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# Interest Rate Risk: Hedging Future Issuance of Fixed Rate Debt

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Companies that need to refinance their debt do not have to wait until they refinance to lock in their interest rate on new issuances.

Treasury organizations may choose to lock in current interest rate curves for the future refinancing date for a couple of reasons. First, to ensure time to review and select a favorable rate as determined and selected by the company; and second, to avoid any market dislocation surprises close to the actual refinancing date.

## Applicable Debt Issuances

Companies hedge future issuances of fixed-rate debt with 5 to 30 year maturities. This type of debt obligates companies for a very long time, so they can take months in advance to lock in rates that they deem acceptable for the organization. It's risky to wait until the last minute to find out what borrowing rate and interest costs the company will incur.

## Hedging Future Fixed Rate Debt Issuances

Since the rate decision is so critical, some companies decide to enter into hedges to fix the rate of refinancing in advance. These types of hedges lock the current interest rate environment (typically LIBOR or Treasury curve) of the interest rate prior to the issuance, leaving the credit component open until issuance. Companies fix the interest rate with instruments such as Treasury Locks (T-Lock) or forward starting LIBOR swaps.

Treasury may enter into several layers of these instruments to provide counterparty and rate diversification. (We continue to see reliance on LIBOR based derivatives in spite of its pending demise.)

- ▶ **Treasury Lock:** A customized derivative indexed to a specific Treasury yield, typically settling within a period of a few hours, a few days to several years. The derivative is zero cost and changes in value based on the rate locked vs. the current market Treasury yield for the elected maturity. At the end of the contractual days/month/year(s), a cash settlement is paid or received based on market changes. The cash gain/loss can be substantial given the notional, tenor and interest rate movements. Special hedge accounting spreads the gain/loss over the tenor of the issued debt.

- ▶ **Forward Starting LIBOR Swap:** A swap to exchange a fixed interest rate and a LIBOR floating interest rate on a specified notional over a specified number of years, starting at a future period aligned with the expected debt issuance. Most forward starting swaps hedging fixed rate debt have a mandatory cash settlement on the forward start date of the swap based on the then fair value of the swap. When used to hedge a fixed-rate issuance, the terms generally require a cash settlement aligned with the forward starting effective date.
- ▶ **Hedge Window:** A T-Lock or Swap both have specific expiry dates; however, the accounting guidance provides the flexibility of a hedge window within which the company can lock down its interest rate. These windows frequently range from one week to one month.

## Hedge Effectiveness For Interest Rate Derivatives

An interest rate derivative such as a T-Lock or forward starting swap will change in value each period. ASC 815 states that all derivatives must be recorded on the balance sheet at fair value. Changes in fair value for the default accounting are recorded in earnings. However, most companies defer the change in the value of the T-Lock in OCI by applying ASC 815 Cash Flow hedge accounting.

One of the major hurdles to achieving special hedge accounting is proving the existence of a highly effective hedge relationship.

To prove a highly effective hedge relationship exists between the derivative (with a single maturity date) and the hypothetical derivative (which is based on the expected debt issuance date), companies test the issuance window beginning and end dates, as well as the company's best estimate issuance date to ensure the derivative will offset the extremes of the hypothetical derivative changes in value.

The T-Lock value is calculated based on the current forward yield of a treasury bond vs. the contractual T-lock yield, and the hypothetical derivative is valued based on a calculation of the change in the fair value of the coupons of the forecasted debt issuance. A highly effective relationship is substantiated if the R-square and slope results for all three regressions of the derivative against the best estimates and window extremes are greater than 0.80 and fall between 0.80 and 1.25, respectively.

Forward starting swap testing is similar to T-Lock testing in that the actual derivative is tested against three different hypothetical derivatives based on the expected debt issuance earliest, best estimate, and longest date in the hedge window.

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# Summary

Corporations with existing fixed rate debt face refinancing risk as the maturity dates grow near. Some companies wish to lock in their borrowing costs ahead of time to ensure a smooth process as well as to have flexibility in selecting a rate they deem acceptable.

T-locks and forward starting LIBOR swap instruments allow companies to lock in a rate today for issuance up to 1 or 2 years into the future. Some companies enter into several hedges to blend the rate and avoid significant counterparty risk. Public companies apply ASC 815 Cash Flow special hedge accounting to defer changes in the value of the derivative into OCI. This way, the actual issuance rate of the debt will be adjusted up or down by the amortization of OCI into income over the life of the debt. It should be noted that although the effect of the hedge can be spread out over the life of the debt, the change in value of the derivative (which is settled in cash in the beginning of the hedge) can be substantial.

Companies can use a goal post regression test approach to prove a highly effective hedge relationship exists, which is one of the most important requirements for taking special hedge accounting, among other compliance requirements.

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