Managing the Aftermath: Restructuring of Mis-sold Interest Rates Derivatives for Non-Financial Corporations

Muadh Alhusaini

4 May 2023

In today's volatile global financial landscape, uncertainty has become the norm. In the midst of this turbulence, it is paramount for non-financial corporations to master the art of prudent risk management, particularly when it comes to managing their interest rate exposure and addressing existing interest rate derivatives that may have been mis-sold.

In this article, we delve into the crucial role of diligence in restructuring these derivatives, focusing on effective market risk management. We have witnessed misconceptions and pitfalls that companies often fall prey to. In a recently published bulletin, we discussed a specific trade that gained momentum recently, which also fits the context of this bulletin.

This prompts us to explore fundamental concepts such as hedging versus speculation, the distinction between mark-to-market (MTM) valuation and cash impact, the implications of hedge accounting, and the significance of applying robust risk management metrics to make informed decisions.

Distinguishing Hedging from Speculation

One mistake non-financial corporations sometimes make is the failure to differentiate between hedging and speculation when dealing with interest rate derivatives. Hedging involves using derivatives as a means to mitigate or offset existing or anticipated risks, such as fluctuations in interest rates, with the aim of protecting the company's financial position. Speculation, on the other hand, entails taking positions in derivatives with the sole purpose of profiting from market movements and would typically involve additional risk taking.

Despite this distinction, we still encounter cases where non-financial corporations inadvertently enter into pure speculative transactions with the misconception of hedging, often due to how the derivative seller (a financial institution) promotes the product. They may also market these derivatives to non-financial corporations as "cost reductions" or "cheapeners," creating the illusion that such products would lower the overall funding cost for the company. And this is where the tragic tale begins.

Non-financial corporations must clearly grasp the difference between hedging and speculation and ensure that any restructuring of mis-sold interest rate derivatives is undertaken with the primary objective of effectively hedging and managing risks rather than engaging in speculative activities that could expose the company to additional risks.

Understanding Mark-to-Market (MTM) Valuation and Actual Cash Impact

Another critical aspect of managing interest rate derivatives is comprehending the disparity between mark-to-market (MTM) valuation and the actual cash impact of the derivative product. MTM refers to the valuation of derivatives based on current market prices, which can fluctuate over time. However, the actual cash impact of a derivative may not align with the MTM valuation, as it depends on various factors, such as the timing of cash flows. Consequently, the MTM valuation consolidates all the future cash flows into a single value using today's prices.

Non-financial corporations need to be aware that the actual cash impact may not necessarily reflect the true financial impact of the derivative on their cash flows and financial statements. Failing to consider the full spectrum of potential risks beyond the actual cash impact of the interest rate derivative hedge can result in inaccurate risk assessments and ill-informed decisions, thereby exposing the company to greater risk.

Failing to consider the full spectrum of potential risks beyond the actual cash impact of the interest rate derivative hedge can result in inaccurate risk assessments and ill-informed decisions, thereby exposing the company to greater risk

The Significance of Risk Management Metrics

The application of robust risk management metrics is pivotal in comprehending the potential impact of interest rate derivatives. Techniques such as Monte Carlo simulation and stress testing can provide invaluable insights into the potential outcomes of different scenarios, aiding companies in evaluating the effectiveness of their hedging strategies as well as offering perspective around the mis-sold derivative trades at hand.

Monte Carlo simulation entails employing statistical methods to model various scenarios and generate probabilistic outcomes, which can help companies understand the potential range of cash flows, MTM valuations, and financial impacts. Stress testing, on the other hand, involves subjecting the derivative positions to extreme scenarios, such as severe interest rate shocks or market disruptions, to assess their resilience and vulnerabilities.

One crucial aspect that requires careful consideration is the contingent liability associated with derivative instruments. Prior to engaging in derivative transactions, companies must typically establish a credit line and prepare hedge documents. Suppose the market moves unfavorably, and the product fails to meet the hedging requirements. In that case, the Credit Equivalent Exposure (CEE) increases, thereby exposing the company to higher risk and consuming more extensive credit lines.

