Hedge Advisory - Should you use a Hedge Coordinator?

When a transaction requires the simultaneous arrangement of hedging instruments with more than one bank, one commonly used solution is to assign one investment bank the role of 'Hedge Coordinator' (sometimes abbreviated to 'HC' in what follows), with a view to optimising transaction costs and reducing the operational risk of the client using the hedging instruments.

'Optimising transaction costs and reducing operational risk'

The Hedge Coordinator is usually selected by the client from among the banks involved in the transaction, in which it then acts as an intermediary: It executes the entire hedging transaction with the client and then allocates all or part of that transaction to the other banks, which ultimately become the client's direct counterparties in the hedging instruments.

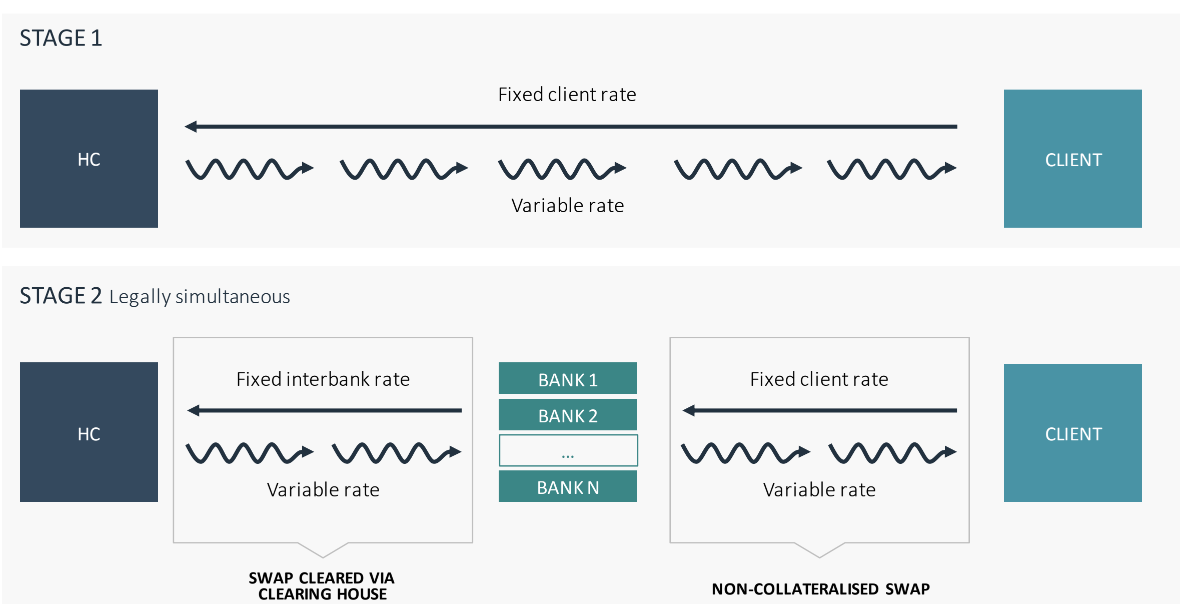
In legal terms, the execution of the transaction with the client and its partial allocation to other hedging banks are carried out at the same time according to a precise template that engages the parties.

Each bank only assumes counterparty risk towards the client for its allocated percentage of the hedging instruments.

When should a Hedge Coordinator be appointed? What are the pros and cons of such an arrangement? How should the Hedge Coordinator be remunerated? These are all important questions to consider before choosing your hedging mechanism.

Outline of a hedging mechanism with a Hedge Coordinator

As shown in the diagram below, the Hedge Coordinator sets up the hedges for the client, then allocates them a moment later to the hedging banks, which thus deal with the client at one remove. The HC simultaneously enters into an interbank transaction with the hedging banks (via the clearing house for the interbank transaction) so as to mitigate the market risk they incur from the transactions carried out with the client.



