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Interest rate risk management - an investigation into the management of interest rate risk in UK companies

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Introduction

This executive summary reports the findings from an investigation into the interest rate risk management (IRRM) practices of UK firms. It is based on a more detailed report of the same name. Details of where to find this can be found at the end of this executive summary. Risk has become very prevalent in society and responsibility for the management of risk, in the guise of corporate governance, has hit the headlines after many recent scandals. Financial risk, in particular, has dominated the discussion in the media, which has focused on the use of fraudulent financial transactions, special purpose vehicles and accounting abuses. Financial risk has also hit the headlines as a result of derivative transactions that are normally used to reduce or hedge risk not working as anticipated, such as at Orange County and Gibsons Greetings. The illegal use of derivatives by rogue traders such as Nick Leeson at Barings Bank and John Rusnak at Allied Irish Bank have further served to concentrate the spotlight on corporate risk management practices.

Interest rate risk management is not purely about managing the interest line in the profit and loss account. It also encapsulates the management of the whole debt profile of the business, including the maturity of the debt, the currency of the debt, the fixed-floating mixture of the debt and expectations of future interest rates.

Several factors have contributed to the recent prominence of interest rate risk in UK companies. These factors include the high volatility of interest rates in recent years; the dramatic increase in the use of corporate debt through shorter-term borrowing; an increase in the number of highly leveraged transactions such as management buy-outs; the use of interest-rate based covenants in corporate funding arrangements by fund providers; and the emphasis on risk, including financial risk, in recent corporate governance codes such as the Combined Code and the Turnbull Guidance, which has led to greater transparency of corporate risk and risk management practices in relation to the external market.

Recent years have seen a proliferation in the use, and derivation, of new and increasingly complex financial instruments (Mallin, Ow-Yong and Reynolds, 2001). Many companies now use derivative products such as swaps, futures, options and forwards to manage their financial risks. However, interest rate risk is probably the most important of all the financial risks which organisations may face as there are several ways in which changes in interest rates can affect a business (Phillips, 1995). For example:

- A company may have debt or bank overdraft finance linked to market interest rates such as the bank base rate or the London Interbank Offer Rate (LIBOR), and as interest rates change, the interest payable on these borrowings may also vary. A highly-geared company, with a large amount of debt financing relative to equity capital, may suffer financial distress if interest rates increase dramatically.
- A decrease in interest rates will reduce the interest income for an organisation that has surplus cash invested in monetary deposits and/or floating-rate investments.
- An increase in interest rates may adversely affect an organisation's business because its customers may be reluctant to make purchases when interest rates are high due to a decrease in disposable income; this scenario is especially true for the UK where a high percentage of the population have mortgages with repayments linked to current interest rates.

Suppliers may raise their prices to cover the increase in their funding costs. This price increase may have a detrimental effect on the financial performance of the supplied business. In some businesses it may be possible to pass on raw material price increases to customers, but in other organisations where competition is fierce or the industry is regulated, this option may not be available. For example, in a recession, a supermarket may be able to pass on price increases to consumers, but a utility with an approved pricing policy, or a manufacturer of luxury goods, may not be able to do so. In the worst case scenario, high interest rates may increase both input costs and interest payments on finance, as well as encourage customers to postpone their purchases. Some organisations will be more exposed to the negative effects of high interest rates than others. Highly-geared manufacturers of luxury goods are likely to be more sensitive to interest rate rises than lowly-geared supermarkets; the former will thus have far more to gain from managing their interest rate risk effectively.

Research objectives

With the recent focus on the use and abuse of financial derivatives, media attention on the financial well-being of organisations has largely ignored the managerial practices of corporate financial risk, particularly interest rate risk. This study tries to bridge this gap. Through the use of interviews with UK treasurers and a questionnaire survey sent to a UK sample of FTSE 350 companies, other listed companies, and AIM companies the study examined a number of key issues relating to the management of interest rate risk management. In particular, the study sought to address the following questions:

(i) Is IRRM important to all UK companies?
(ii) What is the motivation behind IRRM?
(iii) What policies do companies have for managing their IRRM?
(iv) Does the gearing of a company, or covenant restrictions affect the type of debt and the maturities that are preferred?
(v) Do firms prefer fixed or floating rate debt?
(vi) How important is IRRM compared with foreign exchange risk management?
(vii) What derivatives are used to manage interest rate risk?
(viii) What controls are there over IRRM to ensure good corporate governance?
(ix) Will IAS 39 have any impact on IRRM?

