

Foreign Exchange volatility and the risk to Creditors

Jamie Jemmeson explains the 10-20% devaluation risks involved for creditors ignoring FX volatility



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During the Liz Truss Premiership, a \$5,000,000 insolvency could have been impacted by a devaluation of over £600,000, due to currency market volatility.

The significance of FX (Foreign Exchange) movements amidst an insolvency process is a critical consideration, particularly for estates holding overseas assets or assets denominated in foreign currency. Often, the FX translation risk is underestimated, potentially leading to a reduction in realised asset values and, as a consequence, a reduction in the value of creditor distributions.

Although FX fluctuations may sometimes be advantageous, making decisions driven by emotion without conducting proper due diligence exposes us to unnecessary risks. Emotion should not dictate strategy. Therefore, comprehending and managing FX exposure is paramount in navigating insolvency proceedings effectively and ensuring creditor returns are maximised.

What does FX market risk look like?

FX market risk emerges because of several factors that are often difficult to control or predict. These factors can include, but are not limited to geopolitical tensions, domestic politics, economic data, central bank policy and sentiment to name but a few.

To put into context how the value of the currency could be impacted, we can review the last 10 years of annual movements on a high and low basis.

- GBP/USD 10-year high to

low range = 14.4%;

- GBP/EUR 10-year high to low range = 10.9%.

Highlighting some of the more extreme years:

- EU Referendum 2016 = GBP/USD 24.2% and GBP/EUR 20.16%;
- Trussonomics 2022 = GBP/USD 24.9%.

For illustrative purposes, an insolvency process that takes 12 months, where the equivalent foreign currency exposure has a sterling value of £500,000, the average risk based on the last decade is:

- GBP/USD (14.4%) = Circa £72,000;
- GBP/EUR (10.9%) = Circa £54,500.

Similarly, in extremely volatile years (20%+ for GBP/USD and GBP/EUR), this equates to £100,000+ in risk.

FX consideration factors during the insolvency process

Now that we have highlighted the potential risk that your FX exposure could face, let us look at the FX factors you should consider during the insolvency process:

- **Market sentiment** – where the market bias is leaning in terms of the direction of the currency pair;
- **Historic and potential volatility** – the range of movement historically over the potential timeframe of the insolvency process, and therefore the potential impact on the insolvency notional;
- **Execution costs and**

timings – are you receiving the best price when executing the transaction? If you are receiving a competitive price, is now the best time of day to be transacting?

- **Strategic tools to reduce the risk of FX Volatility** – Have you explored products or strategic partners to reduce your FX volatility?

Some FX strategies to consider

Set and forget (a forward hedge)

“Set and forget,” in the context of a forward hedge refers to a hedging strategy, where a company transacts a forward contract to hedge against potential risks, such as currency fluctuations, and then largely leaves the hedge in place without actively managing or adjusting it.

- **Benefits** – the lock in value for IPs of the FX translation when the asset is liquidated. This means that the risk of negative currency movements is removed and certainty provided to creditors;
- **Considerations** – Creditors will not be able to benefit from advantageous moves.

Proportional hedging

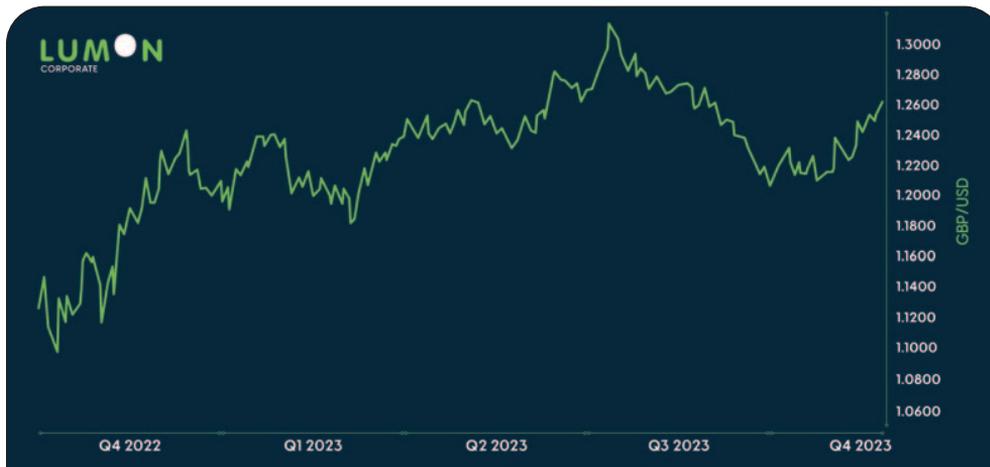
Proportional hedging is a risk management strategy used to mitigate the impact of currency fluctuations on international translations. In a proportional hedging approach, the hedging activity is structured to provide a partial hedge against currency risk rather than fully eliminating it.

- **Benefits** – IPs reduce the market volatility of FX



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Illustrative example

A UK based company goes into liquidation on 26 September 2022. The company has assets overseas that are denominated in US Dollars. Creditors are based in the UK and want settlement following the insolvency to be in Sterling. The US Dollar exposure is made up of a portfolio of properties based in New York with a value of \$5m. The sale of the property portfolio concludes in just over a year and the \$5m is translated to Sterling on 24 November 2023. No FX hedge is considered despite the volatile political drop in the UK during the Liz Truss era.

Using mid GBP/USD on a weekly basis, $(\text{High} + \text{Low})/2$, we can calculate the potential impact of not hedging the \$5m:

- GBP value of USD week beginning 26 September 2022 = £4,626,202.81;
- GBP value of USD week beginning 24 November 2023 = £3,990,582.23
- GBP depreciation = £635,620.58

Based on this example the Insolvency Estate and therefore the creditors would receive a distribution of circa £600,000 less than that if there were a hedge in place.

translation when the asset is liquidated;

- **Considerations** – Creditors will not be able to benefit from advantageous moves.

Participating Forward

A participating forward is a conservative hedging instrument that offers complete protection against currency losses without requiring the payment of a premium. More specifically, it allows hedging at a pre-defined rate while, at the same time, you keep the opportunity to benefit partially from a favourable market move on 50% of the notional amount hedged.

- **Benefits** – IPs lock in value of the FX translation when the asset is liquidated whilst having the ability to benefit from advantageous moves on 50% of the notional amount hedged;
- **Considerations** – The hedge rate will always be less favourable than the forward rate.

Do nothing and convert on the day

Leave the position open and transact the currency close to the distribution of funds to the creditors. The creditor will be able to benefit from advantageous moves but will also be susceptible to all devaluation if the currency moves in the wrong direction.

- **Benefits** – Creditors benefit in full from any advantageous moves;
- **Considerations** – Creditors will be taking a haircut on the value of the asset being liquidated if the currency pair moves in the wrong direction.

Conclusion

The FX translation aspect of the insolvency process is often treated as an afterthought, with little consideration for its potential impact on creditors. This oversight is understandable given the myriad of other factors at play during insolvency proceedings.

However, managing FX risk does not have to be daunting; it can be addressed efficiently and effectively. It is advisable for insolvency practitioners to factor in the FX element and proactively seek information on its potential impact on asset realisation values. This informed approach allows for better decision-making, with transparent articulation of choices made in relation to FX translation.

Inaction regarding FX translation risk is unlikely to yield additional benefits for creditors. Conversely, failure to manage FX risk effectively may result in a substantial reduction in distributions available to creditors, creditors raising questions and potentially damaging reputations. Ultimately, the priority must be safeguarding the interests and maximising the return to creditors whenever FX translation risk emerges. ■