It is, therefore, fundamental to recognize that the mark-to-market (MTM) value represents only the visible portion of the risk, while the potential contingent liability remains hidden. Monte Carlo Simulations are an effective tool for assessing the extent of this contingent liability.

Hedge Accounting Implications: A Matter of Utmost Importance

Non-financial corporations cannot afford to overlook the criticality of accounting treatment when it comes to derivatives. Hedge accounting is not just a mere formality but a crucial tool that allows companies to accurately and transparently reflect the impact of derivatives on their financial statements. It is a delicate process that demands strict compliance with accounting standards such as the International Financial Reporting Standards (IFRS).

The implications of hedge accounting cannot be understated. It is not just about ticking boxes on a checklist but about ensuring that the company's financial reporting is truthful, reliable, and credible. Misrepresentations or discrepancies in financial statements can have devastating consequences, eroding the company's credibility, devaluing its worth, and even threatening its survival.

Once applied, non-financial corporations must leave no stone unturned in ensuring that their hedge accounting documentation is robust, comprehensive, and meticulously aligned with accounting standards. Failing to do means risking the company's financial stability, investor confidence, and reputation.

Conclusion: The Imperative of Diligence

In conclusion, the aftermath of mis-sold interest rate derivatives can be nothing short of a financial nightmare for non-financial corporations. However, by having a financial risk management mindset, companies can overcome the devastation and safeguard their financial future.

Distinguishing between hedging and speculation, understanding the difference between mark-to-market (MTM) valuation and actual cash impact, applying rigorous risk management metrics, and acknowledging the significance of hedge accounting implications are not mere options but imperatives that must be pursued with relentless determination.

Non-financial corporations must not shy away from seeking independent third-party advice from experts in financial risk management. These advisors can objectively provide invaluable insights, evaluate existing derivatives strategies, identify potential risks, and guide in applying sophisticated tools such as Monte Carlo simulation and stress testing to assess the impact of derivatives on the company's financial position.

> **Independent advisors can objectively provide invaluable insights, evaluate existing derivatives strategies, identify potential risks, and guide in applying sophisticated tools.**

By being proactive and vigilant in managing interest rate derivatives, non-financial corporations can rise above the challenges, protect their strategic objectives, and safeguard their financial stability in the face of a volatile market environment. It is time for non-financial corporations to rise to the occasion and navigate the aftermath of mis-sold interest rate derivatives with unwavering diligence.

For more information, please contact Muadh Alhusaini, Partner at Ehata Financial, ***Muadh.alhusaini@ehata.com.sa.*** *You can also read the article from the website* ***here.***

ABOUT EHATA

Ehata is a specialist financial risk management advisory firm, licensed and regulated by the Capital Market Authority (license No. 17183-20). We are independent practitioners with expertise covering interest rate, foreign exchange, commodities, and derivatives. We leverage on our technical capabilities and market know-how to ensure that our clients get the excellence of the advice and the satisfaction that comes with it.

DISCLAIMER

Ehata Financial Company is authorized and regulated by the Capital Market Authority (license no. 17183-20). Ehata Financial Company may only undertake the financial services activities that fall within the scope of its existing CMA license. Principal place of business in Saudi Arabia: King Fahad Rd, Avenue Building, 5th Floor, P.O. BOX 241106, Riyadh 11322. The information contained in this article was prepared by Ehata Financial Company. Though the information herein is believed to be reliable, Ehata Financial Company makes no representation as to its accuracy or completeness. You should not rely solely on this communication when making a decision whether or not to enter into a derivatives transaction. If you are not an experienced user of derivatives, if you are not capable of making independent trading decisions and you do not understand the terms and risks related to derivatives transactions, you should refrain from entering into such transactions. You should consult your own legal, tax and accounting advisers with respect to any proposed derivatives transaction. Under no circumstances shall we or any of our associates or any of our associates' respective directors, officers, employees or agents, be liable for indirect or consequential losses including any failure to realize any profit, advantage or opportunity relating to the transaction or otherwise. The information contained in this article should not be reproduced in any form without the express consent of Ehata Financial Company. The information contained in this article from the sender shall not be considered as advice or solicitation to buy or sell any securities.