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First pick your target

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During the Global Borrowers and Investors Forum organized by *Euromoney* in London last month, we gathered a panel of five of the world's largest and most sophisticated borrowers to discuss their borrowing strategies. The round table panelists –representing two supranationals, a sovereign, a quasi-sovereign and a corporate – described (and argued about) how they judge whether they and their staff are doing a good job. The panel was chaired by *Euromoney* editor Garry Evans. Research and coordination by Philip Blenkinsop

The objective of borrowing in the international capital markets seems simple: borrow as cheaply as possible. But what is an appropriate target? In an environment where bull markets suddenly turn bearish, it seems unrealistic to set absolute targets. But, if borrowers adopt relative targets, what should they choose as benchmarks; other similarly-rated borrowers or artificial formulae?

The calculation is complicated by risk – from interest rates, from currency movements and from the credit of swap counterparties. The fixed costs of managing a department cannot be ignored either. Does the performance of bonds in the secondary market matter? Will an armoury of models and theories produce a measurement of performance any more effective than plain common sense? Should the staff of fund-raising departments be compensated in line with performance? Here are the panel's answers.

How do you measure the performance of your team?

Alex Jurshevski, head of portfolio management, New Zealand Debt Management Office: We have focused intently on performance measurement over the past 18 months. We look at the performance of the portfolio relative to objective benchmarks rather as an asset manager would judge performance relative to, say, the CSFB or JP Morgan bond index. We also look at our performance in managing cashflow mismatches. We may, for example, mismatch a maturity, borrow early or lag the borrowing.

What we have to establish is a default borrowing strategy that is consistent with maintaining our offshore portfolios within pre-set strategic constraints. Then we judge how we have done in terms of the actual borrowings relative to that default benchmark. We look at things in the most objective way possible and try to minimize reliance on, say, press reaction to any particular deal.

Kenneth Lay, director of financial operations, World Bank: Our approach is based on the kind of product we offer World Bank borrowers. The bulk of our lending – all of it until recently – has been via loans with a rate that floats at a spread to the average cost of a basket of our outstanding borrowings. To keep the interest rate volatility of these loans low, we have a well understood preference for medium and long-term, fixed-rate liabilities.

We look at performance against that background. First, are our operations achieving the best possible value for the World Bank credit? We assess that over a three to five-year horizon. Second, we are concerned about whether the timing of transactions helps or hurts the performance of the borrowing pool. We assume that no one can consistently call interest rates over an extended time-period. So, our neutral position is to time the transaction so that, at the duration we are interested in, we sample the average interest rates over time.

Jeffrey Werner, senior vice president, corporate treasury and global funding, General Electric Capital Corporation: We think it is impossible and rather foolish to try to measure interest rate performance. Instead, we watch the World Bank and other corporates. We try to know the spreads and ensure we get a good spread. Within our portfolio, we match against assets to ensure that the profits we make in our enterprise are not eroded by taking unplanned or irrelevant risks. We also look at productivity standards. I have to improve productivity each year. I am running three debt factories: I have short and long-term debt, and an administrative office that takes care of payments and certain system requirements. I think we cannot measure borrowing performance and I am not sure we should want to.

Jurshevski: Do you not measure portfolio management performance?

Werner: What do you mean by that?

Jurshevski: You have an easier job than us because you have an asset side to march against your liabilities. You basically create currency or interest rates exposures and operate within limits defined by your risk appetite. How well you do in that environment is portfolio management performance. It is entirely analogous to what a bank does with the short-term money market portfolio. They have assets that their treasury funds and they measure their performance.

How do you create a benchmark?

Jurshevski: This is the $64 million dollar question. Our policy is to pay down offshore debt. That's been going on for seven years, so we are dealing with a shrinking portfolio. At the same time, we want to create a minimum-risk portfolio structure because the offshore debt is unhedgeable back into New Zealand dollars. We continue to refine the benchmarking process. The important thing is to have one. If you don't you are at sea without an anchor.

Do you compare yourselves to similarly-rated sovereigns?

Jurshevski: No, that is too simplistic. You must look at it dynamically. If you have a benchmark that says your duration should be x and convexity y, you should measure how well you are tracking relative to that benchmark.

How absolute are your benchmarks?

Jurshevski: We have to separate the domestic and foreign portfolios. On the foreign side, we have a strategic framework that we try to conform to. On the domestic side, it is very difficult to establish any objective way to structure your bond market. It is function of a number of things. It depends on how you define benchmark. You might want to draw a line in the sand or you might like to have a general picture. The general picture is what we have got on the domestic side.

