To Hedge or Not?

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This session will consist of a brief hedging case study. The audience will then have the opportunity to comment on whether the proposed hedge should go ahead.

Imagine you are responsible for the investment of a fund, backing the liabilities either of insurance policyholders or members of an occupational pension plan. There is a degree of profit sharing, so that beneficiaries are not entirely unaffected by fund performance. However, there is a guaranteed minimum benefit underwritten by shareholders, either of the insurer or of a plan sponsor. The plan is currently invested in a mixture of actively managed equities, corporate bonds, property and government bonds.

Two papers are to be discussed at an investment committee meeting. Paul Stanworth will propose a hedging program based on structured derivatives to be issued by an investment bank, to underpin the guaranteed minimum benefits. Ian Sykes will propose that the fund retains its exposures to market risk at the discretion of the investment committee.

After discussion from the floor, attendees will be asked by a show of hands whether or not they support the proposed hedge.

Disclaimer: We have prepared these examples for discussion purposes only. The arguments given are meant to be indicative of those countered in practice. Opinions differ on how sound these arguments are, and we do not endorse them all. Don’t take any decisions based on this document. We disclaim any responsibility if you do.

Paper I: Reasons for Hedging
Presented by Paul Stanworth

Financial Statement Volatility

Volatility in our financial statements has been a concern both for our own management and also external analysts. We ar considerably weaker now than we were five years ago. Any repeat of recent fluctuations could undermine confidence in our own management. This in turn would likely be reflected in our share price, with increased risk of being taken over.

Market moves, particularly in equities and interest rates, have been the major cause of movements in our profit and loss account.

The proposed hedge program would substantially reduce volatility in our financial statements.

Engagement with Regulators and Rating Agencies

Regulators and rating agencies frequently ask about the hedging programmes we have in place. They are looking are looking for reassurance on this point. The proposed program will allow us to provide that reassurance.

An effective hedge program helps us to maintain good relations with the regulator. It also gives us strong arguments for an improved credit rating. A strong credit rating helps us to maintain the confidence of our customers, and allows us to borrow more cheaply in the markets.

Cost of Capital

Our existing market exposures place capital at risk. Our economic capital process identifies the capital required for our current market risks – and the result is substantial.

Capital comes at a cost. The proposed hedge program reduces the capital tied up in market risk, releasing that risk capacity for other, more productive uses within the organisation.

In addition, the hedge program is likely to reduce the volatility of our share price, and as a result our overall cost of capital will come down.

Back testing.

If we had implemented this hedge five years ago, we would have recouped virtually all our market losses during that period. We could have continued the profit sharing arrangements which were popular with our members. In addition, we would have avoided all the costs, disruption and reputation damage of our recent financial restructuring.

Preserving Franchise Value	Over the years, we have invested heavily in our reputation. We invest in our people and in the communities around us. These investments do not show on our balance sheet, but they are fundamental to our long term future. Our share price reflects these investments we have made. If we continue to run market risks as we have done, we face a significant risk that our business will fail. In that case, all our careful investment in intangibles will come to nothing.
No value from Retaining market risks	We are kidding ourselves if we think shareholders invest in our business to get general stock market exposure. Shareholders can easily do that themselves with tracker funds – and at much lower cost than having their investment buried several layers down in a complex organisation such as ours. We should therefore focus on our core business – the reason why shareholders chose us in the first place.
Core business	We should stick to what we do best – our core business of serving our customers. The banks have better established processes and controls for managing capital market risks. It makes more sense to buy these services in, than to replicate them ourselves. In addition, if for any reason the underlying hedging problem goes wrong, either because of market moves or system failures, that becomes the bank's problem and not ours.
Transparency	In the past, we have incurred significant cost from mispricing financial promises we made. Sometimes we kidded ourselves that equity market returns would make up for our mistakes, and sometimes we just hoped guarantees would not come into the money. The discipline of hedges forces us to confront the true costs of the promises we make, leading to more transparency and more robust governance.
Tax Planning	Every time we make a profit, we write a cheque to the tax man. When we lose money the next year, we struggle to reclaim the tax we have paid. Our recent alternation of profits and losses mean that we've paid a lot more tax than if we could somehow smooth the results. Hedging provides more stable taxable profits. It provides the opportunity proactively to manage our tax position.