The diagram shows how:

- The Hedge Coordinator sets the client's price for the entire transaction.
- It assumes 100% of the execution risk and is rewarded accordingly.
- The allocation of hedges to the hedging banks does not entail any additional cost for the client.
- Throughout the entire transaction, everything happens for the client as if each bank had carried out the hedging operations directly, without the involvement of an HC.

The Hedge Coordinator and its effectiveness in terms of managing execution risk

It is often accepted that a Hedge Coordinator is useful for executing transactions involving large numbers of banks, because the execution process itself is complex (including the link between the execution price and the financial model), or because the operation is very large and the execution risk is high.

'Aligning the hedging banks around the same competitive price'

As regards the number of hedging banks involved, when this remains limited to four or five and the banking relationships are good, the presence of a Hedge Advisor[1] is usually sufficient to ensure effective management of operational risk and optimal pricing. Beyond four or five hedging banks, depending on the nature of those banks, it may prove more operationally risky to conduct a negotiation with a large number of interlocutors, and the presence of an HC may make things significantly easier.

The operational risk arising when large numbers of hedging banks are involved is related in particular to the following factors:

- Aligning the hedging banks around the same competitive price is harder because of the numerous banks involved.
- The simultaneous execution of the same operation by multiple hedging banks may entail additional execution costs. The presence of an HC is likely to improve the execution conditions.

Where other factors (such as the connection between the execution price and the financial model, the setting of particular conditions or a lengthy decision-making process) add to the complexity of execution, the risks arising from the two previous points are further accentuated.

In addition, a transaction whose size is significant relative to the market's liquidity (a high notional amount, a very long duration, or a less liquid hedging product) increases the risk of a market shift to the client's disadvantage just prior to execution. This type of situation may result, for example, from a clumsy hedging strategy on the part of the banks, or from a situation verging on 'front-running'[2], in which the hedging bank is tempted to pre-hedge all or part of its execution risk a few moments before the financial conditions are settled.

Is this risk of market shift to the client's disadvantage during execution effectively reduced in the set-up with the Hedge Coordinator? Not necessarily, and vigilance with regard to this point is advisable whatever set-up is chosen.

[1] ESTER is a Hedge Advisor. The Hedge Advisor is an independent consultant mandated by the client to help structure and execute hedging transactions in the client's best interests.

[2] Front-running is a practice which consists for banks of placing orders on the market just prior to the execution of a transaction with a client in order to pre-hedge the transaction, at the risk of causing a market shift to the client's disadvantage. Although front-running is strictly prohibited by banking regulations, because it maximises the bank's expected profit to the detriment of the client, the dividing line between front-running and the execution of a client order is sometimes blurred.

The Hedge Coordinator and its effectiveness in terms of hedge price optimisation

As discussed above, the presence of a Hedge Coordinator can theoretically mean a lower execution margin: in particular, if the execution is well managed by the Hedge Coordinator, this can reduce the cost of the operation by several tenths of a basis point or more.

On the other hand, a mechanism involving a Hedge Coordinator often creates a hidden extra cost linked to the choice of discount curve for non-collateralised transaction flows.

It will be recalled that most banks do not discount collateralised and non-collateralised transaction flows with the same yield curve. While collateralised transactions are traditionally discounted on the OIS/Eonia curve – a yield curve that reflects the collateral's rate of return – non-collateralised transactions are generally discounted on a different yield curve that provides a closer reflection of the bank's cost of finance and is defined by each bank in conjunction with its central treasury.

In a typical set-up with a Hedge Coordinator, hedging banks generally require the pricing of the transaction (step 1 in the diagram), although it is not collateralised, to be calculated by discounting the transaction flows on a curve identical to that used for collateralised interbank transactions, as this method facilitates the legal documentation of the syndication of the hedging transactions by the HC to the other banks (and provides an opportunity for financial gain for all the hedging banks).

The consequence of this choice of discount curve is primarily financial: the price of the hedging instruments differs depending on whether the bank is quoting for a transaction that is collateralised or non-collateralised, and discounting the flows on the OIS/Eonia curve generally has the effect of raising the level of the fixed rate[3].

