Building the Case for Hedging

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One of the most demanding queries a financial risk practitioner faces in times of turmoil such as these is the question of hedging. In this article I will shed some light on market risk—in particular, the management of interest rate risk.

In the early months of this year, we have seen dramatic shifts in monetary policy from major central banks around the world that includes the actions taken by the Saudi Arabian Monetary Agency (SAMA) in response to the combined effect of the COVID-19 pandemic along with the plunge of oil prices and their implications on the Saudi economy. The central bank has swiftly, as part of its announced support program, reduced both its reverse repo and repo rates by 75 basis points to 0.50% and 1.00% as a way to reaffirm monetary stability in a time when the economy is about to enter uncharted territory.

Obviously, the Saudi interbank interest rates (SAIBOR) and the Saudi Riyal longer-duration swap rates have followed suit and dropped significantly lower from their relatively high levels only a few months back. Consequently, we noticed how several organizations have started to contemplate their options for seizing the presumed opportunity and managing the cost of funding associated with unhedged positions. Others are considering how to restructure their existing positions. At that point, it was crystal clear to us that the question of hedging has emerged back to the surface.

AN OBJECTIVE VIEW

One thing we tend to allocate less weight on when formulating our recommendation on hedging is the market outlook being forecasted, or any other relevant trend analysis. Frankly speaking, no one is certain what is going to happen, and that is especially true when markets are experiencing periods like the current times that are unprecedented and are characterized by a constant change of market dynamics.

We can try to predict the future state of the economy, growth in local credit or the liquidity stance, inflation, and any other relevant economic indicators, but let there be no mistake—these will always be no more than educated guesses. Hence, we view this as the unknown and the uncontrollable element in our risk assessment process. However, on the bright side, there is an element that is known and to a certain extent can be controlled, that turns out to be the manner in which organizations effectively respond to such market shocks.

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Relying on the organization-established risk management framework should be the starting point for every organization facing any kind of risk, and interest rate risk is no different. First and foremost, an organization should understand its risk appetite to movements in interest rates and its impact on company financial objectives.

The board of directors is responsible for defining the organizational tolerance to risk and for overseeing the establishment, approval, standards, implementation, and review of interest rate risk management strategies, policies, procedures, and risk limits. The responsible teams and departments should regularly engage in the risk identification, evaluation, and response plan. Not to mention the teams that are tasked with risk monitoring and reporting, which are as critical as any other task in the risk assessment process as they facilitate for the much-needed data and analytics meant for risk-based decision making.

The board or delegated sub-committees should review the organization's sensitivity to interest rate risk against established KPI's as frequently as needed. Such information should be timely and of sufficient detail to allow for hedge-related decision making, and moreover, for the board to assess management performance in monitoring and controlling interest rate risk along with its compliance with approved policies.

LONG-TERM GAINS

The idea is that as soon as a known exposure is evaluated against an organization defined KPI's and materiality, the hedge process should be initiated. This way there is limited subjective judgement on broader market timing, and the exercise becomes unambiguous and more transparent. Therefore, it is critical for the organization to choose the appropriate KPI's to protect. Additionally, it is equally as important to determine the different methods that will be used to measure the impact stemming from interest rate variabilities.

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On the other hand, materiality is an organization-specific parameter, and it is a function of its risk tolerance. Therefore, to answer our main question on hedging, one would need to know how much expected loss is tolerable. I myself have experienced organizations that are fine with millions of Saudi Riyals of negative impact to earnings, while others can only bear a small fraction of that. Hence, risk limits and triggers should be commensurate with the organization's business objectives, risk appetite, and complexity of its exposure.

One can evidently assume that organizations that have invested in robust mechanisms and are empowered with a top-down risk culture are better prepared to deal with market-related shocks. To put it differently, the absence of policy that addresses interest rate risk is an indicator that this risk is viewed by the organization as either acceptable or irrelevant.

In my view, the case for investing in risk management processes and proper hedging practices has long-lasting benefits. It is well understood that it comes with its own cost—but nonetheless, this investment over the long run could be the determinant factor in reducing cost and unnecessary business disruptions as well as safeguarding an organization's future.

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