FX HEDGING PROGRAM
COVID-19 CHECKLIST
Impact of Coronavirus on Hedging Operations and Markets

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Coronavirus, with its impact on markets and business operations, presents an unprecedented challenge to investors managing FX exposure. *Extreme market volatility has combined with operational challenges and counterparty risks to create a truly unprecedented situation.*

It is our job to help our clients navigate these challenging conditions. We have put together a short checklist for our clients covering the main issues that we will be focusing on in light of the unusual and fast-moving conditions.

The purpose of this document is to highlight the areas we feel are, or could be, the most impacted; we describe our experiences to date and our approach to five important issues:

- Operational risk
- Counterparty risk
- Credit Availability
- Counterparty Onboarding
- Hedging Costs

I. OPERATIONAL RISK

What’s happening?

Many organizations are implementing working from home (WFH) policies where either all staff, or a significant proportion are working remotely. Amongst our client base, the majority have either implemented or are about to implement such procedures. So far, the impact on hedging operations has been minimal, but it is worth considering whether any issues could arise (especially if remote working extends for several weeks) in order to address them proactively.
Why is it important?

Areas that could potentially be impacted by WFH policies include:

- Trade approvals / signoffs
- Communication surrounding hedge adjustments / settlements (new deals, rolls etc)
- Trade execution (e.g. electronic trading access)
- Market pricing transparency

What can we do about it?

- For trade approvals / sign-offs, it is prudent to ensure that the necessary authorized signatories will be available to provide approvals as required. In cases where physical signatures may be required (e.g. historical rate rollovers, some confirmations) ensure this capability is enabled for remote working.

- Regarding communication for hedge adjustments, we suggest allowing for more time to enable adjustments to occur (due to internal constraints as above and potential similar constraints with banking counterparties). At Validus, we are generating daily trade and settlement reports for maturities and rolls for all clients using our trade execution service – if you would like to receive these reports and you are not already doing so, please speak with your Validus contact person to arrange. This information is also accessible via the Validus RiskView platform, if you subscribe to this service.

- The Validus trade execution desk is fully operational, even should a 100% WFH strategy be required. We have full trading capability from our three offices, all trading staff working from home have access to our trading system and market data through our VPN, and all voice trades will be recorded, even if traders are working remotely. For clients who manage some or all of the trade execution process internally, trading systems and market data access should be configured to enable remote trading.

II. COUNTERPARTY RISK

What’s happening?

Equity markets have recently plunged, with the S&P500 dropping 12% in its biggest one-day fall since Black Monday in 1987 as the US and other countries toughened containment measures and extended restrictions on public movements to curb the spread of COVID-19. Meanwhile, major central banks have announced emergency rate cuts and additional QE in an attempt to counter the economic shock of the virus. Global banks have most certainly been affected by the recent global developments and negative sentiment over the financial sector continues to build and is exacerbated by the risk of a recession which is likely to weaken demand and increase credit risk. Both US and European banks have seen their market cap plummet, especially following a
major selloff in equity markets in the past few days. The KBW Bank Index has dropped 45.3% since Jan-20, while European bank shares now trade at their lowest level since the 1990s.

Although banks are likely to come under pressure as the economic shock of COVID-19 starts to materially surface, it is important to note that banks have stronger buffers today than they did back in 2008 in terms of capital and liquidity, which helps alleviate the counterparty risk.
**Why is it important?**

Rising counterparty risk implies a greater chance that the protection provided by an FX hedging portfolio may be eroded if the counterparty is unable to fulfill its obligations. Focus should be on current material unrealized hedging gains and / or upcoming trades.

**What can we do about it?**

- Review all current positions and associated counterparty exposure. **Validus is preparing counterparty risk reports for all trading clients highlighting current counterparty risk exposure and risk assessment.**

- Trade allocation decisions should consider counterparty credit worthiness and current (and potential future) exposure.

- If current counterparty exposure is deemed excessive, it may be worth considering **novating** trades to another counterparty or **re-striking** trades to monetize unrealized gains and reduce exposure. Such measures should be discussed with the relevant bank, and any relationship considerations should be taken into account.

