Hedging interest rate exposure with BAX futures

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Interest rate fluctuations can represent significant risks for any corporation that has "floating rates" financing exposure. When a corporation finances its activity and projects by borrowing significant amounts at floating rates, an interest rate exposure exists. An appropriate hedging strategy can help these corporations manage these risks.

A hedging strategy aims to minimize the exposure to interest rates fluctuations and provide a known cost for financing. The objective of a proper hedge is to eliminate the uncertainty of "floating rates" on funds borrowed, not to maximize profits from speculation. A successful hedge will therefore not produce excess returns, but will protect the hedger against additional costs that could result from unfavorable interest rate fluctuations. An appropriate hedge will consist of two positions: a borrower or a lender position by which the corporation is vulnerable to an interest rate fluctuation (a "floating rate" loan or an investment on the money market) and the other position will be a derivative position so that an unfavorable interest rate fluctuation in one position will be offset by gains in the other.

CASE STUDY – ABC CONSTRUCTION INC.

ABC Construction Inc is a Canadian corporation that specializes in construction and renovation of commercial buildings. ABC Construction Inc., which must regularly borrow significant amounts for its projects, is usually funding these projects by borrowing on the Bankers Acceptance market. So, when ABC Construction Inc. needs to borrow funds for a project, they call their bank, which will fix on that day the cost for the loan based on the CDOR (Canadian Dealer Offered Rate). This rate is adjusted by a premium that represents the cost charged by the bank to issue Bankers Acceptance on behalf of ABC Construction Inc. By acting this way, ABC Construction Inc. can benefit from a better financing rate than it would be charged if it went with the Prime Rate.

Today is September 9, 2011 and the directors of ABC Construction Inc. know in advance that they will need to borrow $10 million CAD in June 2012 for a project that they will start then. The directors of ABC Construction Inc. are afraid that interest rates will go up between now and June 2012, and a rise of interest rates would add to the financing cost and consequently would reduce the profit margin that they actually estimate on this project. The three-month CDOR rate is at 1.28%.

To hedge its exposure to rising interest rates, ABC Construction Inc. will sell 10 BAX Futures for June 2012 at 99.20. By doing so, ABC Construction Inc is locking a three-month CDOR rate of 0.80% (100-99.20) for the month of June 2012. If the three-month CDOR rate was to go up between the moment that the hedge has been initiated and June 2012, the profit on the BAX Futures would offset the additional cost of the loan in June 2012. Conversely, if the three-month CDOR rate was to come down, the financing cost on the loan will be reduced, offsetting the lost on the BAX Futures.

When the ABC Construction Inc. is ready to borrow the $10 million CAD in June 2012, it will buy back its BAX Futures. In our example, let's assume that the three-month CDOR rate has increased to 2.00%. The profit realized on the BAX Futures will reduce the financing cost for ABC Construction Inc.

September 2011 :

ABC Construction Inc. anticipates the need to borrow $10,000,000 CAD in December

Sell 10 BAX Futures for June 2012 at 99.20 (Fixing three-month CDOR rate at 0.80%)

June 2012:

ABC Construction Inc. borrows $10 million CAD for three months at CDOR rate of 2.00%

BAX Futures sold at 99.20 are bought back at 98.00

Profit on BAX = 10*(99.20 – 98.00) * 100 basis points per contract * $25 per basis point = $30,000 CAD

The profit realized on BAX Futures of 120 basis points reduces the financing cost (2.00 – 1.20 = 0.80%)

In this example, ABC Construction Inc. is able to benefit from the BAX market anticipation that the three-month CDOR rate will be falling from its actual level of 1.28% to a lower level of 0.80% in June. Also, ABC Construction Inc. could be locking a three-month CDOR rate for a period longer than three months by selling additional deferred BAX Futures. For example, ABC Construction Inc. could sell September 2012 BAX Futures at 99.20 (fixing three-month CDOR rate at 0.80% for the month of September 2012), December BAX Futures at 99.18 (fixing three-month CDOR rate at 0.82% for the month of December 2012) and March 2013 BAX Futures at 99.14 (fixing CDOR rate at 0.86% for the month of March 2013).

For more information about Hedging interest rate exposure with BAX futures, or commodity/financial futures, please contact us.

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