Transaction hedging post-crisis

LLOYDS BANK

Amending existing hedge portfolios and re-hedging in the current market – June 2020

Significant markets movements, collapse in demand and cash flow uncertainty impacting hedge portfolios

With the onset of the COVID-19 crisis around the world, many companies have faced significant changes in their forecast cash flows as large swathes of society and normal economic activity have been shut down – orders have been cancelled or deferred, payments to suppliers have not been required and near term sales forecasts have fallen dramatically for many.

At the same time, severe market movements have meant that companies are now faced with hedge portfolios which are either significantly in-the-money or out-of-the money depending on the 'direction' of the hedge and the asset class involved.

- **Importers**: the weakening of GBP alongside the collapse of previously favourable forward points against other main currencies has meant that existing hedges to buy currency may be significantly in-the-money.
- **Exporters**: conversely, companies selling currency against GBP are likely to have out-of-money portfolios due to the same reductions in spot rates and forward points.
- **Commodities & interest rate hedges**: companies hedging future fuel requirements or those with interest rate swaps in place to fix interest costs are likely to have heavily out-of-the-money positions due to the decrease in the oil (and diesel) price and interest rates. Cross-currency swaps may also be significantly in or out-of-the-money.

Companies have had to consider how best to deal with the impacts of these movements in their portfolios, particularly where hedges are no longer required, forecasts continue to be uncertain and markets remain volatile, and to understand the options available to them – something which many treasurers may not have had to face in the past.

For some companies, **in-the-money portfolios** have provided an additional source of liquidity, either by enabling them to receive cash gains as hedges fall due or by more proactively closing out over-hedged positions in order to receive cash today. Others, which have been less impacted by the crisis have been able to roll these gains forward to improve hedging rates achieved for future periods where forecast certainty allows.

Out-of-the-money portfolios have resulted in increased credit line usage at a time when companies have been using available lines to draw down additional liquidity from their banking groups. This has made it more difficult for companies to take advantage of market levels which they perceive to be attractive to hedge exposures over future periods when cash flows and requirements may be more certain – hedging future fuel purchases at historic lows or fixing portions of existing debt or future financing requirements at historically low interest rates. It has also meant that companies have had to determine how to utilise their available credit limits most efficiently as market volatility continues.

What options are there for dealing with existing hedges which are no longer required?

	Description	Details & considerations
Leave in place	Leave hedges to mature as they fall due	► Avoids immediate cash in/out flows. May not be in line with policy where underlying cash flows are no longer expected, however, trades could be seen as partial term hedges of more certain flows in later periods.
Terminate	Close out hedges for cash	► Future hedge cash flows are present valued to provide a close out amount, i.e. an upfront cash amount in base currency (e.g. GBP) paid to settle out-of-the-money hedges or received on in-the-money hedges. ► In-the-money trades: termination provides a source of liquidity while closing out over-hedged positions. Funding charges applied in determining cash amount may be similar to other sources of liquidity. ► Out-of-the money trades: companies under liquidity pressure may prefer to roll forward or restructure hedges, deferring cash outflows to future periods.
Roll forward	Roll forward hedges at current market rates to new forecast date	► FX swaps can be used to roll existing FX forwards to a future date, effectively extending their maturity. ► Avoids an up-front foreign currency cash requirement. Instead, the fair value of the original hedge is settled in base currency terms (e.g. GBP) on its original maturity date. ► Requires available credit line as maturity of hedges is extended. Roll forward is subject to current pricing which is likely to capture increased market volatility and funding, credit & capital costs for banks.
Roll forward (HRR[1])	Roll forward hedges at historic rate to new forecast date	► As above, however, hedges are rolled forward at the historic hedge rate rather than current market rate. ► No initial cash impact. All hedge cash flows are deferred to the new maturity date. Provides a means of deferring cash settlement of trades when liquidity is constrained. ► Higher credit line requirement vs. 'vanilla' roll forward due to the deferral of out-of-the-money position. As above, subject to pricing based on current market conditions.
Restructure	Restructure existing hedges to spread existing fair value across new (longer) hedge period	► Instead of rolling forward existing hedges individually as they fall due, a series of FX or commodity transaction hedges or interest rate hedges can be restructured in a more proactive manner. A common example is a 'blend & extend' of existing hedges across a longer maturity period. ► For example, a company may have outstanding monthly FX or diesel hedges in place for months 1 to 6 that are no longer required and which are out-of-the-money. ► In order to (i) lock in current market rates for future periods when requirements have normalised, and (ii) avoid an immediate cash outflow, the company could restructure the trade to hedge months 7 to 18, blending the fair value of the old hedges into the rate achieved for the new, extended period. ► This approach is also commonly used by companies hedging interest rate risk – extending the maturity of existing interest rate swaps while reducing the running cash interest rate payable.

