COMMERCIAL BANKING

A focus on financial risk management

>35 million

confirmed cases and **>1 million** deaths from Covid-19 globally

Source: John Hopkins University

8%

contraction in the global economy in the first half of the year

Source: OECD

50%

chance of negative interest rates in the UK by August 2021

Source: Market pricing on 2 October 2020

90%

of the losses in UK economic output from Covid-19-induced recession already recovered

Source: BoE Chief Economist Haldane – 'Avoiding Economic Anxiety' speech – 30 September 2020

Financial market volatility poses a significant threat to corporate profitability. However, swings in market prices for currencies, commodities and interest rates offer opportunities to secure cashflow certainty in an uncertain world. We discuss the economic backdrop, three key risks going into year-end and highlight three case studies in which we have helped clients manage currency, commodity and interest rate risks.

By the side of business

LLOYDS BANK

A focus on financial risk management

Key highlights:

- The coronavirus pandemic has triggered the most significant global economic shock in modern history.
- Volatility in financial markets – including in currencies, commodities and interest rates – has posed and will likely continue to pose a significant threat to corporate profitability.
- Effective risk management strategies can help businesses reduce their exposure to large swings in market prices and gain much needed cashflow certainty in these unprecedented times.

The crisis so far

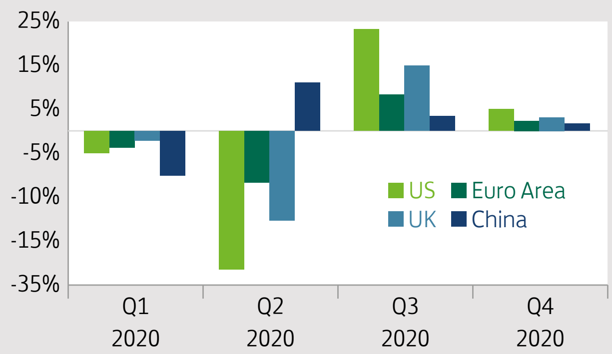
The coronavirus pandemic has arguably been the most challenging crisis since the Second World War. Already, over 35 million people globally have been infected by the virus and more than 1 million have lost their lives. Through the first half of 2020, the global economy contracted by a staggering 8%, a decline greater in magnitude than even the Global Financial Crisis.

Countries across the world have adopted a wide range of economic and social responses to the pandemic. Some implemented strict containment policies, aimed at curbing the spread of the virus, but at a significant near-term economic cost. Others have been less forceful on mandatory stringency measures, keeping more of their economies open.

With the path of the virus still difficult to predict and many countries already experiencing a worrying resurgence in infections, the pandemic will remain a significant challenge for individuals, communities and policymakers to contend with for the foreseeable future, especially as a major medical breakthrough is still, at best, many months away.

While the onset of the pandemic had severe consequences for global economic growth, a fall in infection rates, faster-than-expected easing of restrictions and unprecedented policy support has provided a major boost to activity in Q3. China, which, in February, was the first country to enforce a strict lockdown has reopened and actually saw activity rebound in Q2, avoiding a technical recession (two consecutive quarters of negative economic growth). Having fallen in the first and second quarters, activity in the US, Eurozone and UK economies is likely to have bounced back strongly in the third quarter (Chart 1).

Chart 1: Global GDP set to rebound in Q3



Source: Bloomberg, Lloyds Bank Commercial Banking (2 October 2020)

The path of the recovery remains very unclear but the situation looks less threatening than earlier this year. And, while there is a risk that a prolonged 'second wave' over the coming months could derail this nascent economic recovery, a greater understanding of the virus also underpins hopes of a major medical breakthrough.

