Financial Risk Management in Today's Volatile Market

AFP Nashville

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Chatham
FINANCIAL

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Today's speakers

Mike Burns

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Mike Burns is a Director on the Corporate's Treasury Advisory practice providing financial risk management services to Chatham clients. Mike works with management teams from family firms to the Fortune 500 to design, implement, and operate commodity and foreign currency hedging programs. His clients span industries including information technology, healthcare, consumer discretionary and staples, industrials, energy and materials. Prior to Chatham, he served in the U.S. Navy as a Nuclear Surface Warfare Officer where he deployed five times during OIF/OEF. Mike earned his B.S. in applied mathematics from the United States Naval Academy and his MBA from the Wharton School at the University of Pennsylvania. He also holds a Master of Engineering Management from Old Dominion University.

Sean Marcellus

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Sean Marcellus is a Director on the Corporates Hedge Accounting Advisory team. He provides risk management solutions for corporate clients by helping them achieve and maintain hedge accounting for interest rate, foreign currency, and commodity risk. Previously, Sean worked in public accounting at RKL, LLP auditing financial institutions. He graduated cum laude from West Chester University with a B.S. in Accounting.

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Financial risk management solutions that take your organization further

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$6.6 trillion hedged notional since 1991

3,000+ clients around the world

200,000 end-of-day valuations run nightly

3,000+ ISDAs reviewed annually

Seven global offices

600+ employees

Access unequalled expertise that spans industries

Unlike most financial risk management companies, we offer advisory and technology services across a wide range of industries. This provides us with a broader perspective and allows us to see the marketplace on a macro-scale.

Corporates

Real Estate

Financial Institutions

Private Equity and Infrastructure

Services:

Interest rate, foreign currency, and commodity hedging

Hedging execution and processing

Hedge accounting

Derivative and debt valuation

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ISDA review and negotiation

Defeasance and yield maintenance

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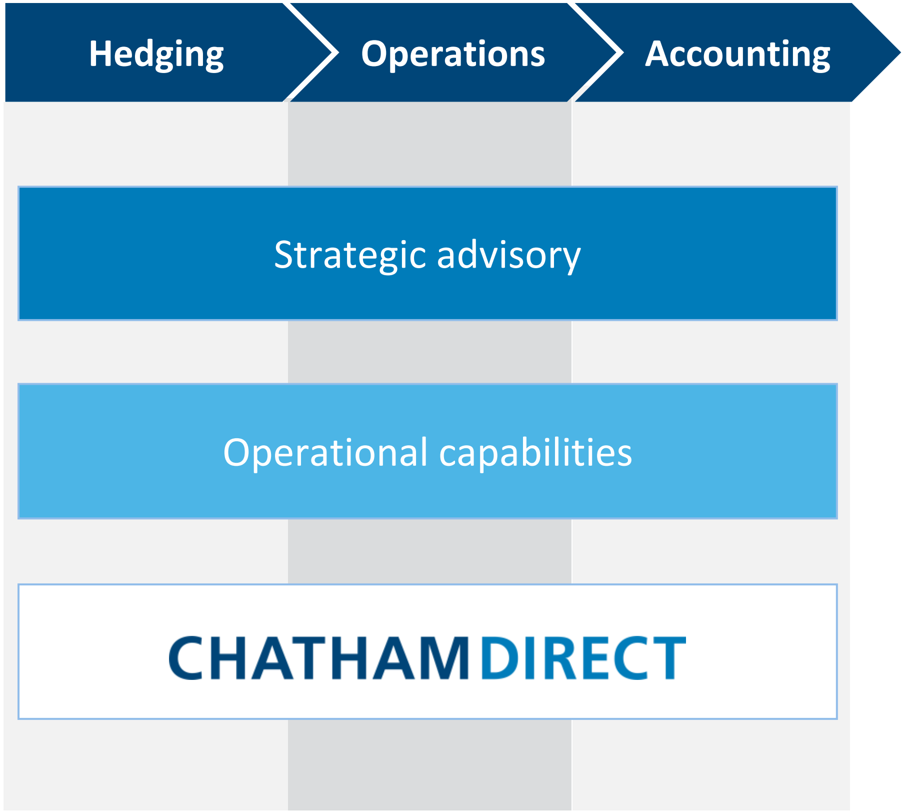
Integrated advisory, operations, and technology for financial risk

Partnership that propels you forward - Chatham partners with your team, leveraging a unique mix of advisory, operational capabilities and technology so you can manage risk better and take advantage of opportunities.



Solutions for FX, Interest Rate, and Commodity Risk:

Hedging advisory

Hedge execution

Hedge accounting & valuations

CHATHAMDIRECT™ for treasury risk management

Derivatives compliance

ISDA advisory

Agenda

Learning objectives:

- Understand how recent fiscal and monetary changes are driving the interest rate landscape
- Discuss trends in current interest rate hedging strategies
- Define key strategic questions that will inform managers of the appropriate risk decisions and trade-offs