Source: Lloyds Bank analysis; Notes: (1) 'HRR' refers to Historic Rate Rollover

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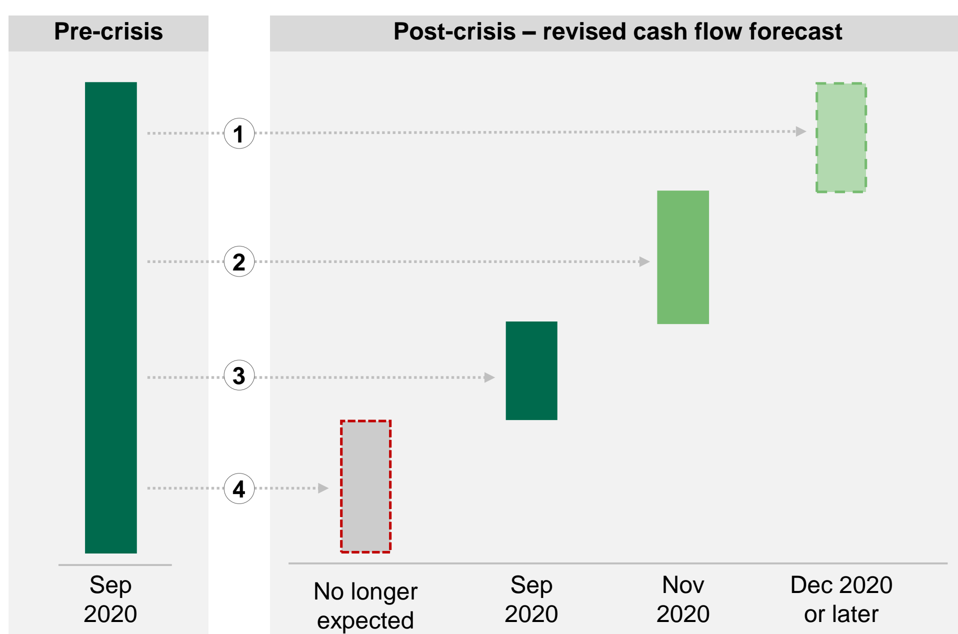
What are the IFRS or UK GAAP accounting implications of terminating or amending existing hedges?

Many companies apply hedge accounting to their FX, commodity and interest rate hedges in order to reduce income statement volatility. For these companies, the accounting impact of terminating or amending existing hedges to deal with dramatically changed forecasts is often something which needs to be understood prior to proceeding.

Key hedge accounting principles

- The accounting impact of changes in forecasts of future cash flows and of terminating or amending existing hedges does not necessarily follow the cash impact.
- Hedge accounting can generally continue where the underlying hedged cash flows continue to be 'highly probable'[1] and the hedging instrument remains in place.
  - In relation to the latter point, for transaction hedges, the hedging instrument can often be rolled forward to a later forecast date without terminating the existing hedge relationship. Some companies include 'rollover' language in their hedge documentation to specifically allow for this outcome.
- If the hedged cash flows are no longer highly probable, the hedge relationship is terminated as the criteria for hedge accounting are no longer met. In this case, whether there is an immediate impact on Profit & Loss ('P&L') depends on the underlying hedged cash flows rather than on what happens to the hedging instrument.
  - If the hedged cash flows are still expected to occur (i.e. a lower hurdle than 'highly probable'), there is no immediate release from the cash flow hedge reserve, even if those cash flows are now expected to occur at a later date.
  - If the hedged cash flows are no longer expected to occur, the portion of the hedge reserve that relates to this hedge must be released immediately to P&L.