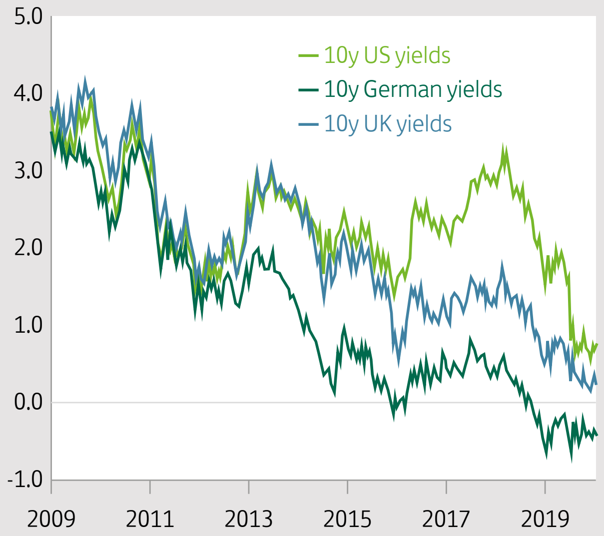
Many European countries are contending with a 'second wave' in cases. In recent weeks, France and Spain in particular have experienced a sharp rise in the number of confirmed daily cases, which are now well above their previous peaks from the first wave.

The UK is seemingly at an increasing risk too, with Covid-19 infections on an upward trajectory and prominent scientists and officials warning that a further tightening of restrictions may be needed to contain the spread.

Policymakers around the world continue to provide extensive monetary and fiscal support to the global economy. The Federal Reserve, European Central Bank (ECB) and Bank of England (BoE) have all recently signalled that further stimulus will be provided if needed. Their main tools so far have included reducing policy interest rates, increasing quantitative easing and lending to businesses and banks. As a result, their balance sheets have risen rapidly to unprecedented levels.

Policy interest rates are expected to remain at their current ultra-low levels for years to come. In fact, at the time of writing, the next policy rate rises from the Fed, ECB and BoE are not anticipated until 2024, 2025 and 2027 respectively. Alongside unprecedented government bond purchases, this has pushed key market interest rates to all-time lows (Chart 2).

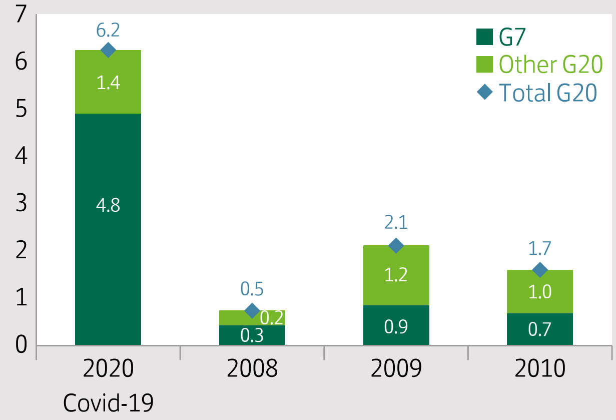
Chart 2: 10-year government bond yields are at their all-time lows



Source: Bloomberg, Lloyds Bank Commercial Banking (1 October 2020)

Chart 3: Governments have provided significant fiscal stimulus

IMF's record of fiscal response to Covid-19 vs GFC, % of G20 GDP



Source: IMF, Macrobond, Lloyds Bank Commercial Banking (2 October 2020)

Governments have also been bold in their response to the crisis. G20 governments have already provided fiscal stimulus to the tune of more than 6% of GDP (Chart 3). For comparison, their response to the Global Financial Crisis amounted to around 4% of GDP in total, and came gradually over a number of years

The unprecedented policy response from central banks and governments has been critical and will remain crucial during the recovery. Facing the threat of a long 'second wave' as we head into winter, policymakers are already considering how to go further.

> While there are a number of risks on the horizon, we mustn't forget that the UK economic recovery from the coronavirus crisis so far has been stronger than expected.

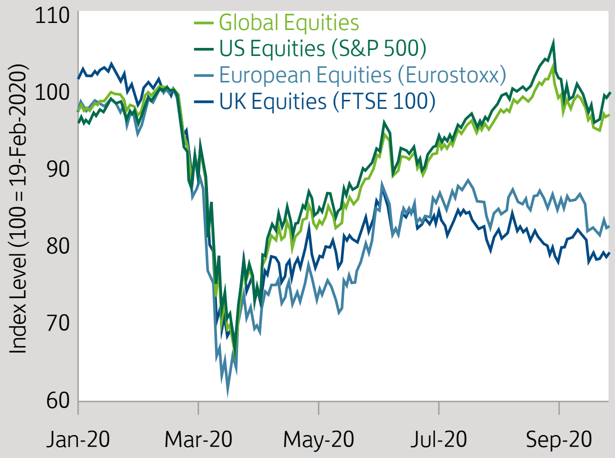
Ed Thurman
Managing Director,
Head of Global Transaction Banking,
Lloyds Bank Commercial Banking