Quick LIBOR-SOFR update

Questions

Economic and market update

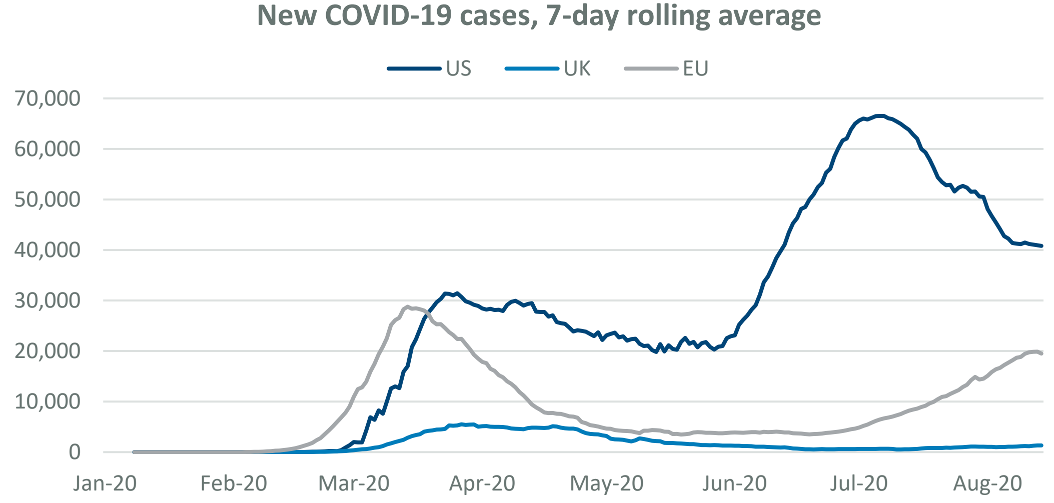
Poll question 1

What areas are getting the most attention in your organization related to the following policy actions or financial markets?

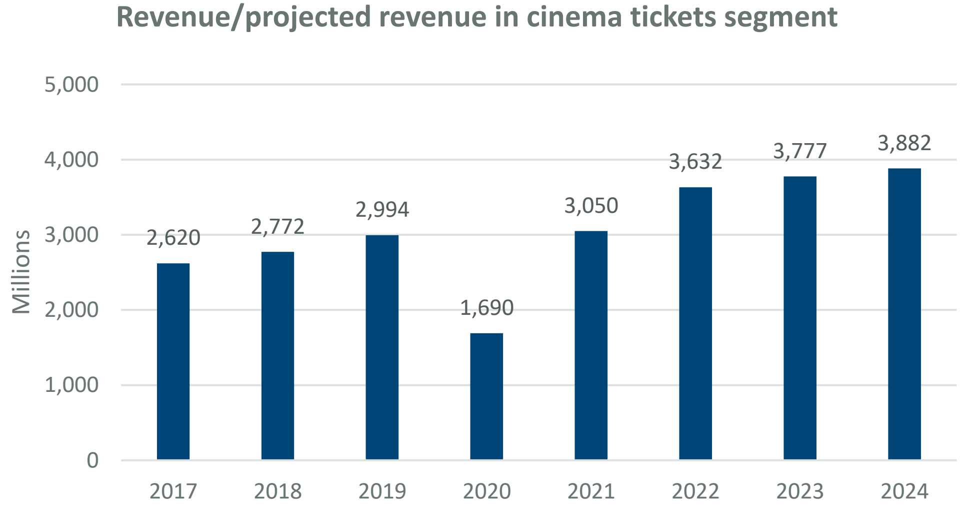
Select all that apply:

A. US and global fiscal stimulus
B. US and global monetary policy
C. Equity and corporate credit markets
D. Interest rate markets
E. Foreign exchange markets
F. Commodity markets