Can a borrower as big as the World Bank find a benchmark?

Lay: We are more interested in the trend. I have a simple job: to deliver the maximum value for the credit over the medium-term. The question is, if I go back five years, where was my paper pricing relative to others with the same credit, and what has happened to that relationship. If you can show an improving trend then you’re getting value for the resources you’re dedicating to your funding operations.

What about GECC?

Werner: We live in a different world, where there is no benchmark to say how we are doing. There is so much luck involved. I certainly have to reduce my costs every year as a percent of my in-place portfolio. That means either that my portfolio grows and I must be very careful in matching up my capacity, or that my portfolio doesn’t grow and my costs must go down. Legal and staff costs are a critical part of that. The organization pays me for the cost of borrowings, but they pay me for a lot of other things too, and I would rather be judged as a manager on the entire range of things that I do, than by some arbitrary outside market benchmark that has much movement and luck associated with it.

Santistevan: I agree we should not have absolute benchmarks. We have an easier job than GECC, because we are similar to the World Bank. We look at spreads relative to the World Bank, but we also look at them over time. Over the last five years, we have experienced a positive trend, because we have become more sophisticated.

Yngwe: Nevertheless, you have to look at how effective each transaction is. Since swaps have become a commodity, you can always use the swap market to find the currency you need. Overall, we measure our performance against US dollar Libor. I guess all of us look at Libor.

Jurshevski: Absolutely, we regularly run matrices on where we can borrow in various currency markets and we identify where it would end up the cheapest. But you have to go beyond that and also credit-adjust the whole thing. The moment you do a swap you are not dealing with apples and apples. Libor minus 10 straight is not the same as Libor minus 10 with a 10-year currency swap because of the counterparty credit risk.

How much does that cost?

Jurshevski: A ten-year cross-currency swap adds more than 10 basis points to the cost dependent on the currency pair and the structure of the swap.

How do you measure risk?

Yngwe: As a rule, we don't take on interest rate risk or currency risk, so we hedge ourselves. In doing so we get a credit risk. You have to look first at the creditworthiness of the counterparty, and then at the volatility of the hedging. We are no Einstein's. We try to have a simple formula to account for this, and plug everything into that formula and out comes a number. It is not a mathematically correct number, but it gives you a rough idea.

Lay: We have put a lot of effort recently into stepping up the sophistication with which we estimate potential exposure. We have a relatively sophisticated Monte Carlo simulation which we use to get a handle on the risk adjustments. Some say this doesn't help because if you use, say, a 95% confidence interval it can create a false impression that you're protected. But used properly it is a way to understand your risk.

Jurshevski: Our thinking runs precisely along the same lines.

Santistevan: We are also measuring risk in transactions, and we apply it against the limits for each counterparty. It is easier for us to manage because we swap less.

Lay: One can hope these considerations become obsolete. If this market moves to what some of us would consider a more realistic basis – marked to market and with frequent margin calls – you come close to simply needing to measure actual exposure. The technology would allow you to call for and respond to margin calls as quickly as in the futures market.

Werner: We are a lot more skeptical of what you call the high-tech approach. How much better is it than a simplistic low-tech approach? We prefer the common-sense, keep it simple approach. I don't know anyone who is losing money on swaps but I am concerned that regulatory requirements will lead us to this high-tech approach. The work necessary to simulate theoretical maximum exposure over the life of the swap is expensive, difficult, and relatively pointless for us. Most of our book is in five-year swaps with strong counterparties. I don't see what we would do differently with a high-tech approach.

Lay: Might it change the way you look at individual transactions?

Werner: Probably not.

Lay: It does for us. We'll be presented with two transactions, the claim for both of which is Libor minus 60. One involves a ten-year yen/Deutschmark swap, the other does not. We run our model which will add a number of basis points to our estimated cost of transaction A relative to transaction B. Operationally, that is the effect.

Werner: That *is* the effect but I not sure how you figure that risk, and how much the cost for the currency swap adds up to. I might miss some good transactions my way, but there is no lack of thought behind it.

Yngwe: I wouldn't say that our approach is very high-tech. With a swapped transaction, there is a difference in risk and therefore a difference in cost, so we should demand something more on the table.