For example, speculation is growing that the Bank of England may need to reduce policy rates below 0%. With the minutes from September's Monetary Policy Committee meeting showing policymakers plan to explore how a negative Bank Rate could be implemented, this looks to be a very real possibility. Meanwhile, the UK chancellor recently unveiled a series of further fiscal support measures as part of his 'Winter Economy Plan'. Other governments and central banks are likely to announce further initiatives to support their economies.

Following the decisive interventions from central banks and governments, the Purchasing Managers' Indices (PMIs) suggest that economic sentiment has recovered. Having dropped to their respective all-time lows in the US, Eurozone and UK in April, the PMIs have bounced back remarkably in recent months. Interestingly, our new **Lloyds Bank Recovery Tracker report**, which uses sector level PMI data, shows that positive momentum among UK businesses is now building more quickly compared to our global counterparts. In a recent speech entitled 'Avoiding Economic Anxiety', the Bank of England's Chief Economist Andy Haldane struck a relatively upbeat tone and suggested that the UK economy has already recovered around 90% of its earlier losses.

The Lloyds Bank Recovery Tracker showed that in August, across 13 of 14 sectors, momentum built more quickly among UK businesses compared to their global counterparts.

Chart 4: Global equities have rebounded from their pandemic lows



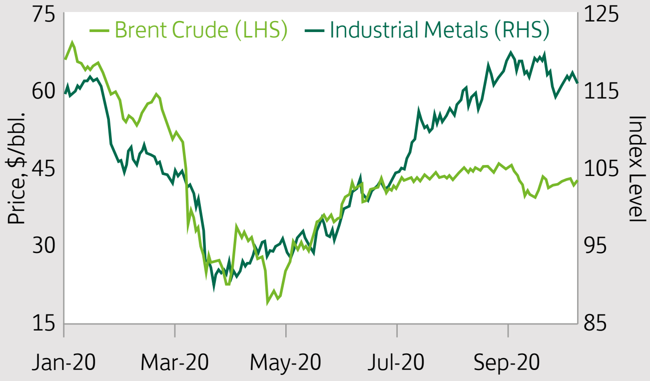
Source: Bloomberg, Lloyds Bank Commercial Banking (1 October 2020)

There has also undoubtedly been a positive effect from monetary and fiscal interventions on markets. The lowering of interest rates, injection of liquidity into credit markets and improvements in risk sentiment have aided global financial conditions. From the height of the panic in March, measures of equity, interest rate and currency volatility have fallen sharply.

After precipitous declines, up to 40% from their pre-coronavirus peaks, global equities have rebounded (Chart 4). Led by the technology sector, the US S&P 500 reached a new all-time high in September. However, there are some growing concerns over a perceived disconnect between the performance of financial assets and the health of the real economy.

While such worries may be warranted, other markets are also displaying optimistic signs for the recovery. Following the onset of the current crisis, prices of industrial metals fell sharply. However, since May, driven by strong demand, prices have rallied from their lows to reach year-to-date highs (Chart 5). Oil prices tell a slightly different story. After collapsing to just $16/bbl in May, the recovery in Brent Crude prices stalled around $40/bbl, reflecting that demand from some key sectors, including travel and transport, is still well below pre-coronavirus levels.

Chart 5: Commodity prices have risen from their lows in May



Source: Bloomberg, Lloyds Bank Commercial Banking (1 October 2020)

Movements in the US dollar (Chart 6) also suggest financial markets are more stable. At the height of the panic, there was a surge in demand for dollars, so much so that key central banks across the world took coordinated action to increase the availability of US dollars. Now, with markets much calmer, narrowing interest rate differentials and rising political and geopolitical risks associated with the US have made the dollar less attractive to hold. Our Radar Economic reports – '**Will the USD still be smiling?**' and '**US Dollar pressured by prevailing risks**' – tell the whole story.