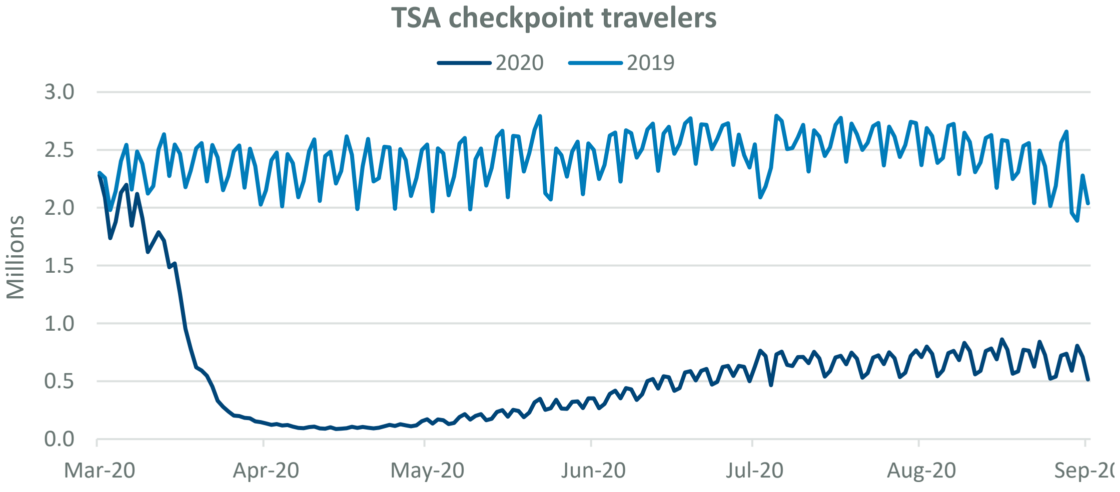
Economic and market update



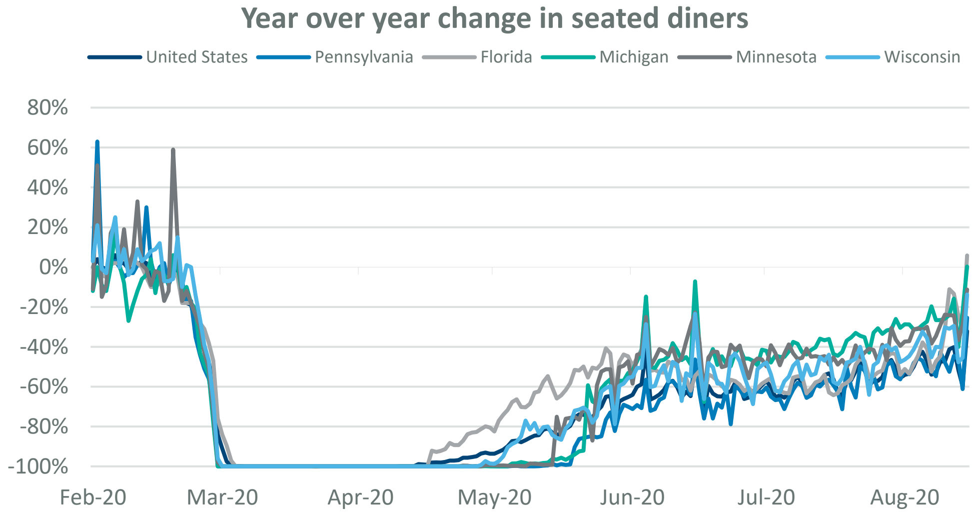
Source: World Health Organization



Source: Statista

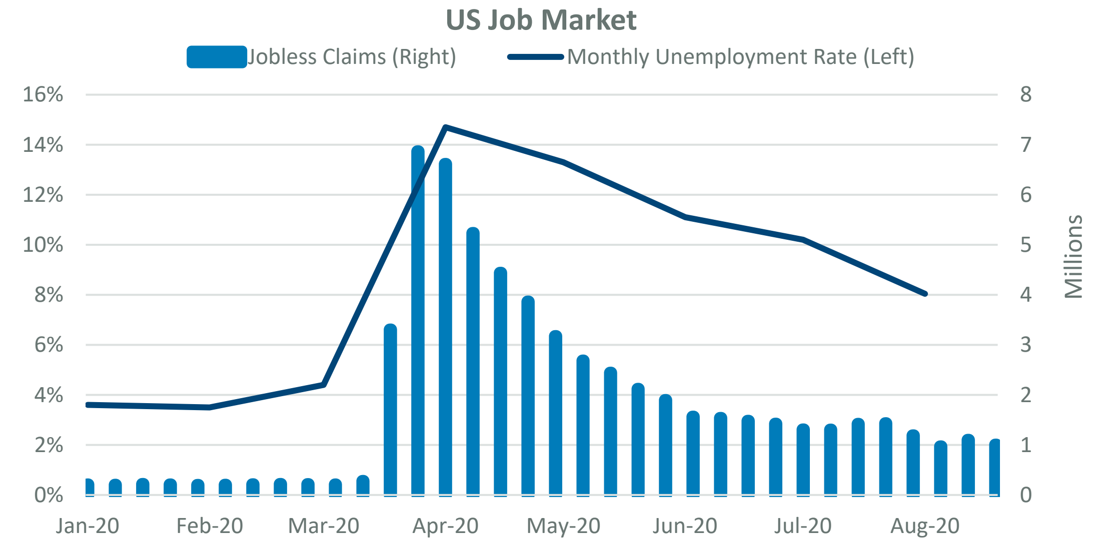


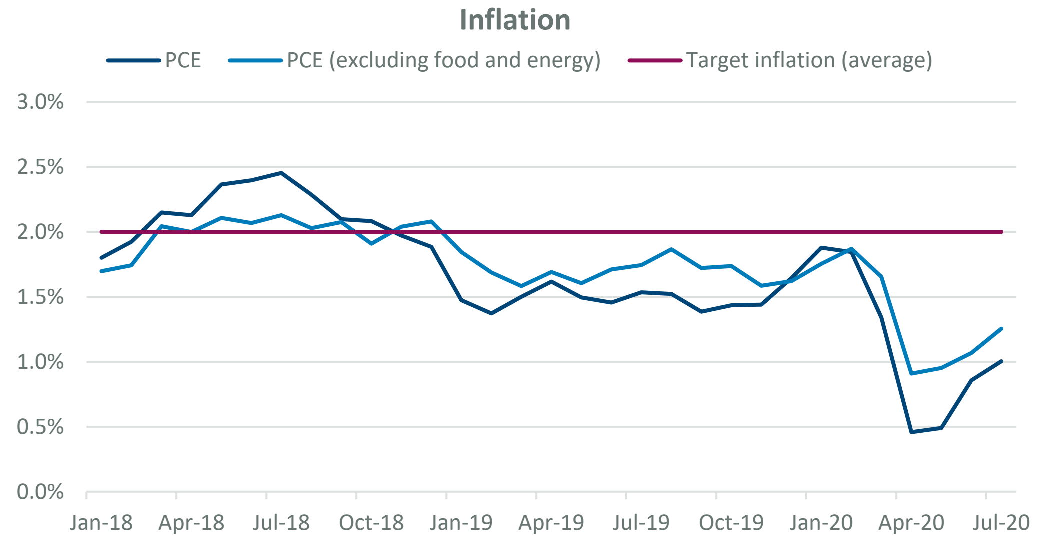
Source: TSA.gov

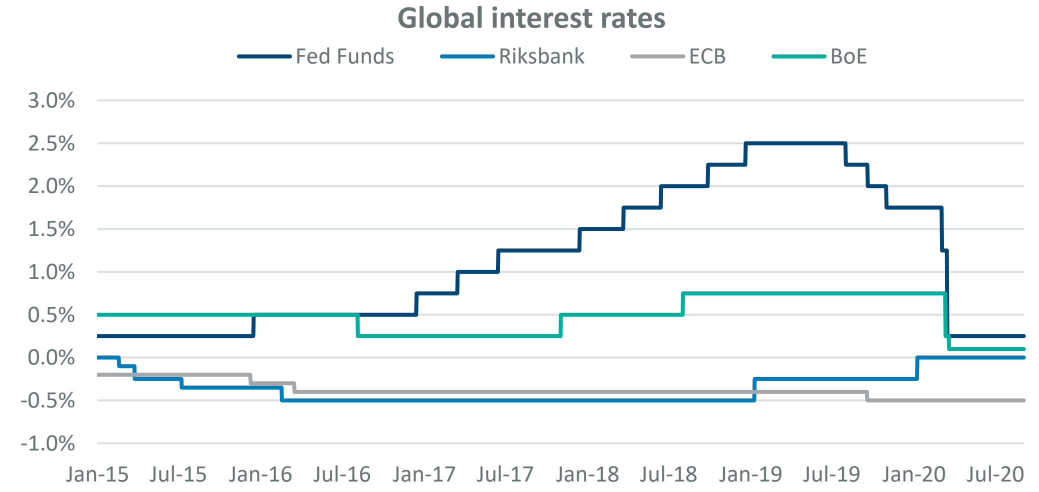


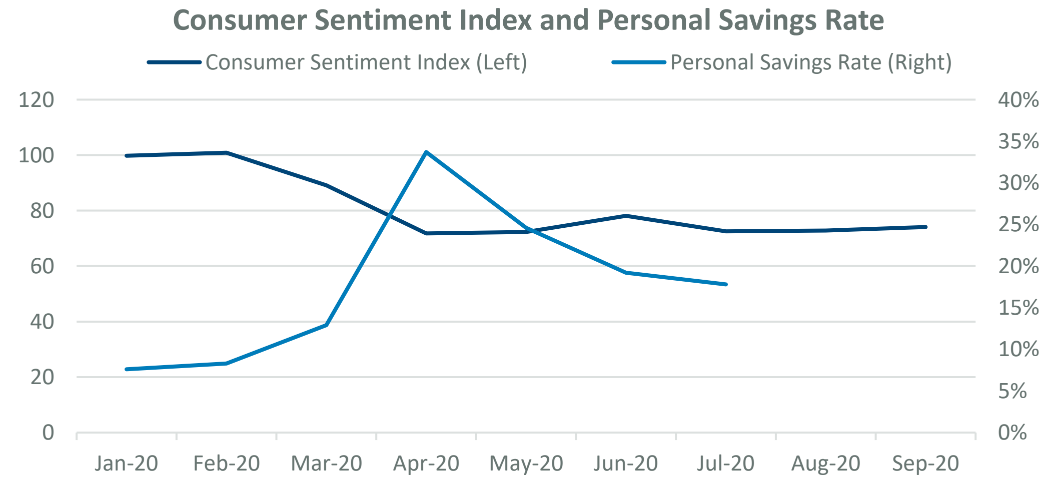
Source: Open Table

Economic and market update









List of monetary and fiscal policies taken

United States

Monetary policy

Fiscal policy

Executive order

Mar. 3
Fed cuts interest rates by 50 basis points

Mar. 15
Fed cuts interest rates by 100 basis point, bringing Fed Funds Rate to 0-0.25%

Mar. 15
Fed pledges $700 billion in asset purchases.

Mar. 23
Fed promises unlimited QE, including purchases of corporate bonds

Mar. 27
Congress passes a $2.2 trillion aid package

Apr. 9
Fed announces $2.3 trillion effort to bolster local government and mid-sized businesses

Apr. 16
Paycheck Protection Program runs out of funding

Apr. 23
Congress passes additional $484bn stimulus package.

Jun. 8