Key findings

The importance of interest rate risk

The findings from this study confirm that interest rate risk management is important to UK firms, but that larger firms often have more resources to manage this risk on a daily basis. Smaller firms possibly have more pressing needs such as strategy implementation, establishing a loyal customer base and sourcing raw materials rather than fine-tuning the management of financial risk.

Motivations for IRRM

Intuitively, companies with high gearing or low interest cover should be much more likely to hedge, as an increase in interest rates would have a relatively more dramatic effect on their financial viability than companies with sound financial ratios. The research found that there are three factors that are important in explaining why companies attempt to manage their interest rate risk: (i) to manage reported profits; (ii) to protect shareholder funds; and (iii) when the interest charge to earnings before interest and tax (EBIT) or earnings before interest, tax, depreciation and amortisation (EBITDA) is significant. Surprisingly, factors such as a high dividend payout ratio or poor financial ratios do not appear to impact on UK companies' interest rate risk management decisions.

IRRM policies

Larger UK firms normally have clear goals and policies for their interest rate risk management, with limits often set by the Board of Directors on the amount of funding that should be at fixed rates and with established parameters for their gearing levels. Often the interest rate risk policy approved by the Board of Directors reflects the risk preference of the company and financial factors, such as its gearing, credit rating and the existence of covenants. Firms often have this formalised into a Financial Risk Management Policy document that details the amount of funding that should be fixed, with ranges set, by currency, for different periods out into the future.

Smaller companies, however, are less likely to have formalised their interest rate risk management policies to the same extent as larger companies.

When determining their interest rate policy, UK companies appear to review the direction of interest rates and the magnitude of interest rate changes, but are ambivalent about GDP and industry trends. Inflationary and deflationary indicators are also important, but not to the same extent as interest rates. Companies use a variety of external forecasts including those offered by banks, economists, and analysts, as well as those offered by information service providers such as Bloomberg and Reuters. Overall, the results from the study indicate a wide range of corporate practices and policies.

Gearing, covenant, type of debt and maturity

Interest rate risk management is important to all companies, irrespective of their gearing level or their financial standing. However, some factors are especially influential in determining interest rate risk policy. For example, companies with operations overseas are more likely to raise finance in those same foreign currencies, and highly geared companies, close to covenant restrictions, are more likely to have fixed rate finance in their debt structure. Most companies are more likely to fix the interest rates on their funding in the short-term, but this tapers away as the time horizon extends into the future. Funding is usually through the banks, with only about a quarter of non-equity financing being raised through the issue of bonds. The term of the debt raised is generally medium-term, from about 4 to 7 years. Most funds are raised in Sterling or Dollars rather than Euro, possibly indicating that the US is still the main trading partner for UK firms. The Euro was used relatively little, although companies might change this as the UK extends further its links with Continental Europe.

Fixed versus floating rate debt

The views of treasurers on interest rate movements, the shape of the yield curve and other economic factors also influence the interest rate risk management practices of UK companies. For example, companies' interest rate risk policies have a great deal of flexibility, and treasurers have a lot of freedom within these parameters for active risk management. Depending upon treasurers' views of the interest rate and inflationary environment, companies either fix the interest rates on their debt for the medium to long-term or, alternatively, decide to keep their debt at mainly short-term floating rates of finance. Other factors that influence interest rate risk management include: the shape of the yield curve and the zero-coupon yield curve; debt covenants; a belief that floating rate finance is generally cheaper than fixed rate finance; the recognition that floating rate finance in the capital structure results in greater earnings volatility; and a tendency to ignore analysts' forecasts as these are generally considered to be poor.

IRRM compared with exchange rate risk

Respondents to the questionnaire survey were asked about their views on interest rate risk management in comparison with exchange rate risk management; the findings suggest that interest rate risk management is more important to UK companies than foreign exchange rate risk. The questionnaire respondents' ranking of the importance of certain economic factors, for example, interest rate changes, inflation and exchange rate changes, in assessing the importance of interest rate risk and exchange rate risk, show that UK economic indicators appear to be most important. In addition, the results from a principal components analysis of questionnaire respondents indicated that interest rate factors dominated exchange rate factors. In particular, the analysis revealed that companies focused on: US dollar and other currency interest rate changes; inflation and deflation; the Euro currency interest rate and exchange rate; the UK base rate; the Euro and other currency interest rates; and oil price changes together with inflation when assessing financial risk.