Chart 6: The USD has been under pressure in recent months

Source: Bloomberg, Lloyds Bank Commercial Banking (1 October 2020)

The messages from gauges of economic sentiment, global equity markets and industrial metals prices are encouraging. However, it is still unclear whether the global economic recovery will ultimately be 'V', 'U' or 'W' shaped. Labour markets around the world are stressed. And, while various central banks and governments have provided extensive support to individuals and corporations, it remains to be seen how well households and businesses will hold up as this is gradually withdrawn.

Recently, interest rate markets and gold prices suggest that investors may be preparing for a further deterioration in the economic outlook. Across the US, German and UK government bond yield curves, there has been a disappointing lack of 'curve steepening' – when longer-term interest rates rise at a faster pace than shorter-term interest rates – suggesting that the market is cautious on the current recovery. Moreover, gold prices recently rose to a new all-time high, peaking close to $2,100/ounce. Given its well-known status as a 'safe haven' asset, the recent rally is potentially a warning sign.

Risks on the horizon

In this section, we highlight three key events that could trigger significant volatility in financial markets going into year-end:

1 Resurgence in coronavirus cases

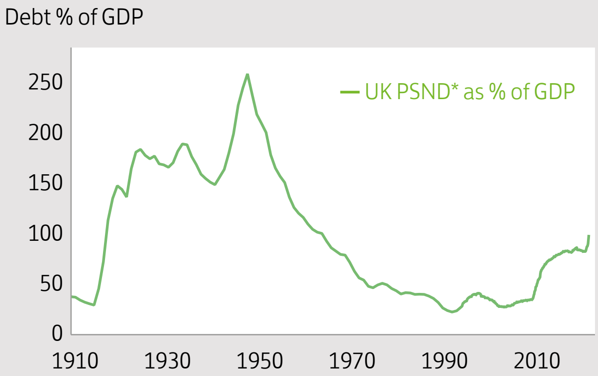
The greatest near-term threat to the global outlook comes from an escalation in virus infections and deaths, leading governments to impose further restrictions, which will damage confidence among consumers and businesses. As highlighted earlier, the impact and response to the coronavirus across countries has varied.

The US and India continue to contend with the highest caseloads globally, while some countries in Europe, including France, Spain and the UK are experiencing a sharp rise in the prevalence of the virus.

There are concerns that the transmission of the virus may rise during autumn and winter and the re-introduction of even tighter restrictions may become necessary. BoE Chief Economist Haldane has described the coronavirus as one of an "unholy trinity" of risks facing the UK economy (alongside a possible labour market shock and Brexit).

A resurgence in coronavirus cases may require further monetary and fiscal stimulus from policymakers. For financial markets retaining confidence will be crucial. Having recently passed £2 trillion – more than 100% of GDP – UK government debt is at elevated levels (Chart 7).

Chart 7: UK debt is greater than 100% of GDP



Source: ONS, Macrobond, Lloyds Bank Commercial Banking (2 October 2020)
* PSND: Public Sector Net Debt

That said, given interest rates are so low, servicing the debt appears to be affordable. Based on data from the Office for National Statistics, it only took 4% of UK government revenue to service the national debt in 2019/2020, the lowest in the post war period. However, with government revenue under pressure and additional debt taken on as a result of the pandemic this could potentially change.

Key will be what happens to long-term government bond yields, or the price at which governments fund themselves. If bond yields rise sharply, government finances may become a bigger concern for the market.

2 The US Presidential election

Scheduled for 3 November, the US Presidential election may trigger volatility across a range of asset classes. With the US economy still finding its feet following the coronavirus-induced recession and his decision making through the crisis coming under fire, support for President Trump appears to have faded.

At the time of writing, former Vice President Biden leads Trump in the polls, and by a margin most commentators suggest is enough for a comfortable Democrat victory.

Historically, a Republican victory would be viewed as a 'pro-business' outcome and positive for financial markets. However, this time may be different. President Trump's aggressive foreign policy and divisive leadership at home have resulted in a significant risk premium being attached to Republican success.

Escalating geopolitical tensions with China also pose a significant threat to the global economy. Ongoing 'trade wars' and the targeting of Chinese corporations in the US have been particularly unsettling for investors. Either way, the election result will have important implications for US fiscal and foreign policy.