Fed expands Main Street Lending Program.

Jul. 4
PPP extended through August 8, 2020.

Jul. 28
Fed extends all emergency lending programs through 2020.

Aug. 8
POTUS signs order to extend pandemic relief after Congress fails to reach stimulus deal.

Aug. 27
Fed announces it will target 2% as an average rate of inflation

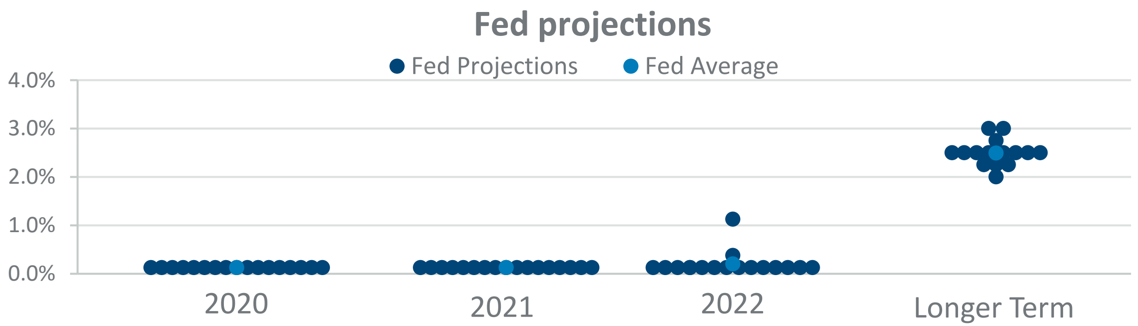
Source: Reuters, Peterson Institute for International Economics, FRED

The Federal Reserve

What's next?

Actions taken by the Fed

- Dropped fed funds target rate to 0-0.25% in March
- Continuation of 9 different lending programs
- Provided a new consensus statement on the interpretation of their congressional mandate in August



Latest dot plot from June 10th FOMC meeting

Topics of interest going forward

Negative rates

- *"The committee's view on negative rates really has not changed. This is not something we're looking at" – Chairman Powell*
- Europe and Japan continued to struggle (pre-COVID19) since implementing negative yields across the duration curve of their government bonds.

