Corporate hedging gets harder

The perils of prudence

The credit crunch has made it much more difficult and expensive for firms to hedge their risks

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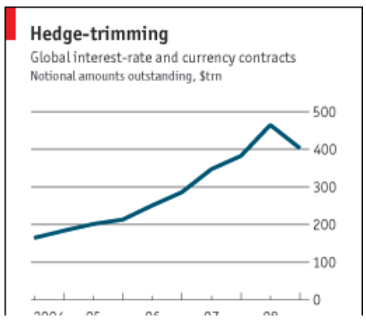
WARREN BUFFETT, one of the world's most famous investors, once called derivatives "financial weapons of mass destruction". Central bankers worry that those sold "over the counter", meaning outside exchanges, threaten the stability of the whole financial system. Yet firms that rely on derivatives to limit their exposure to swings in commodity prices, interest rates or exchange rates cannot get enough of them—literally.

Several firms using derivatives in an attempt to manage such risks have suffered huge losses of late, on paper at any rate. Among the hardest hit have been airlines, many of which paid to protect themselves from higher fuel prices last year when the oil price peaked at $147 a barrel. Because oil now costs much less, many have had to write down the value of those contracts, even if they are not due to be settled for years. The losers included Cathay Pacific Airways, which made paper losses of close to $1 billion, Ryanair, Air France-KLM and Southwest.

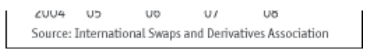
Nonetheless, firms seem as keen to hedge as ever. According to a study by Greenwich Associates, a consultancy, big American, European and Asian firms hedged 55% of their exposure to fuels last year, up from 45% the year before. Even some of the airlines that posted large losses on derivatives tied to the oil price are buying more of them. Ryanair recently said that it has entered contracts to fix the price of 90% of its fuel for the first nine months of this year, almost twice the proportion it had hedged in January. Cathay Pacific, meanwhile, is buying instruments that will protect it from falling as well as rising fuel prices.

The main reason for this enthusiasm, says David Carter, an academic at Oklahoma State University and one of the authors of several papers studying fuel hedging in the airline industry, is that banks are normally more willing to lend to firms that have reduced their risks by hedging. That in turn allows them, for instance, to buy cheap assets from ailing rivals.

Far from suppressing firms' appetite for derivatives, the turmoil in the world's financial markets has increased it. Of the big corporations Greenwich surveyed last year, 38% used options to manage currency fluctuations, up from 28% a year earlier, and the volume of currency options they bought had increased by about a third. In general, the use of interest-rate and currency options has risen dramatically in recent years (see chart).



But in the second half of last year, such hedging declined for the first time since 2001, according to the International Swaps and Derivatives Association, an industry group. Thanks largely to the credit crunch, banks are selling fewer derivatives at a higher cost. Many firms, especially those with weaker credit ratings, have simply been frozen out of the market for derivatives by banks' reduced willingness to carry risk. Bankers say that only the few airlines with the highest credit ratings have been able to add to their hedge books in recent



Source: International Swaps and Derivatives Association

months to take advantage of lower oil prices.

The bankers' reluctance stems from the nature of hedging contracts which, although not officially loans, nonetheless create liabilities between banks and their customers which grow or shrink as the underlying variable changes. Thus many of the airlines that had hedged their fuel consumption when oil prices were higher built up huge notional debts to banks, even though no money was due to change hands until the contracts reached the end of their lives, by which time oil prices could have risen again. The amounts concerned can easily grow to exceed the internal limits that banks place on their exposure to particular clients or even industries, preventing them from extending additional credit or writing new contracts.

It is not just airlines that are affected. Indian textile exporters, for instance, complain that their banks are not allowing them to take on new currency hedges because of paper losses on contracts tied to the dollar. Pension funds are being affected too, mainly because some specialised derivatives, including certain types of hedges against inflation, completely dried up for a time last year.

Those hedges that are available have become much more expensive. That is partly because markets are less liquid and less competitive since the collapse of Lehman Brothers last September. But banks are also now explicitly charging for the credit risk that they assume when writing a derivative contract. Estimates of the additional cost that companies are paying to hedge risks vary from firm to firm and product to product, particularly as they depend on the creditworthiness of those who are buying them. But some in the industry talk of bank fees rising from less than 0.1% of the value of a deal to as much as 2%.

For many firms, such costs are prohibitive. The main victims are big exporters of manufactured goods. ThyssenKrupp, a German industrial firm, hedges its currency exposure each time it signs a large export order, for example. Similarly Rolls-Royce, a British aerospace company, is active on foreign-exchange markets because most of its revenues are in dollars but many of its costs are paid in pounds.

Ever since the collapse of Lehman Brothers last year, firms have been worrying about whether they will ever be able to collect on the hedging contracts they have bought if their bank collapses. John Grout of the Association of Corporate Treasurers, an industry group, says that some perfectly solvent banks have wriggled out of derivative contracts by invoking obscure break clauses that they had previously promised their customers they would never use.

Banks, meanwhile, fear that some of their cash-strapped customers may default. The result, says one banker involved in advising firms, is that many of them are asking firms to post collateral for the money they owe on derivative contracts. In effect many are edging towards the sorts of arrangements that regulators are thinking about imposing more broadly: moving most derivatives onto exchanges and having them centrally cleared.

Yet such arrangements, too, are deeply troubling for many big firms. By turning paper losses into real ones they represent, in effect, a massive withdrawal of credit. Timothy Murphy, the foreign-currency risk manager for 3M, a large manufacturing company, gave warning in testimony before a subcommittee of America's Congress earlier this month that mandatory clearing of derivatives would "add significant capital requirements for end-users, adding significant costs, discouraging hedging, and diverting scarce capital". The only thing more dangerous than having too many derivatives floating around the financial system, it seems, may be having too few of them.

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