Paper II: Reasons for Retaining Market Risk
Presented by Ian Sykes

Opportunity Costs

Risk taking is a fundamental part of our business. Investment returns are a major source of profit for us. Over the long term, we have benefited from our exposure to the stock market, from our ability to predict interest rates and from the tactical skill of our fund managers.

If we hedge the market risk, we lose all these sources of profit. Our expected liability costs will increase because we will reduce the investment return available to meet those liabilities. Lower future profits will in turn put us at risk of a credit downgrade.

Peer Comparisons

We measure and manage our performance with reference to a peer group of our competitors. This hedging transaction would put us out on a limb.

It would be embarrassing to put on a hedge and then see competitors leap ahead on the back of strong investment performance. Who would want to invest in our business if we offer inferior returns?

We currently benefit from safety in numbers. If markets go against us, then it is likely the regulator and our actuaries will find some way to relax their solvency requirements. It would be unrealistic to close our whole industry, and we are better placed than many. If we implement the proposed hedge, then we could still face future hardship, but not at the same time as everyone else. We are then in a weaker to beg regulatory favours.

Profit Margin

This transaction is simply lining the pockets of investment bankers. They are charging much more for this hedge today, compared to their proposal four years ago. Their pricing assumptions, especially volatility, are higher than anyone expects for the period covered. In addition, their pricing of put options gives us no credit for the expected risk premium on the underlying assets.
Even if we wanted to reduce risks, the price for this trade makes it unattractive for us. We are better off retaining the risks in house.

Security

If we reduce our exposure to investment markets, this might benefit our creditors because their benefits are more secure. Anyone that lent us money will be delighted – they've locked into a high interest rate reflecting the risks we planned to take, and now we're generously cutting back the risks. Needless to say, we won't get any reduction in interest cost until we refinance our current structure in five years time.

	So this hedging does not make shareholders any better off. If anything, it hurts shareholders by reducing the value of their limited liability. A reduction in risk may simply benefit policyholders or lenders by making their assets more secure, with little benefit to shareholders.
Legal Complications	In some cases, there may be questions over admissibility or tax treatment of complex structures. There may also be legal difficulties with holding hedging assets outside a profit sharing fund. The people who draft and redraft these rules usually know little about derivatives, so a deal which looks good today could still unintentionally fall foul of some future rule. Given the current uncertainties in the accounting, tax and regulatory environment, this is not a risk we want to take.
Imperfect Hedge	Creating a hedge does not get rid of all the risks. It simply replaces our existing simple risks with more complicated risks such as counterparty risk and basis risk.
Reputational Issues	The use of derivatives does not have a good name – and for many observers the word is equated to foolhardy speculation. Furthermore, several of our competitors implemented so-called hedges, but in order to reduce the cost they ended up buying structures that transferred little risk. We are strong firm with a proud tradition of investing for the long term, not swayed by fads such as exotic derivatives.
Hedge finance	We must liquidate assets to buy the hedge. How can we pick which assets to liquidate? Any choice will incur transaction costs for the assets we have to sell, and further annoy our successful fund managers. Furthermore, our hedge calculation is invalidated if we then liquidate risky assets to finance the hedge.
Rebalancing costs	If we later decide the hedge is inappropriate, if we change our investment strategy or if decrements are not as expected, then we need either to unwind or extend our hedge position. If we commit now to hedging, then we are at the mercy of the bank for fair prices when we try to unwind the position.
Accounting issues	Although we run a mismatch on an economic basis, the accounting and regulatory treatment are immunised. The construction of a hedge will alarm senior management and analysts who may not have been aware of the economic volatility. Hedging economic risks may create additional volatility elsewhere, for example in accounting or regulatory measures of profit.