Moreover, President Trump has suggested that should he lose, there may not be the usual smooth passing of power from one president to the next. A post-election constitutional crisis presents an unusual risk going into the 2020 election. In addition, the balance of power between the Republicans and Democrats in the House of Representatives and Senate will be an important factor in the path of the presidency.

The run up to the election has been further complicated after President Trump confirmed that he tested positive for coronavirus, and was subsequently hospitalised. Clearly the final few weeks of campaigning will be significantly disrupted. An act of Congress would be needed to postpone the election, although this appears very unlikely. Even so, given the fluid political situation, significant swings in risk sentiment could drive volatility in equities, commodities and the USD.

3 UK–EU trade negotiations

For the UK, trade negotiations with the EU present another risk going into the final months of the year. Recent developments have raised concerns over the prospects of the UK and EU ending the transition period without a trade deal in place, and defaulting to World Trade Organisation terms.

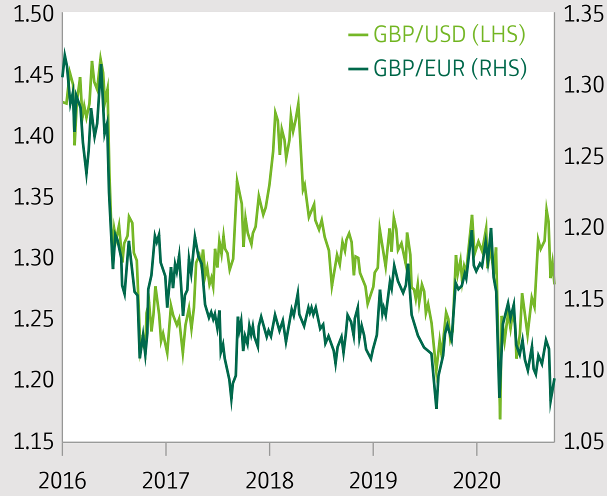
The publication of the Internal Markets Bill has further soured relations between the two parties, with the EU responding by initiating legal action against the UK. Negotiations remain delicately poised. More recently, UK Prime Minister, Boris Johnson, and President of the EU Commission, Von der Leyen, agreed to intensify talks ahead of the EU Council meeting on 15 October. Should sufficient progress be made in the coming weeks, subsequent 'tunnel' discussions – a final phase of intensive negotiations – may open a path to a deal.

Three possible outcomes still remain - the UK and EU negotiate a free trade agreement; the UK and EU fail to negotiate an agreement and a 'no deal' exit ensues; the UK and EU agree to extend negotiations beyond the end of the year.

It has been suggested by some commentators that a disruptive 'no deal' could be the most damaging scenario. Previous guidance from the BoE in September 2019 suggested that its worst case scenario would result in a peak-to-trough fall of 5.5% in UK GDP. The economy is undoubtedly in a very different position now compared to when that assessment was made, but the market is still concerned about the degree to which a 'no deal' exit would slow the ongoing recovery.

If a deal is not reached by the end of the year, and UK economic activity comes under pressure, the BoE could act to support the economy. This may be one reason why financial markets are speculating on negative interest rates in the UK. Even if a free trade agreement is successfully negotiated, the UK and EU will be moving to a less open trading relationship. A closer relationship will likely lead to less economic stress, while a more distant relationship could cause greater economic harm.

Chart 8: The pound has experienced sharp moves against the USD and EUR



Source: Bloomberg, Lloyds Bank Commercial Banking (1 October 2020)

The pound has been rudely awakened to the risks associated with the UK and EU not reaching an agreement on a trade deal. The GBP fell below 1.30 against the USD and below 1.10 against the EUR (Chart 8). Movements in GBP risk reversals - which reflect the relative demand for protection against rises or falls in the pound - suggest the market is concerned about GBP weakness.

That said, the overall rise in GBP volatility is evidence that investors are preparing for the potential of larger moves in either direction compared to just a few weeks ago. Should a 'no deal' scenario ensue, sterling may fall further. Based on market pricing*, the market assigns a 10% chance to the pound declining to 1.19 against the US dollar and to 1.03 against the euro by the end of the year.

