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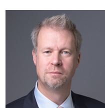
Interest Rate Hedging in Volatile Markets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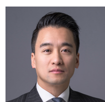
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The mini budget delivered by UK Chancellor Kwasi Kwarteng on Friday, 23 September received an overwhelmingly negative response from the financial markets. When Asian markets reopened on the Sunday night UK time that followed, and having had the weekend to digest the media response, the initial reaction to the budget was exacerbated, with the GBP hitting an all-time low of 1.03 against USD.

This market reaction was caused by a combination of the Government's proposed unfunded tax cuts, together with the rife circulation of rumours that the Bank of England was stepping in with an unscheduled interest rate rise. Whilst further interest rate rises since that budget have not yet materialised, we have instead seen some significant U-turns by the Government on its proposed unfunded tax cuts as well as a change in Prime Minister, resulting in a settling down of the financial markets. GBP now sits at 1.15 against USD. Whether this is just the calm before the storm is worthy of consideration.

At the peak of such market volatility, the Bank of England did act elsewhere through its intervention in the gilt markets by carrying out an exercise of temporary purchases of long-dated UK government bonds in order to help restore orderly market conditions. Ultimately, this exercise was conducted for a very specific technical reason surrounding the UK pension funds and their exposure to higher interest rates, which caused these funds to have to post significant collateral against their liability hedges, causing a large liquidity issue.

In practice, the GBP hedging markets effectively closed during the immediate aftermath and market turmoil that following the budget and many hedging products were temporarily unavailable. For many of our borrower clients, a short-term "wait and see" was effected before putting their hedges in place. Equally, we have also seen the payment of large cash premiums to reduce ongoing interest servicing as a solution deployed by those who have the liquidity to do that.

For many other borrowers, interest rates are testing modelled base cases, meaning that entering a fixed-rate could immediately challenge their covenants. Moreover, we expect banks to realign lending parameters to reflect increasing projected debt servicing costs on interest cover. This could also lead to a further worsening of credit positions if it is coupled by a revaluation and reduction in asset values.

From a legal perspective, it is critical for borrowers and lenders to agree the parameters of hedging products. Borrowers will want to ensure that products entered into are properly documented as both standalone instruments where necessary (such as CAPs) and permitted contracts, capable of being used to hedge rising finance costs within the confines of their lending agreements. Particular care should be given to the trading confirmations that are often prepared before the governing hedging documentation is entered into in order to ensure these details are stated clearly in the confirmation documents.

Equally, lenders will be keen to ensure that products bought (particularly CAPS) work within their credit approvals committees. It should not be taken for granted, for instance, that credit teams will permit cash flows from products to be used to net rising finance costs – in particular, in non-recourse loans, when we are in an environment where underlying cash flows are under threat in asset classes (for instance, the retail sector). Whilst hedging products help ameliorate risks, the strength and foundation of the cash flows remain of central importance.

We are continuing to monitor the developments on this from both macro and micro perspectives, assisting our clients to help find and facilitate ways in which to navigate through such market instability.