

CORONAVIRUS – CURRENCY RISK HEDGING AND THE IMPACTS ON LIQUIDITY IN THE CZECH REPUBLIC

Current fluctuations on currency markets can adversely affect the liquidity of companies that have entered into derivative transactions with banks and other financial institutions in order to hedge themselves against the risk of foreign exchange movements. These derivative transactions are usually governed by any of the master agreements prepared by professional associations, such as ISDA or the Czech Banking Association. As a standard practice in entering into master agreements, financial institutions insist on that the master agreements also contain a provision requiring the client (i.e., the company wishing to be hedged against risks) to provide the particular financial institution with collateral if the financial institution's exposure against the client under the derivative transactions entered into with the client exceeds an agreed threshold. The financial institution's exposure against the client then depends, very simply put, on the loss or profit generated by the financial institution should the transaction be terminated on the calculation date of the exposure. Market conditions on the calculation date can differ quite substantially from those prevailing on the date when the derivative transaction was entered into.

DEPRECIATION OF THE CZECH CROWN AND OBLIGATION TO PROVIDE COLLATERAL

Hence, provided that the master agreement contains such a provision, then if the mark-to-market value of the derivative transactions is negative for the client and, at the same time, exceeds the agreed threshold, the financial institution may require the client to collateralise the exposure, which usually takes the form of cash transferred to the financial institution's account. It is not unusual that exposures are calculated on a daily basis and, upon request, cash must be transferred on the same or next business day.

Given the current depreciation of the Czech crown and a decline in liquidity resulting from the unexpected dampening or suspension of business activity, the requirements of financial institutions for having their exposures secured by cash collateral may cause problems to many companies. This may also apply to companies with income in euro and expenses in Czech crowns, which have entered into derivative transactions to hedge themselves against the appreciation of the Czech crown against the euro. As a result of the depreciation of the Czech crown, these derivative transactions may become profitable for the financial institution, and if they are terminated early, the financial institution would generate a loss which the client would be obliged to cover.

IMPACT OF CASH COLLATERAL ON THE LIQUIDITY

If a potential loss so calculated exceeds the threshold stipulated in the master agreement, financial institutions are entitled to call on their clients to provide collateral. In the event of a sharp drop in the Czech crown exchange rate, companies may overnight get caught in a situation when their financial institution will be entitled to require cash collateral from them, often

in the region of tens of millions of Czech crowns. A breach of the obligation to provide collateral will then not only mean a breach of the master agreement but it will also result in the possibility of terminating the derivative transaction and the client being obliged to cover the loss to the financial institution but, in some cases, it will also trigger the cross-default clause contained in other financial agreements.

Our current experience suggests that in the case of clients that have so far fulfilled their obligations, financial institutions do not insist on immediate provision of collateral but they often agree to enter into negotiations regarding amendment of the existing documentation.

We recommend that companies that have entered into master agreements containing provisions on collateralisation and have made transactions that can have the impacts described above should analyse the relevant provisions, monitor the situation closely and, if necessary, promptly start negotiations with the financial institution regarding possible modification of such provisions.

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