In contrast, confirmation of a UK-EU trade deal may lead to a rise in sterling. Market pricing* suggests there is a 10% chance that the pound could rally to 1.38 against the US dollar and to 1.16 against the euro by year-end. However, ultimately the perceived closeness of the future relationship between the UK and EU will be crucial in determining whether the pound is able to continue to rise over the medium term.

* GBP/USD: spot – 1.28, 3-month volatility – 11.4
GBP/EUR: spot – 1.10, 3-month volatility – 9.4
(based on Bloomberg as of 2 October 2020)

Case studies

The coronavirus crisis triggered many operational challenges for businesses across the UK and around the world. But having overcome many of these difficulties, clients are more actively considering financial risk management strategies to mitigate market exposures over the coming months and years.

Financial market volatility poses a significant threat to corporate profitability. However, at the same time, swings in market prices for currencies, commodities and interest rates also offer opportunities to secure much needed certainty in cashflow expectations. Through regular communication, our teams have been helping clients capitalise on advantageous market moves, facilitating them to lock-in favourable hedging rates for future purchases or sales.

Given the ongoing uncertainties with supply chains, budget rates, expected demand and distribution channels, hedging future exposures has given many clients the confidence to re-focus on their core business in the knowledge that upcoming risks, including a second wave of coronavirus, the US election and Brexit, have been at least partially mitigated. We present three cases in which we have helped clients manage their currency, commodity and interest rate exposures.

Currency Risk Management:
GBP/USD exchange rate

For many years we have worked closely with a supplier of bicycle equipment into both major retail and independent stores, helping them manage significant currency risk arising from supplier purchases in the Far East. As movements in the GBP/USD exchange rate represent the largest financial market risk to the business and having restructured their portfolio of hedges in January to take advantage of the post-election rally in the pound, we were ideally placed to open strategic discussions as soon as the effects from the first wave of Covid-19 were felt.

Not only were there immediate concerns about supply chains in general out of the Far East and the disruption to demand, but the precipitous fall in the GBP/USD exchange rate coincided with an uptick in demand for their products that gathered pace throughout the lockdown period. As the sector benefitted from swift changes in commuting, transportation and lifestyle choices, we engaged with the customer to understand the extent of this unforeseen demand. We conducted an analysis on their existing hedging program and the associated impact from the new exposures, resulting in a requirement to overhaul the current policy to meet their new requirements.

With uncertainty remaining at unprecedented levels, and following the publication of our retail sector update, the client wanted a product that would offer them full protection on their USD purchases above their budget rate while at the same time providing flexibility to adjust their currency requirement in the face of unfolding domestic and international developments. The Participating Forward structure perfectly met their needs while also giving them a chance to benefit from any recovery in GBP/USD over their hedging horizon.

With these in place, we set up a bespoke markets call with our economics team that helped outline the additional risks that lie ahead in the form of the US election and Brexit. This proved invaluable to the management team who consequently asked for solutions that could help protect against these. By keeping in daily contact as we updated the team on market developments, they were able to layer in currency hedges for expected demand in H1 2021 that gave their hedging program welcome resilience facing into ever-evolving event risks for GBP/USD.

Commodity Risk Management:
Diesel prices

As the virus took hold across the world at the start of the lockdown, global oil prices were hard hit as demand from the world's largest consumers ground to a halt with economies effectively shut down. Despite coordinated efforts by OPEC to support prices before lockdown, the price of Brent Crude dropped by over $50/bbl from early January to late April ending as low as $16/bbl. As transportation compromises roughly two-thirds of crude consumption, domestic and international travel restrictions crushed demand for gasoline, diesel and jet fuel.

We work closely with a Midlands-based waste management specialist who are exposed to fluctuations in the price of UK diesel used to fuel their fleet of waste collectors. Despite not being their primary banker, our unique commodity hedging offering allowed us to work with the client to capitalise on the multi-year low in UK diesel prices. Having assessed the immediate impact from Covid-19 and using the company's forecasts through the recovery phase and beyond, we helped adapt the existing hedging policy to incorporate a much longer purchasing horizon. We presented the client with a range of solutions to take advantage of the prevailing price falls and supported this with scenario analyses and market forecasts.