- Adding counterparties should be considered if there is a high concentration of counterparty exposure to a given bank.

**III. CREDIT AVAILABILITY**

**What’s happening?**

**New FX Trading Lines**

In times of stress, there is always a risk that the banks will have a reduced appetite to extend credit for new funds or additional capacity for existing entities. It is also possible that banks may become more selective with any credit they do extend. Although, at the time of writing, we haven’t seen this manifest in a significant way, there is a risk if current market conditions continue to worsen that funds may find it more difficult to find counterparties and enjoy the same limits and level of credit that they have been accustomed to.

**Existing FX Trading Lines**

We have begun to observe banks looking to ‘right size’ credit lines in this environment, by reducing the lines for those clients who haven’t been using them, so that they can apply them to clients they do business with. Higher volatility increases the Probable Future Exposure (PFE) for trades, so the banks want to make sure...
they can accommodate flow. It may also become more difficult to secure some of the most credit intensive lines and products such as historical rate rollovers (HRR) and very long-dated tenors. We have seen at least one bank decline to roll a trade on HRR basis this week due to market conditions.

**Why is it important?**

For new funds and / or existing funds, current market conditions means there is a rising probability hedging may become constrained or restricted due to tightening credit conditions.

**What can we do about it?**

**CSA / Non-CSA Lines**

Non-CSA lines are always a risk in times of stress because the limits are more opaque compared with a CSA threshold. For clients trading via the Validus execution desk, we will speak to banking counterparties to check all thresholds and daily settlement limits. If the fund’s exposure is expected to increase (for example those in the early stages who are expecting to deploy capital very quickly or with a short hold period & heavily reliant on recycling of capital), we will model these exposures and assess capacity. This is particularly important if your fund is heavily reliant on one (or two) counterparties and trading under a non-CSA line. In this case, it might be worth considering additional counterparties even as a contingency.

**ATE Monitoring**

Most funds have some form of NAV or other performance-related triggers in their ISDAs. In times of stress, there is an increased risk that banks will be looking for reasons to terminate certain lines. For clients using our execution service, we’re already conducting regular testing but can also undertake some more in-depth stress-testing if you have assumptions you’d like us to test. In addition, we have recently developed a new ATE Tracker Module for the RiskView application which monitors and stress-tests these thresholds to ensure full transparency and compliance.

**IV. COUNTERPARTY ONBOARDING**

**What’s Happening?**

Given that many organisations (banks included) have now implemented remote working policies, as teams within banks fragment, it will be prudent to allow more time for the onboarding process. Onboarding requires significant input from a wide variety of different individuals, from AML/ KYC teams to regulatory teams, credit committees and FX front-office contacts. At the time of writing, we haven’t encountered any
significant issues, although there is a pertinent risk that onboarding times could increase, if staffing numbers were to drop significantly.

**Why is it important?**

This is a key risk particularly for both new & existing funds, with complex structures with a series of SPVs and hedging on a deal-by-deal basis, who need to set-up lines and hedge deals quickly.

**What can we do about it?**

We would recommend allowing more time than usual to onboard new entities. We are also keeping open and regular communication with both banks and clients in case any unforeseen delays are encountered.

**V. HEDGING COSTS**

**What’s Happening?**

**Transaction Costs**

Due to the increased volatility, intraday liquidity is very thin – trades as small as USD 5 million can move the market in normally liquid pairs like GBPUSD. **Depending on the currency pair, the bid/offer spread on spot is 4-10x wider than in normal conditions.** One major international bank quoted 50 million GBPUSD 40 pips wide, and has “struggled to get out flat on more than one trade on that spread.” In addition to the increased volatility which results in wider bid/offer spreads, many senior traders are now working from home, which reduces the risk taking, and therefore the risk appetite in the market. Some currencies are impacted more than others - all energy-currencies like CAD, NOK are seeing very large spikes in volatility, and therefore they are being priced much wider on a relative basis.