Average inflation targeting

- On August 27th Chairman Powell announced the Fed unanimously agreed to target an **average of 2% inflation**, rather than the standard 2%
- This change implies that the Fed will allow inflation to "moderately" exceed 2% "for some time" after periods of weakness
- The goal of the new approach is to raise longer term expectations and allow inflation to float higher even as rates remain low

Employment mandate approach

- *"Our revised statement says that our policy decision will be informed by our 'assessments of the shortfalls of employment from its maximum level' rather than by 'deviations from its maximum level' as in our previous statement." – Chairman Powell*

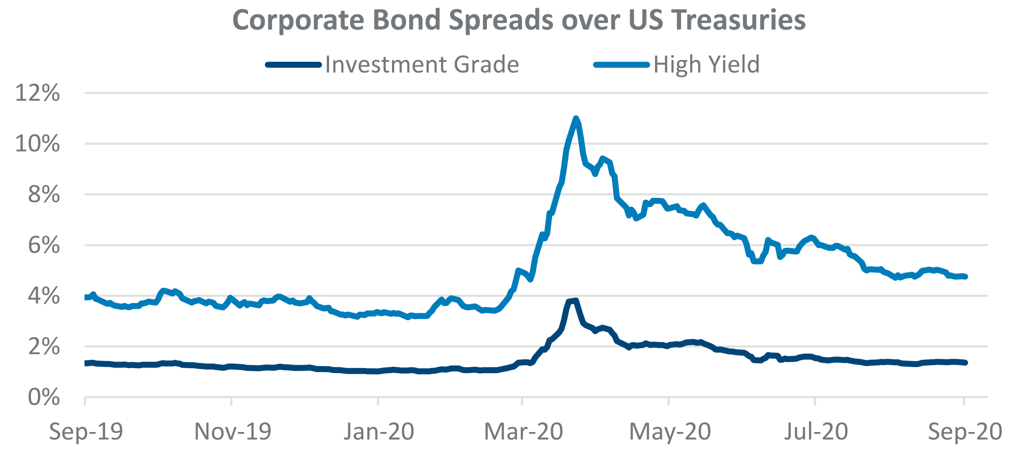
Hedging in the current interest rate environment

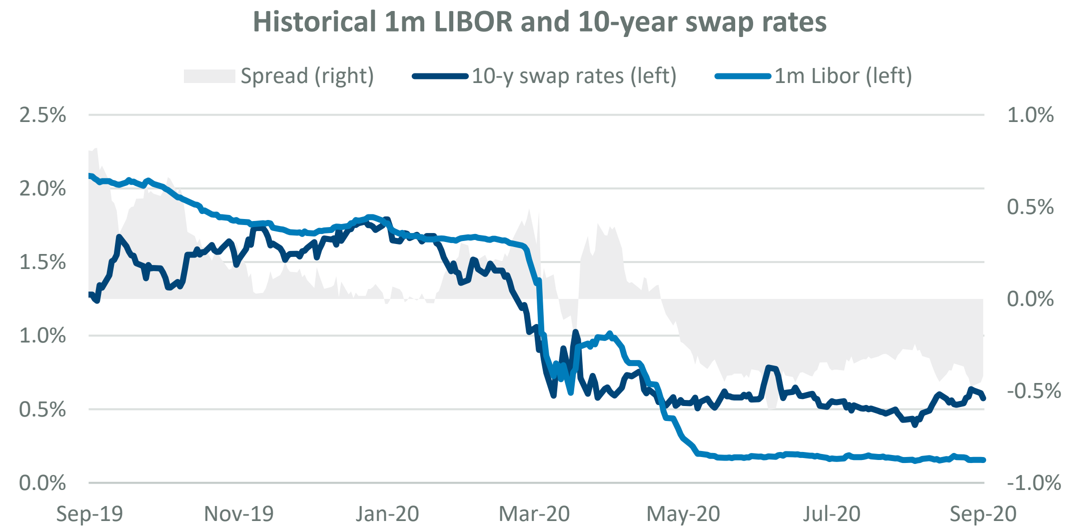
Overview

- Recent COVID-19 related events have resulted in lower base rates, countered by increased credit spreads
- Over the past three months both 1m and 3m Libor have continued to drop and remain at relatively low levels

Strategies for current economic environment

Increasing fixed-to-float ratios	Forward hedging to renew maturing swaps/extend-and-blend trades if applicable
Forward hedging with cash settled swaps in anticipation of further debt issuance	Locking-in the benefit of lower interest rate payments





Market data as of 9/02/2020

Current trends in interest rate hedging

Poll question 2

Which of the following topics have generated discussion in your organizations in the current market environment?

Select all that apply:

A. Cash-management / liquidity planning
B. Restructuring existing hedge portfolios
C. Floors in debt or derivatives
D. Bond issuances / pre-issuance hedging
E. Changes in policy (products, target fixed-floating mix, risk tolerance)

Locking in lower interest-expenses

Extend-and-blend strategy

Corporates with existing pay-fixed swaps could potentially benefit from hedges that are currently liabilities by adopting an extend and blend approach. This hedging strategy allows companies to extend the liability over a longer period than the original term. The overall value of the swap remains the same, but cash flows are spread out over the new time period.