The client chose to use a combination of the proposed products to meet their needs and, with daily contact from the sales teams in the form of bespoke market updates and pricing, they were able to lock in extremely favourable prices for their diesel requirements for the next 6 quarters.

Interest Rate Risk Management:
Debt Servicing Costs

The onset of the pandemic created immediate cash-flow challenges for corporates all over the world. We worked with a long-established media group to assess their upcoming debt commitments and implement a capital restructuring strategy that would bolster their working capital until business resumed.

The Lloyds Banking Group team presented a number of ideas to the client that would provide immediate relief to their balance sheet in the form of debt repayment holidays. In addition to these, the team took advantage of historic low levels of interest rates and proposed a risk management solution that would overlay a new debt hedging program over their existing products. The net effect was to reduce their fixed debt servicing costs by over 50% for a longer period, giving the company more certainty over their future obligations.

Consequently the group and its investors now have the time and confidence to refine and implement their response to Covid-19.

Conclusion

The coronavirus crisis, which resulted in the deepest economic recession in modern history, has reiterated the importance of financial risk management, particularly during periods of unprecedented uncertainty. Key developed market economies, including the US, Eurozone and UK have already suffered record declines in GDP through the first half of the year. Financial market volatility, including in equities, currencies, commodities and interest rates, has, at times, reflected the high degree of stress among market participants. Such volatility has the potential to significantly reduce corporate profitability.

However, swings in market prices also provide opportunities for businesses to use risk management strategies to secure much needed cashflow certainty in these highly uncertain times. We see three key risks that may impact the current economic and financial market recovery – a major second wave of coronavirus, the result from the US Presidential election and the outcome of UK-EU trade negotiations.

As recent moves in the pound confirm, these risks have the potential to quickly raise market volatility and reinforce the need to manage and benefit from effective financial risk management.

Key actions include:

- Keep up to date on the rapidly evolving economic and financial market backdrop as we continue to recover from the coronavirus pandemic via our Economic and Market Insight Hub.
- Explore how key risks may impact financial markets and investigate the degree to which large swings in currencies, commodities and/or interest rates affect the performance of your business.
- Discuss whether risk management products can insulate your business from financial market volatility and provide greater certainty in cashflow through these uncertain times.

Our risk management solutions

Lloyds Bank has solutions that can help you identify, quantify, and manage the potential impact that movements in the financial markets can have on your business.

Typical solutions, depending on requirements, include:

- **Forward Contracts** which offer complete certainty and protection from exchange rate fluctuations, on a fixed date or agreed window of dates;
- **FX Orders** which protect against an agreed worst case FX rate and/or a desired rate should the market move favourably.
- **Interest rate risk management** during a historic low rate environment. **Fixed rate loans** which provide known repayments over a defined term to suit your business strategy on all or part of your loan. Variable rate loans with the protection of a **capped maximum all-in rate** or **interest rate cap**.

These are available from our team of experts. For more information and points of contact, **please click here** or access our digital channel **Arena** for support.

In addition, our team can help with **Interest Rate**, **Commodity** and **FX Management** Solutions designed to protect against ongoing uncertainty, which include:

- Protection against unfavourable FX, Interest Rates and Commodity Prices whilst offering flexibility through periods of uncertain future cash flows;
- Adaptability to respond should prevailing market conditions be favourable to an established base case.

Lloyds Bank also has a variety of solutions that can help companies trading both in the UK and globally, including:

- **Supply Chain Finance**
- **Receivable Purchase**
- **Letters of Credit**
- **Trade Loans**
- **Guarantees**

These products can help address payment, counterparty and country risks. For more information, **please click here**.

Our service promise

If you experience a problem, we will always try to resolve it as quickly as possible. Please bring it to the attention of any member of staff. Our complaints procedures for businesses with an annual turnover of up to £25m are published at **lloydsbank.com/business/contactus** and for businesses with an annual turnover of £25m or more they can found at **commercialbanking.lloydsbanking.com/contact-us/**

Go to:
lloydsbank.com/help-guidance/coronavirus

If you would like to know more, please speak to your Relationship Manager

Please contact us if you would like this information in an alternative format such as Braille, large print or audio.

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