Management of interest rate risks

Following the interest rate decision of the US Federal Reserve in December 2016 and signs of a further increase in 2017, interest rate management has reported cautious signs of life. In light of the ECB's extension of its bond buying programme, no significant changes are expected in the eurozone in the near future. However, the signal from the US should be taken as a reason to re-engage with the topic of interest risk management and to question whether treasury has established the appropriate strategies, systems and procedures.

Setting targets for managing interest rate risk exposure

In managing interest risk, treasurers generally aim to limit the interest rate risk arising from the risk positions (risk-averse strategy). This involves minimising the share of the variable interest risk positions in the overall risk exposure or restricting the variable interest rate risk position to within a defined range. In the current market environment, however, strategies can also be observed with which treasury departments aim to minimise interest expenses by managing the risk positions accordingly (opportunity-oriented strategy). An example of this is the swapping of fixed-income security exposures using financial derivatives for short-term, variable exposures.

Managing interest risk positions is often closely connected to the process of liquidity management and financial planning. If specific maturity patterns and funding volumes are defined within a structured budget of liquidity and financing requirements, interest management policy is tasked with ensuring optimisation and risk management of the corresponding interest. Apart from maturity transformation, the use of different currency zones also needs to be monitored.

The basis for all decisions: interest rate risk exposure

Interest rate risk exposure traditionally arises from existing borrowings and investments with variable interest rates as well as from refinancing risks for projected borrowings or investments. In practice, many treasury departments stretch the concept significantly and include other interest-sensitive balance sheet items in the risk position (e.g., lease liabilities, trade receivables and payables).

When interest rate management and liquidity management are closely connected, it may also be sensible to include items that are not immediately interest-sensitive when considering interest risk. For example, this approach can aim to use integrated financial and liquidity planning as a base to also make the interest risk from divestment visible (i.e., interest risk related to reinvestment) and to establish corresponding management mechanisms.

Ultimately, the issue of specifically defining a company’s interest risk exposure is very closely related to the interest risk strategy and the company-specific definition of the interest risk. As is always the case with financial risk management, the individual components of interest risk management need to be properly discussed and agreed in order to develop their efficacy.

Managing interest risk exposure — overview of common approaches

When it comes to managing risk exposure, there are fundamental differences between the possible approaches. For effective deployment, all approaches need information on the interest risk position to be available and tools for risk analysis (including data aggregation and drill down functions, scenario analysis and key figures for interest management such as basis point value and duration).

A simple management approach decides on the techniques of interest rate risk management using a microcontrol method based on individual interest rate risk positions, in accordance with a discretionary decision within the rules of the risk guidelines. This appears to be useful for companies with a low number of interest risk positions, as effective risk management can be achieved with comparatively low
procedural and technical outlay. A downside is the lack of flexibility as regards changing interest structures in capital markets, as there is a specific relationship between the hedged item and the hedging instrument.

With macro approaches, management across all positions is possible and allows for improved responsiveness to market changes. This means, for example, managing at the level of currency zones, business divisions or other defined portfolio interest risk exposures using aggregated, maturity-profile-based mapping. The interest strategies can be established for the portfolios (e.g. defined fixed-variable targets for each currency zone) and if required can be adjusted for changing market situations. Notable disadvantages include increased complexity when implementing data storage and methods requirements as well as for financial reporting (e.g. hedge accounting). The advantages of portfolio management in relation to possible flexibility increase proportionally to the number of risk positions and their corresponding volume.

Depending on the level of integration, interest management, alongside liquidity management and budget planning, also represents a component of asset liability management — in that it undertakes to optimise costs in generating and managing liquidity. This approach leads to the overall optimisation of the capital structure and the corresponding interest expense and therefore requires an integrated management concept for liquidity and interest rate risk, including comprehensive data availability and system support.

Is everything correct?

As with all financial risks, the identification and analysis of risk positions are decisive factors for managing interest risk. It is of no great help if elaborate management methods and strategies are executed on the basis of incomplete or inaccurate risk exposures. A second key aspect is connecting the management of interest risk exposure and corporate management — risk appetite and medium and long-term liquidity and financing targets are here significant factors.

Even if the latest signals from the US Federal Reserve may have only briefly brought interest rate risk management to the attention of treasurers, the current strategy and established systems and procedures should also be regularly scrutinised. It never hurts to be prepared.