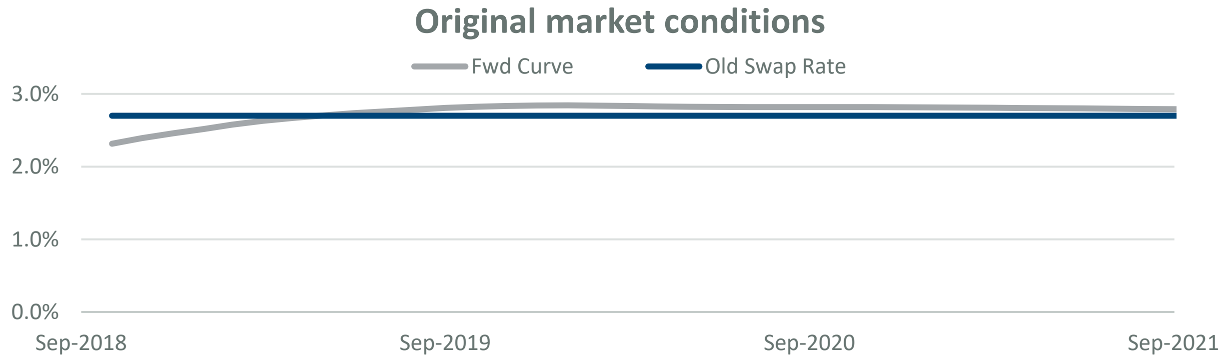
Advantages

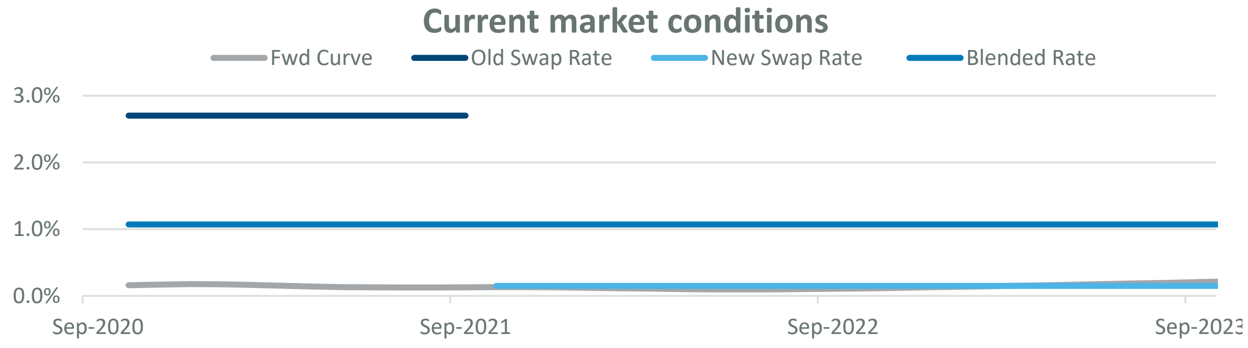
- For swaps that are liabilities, cash payments immediately decrease
- Liability on current swap is effectively reduced to near zero
- The long-term swap rate provides protection through the end of the new term
- Lower swap payments over time provide companies with increasing liquidity, freeing up cash for other financial activities

Additional considerations

- Extend and blend is considered a hedge accounting de-designation/re-designation event
- Offers less visibility into pricing and costs than entering a new swap
- The decline in payments will not be recognized in the income statement at the same time they occur

Extend and blend example – 3y swap in 2018 vs 2020





Market data as of 9/02/2020

Locking in lower interest-expenses

Cross-currency strategy

Falling global interest rates, especially those in the US, have marginally decreased the benefit of cross-currency swaps. However, despite the current market environment, savings still exist in major currencies. Business should exercise caution when considering such derivative instruments for the first time and when re-structuring an existing portfolio.

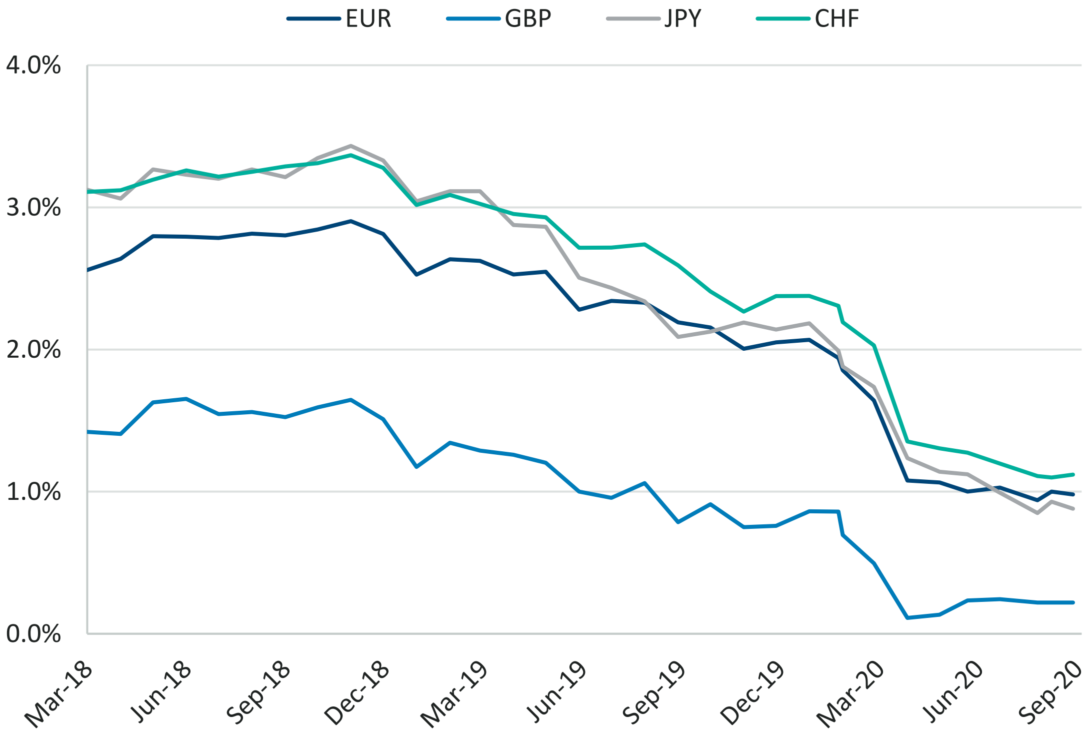
Motivations for strategy

- Allows corporates financing foreign acquisitions with USD debt to align their capital structure and mitigate FX risk associated with the foreign entity's sale
- Swapping to synthetic debt enables corporates to take advantage of the interest rate differential between currency pairs, resulting in a lower effective interest rate
- With liquidity becoming a concern for many global corporates, companies could unwind their cross-currency swap assets and pull out cash from trades in order to meet other financial needs

Additional considerations

- Although they've fallen from their peak, credit spreads are wider than pre-pandemic levels, resulting in higher credit charges
- Inefficiencies in pricing due to increased volatility in FX and interest rate markets, adding a further layer of pricing complexity

Per annum savings from swapping USD 2% fixed to select currencies



Market data as of 9/02/2020

Locking in lower interest-expenses

Accounting considerations

Extend and blend

- Change in the critical terms of the original derivative will stop the current hedge accounting relationship
- Amended trade can then be designated as an off-market hedge
- Watch out for embedded loans!