**Credit Costs**

From a credit perspective all of the banks we have spoken to have indicated that they are open for business, but that CVA charges are far wider due to volatility (as volatility is a determinant of Probable Future Exposure, which in effect represents the bank’s credit risk). **Currently, we are seeing a significant increase in CVA charges, anywhere from 20% to 100% depending on the bank.**
Carry Costs

Forward points are determined by interest rate differentials and cross-currency basis. The recent dramatic cuts by the Fed have significantly narrowed the interest rate differential between the USD and other major currencies like EUR and GBP.

The following table shows the changes in carry (and hedging costs) from the start of the year until now (19th March):

<table>
<thead>
<tr>
<th>Currency Pair</th>
<th>Carry (Start of the Year) (3M / 12M)</th>
<th>Carry at March 19 2020 (3M / 12M)</th>
<th>Change in Carry</th>
</tr>
</thead>
<tbody>
<tr>
<td>EURUSD</td>
<td>226 / 226</td>
<td>188 / 129</td>
<td>-17% / -43%</td>
</tr>
<tr>
<td>GBPUSD</td>
<td>100 / 96</td>
<td>95 / 31</td>
<td>-5% / -67%</td>
</tr>
<tr>
<td>GBPEUR</td>
<td>-125 / -127</td>
<td>-92 / -96</td>
<td>-26% / -24%</td>
</tr>
</tbody>
</table>

*Carry Calculated as annualized basis points based on 3-month / 12-month rolling hedging program*

*Source: Bloomberg*

Basis

FX forward points are theoretically a measure of the interest rate differential between the two currencies in question. At the moment, due to the demand for USD funding, people are buying for spot and selling USD forward via the FX forward market in order to get the USD they need. In EURUSD this means that while they buy and sell USD, they are selling EUR for the spot date and buying EUR for the far date.

The basis is a measure of how far the demand for USD funding has pushed the forward rates away from their theoretical values. During the Global Financial Crisis in 2008, the USD demand pushed this out as far as 210 basis points – earlier this week we saw this basis go above 100 bps, although this has since narrowed slightly as the Fed continues to add liquidity to the funding market.

The impact on FX hedgers is that in the short dates, the forward point pick-up/cost is greater than it otherwise would be. Great news for those selling EURUSD forward, not so good for those buying EURUSD forward.
Why is it important?

The management of hedging costs is a critically important part of an FX hedging strategy. Without careful management and control, hedging costs can eat into fund performance and outweigh the positive risk-reducing effect of the hedging program. This is true in any environment, but in extremely volatile and illiquid markets like those we are currently experiencing, hedging cost management becomes even more critical.

What can we do about it?

- As spreads and credit charges increase with volatility and declining liquidity, it is critical that pricing is carefully evaluated and benchmarked. Our trading desk regularly handles more than $12 billion in hedging transactions per month, dealing with over 50 banks on behalf of hundreds of private capital fund entities. As such, we are well placed to ensure transaction and credit pricing remains fair for our clients. For clients who trade via our execution desk this happens automatically; for clients who trade independently we can work with your internal teams to ensure fair pricing if required.

- Current market conditions make it more difficult to negotiate pricing. In addition, pricing discrepancies between counterparties will increase to reflect individual bank positions - bank traders will be told to reduce risk in this environment, so risk-reducing trades will be priced aggressively, whereas risk-additive trades will be priced wide, to reflect the lack of appetite by the bank. As such, an increasing proportion of trades will benefit from a competitive bidding process rather than bilateral rate negotiation.

To Conclude:

We are now in unprecedented times, and risk management is more important than ever. For those that are already managing FX exposures by way of hedging, the current situation warrants a close monitoring of the risks highlighted in this document as well as a potential operational review. For those that are considering implementing FX hedging (or indeed any risk mitigation through financial instruments) the topics in this document will be important considerations as such programs are rolled out. The key takeaway is that, similar to the global financial crisis more than a decade ago, the evolving macro conditions are causing financial markets significant amounts of stress and the machine is suddenly not as well-oiled as we have become accustomed to. This means “business as usual” no longer applies, and firms should pay close attention to their risk management activities as these may be under close scrutiny now, and perhaps even more so after the dust has settled.

We remain committed to guiding our clients through the situation as it evolves, and are also available to speak to others who want to discuss the topics of this document in more detail.