of further rate increases, but also preclude the prospect of returning all of the hedge gains to the market if rates were to decline. In effect, these alternatives amount to hedging the hedge.

There is, admittedly, a leap of faith here that a disciplined risk management approach will ultimately add value to the organization over time. Hedging decisions boil down to making considered business choices in the face of new information, versus ignoring information and pretending that the company has no capacity to respond to changing conditions.

### Keys To Savvy Risk Management

The starting point for treating risk management as a process is deciding that exposures will be reviewed periodically. Under this review three issues should be addressed:

1. What is the appropriate time horizon for the firm to be looking at in assessing its risk?
2. Does the exposure that the firm currently bears over that horizon (inclusive of any derivative positions designed as hedges) fall within the bounds of the risk appetite of the firm?
3. Does the existing derivative position hold the preferred types of derivatives, or would other types of derivative instruments be better in the current environment?

It should be clear that within a corporation, this approach might be taken with different frequencies at different levels. Conceivably, the person/group with direct transactional responsibility might consider these questions daily or weekly. At the CFO level, this review might be done monthly; and at the board level, it might be done quarterly or semi-annually, but no less frequently than annually. Also, different companies facing the same circumstances would likely make different decisions based on their market needs. Logically, no set of answers can be right for all entities.

A number of considerations will likely influence hedging decisions. For instance, confidence levels associated with forecasts—whether pertaining to market conditions, business activity, or exposures—tend to decline with the length of horizon. For that reason, barring any other over-riding factor, treasury managers often think about hedging higher proportions of near-term risks and lower proportions of deferred risks.

When deciding which instrument to use, it's important to consider the cost of hedging versus possible lost opportunity. For swaps, the "cost" of hedging is the willingness to forego the benefit of an attractive interest move. For caps, on the other hand, the cost is the premium paid for the cap. Ultimately, caps (and floors) are nothing more than portfolios of options; and option pricing is not a trivial issue.

### Price/Risk Correlation

Options tend to become expensive (cheap) when the perceived risk is great (small). These price adjustments, however, generally tend to reflect fairly short-term horizons. As a result, the hedger with longer term perspectives may very well be able to discern situations where options would be particularly attrac-

## Swaps Vs. Caps

### *How to choose the right hedging instrument.*

Hedging decisions can be reduced to whether or not the prospective outcomes could be reliably predicted with the use of a derivative instrument.

To illustrate, consider a company that is exposed to the risk of rising interest rates, in connection with variable-rate funding. The two most basic alternative tools for managing this risk are interest rate swaps and interest rate caps. Swaps allow the company to exchange its variable rate payments for known, fixed cash flows, effectively converting the variable-rate funding mechanism to fixed-rate debt. The cap assures realizing no more than a maximum interest expense, with the prospect of allowing for lower interest costs if interest rates stay below a critical level defined by the cap's strike rate. Importantly, swaps are generally entered into without any initial payment for the derivative, while caps require the payment of a premium to the cap seller.

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tive—or unattractive—and switching into or out of option positions based on these considerations would likely lead to improved hedge performance.

A solid hedging program should begin with the establishment of a risk policy that identifies the sources of risk that could potentially be hedged, acceptable instruments and counterparties, key personnel, position limits and guidelines which would be designed to provide some discipline to the hedging program. It is critical that this guidance be sufficiently flexible to allow the manager to respond to changing market conditions/opportunities; but at the same time, be sufficiently constraining to assure that the end result of the hedging activity will correspond to the firm's overall hedge objectives.

Instituting an effective risk management program, of course, isn't easy. Where the program fits, who bears responsibility, and

how the players are evaluated and compensated are not easy decisions, but despite these difficulties, risk management activities (or a lack thereof) can have a material affect on reported income. A responsible leader should work to institute a disciplined approach to hedging—one that incorporates periodic reviews of exposures and hedge strategies.

This discipline notwithstanding, even the most trusted hedge managers should be expected to justify their hedging decisions and verify that the hedge is consistent with the stated hedge objectives. Sarbanes-Oxley regulations add a dimension of personal exposure for senior management that should reinforce the idea that independent review or oversight of hedging practices serve as a safeguard.

So when the Open Markets Committee meets again on March 22, the question remains: Will your company be ready? 



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