

CROSS-CURRENCY SWAPS: AN ELEGANT SOLUTION TO MANAGING INTEREST RATE AND CURRENCY RISK



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KEY INSIGHTS

- A cross-currency swap is a hedging strategy that ties together two important areas of corporate finance: interest rate and currency risk management.
- This type of hedge is flexible and offers a way to potentially lower interest rate payments, manage currency risk and qualify for favorable accounting treatment.
- Because cross-currency swaps are complex, it is critical that companies build institutional knowledge, assess their operations to be aware of their interest rate and currency risks and conduct industry peer reviews to understand how these swaps work in action.

U.S. companies with regular overseas cash flows and significant foreign equity positions may want to consider cross-currency interest rate swaps (or simply cross-currency swaps). This powerful type of hedge ties together two important areas of corporate finance: interest on debt financing and currency risk management. In fact, corporate treasury departments are increasingly adopting the strategy. According to the Bank of International Settlements, cross-currency swap trading volume increased by almost a third between 2016 and 2019, to \$108 billion per day, doubling from \$54 billion in 2013.

Unlike a standard single-currency interest rate swap, a cross-currency swap sets the notional amounts and payments on the pay-leg of the swap in a currency other than that of the receive-leg (e.g., U.S. dollars (USD) vs. the Euro). This swap helps when a company has unhedged revenues originating in the Eurozone, for example, that it wishes to use to pay down U.S. debt.

Cross-currency swaps are very flexible. They can be tailored to the specific needs of a company and help in three primary ways: possibly lowering interest cost and qualifying for favorable accounting treatment, as well as helping to manage currency risk. Moreover, they require minimal ongoing administrative work, adjustments or layering of additional hedges. For these reasons, many corporate treasury officials consider cross-currency swaps an elegant solution to many challenges related to simultaneously managing interest rate risk and currency risk in international operations.

Potentially Lowering Interest Rates

Because these swaps typically have zero upfront costs and the spot exchange rate is applied to all cash flows, a company can convert a loan or bond obligation with a higher interest rate (e.g., USD) into one with a lower rate (e.g., EUR, CHF or JPY). This reduces net interest payments. This is advantageous for, say, a U.S. company that has funded a European acquisition with U.S. dollar financing, but wants to repay that debt with income generated by the acquired company.

5-YEAR SWAP RATES: EUR vs. USD

■ USD 5-Year Swap Rate ■ EUR 5-Year Swap Rate



Source: Bloomberg

Reducing Currency Risk

As a company expands internationally, its capital structure is often slower to adjust. For U.S.-based companies in particular the capital structure and debt tend to remain in dollars since U.S. capital and debt markets are very liquid and more easily accessible. As a result, companies often adopt ongoing hedging programs to cope with the growing currency risk. While these provide flexibility, they tend to be administratively burdensome. Cross-currency swaps offer a viable alternative: managing currency risk by synthetically creating liabilities in the currency in which a company generates revenues. In the case of a U.S. company that's funding a European acquisition with U.S. dollar financing, the cross-currency swap allows it to financially engineer those dollar liabilities into Euros.

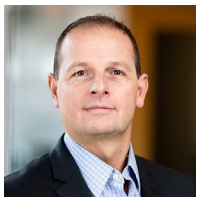
Accounting Benefits

Once executed, the swap must be recorded on the company's balance sheet, measured at fair value. That value will fluctuate based on changes in a range of factors over time, primarily, the spot exchange rate and interest rates for the two currencies involved in the swap. This fluctuation in fair value could have a material impact on current earnings. To protect against this, the company can designate the swap as a net investment hedge, which then allows the company to use changes in the swap's fair value to partially offset the impact of exchange rate fluctuations on the company's long-term equity exposure in a foreign operation. Thus, this hedge helps to minimize fluctuations of the equity value of that operation.

Cross-country swaps are more complex than other more commonly used hedging tools, and they may be difficult to adjust once executed. They require a good knowledge of interest rates and foreign currency markets, as well as various accounting treatments to avoid the adverse effects of any large swings in value. At the same time, they do offer powerful benefits. For a company considering cross-currency swaps, connecting with the right expertise to learn about them is critical.

Next steps:

- **Educate Stakeholders:** There's a learning curve with cross-currency swaps, and companies should seek out expertise to educate decision makers and stakeholders across treasury, corporate finance and accounting departments to build understanding and confidence with this strategy.
- **Assess Operations:** To determine if cross-currency swaps are appropriate, evaluate operations and run internal analyses on revenues by jurisdictions and currencies.
- **Conduct a Peer Review:** An industry peer review, often facilitated by outside experts, is an excellent way to learn how the hedging strategy works in practice at other companies within the industry.



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