

Free Money

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The allure of something for nothing is always enticing, but rarely achievable. Still, when such an opportunity seems to present itself, the prudent fiduciary has an obligation to check it out.

The situation recently brought to my attention has to do with an option frequently available to corporate borrowers. That is, many lenders extend a “chooser option” to their corporate customers who borrow on a variable rate basis. These loans are typically tied to the London Interbank Offered Rate (LIBOR), but banks often allow borrowers to select and vary the maturity of LIBOR. For instance, if the company were to choose a one-month maturity for the first reset, the associated interest payment would be one-month LIBOR; but with the maturity of that first accrual period, the borrower could then switch to, say, three-month LIBOR for the next payment. Ordinarily, lending arrangements will require a spread to be paid over the LIBOR, but the same spread typically applies, irrespective of the maturity selected.

In an upward-sloping yield curve, shorter maturities have lower associated interest rates, and longer maturities have higher interest rates, suggesting that there might be some cost savings by resetting

to the shortest available maturity option, but this selection may be short-sighted. Changing credit conditions could force all interest rates higher (i.e., the yield curve might shift upward). Thus, just because the starting conditions seem to favor the shorter maturity selection, there is no guarantee that this advantage will be maintained when rolling these shorter maturity borrowings over time.

For example, suppose that at the reset decision point, the company could select one-month financing at three percent or six-month financing at four percent. While it seems that the shorter maturity would have a cost advantage, it is impossible at the decision point to be certain which funding option will ultimately yield the lower cost. The critical question is whether the effective cost from rolling over one-month funding will be higher or lower than the original six-month LIBOR funding, but this answer depends on the future path of one-month LIBOR rates. Clearly, if the company expected the yield curve to remain stable or to shift downward, the shorter-term funding strategy would be preferred. On the other hand, if an upward shift or an inversion of the yield curve (of sufficient magnitude) were expected, the original six-month-term

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funding option be preferred. Of course, expectations might not be realized, so even the well-considered selection might prove to be the wrong one.

The question is: Is there a way to lock in the seeming advantage presented by a sloped yield curve—whether upward-sloping (seeming to favor shorter-term rollovers) or downward-sloping (seeming to favor longer-termed rollovers)? In fact, there might be.

Aside from the objective of minimizing interest expenses, an alternative objective often sought is to minimize income volatility. Thus, many firms may (quite rationally) select the longer-term funding option, expecting to pay slightly higher expenses over time, simply because in so doing, they've eliminated the volatility associated with borrowing on a short-term basis.

The issue gets a little more complicated when interest swaps are introduced into the equation. Interest rate swaps can be

used to convert variable rate funding synthetically to fixed rate funding. With this objective in mind, we'd want to match the variable rate maturity on the swap to the variable rate maturity of the funding, but what maturity should that be? Should it be one month, three months or six months? You might expect all alternatives to end up with the same fixed rate, but that happens not to be the case — at least not always. For various reasons, from time to time, these alternative choices will allow for different outcomes, and the one with the lowest fixed rate, of course, would be preferred.

Once the decision is made, the company would select the preferred swap position and document this hedge relationship to allow for applying hedge accounting, which, if the hedge is appropriately structured, essentially permits the deferral of earnings recognition on the swap's unrealized gains and losses. In any case, one of the conditions to qualify for hedge accounting is that the designated hedged items—in this case, interest payments—must all have the same risk exposure (read: maturity). Thus, to qualify for hedge accounting, the company must assert its willingness to forgo the chooser option and fund on the basis of a single maturity thought the hedging horizon.

Now the question arises as to whether the company can change its mind. For example, if it originally entered into a three-month LIBOR versus fixed swap, could it now start borrowing, say, on the basis of one-month LIBOR, and exchange the current swap for a new, one-month versus fixed swap? More pointedly, would there be any adverse accounting consequences from taking those steps? Hedge accounting can be terminated at will, any time, but is there comparable flexibility associated with implementing replacement hedges?

Here's the possible glitch: Any new hedge documentation would have to stipulate that, going forward, the entity

would commit to borrowing on the basis of this new maturity choice.

But as the company has just shown a willingness to reverse itself on the earlier assertion relating to the first hedge documentation, the credibility of the reporting entity could now be tainted, and hedge accounting could be denied on that basis. It is unlikely that a single election to change the maturities basis on the funding would jeopardize hedge accounting, but repeated adjustments of this type and establishing a pattern would certainly be problematic. Nevertheless, given the lack of certainty in this regard, it is probably a good idea to consult the auditing firm before implementing this strategy.

Beyond the question of whether hedge accounting would be allowed going forward, the company might also want assurances that the intended actions won't foster an immediate earnings impact as a consequence of terminating the original hedge relationship. Guidance presented in Paragraphs 153–158 of Financial Accounting Standard No. 133 (FAS 133) indicates that this should not be a problem. These paragraphs present an example and discussion that clearly states that as long as interest continues to be paid on an outstanding balance no smaller than the notional amount of the original derivative, the AOCI from the initial hedge relationship would not have to be accelerated through earnings. Unfortunately, this guidance appears to contradict other guidance.

Recall that the original hedge relationship applied to our planned borrowing on the basis of some specified maturity. An active decision to no longer fund on this basis would present a case where the originally designated hedged item would no longer be expected to occur. Paragraph 33 directs that in such cases—when it is probable that the designated forecasted cash flow will not occur, all associated accumulated other comprehensive income (AOCI) would

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have to be reclassified immediately as earnings. It would seem, then, that the earlier-cited example either overrides or ignores the provisions of Paragraph 33—at least in consideration of this question about accelerating the reclassification or AOCI to earnings for discontinued cash flow hedges of interest payments. Given this ambiguity, this issue might best be discussed with the audit firm as well.

As already stated, these market opportunities are not always available, but it is not unusual for them to crop up in times of financial distress—and there does not seem to be any shortage of that these days. It literally pays to pay attention. Each basis-point reduction in funding costs translates to \$1,000 per million per year. This strategy has enabled a savings in excess of 10 basis points in the recent past. It is nothing you can count on, but it is certainly ample enough to be worth assessing on a periodic basis.

The more you got, the more you could save.

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