Werner: Very few of our choices are between a pure bond or a swap. More often, there is a bond with a swap associated and the entire package reaches a certain level that we like.

Santistevan: We generally have the option of swap or no swap. We will do the swap only if we save 15 basis points or more. This may look less sophisticated, but the concept remains that we will not take risk if there is no saving.

Jurshevski: There are also implications for utilizing your credit limits which are a scarce resource. Say you have got one opportunity through an MTN which involves three or four swaps, and another in the bond market which involves one swap. You ask how credit intensive the first transaction is relative to the latter. What is the cost differential once you have adjusted for credit intensiveness? Do you want to use your limits up for the more credit-intensive deal? How much compensation do you require in the form of a better price?

How important is secondary market performance as an indicator?

Yngwe: It is hard to say. Involvement with your own issues gives you some knowledge of investor behaviour and you can use that for your next transaction. We buy SEK paper in the market basically when it is too cheap and sell when it is too expensive. How you value that is hard to say. But the single institution that knows best where SEK should be trading is ourselves.

How do others trade their own bonds?

Lay: Yes I can sound pretty extreme on this point, but we each need an horizon for thinking about the performance of our operation, and for us it is a medium or long-term horizon.

Werner: Is it so important that secondary trading in the bonds comes into your personal performance compensation?

Lay: It is not as explicit as that. But primary market price performance is clearly related to investors' expectations regarding secondary market behaviour. Take the global bond programme where we have tried hard to improve the price discovery process. There have nevertheless been cases when the market has mispriced the paper. Our first yen deal came out at JGBS minus 19. Investor consultations and book building set the price, and all the bonds were sold. But the level was unsustainable and we had to dig ourselves out of a hole the next time we came to market with yen transactions. I would have preferred if, in the long-term, the market had come to a more sustainable conclusion.

You must also ask who your customers are. If you do a smaller volume of transactions, you might say your customers are the dealers with robust propriety trading operations who are interested in a trading inventory. Many firms will pay significant amounts for that and it is perfectly legitimate to take advantage of their appetites.

Werner: We don't believe our bond pricing is affected by the secondary market. The fact that our paper is trading at T plus 13 does not mean we can get new issues away at T plus 13. Our customers are the investment banks, the distribution network. What they do with the bonds is their concern.

The World Bank is different from everybody else. They do globals and return to the same investor base, whereas we do 40 or 50 %250 million transactions a year in various currencies and markets and we don't keep on going back to the same investors. I don't care what happens in the relative performance of our three-year Swiss franc bond for the next month if I'm going to issue a five-year dollar bond.

For us the benchmark is what is happening in new issues. We need to look very carefully at other issues by triple-A industrial and financial borrowers in the US and European markets.

Should your compensation be linked to your performance?

Werner: Absolutely. The question is how to define and measure performance. We pay everybody a salary with a large bonus element and the size of the element depends on whether the individual accomplishes a set of objectives negotiated at the beginning of the year. The objectives never include "borrow cheaper." Some of them are programme-related, some of them are project-related, some of them are individual development related. If you achieve, say, 20 of the objectives you will get a lot more money than if you just make one or two. If you make just one or two, you are probably not going to be with us very long.

Yngwe: Do your staff measure these objectives themselves?

Werner: Absolutely. We start now, half-way through the year, and we say, "How are we doing?" [Over the course of the next 12 months] we will drop some of the objectives because the environment changes but some we will keep.

Santistevan: There are differences between the private sector and our public institution. I do not envisage the possibility of private-sector type remuneration. The rewards in our type of organization are of recognition. We would no pay bonuses, but we will reward people, and we will use indicators that are as objective as possible to measure their performance.

At the World Bank, do you pay bonuses?

Lay: I wouldn't dignify them with that term. Within each unit, there is a kitty distributed according to relative performance. It's a very small amount and doesn't result in dramatically different salaries. The interesting thing is that, although the money involved is not great, the staff are very concerned where they stand in that ranking. It is incumbent on us as managers to know our operations objectives and to ensue our staff know what their contribution is expected to be.

Santistevan: it’s the same with us: little money, but much prestige.

Jurshevski: Everybody within the Debt Management Office has performance agreements that tie in directly to the corporate plan. We review progress quarterly, but in terms of compensation there is not much that can come out of that at the end of the year. The targets for these individuals are very stringent qualitative and personal development goals.

Yngwe: Bonuses are one incentive, but there are many others, such as degree of influence in decision making.