On 22 August 2018, for a euro transaction amortised on a straight-line basis quarterly over 20 years, the fixed rate of a three-month Euribor rate swap was 0.9787% if the flows were discounted with the Eonia curve, but only 0.9742% if they were discounted with the three-month Euribor curve – a difference of 0.45 basis points per year.

Unless the hedging scheme and the documentation are adapted to manage this effect, the choice of an HC scheme therefore has an implicit hidden cost of 0.45 bp per year. Such an adaptation is possible, but must be evaluated with a Hedge Advisor and accepted by all the hedging banks – not always a straightforward matter.

Remunerating the Hedge Coordinator

From the bank's perspective, the Hedge Coordinator's remuneration must cover:

- The service it provides in facilitating the execution of the transaction and the associated contractual and legal set-up.
- The execution risk, the extent of which varies depending on the characteristics of the transaction, including the size and nature of the hedge.

In view of this, it is not enough to negotiate the Hedge Coordinator's nominal margin: both the discount curve characteristics and the fast market clauses that accompany the bank's commitment to the execution margin must also be precisely defined.

While an execution margin of 0.25bp may be considered aggressive, an execution margin of 1bp or more may often be regarded as defensive.

[3] This difference is all the greater when the transaction has an amortizing notional amount profile and the yield curve is steep, as is the case with the euro yield curve.

Besides the margin, the other consideration that determines the effectiveness of the part played by the Hedge Coordinator is reliability of execution.

Conclusion

Although it is in the banks' interest to offer their services as a Hedge Coordinator, as a way of maximising their returns through the execution margin on the hedging derivatives, it is far less clear that the use of an HC is in the client's interest; this is certainly not invariably true.

In some cases, an HC can be highly beneficial, but in other contexts it may be a source of cost to the client and a source of frustration to the other hedging banks that have not been selected as HC and see their potential returns reduced because they do not receive the execution margin on their allocation.

The choice of whether or not to use an HC is therefore a complex one that a client should always make by assessing all associated benefits, costs and risks, depending on the characteristics of the transaction.

The Hedge Advisor will be able to advise the client on the suitability or otherwise of selecting an HC or implement another hedging process. As the case may be, the Hedge Advisor will guide the client during the HC selection process. It will help the client to negotiate and document an HC's engagement. Where an HC is used, the involvement of a Hedge Advisor is therefore particularly useful, as it will ensure that the structuring and documentation of the hedged instruments are optimised in the client's best interests, reinforce operational security and optimise the price of setting up the hedging instruments.

As a specialist in the financial markets, ESTER is available to explore this subject alongside you.

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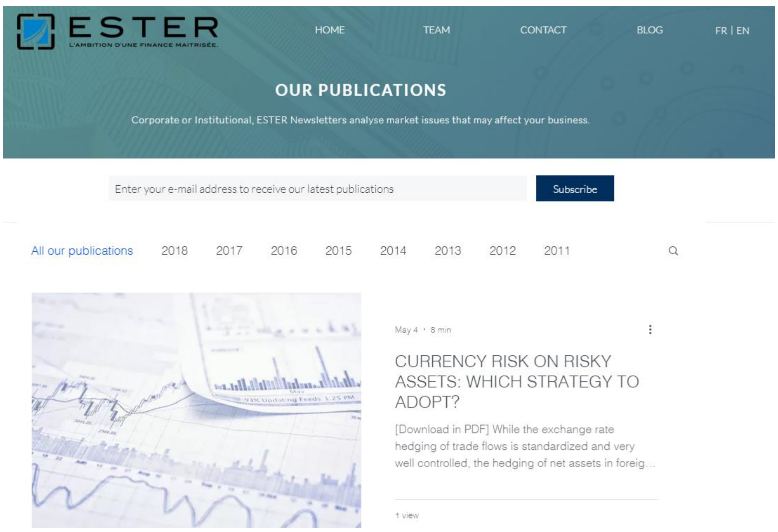

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