These principles have been illustrated in the example below. The diagram shows an amount of USD cash flows originally forecast to occur in September 2020 which had been hedged using FX forwards with hedge accounting applied. The impact of the crisis on forecasts is shown in the 'post-crisis' diagram alongside the hedge accounting outcome.



Hedge accounting considerations

1. No longer highly probable; hedge relationship terminated. Cash flows are still expected to occur at a later date, so no immediate release to P&L. Company may wish to terminate hedging instrument rather than roll it forward if revised timing and amounts are not sufficiently certain.
2. Remains highly probable; now expected to occur 2 months later than originally forecast. Hedge relationship can continue. Hedging instrument could be rolled forward to Nov. 2020 while maintaining hedge accounting.
3. This portion remains highly probable with no change in timing. The existing hedge relationship continues as before assuming the relevant portion of the hedging instrument is left in place.
4. No longer expected to occur, even at a future date. Hedge accounting terminated. Amounts deferred in the cash flow hedge reserve released immediately to P&L. Company may wish to terminate the hedging instrument to avoid P&L volatility from a non-hedge accounted derivative.

Note that the hedge accounting outcome may be subjective in practice.

Challenges and opportunities for hedging in the current market environment

For companies which have been materially affected by the crisis, the past few months are likely to have been spent 'fire-fighting' – renegotiating existing facilities, arranging new sources of liquidity, updating cash flow forecasts and scenarios regularly and restructuring existing hedge portfolios for the new reality.

Now that the initial stages of the crisis are passing and economies start to relax lockdown measures, we are beginning to see a tentative return to 'BAU'[2] transaction hedging from such companies, including hedging over longer periods in some cases. In addition, companies in sectors less significantly impacted by the crisis, and indeed, in which demand may actually have increased (e.g. supermarkets) have in many cases continued to hedge their forecast exposures throughout the past few months.

Regardless of which camp a company falls into, treasury teams that want to take advantage of current market opportunities to hedge are having to deal with the challenges of the uncertain environment. Some of the main considerations in doing so are outlined below.

Key considerations of hedging in the current market

- Companies may consider current market levels to be attractive: low fuel prices; perceived weak GBP and low forward points for exporters; low interest rates and flat curves providing opportunity to hedge or pre-hedge future interest costs.
- However, ongoing forecast uncertainty remains a key issue for many.
- Credit line availability may have reduced due to existing hedges, drawings on bank facilities and bank appetite due to perceived credit deterioration.
- Market volatility increased notably in the early weeks of the crisis in many asset classes although has now abated to an extent.
- These factors feed through to banks' pricing and risk models which may mean higher charges and greater credit line usage for the same instruments vs. pre-crisis.

Hedging approaches to consider

- Review hedging strategy across asset classes: a more proactive and flexible approach is likely to be required to deal with continued uncertainty and volatility.
- Work with banks to understand credit limits available and credit line usage of different instruments to determine the most efficient approach.
- Consider hedging longer-dated exposures on a rolling, partial-term basis or providing cash backing for hedges to deal with credit limit issues. Breaks can be included in longer dated interest rate hedges to reduce charges and credit usage.
- Consider using purchased options to deal with uncertain forecasts and to provide protection from adverse market moves without having an obligation to deal. This also frees up credit line for other hedging instruments.
- Monitor markets proactively to take advantage of tactical opportunities; use banks for market updates and commentary; consider using orders to capture favourable short term movements as volatility continues.

Please note that Lloyds Bank does not provide accounting advice. Please consult your auditors or advisors as appropriate.

Source: Lloyds Bank analysis, Accounting standards (IFRS 9 & FRS 102); Notes: (1) 'Highly probable' refers to hedge accounting requirements; (2) 'BAU' means business-as-usual

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Conclusion & further information

Dealing with the level of changes and uncertainty in forecasts and operating cash flows that has been seen over recent months is something that many corporate treasurers are unlikely to have faced in the past. Understanding the options available for amending existing portfolios and for developing hedging approaches as forecasts become more certain and market opportunities open up is important in the current environment.

For further details of how hedge portfolios and strategies can be amended to deal with the new, post-crisis reality or on any of the information presented in this note, please contact your Lloyds Bank relationship manager, your usual Sales contact or use the contact details below.

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Source: Lloyds Bank analysis