Cross-currency swaps

- Need to have enough net asset capacity to designate as a net investment hedge
- Coupon settlements can be taken to the P&L, providing a pickup
- Instrument needs to be FX only (fixed-fixed or float-float)

Hedging in the current interest rate environment

Economic and accounting considerations with respect to floored swaps

While it has become standard market practice for lenders to insert 0% - 1% floors on Libor into credit agreements, companies should consider the economic and accounting implications of including (or excluding) floors from their derivative relationships in the current market environment.

Market overview

- Over the past two years, swap rates have continued to trend downward.
- With the Fed's decision to lower base rates near-zero, the cost of including floors in hedging relationships has increased.
- From 2018 to 2019 to 2020, the cost of an embedded 3-year 0% floor has risen from **1 to 6 to 11 basis points**.

Example of historical swap pricing (3y, 1m Libor with a 0% floor)

Date	Sept-18	Sept-19	Sept-20
Mid swap rate	2.70%	1.25%	0.14%
Floor value	0.01%	0.06%	0.11%
All-in rate	2.71%	1.31%	0.25%

Pricing as of 9/2/2020

Existing hedge portfolio

- Corporates should consider aligning trade structure with terms outlined in credit agreements; e.g. including 0% floor in swap if debt is floored to 0%.
- This would allow for smoother applicability of accounting guidance and prevent hedges from failing out of hedge accounting.
- Corporates that previously hedged but excluded 0% floors from swap structures should consider buying back the 0% floor value.

Challenges to navigate

1. With rates reaching close to 0%, bank pricing on floors has become increasingly opaque.
2. Bank credit spreads continue to widen over liquidity concerns, further leading to inefficient pricing.
3. Hedging relationships with floor mismatches may no longer be highly effective even before rates fall below the floor strike, resulting in failure out of hedge accounting.

Hedging in the current interest rate environment

Accounting considerations with respect to floored swaps

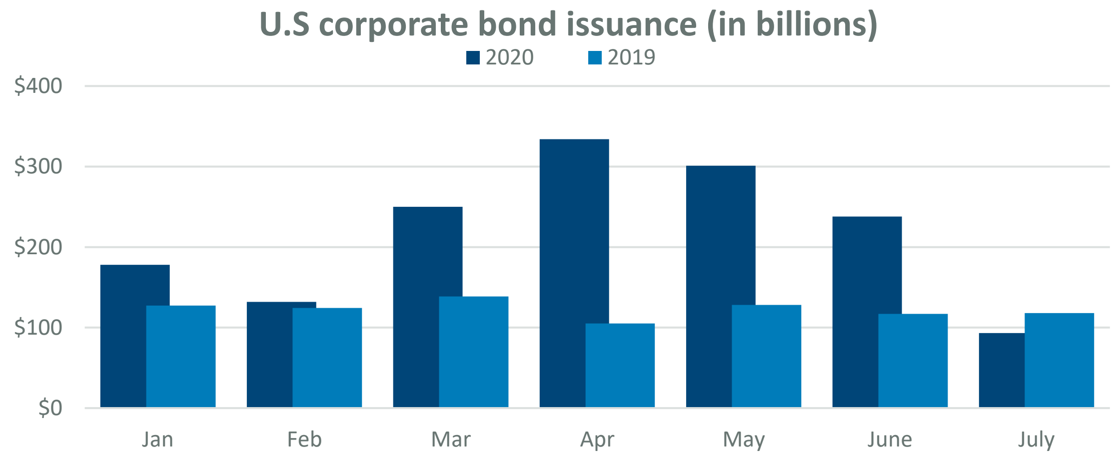
	Pros	Cons
Buy matching floor	Removes mismatch with underlying exposure	Most expensive upfront cost
Buy lower strike floor	Lessens mismatch while being less expensive than matching the floor	Expensive upfront costs and cannot guarantee highly effective relationship ongoing
Buy partial term floor	Least expensive option to provide some protection	New strategy and cannot guarantee highly effective relationship ongoing

Hedging in the current interest rate environment

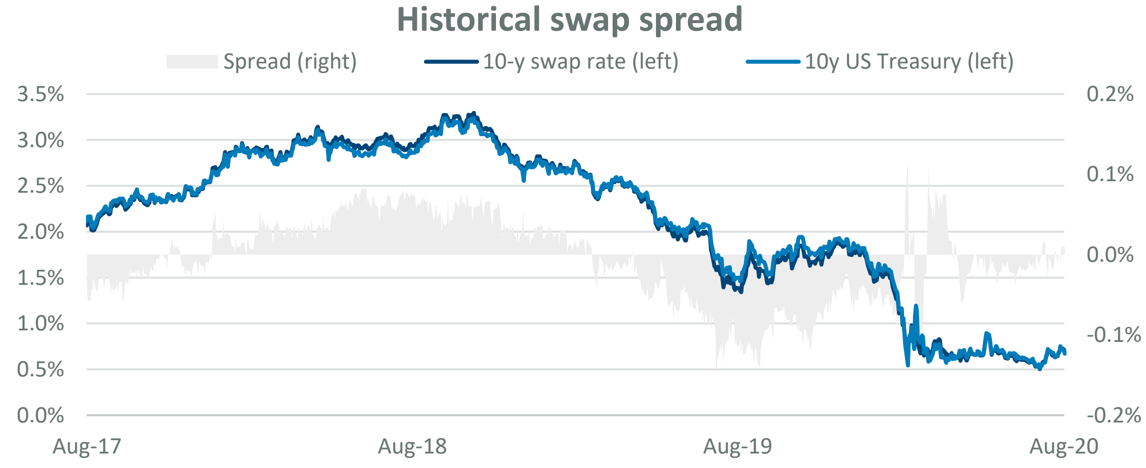
Forward hedging for fixed-rate debt issuance

