Hedging a Future Debt Exposure: A Risk Management Approach

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6 May 2021

Central banks' unprecedented efforts to revive economies and restore market confidence following COVID-19 have left short-term interest rates trading at relatively low levels. The 3-Month Saudi Riyal Interbank Offered Rate (SIBOR), the most liquid interest rate index tenor in Saudi Arabia, has been hovering around 0.80% for months. Historically, the 5- and 10-year 3-Month SIBOR averages are 1.96% and 1.43%, respectively. This low interest rate environment combined with ample liquidity in the local market are prompting many businesses to consider raising debts for various objectives. But whether to fund an acquisition, refinance a loan, or support ambitious capital expenditure, you must carefully plan your hedging strategy. After all, if the pandemic has taught us anything, it is that the future is radically uncertain.

In this bulletin, we focus on an essential financial risk management concept: pre-hedging a future debt exposure. We discuss key benefits and reveal critical considerations businesses should contemplate before adopting such a strategy.

Think Big Picture

Before they consider hedging debt exposure, companies must identify their hedging objectives and answer crucial questions: "What exactly is at risk?", "What is the potential downside?", "Can we hedge it?", "What does it cost to hedge?", and "How much do we hedge?" When considering anticipated debt, the mature question is, "How do we manage its interest rate risk?"

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We are witnessing a local trend where companies shift their debt from short-term and revolving exposures to tilt toward medium- and long-term maturities. Hence, future refinancing events could expose the balance sheet to undesirable interest rate volatilities. Debt exposures are typically linked to the local SIBOR rates for SAR-based financing. The financial derivative instruments are available locally to facilitate the hedge decision.

The Pre-Hedging Strategy

As part of the hedging assessment and feasibility process, a company must build reasonable expectations around future debt or the need for refinancing. Those include the duration, amortization plan, and floating interest rate index. The company should also evaluate the hedging tool available to implement its intended hedging strategy.

The most common derivative instrument to hedge a future debt is the forward-starting Interest Rate Swap (IRS). As the name implies, this is simply booking a fixed swap rate in the future. For example, a company expects to borrow a 5-year SAR 100 million in 18 months. It can enter into a forward-starting IRS that, when executed, will offset the floating debt exposure, effectively locking the rate of the future debt cost. Hence, it could be suitable if the company has fair assurance regarding the anticipated debt and can, therefore, sustain any potential unfavorable market movement upon kicking off the swap and debt.

More flexible strategies exist for hedging future debt, but they typically require a premium payment. Many use an interest rate Swaption or forward-starting interest rate Cap. Simply, an interest rate Swaption is buying the option (but not the obligation) to enter into an IRS at a future date. It works similarly to the forward-starting IRS, but the buyer retains the right (on the forward date) to enter into the hedge, depending on whether the market is favorable at the time. A forward-starting interest rate Cap is the most expensive strategy, yet also the most flexible. The holder of the Cap option retains the right to exercise it on every future interest rate fixing.

Key Considerations

1. Pricing aspects. For example, take a 4-year SAR 100 million forward-starting IRS hedge beginning in one year. Each 1 basis point (0.01%) extra spread over the fair price represents an amount equivalent to SAR 38,500. So, learn the fair market pricing first, then evaluate the negotiated credit spread before placing the hedge. Is it reasonable?

2. Liquidity constraints. The Saudi Riyal option market is less liquid than the U.S. or other developed markets. Generally, a duration beyond 5 years carries an extra premium.

3. Mark-to-Market (MTM) fluctuations. The MTM is a measurement of the fair value of the derivative instrument, which fluctuates over time depending on the underlying asset class's movement. The MTM could be an asset (positive number) or a liability (negative number). If you wish to minimize the MTM volatility, consider option-based strategies before a forward-starting IRS.

4. Hedge accounting. This way of accounting reduces the volatility of financial statements in the entity's bookkeeping. When applying it, we reduce the profit and loss (P&L) statement volatility created by repeated adjustment to a hedging instrument's fair value (MTM). The critical terms of the hedged item (the debt) and its associated hedging instrument (financial derivatives) should match, which is a challenge for hedging the future debt compared to a specific existing exposure. Nonetheless, the designation of the risks associated with forecasted debt exposure is permitted under IFRS9 as long as they are highly probable.

Ultimately, any strategy to hedge the future interest rate exposure should assess the cost-benefit trade-offs. The firm's risk tolerance and endorsed risk appetite guide these decisions. Because future debt expectation is usually part of a strategic project, you should integrate the financial risk management aspects with the strategic ones to mitigate risk and create value in the long run.

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