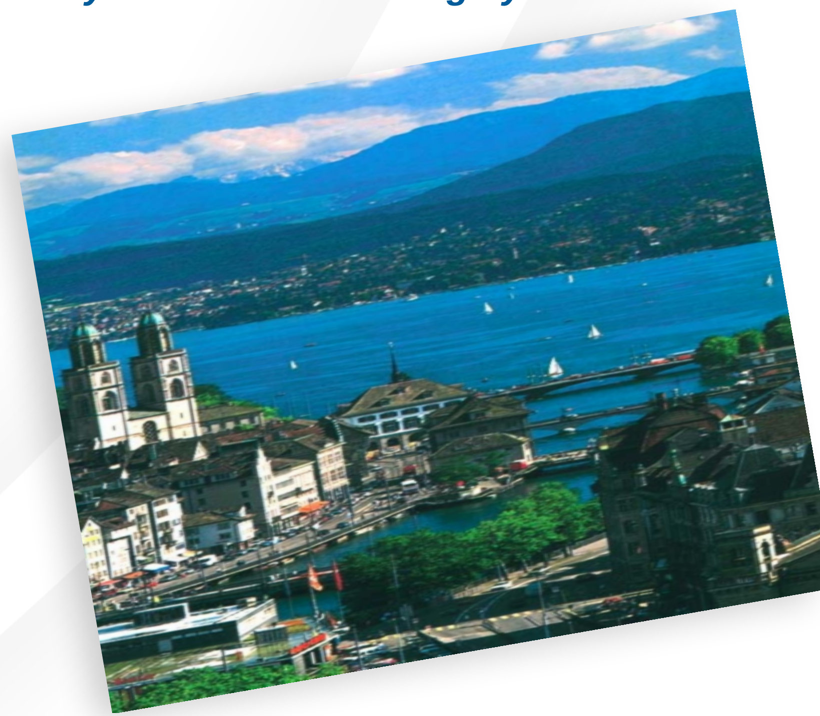
Nordea

# Are the Debt Capacity Effects of Foreign Currency Hedging Real or Illusionary? by Ephraim Clark and Amrit Judge

**Discussion at SNB-CEPR Conference *"Foreign Currency Related Risk Taking by Financial Institutions, Firms, and Households“***
***Zürich September 22-23***



**Fredrik Wilander, PhD**

# Introduction

- **Many reasons for firms to hedge**
  - **Taxes**
    - Direct: tax function convexity
    - Indirect: increasing debt capacity (hedging lowers cash flow volatility)
  - **Pecking – order financing (increasing marginal cost of outside finance) and underinvestment risk**
  - **Managerial risk aversion**
  - **Information asymmetries**
- **When asked, firms respond that limiting variability of cash-flows is indeed important goal of risk management (Friberg & Wilander 2008)**
  - **But that could be for any/all reasons above…**

# This paper

- **Does foreign currency (FC) hedging lead to increased debt capacity?**
  - **This paper: Disentangle effects of FC hedging on debt capacity**
  - **Argues that evidence up until now may be misleading**
    1. FC hedgers may be interest rate (IR) hedgers
    2. Firms can, instead of using derivatives, borrow in foreign currency to hedge FC risk – do not classify these firms as non-hedgers!
    3. Firms with FC debt could have higher leverage due to access advantages and not because of hedging
    4. **Not mentioned:** Reversed causality – do firms hedge to increase their debt capacity or does high leverage increase the need for hedging
- **The authors show that FC hedging effects on leverage come from use of FC debt**

# Comments/feedback to authors

- **Define debt capacity, and relate it to your measure**
  - **Firms may not leverage up to its debt capacity ➔ Measurement error in dependent variable?**
- **Section 2.2: Firms are categorized based on qualitative disclosures**
  - **Do firms have to report hedging for FC, IR or commodity?**
  - **If not, potential misclassification problem (firms may be a hedger even if it does not report it)?**
- **Section 2.3: Nice to see the actual significance levels for t-tests for difference of means between FC derivative hedgers only and non-hedgers**
  - **At what level of significance do we fail to reject the null?**

# Comments/feedback to authors

- **Section 3**
  - **Somewhat unclear methodology: Is this in principle IV - 2SLS (with a probit estimation as a first stage regression)?**
    - If it is 2SLS, we obviously need to select instruments for the first stage regression that are (preferably highly) correlated with FC hedging, but not correlated with leverage (except through the effect on hedging)
    - It would be interesting to see the list of instruments
    - First-stage regression results should in this case be presented in an appendix so we can judge the quality of instruments (strenght, endogeneity tests etc.)
    - If this is something else than 2SLS – explain what
  - **Error term in second stage regression:** states "corrected standard errors" in regression tables
    - Does this refer to taking into account sampling variation from stage 1?
    - Something else? Could be more specific regarding assumptions here