EUROMONEY

Corporate treasurers must learn the lessons of rate rises

Paul Golden February 08, 2024

Corporates continue to exhibit worrying levels of complacency when it comes to the implications of rate rises for their bottom line.

Photo: iStock

According to the Bank for International Settlements, just half of 14,000 European and US companies with variable-rate debt were hedging their interest-rate risk at the end of last year, despite evidence that firms that hedge experienced a smaller negative impact on their interest coverage ratios and market valuations as rates rose.

This tallies with the findings of Chatham Financial's January 2024 'State of financial risk management' report, particularly that smaller companies with less robust interest-rate hedging practices have been disproportionately impacted by the rising rate environment.

Chatham Financial also noted that although a smaller percentage of companies are exposed to foreign currencies than interest rates, those that are are more likely to hedge that FX risk – suggesting that treasurers need to become more knowledgeable about the impact of interes movements on their businesses.

Sigh of relief

Some financial directors have learnt the hard way about the risk of remaining 100% on floating-rate debt, suggests Abhishek Sachdev, founder of Vedanta Hedging.

"Following a very challenging period last summer, treasurers are now breathing a sigh of relief that they no longer need to pay to enter into swaps," he says. "This was a very unusual situation and led to some acrimonious discussions between borrowers and lenders about the cost of interest coverage ratio compliance."

"The current downward curve is providing significant financial incentives to act without the material appreciation for financial market risk management that these treasurers now have"

Francesco Podestà, Audere Solutions

Francesco Podestà, head of interest rates at risk-management consultancy Audere Solutions, reckons many treasurers have learned more about their businesses in the last four years than they would have in the previous decade or more after experiencing a pandemic, supply-chain upheaval, digital transformation and an extreme rate hiking cycle.

However, he warns that this accumulated knowledge is at risk of being wasted by privately owned companies where a keen eye on risk management is opposed by the trader mindset of critical decision makers.

"The current downward curve is providing significant financial incentives to act without the material appreciation for financial market risk management that these treasurers now have," he adds.

For corporations with excess cash, finance and other leaders need to focus on driving continued cash visibility and centralization, segmenting long-term cash reserve from funding required for short-term operational needs, says Benny Koh, Deloitte's global treasury advisory leader.

"In some instances, long-term cash reserve plans demand investing in longer-tenured, high-quality debt assets to enhance yields – something that requires a robust, board-approved framework," he says.

According to Juan Enrique Arreola, senior manager risk advisory at GTreasury, any treasurer who hasn't come to understand the impact of interest rates on their business – or see the value of interest-rate hedging – may want to start paying attention before they are forced into a job change.

"While we see the use of interest-rate caps, I am a bit surprised we are not seeing a higher level of cap volume in the market," he says. "With the current shape of the interest rate forward curve being so steeply inverted, caps are available at a relatively decent premium cost. Many companies are reluctant to buy caps because they feel that rates have peaked, but we try to remind them to be careful predicting the market."

Lock for less

With the current forward curve pricing in roughly six US Federal Reserve rate cuts this year while the Fed itself has predicted three rate cuts, there is an opportunity for companies to lock in their floating interest-rate risk at a rate that could be lower than what eventually plays out.

"While inflation does seem to be on a downward trajectory (supporting the narrative of rate cuts), companies see a greater risk of rates staying higher than the risk of locking in an unfavourable rate with a swap," says Amol Dhargalkar, managing partner Chatham Financial. "While most corporates employ swaps, we are seeing some companies consider caps and collars in order to participate in some upside if rates fall faster than what the forward curve suggests."

"While the Fed continues to communicate that rates will need to stay high as long as necessary, the market appears to have gotten ahead of itself on future rate cuts"

Juan Enrique Arreola, GTreasury

Not all analysts are convinced that the widespread expectation of rate cuts by the Fed and other central banks will come to pass, arguing that if the rate cut cycle isn't as immediate or deep as current market sentiment suggests, longer-term rates may be primed to climb.

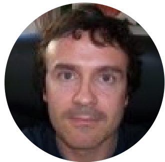
"Investors are not going to sit around and accept lower yields if they sense that rate reductions won't come fast or be substantial enough to counteract lingering inflation or sustain economic growth," says Matthew Weller, global head of research at Forex.com.

Any basic overlay of actual interest rates versus the forward curves shows that the market forecast was consistently incorrect during 2023 and that this dislocation appears to have continued into this year.

“While the Fed continues to communicate that rates will need to stay high as long as necessary, the market appears to have gotten ahead of itself on future rate cuts,” concludes Arreola. “Most forward curves show a quick reduction in rates of between 110 and 130 basis points by the of the year, which simply does not square with the Fed’s messaging.”

Topics

Western Europe | United States | Treasury



Paul Golden

Paul has written about finance since the early 2000s, with a particular emphasis on foreign exchange, treasury and wealth management. He is a regular contributor to several industry titles in addition to Euromoney.