Background

- Given the low rate environment, companies can **consider issuing new debt** by either prepaying existing bonds and or making plans to issue when existing bonds mature.
- Planning to issue in the future introduces the **risk of Treasury yields rising** between today and the new issuance date.
- Companies can hedge that risk, and lock in a component of future fixed issuance today (which are at historic lows) using a **forward starting swap** or **treasury lock**



	Spot start	6m fwd	12m fwd	18m fwd
10y US Treasury rate	0.67%			
10y swap spread	0.01%		-	
10y swap rate (spot starting)	0.68%			
Forward carry		0.05%	0.10%	0.16%
10y forward starting swap rate	-	0.73%	0.78%	0.84%
Effective Treasury rate		0.72%	0.77%	0.83%



Market data as of 9/02/2020

Hedging in the current interest rate environment

Forward hedging for fixed-rate debt issuance

Forward hedging involves entering into a trade now to lock in future exposure, such as an anticipated bond issuance. The most common derivative instruments considered when contemplating implementing a forward hedging strategy are:

	Treasury locks (T-locks)	Forward-starting swaps
Tenor	• Typically used for short-term hedging	• Flexibility for both short- and long-term hedging and uncertainty in issuance pricing
Risk component hedged	• Only hedges treasury component (not swap spread)	• Hedges both treasury component and swap spread
Transaction costs	• Generally more efficient pricing when tenor less than three to six months	• Liquid market and efficient pricing for tenors that exceed six months
Hedge accounting	• Increased complexity	• Easier to qualify for hedge accounting

Considerations

- Larger DV01 than typical interest rate swaps
- Lower credit charge
- Mandatory cash settlement
- Treasury pass inefficiencies
- ‘In the market twice’ (initial trade and cash settlement)

Additional accounting considerations

Timing

Certainty of timing of issuance

Scope

Defining the hedged forecasted transactions

Notional

Knowing how much debt will be issued

Tenor

Certainty of the tenor to be issued

Poll question 3

How does hedge accounting influence your organization's financial risk-management strategies?

A. Achieving hedge accounting treatment is a high priority and limits our strategic options
B. Achieving hedge treatment is a high priority, but does not limit our strategic options
C. Achieving hedge accounting treatment is not a high priority and therefore does not limit our strategic options
D. Volatility associated with mark-to-market is not currently a concern, but may be in the future

Quick LIBOR-SOFR transition update

Impact of COVID-19 on timing of LIBOR transition

June 30, 2020
FHLBs may no longer enter into LIBOR-based transactions maturing after Dec. 31, 2021

July 2020
Publication of Bloomberg indicative fallback rates

Sept. 2020
Scheduled publication of amendments to the 2006 ISDA Definitions and related protocol
Previously set for August

Freddie Mac and Fannie Mae will no longer accept applications for LIBOR-indexed loans beyond Q3 2020

Oct. 19, 2020
CME and LCH clearing houses switch from Fed Funds to SOFR discounting for valuing cleared trades

Nov./Dec. 2020
Effectiveness of amendments to the 2006 ISDA Definitions and related protocol

Dec. 31, 2020
Freddie Mac and Fannie Mae will no longer purchase LIBOR-indexed loans beyond EOY 2020

Mar. 31, 2021
All GBP-denominated loans must be indexed to SONIA, rather than GBP LIBOR
Previously set for Sept. 30, 2020

Dec. 31, 2021
LIBOR panel banks are no longer mandated to submit LIBOR quotes after which market is expected to transition from LIBOR

Monitor trigger events and the possibility of early discontinuation of LIBOR

LIBOR-SOFR transition issues

	Impact	Highlights	Action items
Impacts to current debt & trades	• Legacy LIBOR loans and trades will need to fallback to SOFR; questions outstanding on Protocol and fallback triggers	**ISDA fallback** • Protocol and amended definitions for fallback rates, triggers, and pre-cessation triggers • Fallbacks may include spread adjustment (5y historical median between LIBOR and compounded SOFR); Bloomberg selected as the vendor to calculate and publish	• Inventory LIBOR exposure under existing loans and derivatives • Assess fallback language • Watch for correspondence from bank counterparties
Impacts to future trades	• Questions outstanding on how SOFR products will trade and are heavily dependent on the development of a SOFR debt market		• Be aware that some documents may permit the parties to voluntarily move to a new reference rate
Operational impacts	• Calculating SOFR in arrears, rate is set at the end rather than the beginning of period	• Interest rate will reflect the exact rate over the period rather than a projected rate • More complex calculation required	• Evaluate and update internal systems as needed to reflect new reference rate and any applicable spread adjustments
Hedge accounting impacts	• Changes in derivative critical terms may result in termination, causing a de-designation of the hedging relationship	**ASC 848 –** Reference Rate Reform • FASB issues to provide operational and accounting relief for transition away from IBORs	• Discuss with local audit team • Understand accounting elections for the transition • Prepare documentation

Questions?