Use of derivatives

The companies that actively manage their interest rate risk do so through a variety of means, but one of the most common methods is through the use of the derivatives market - especially the use of interest rate swaps. Treasurers do not like using futures or other exchange-traded instruments for interest rate risk management as they are administratively onerous with the requirement to settle daily margin payments. Instead, treasurers prefer over-the-counter (OTC) instruments because of the flexibility that is offered and the knowledge and experience they have gained from using OTC products in the past. Boards of Directors sometimes prohibit the use of certain derivatives, especially options, due to their complexity and high costs, and also because a simpler or cheaper product, such as interest rate swaps, provide the required functionality. Treasurers are happy with the derivative products on offer and do not indicate the need for new and better instruments in the future.

Corporate governance implications

Recent scandals over the use of derivatives, and the concomitant focus on corporate governance, suggest that companies should, by now, have implemented a strict regime of monitoring and control over treasury departments' activities. However, this does not appear to be the case; companies appear to rely upon the appointment of dedicated professionals to implement interest rate risk policies as effectively as possible. Thus, a disturbing finding of this study is that corporate governance issues surrounding the use of derivatives by UK companies probably still have some way to go to meet stakeholders' requirements. In particular, the lack of involvement of audit committees in financial risk management and the ad hoc nature of the monitoring of risk management by the Board of Directors is disturbing. Many companies have not adopted a frequent reporting pattern for their treasury departments to report at a Board of Director level; some companies admitted that they only reported once a year, while some claimed that they never reported to a Board committee. Hopefully, as corporate governance issues increasingly make the headlines, audit committees, Boards of Directors and non-executive directors will increasingly play a larger part in the financial risk management of companies.

IAS 39

Current interest rate risk management practices may change with the implementation of IAS 39, the International Accounting Standard for Derivatives that came into force in January 2005 for all EU-listed companies. The topic of hedge accounting and the treatment of fair values may have a significant impact on many companies' reported profits, and the volatility of earnings is likely to increase. This study found that there is a lot of discomfort with the implementation of IAS 39, and that the current operational activities of treasurers may change as a result of this accounting standard. The respondents to the survey and the interviewees were all clear that IAS 39 may have far-reaching consequences for the use of derivative products. In particular, the use of options and exchange-traded products are likely to decrease as companies try to improve their practices to meet the onerous 'hedge accounting' rules and 'effectiveness' rules. Clearly, treasurers are concerned about the implications of complying with the provisions of IAS 39 for their future interest rate risk management strategies.

Policy implications

The findings of this research have a number of policy implications for governments and regulators. The decisions of the Bank of England's Monetary Policy Committee are vitally important to the financing activities of UK companies and any surprise decisions may cause the future investment plans of companies, and hence job creation opportunities for society, to be shelved or altered drastically. Many UK companies have large operations overseas, and the funding for these activities is often carried out in currencies that match the currency of the countries in which they are located. Any surprise decisions by these overseas monetary authorities may also cause hardship or force companies to abandon their planned investment activities.

The effectiveness of Board of Director control over the activities of treasury departments should be enhanced, especially with respect to the use of financial derivatives. This may be attained through the active involvement of audit committees and the role of non-executive directors in monitoring and control.

Many companies were apprehensive about the implementation of IAS 39 in January 2005, especially the requirement for hedge accounting and the documentation and 'effectiveness' rules that have been introduced. A significant number of companies may have changed their current interest rate risk management practices as a result of this standard. Respondents expressed concern that company practices and real cash flows may be affected by the implementation of this accounting standard.

The professional bodies, such as CIMA, should examine their training for new recruits and also their continuing professional development (CPD) programmes. New trainees should be rehearsed in basic interest rate risk management skills which they can then apply, once professionally qualified, in the firms within which they will eventually work. Further, those that have qualified may need to keep up-to-date with the latest innovations and best practice recommendations. For example, CIMA members now have a fast-track route to qualification with the Association of Corporate Treasurers, and these individuals may be responsible for the interest rate risk management requirements of many large companies. Their professional expertise should be continually updated through a rigorous CPD programme.

Summary

In summary, this research has demonstrated that interest rate risk management is of paramount importance to UK companies and the effective management of IRR should be of major concern to accountants, treasurers, regulators and governments.

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