Ring-fencing
The unintended consequences of reducing risk
Background

The objective of the legislation is two-fold:

1. To reduce the frequency and impact on any banking failure; and
2. In the event a banking failure does occur, the management of this process should not require any public funds (unlike the events of 2008)

Ring-fencing is set to become law on 1 January 2019, although several banks are implementing these changes ahead of this deadline.

The costs associated with these changes are substantial. Banks are required to have completely separate legal, HR, risk and payment operations which will cost hundreds of millions per annum and, more significantly, the requirement to increase the capital buffers to protect against banking failures will run into tens of billions. It is not a stretch to conclude that banks customers will ultimately pay these costs.

Unintended consequences:

At JCRA, we are beginning to see unintended consequences of the ring-fencing initiative impact our client base. Without a standard approach across banks in terms of their categorisation of derivatives, the impact on borrowers and exporters/importers with hedging products is uncertain, depending on the bank in question. While the primary reason for the legislation was, at a macro level, to avoid and/or minimise the impact of future banking failures, the reality is that, at a micro level, the changes are beginning to affect some of our clients negatively, increasing their costs and exposure to risk.

How JCRA can help

If you are approached by your bank to discuss the impact of ring-fencing on your existing interest rate or inflation hedging positions or if your FX provider indicates that you will no longer be able to hedge using the same derivatives, please get in touch with JCRA to help you navigate this process. It is important that borrowers and importers/exporters do not bear the full brunt of the costs of ring-fencing. JCRA can assist in ensuring our clients achieve optimal outcomes from these changes.

We have experience in a variety of cases and have set out some examples of the impact ring-fencing is having across the sectors in which we operate.

i. Increased risk on FX hedging:

A Scottish oil services company has revenues in USD and overheads in GBP. The company has traditionally hedged GBP/USD exposure with a series of participating forward contracts. These serve to protect against USD depreciation, provide some upside in the event of subsequent USD appreciation and also allow for some variation without breakage costs if USD revenues are below forecast.
Due to the options included in their structured FX hedging product, participating forwards cannot be sold by the retail bank (NB: not all banks have categorised this product in this way). This means the company either has to change their FX hedging strategy to one where they are limited to using vanilla forwards only, or they will have to source an alternative FX provider to continue using participating forwards. Both courses of action are inferior to their current approach. Vanilla forwards will not allow the company to benefit from USD depreciation, or reduce the risk of termination costs in the event of lower than forecast USD revenues. Dealing with a FX broker, rather than with their incumbent bank has the potential for cash collateral requirements for an upfront and variation margin to cover the credit exposure. While the legislation seeks to reduce risk to customers (in particular, retail customers), in this example, the unintended consequence of ring-fencing is that the company cannot hedge efficiently and may face cashflow difficulties in supporting the credit line in the event they hedged with a broker.

Solution: We were able to reach a solution with the bank (which required senior sign-off from their compliance team), where our client was able to reconstruct the participating forward using bought options and forward contracts to achieve the same end-result from previous years hedging.

ii. Increased cost on interest rate hedge restructure

A UK commercial property investor (family office) with long-term investment objectives. This borrower has a portfolio of long-dated hedges, with relatively far out-of-the-money rates. The company remains covenant compliant thanks to a very low LTV and high yielding assets. Two of their hedges are subject to Bermudan options in favour of the bank. The bank's categorisation of Bermudan options is such that the derivatives will need to be moved to the investment arm of the bank, whereas the borrower will be in the retail arm. The bank has suggested to the borrower that the Bermudan options are terminated at the borrower's cost. What the bank has not explained is that there will be an increase to the bank's capital costs as well as an increased administrative burden if the derivative is moved to the investment arm. Therefore, it is in the bank's interest to avoid this outcome if possible.

The borrower is entirely neutral about the derivative position; their view is that the option is highly unlikely to ever be exercised and are therefore ambivalent about terminating this element of their hedging – why part with any cash to eliminate an unlikely outcome? The bank on the other hand is highly motivated to avoid the ring-fencing of these derivative positions and should be willing to contribute the savings they will make towards the borrower's cost of terminating the Bermudan options. The unintended consequence here is that a borrower is being asked to pay an upfront fee to assist the bank to save costs associated with ring-fencing.

Solution: We advised the client to maintain their current position (i.e. leave the form of the hedging in place for the time-being) until and unless the bank comes forward with a funded proposal to make the change to the derivatives - with costs fully, or at least partly, borne by the bank.
iii. Increased cost on inflation hedge restructure

A large housing association has a portfolio of different hedging instruments, including some embedded fixed rate loans which reference RPI rather than LIBOR for the interest payment. While the borrower does not have stand-alone hedging (the derivative element is embedded into the loan), the lending bank will have managed their exposure to the inflation-linked interest payment via an inflation swap with a market counterparty. This creates some difficulties for the bank as, in theory, the offsetting hedge will be in the investment arm and the embedded derivative will be in the retail arm after ring-fencing. The bank has approached the housing association to suggest a restructure; amending the fixed rate contract from an inflation reference to an interest rate reference, which would result in the fixed rate loan remaining in the retail arm. However, the inflation-linked loan is out-of-the-money and the transaction costs (bid-offer spread) of unwinding long-dated inflation hedging are significant and would result in the bulk of the costs being incurred by the borrower to fix the bank’s problem. Given the savings the bank stands to make by avoiding the transfer of the inflation hedge to the investment arm, it seems clear that the bank should be making a meaningful contribution towards the costs of any restructure.

Solution: This situation remains live with negotiations on going with respect to the apportionment of the hedge restructure costs.
Get in touch:

Samantha Bett,
Director, Private Equity
Email: Sam.Bett@jcrauk.com
T: +44 (0)207 493 3310
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