AUSTRALIAN SUPER FUNDS

CROSS CURRENCY SWAPS

Russell Investments

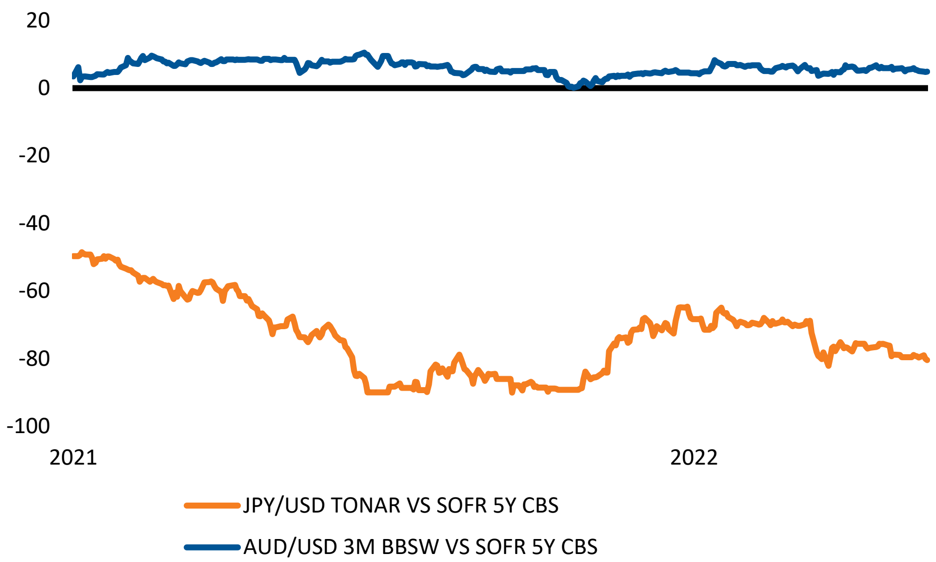
FORWARD-STARTING CROSS-CURRENCY BASIS SWAPS TO ENHANCE RETURN FOR AUSTRALIAN SUPER FUNDS

As the Australian superannuation (super) industry grows and exceeds the capacity of domestic equity and fixed interest markets, super funds are expanding their ownership of international assets. This raises the importance of currency management to total portfolio risk management. Cross-currency basis swaps are a useful instrument for investors to manage their portfolio's currency risk. Super funds can also take advantage of imbalances between demand and supply in the cross-currency basis swap market to enhance yield and earn additional return. In this short note, we explain how the latter can be achieved with **forward-starting cross currency basis swaps.**

What is a cross-currency swap and how is it used?

A cross-currency basis swap (or cross-currency swap) is an over-the-counter (OTC) derivative contract to exchange interest payments and principal in two different currencies. It can be used to hedge against exchange rate risks. The interest payments are usually based on benchmark rates, such as BBSW (Bank bill swap rate) for the Australian dollar or SOFR (Secured overnight financing rate) for the US dollar. In addition, a basis spread is quoted for the non-US dollar leg of the swap. To hedge the currency risk of a long -term USD-denominated investment, an Australian investor could enter a cross-currency swap to receive AUD interest (plus basis spread) and principal and pay the corresponding USD cash flows.

Chart 1: AUD-USD and JPY-USD 5-year basis spread (USD SOFR basis)



The sign of the basis spread tends to be persistent over time (see Chart 1). For example, it is usually positive for the AUD leg in an AUD-USD cross-currency swap. This means that the party receiving the AUD payments also receives an additional positive spread. On the contrary, when the basis is negative, such as for the Japanese Yen (JPY), the counterparty receiving JPY pays the spread. The basis has implications for the cost of using cross-currency swaps for currency hedging. A positive basis makes hedging USD back to AUD less costly for Australian investors than implied by the interest rates in Australia and the US. The opposite is true for Japanese investors.

What determines the basis spread?

The sign and magnitude of the basis is driven by the balance between demand and supply for lending and borrowing in the respective currencies. The spread also reflects the relative credit risk of the two reference rates. There tends to be an excess demand to pay AUD in the cross-currency swap market. Australian banks regularly acquire a significant share of their funding in foreign currency from overseas wholesale debt markets. Suppose an Australian bank issues a USD bond in the US market and exchanges the proceeds to AUD to create Australian mortgages or other AUD assets. To hedge the exchange rate risk of the funding, the bank would enter a cross-currency swap to receive USD (which it can pass through for interest and principal payments on the USD bond it issued) and pay AUD.

The previous benchmark interest rate for the USD, the London Interbank Offered Rate or LIBOR, has been phased out and replaced by SOFR. This means that the credit risk of the two standard reference rates in Australia (BBSW) and the US (SOFR) now differs significantly. The AUD rate reflects the credit risk of Australian banks while the SOFR rate is free of credit risk due to collateralisation. This disparity in credit risk should be considered when interpreting the basis spread on an AUD-USD (BBSW-SOFR) cross-currency swap.

Why should investors consider cross-currency swaps?

Apart from allowing issuers and investors to hedge their currency risk, investors could take advantage of the persistence of non-zero basis spreads to earn additional returns, irrespective of their currency hedging needs. So far, we have described the case where market participants enter cross-currency basis swaps immediately (spot-starting).

However, they can also use a forward-starting structure, for example a 2-year cross-currency basis swap starting in 2 years (called a 2Y2Y cross currency swap). Such a structure enables investors to take advantage of the positive basis of AUD-USD cross-currency swaps, which rises as we go further out in maturity. The current 2Y2Y AUD-USD basis swap spread is 10 basis points and the current 2Y basis swap spread is -1.4 basis points. If held for the forward period of 2 years, a receiver of the AUD-USD 2Y2Y basis can benefit from a rolldown of 5.7 basis points per year. If the basis curve stayed unchanged over that period, an investor could approximately gain AUD 210,000 on a notional position of AUD 100m[1].

The position can be taken on without upfront exchange of principal and no interest payments are exchanged over the first 2 years. It is therefore a capital-efficient and operationally convenient way to potentially exploit a demand-supply imbalance in the AUD-USD cross currency swap market, which is reflected in a positive and upward-sloping basis spread curve. Investors do need to exchange variation margin, which reduces the counterparty risks involved in the position.

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[1] This example is illustrative only and the approximate indicative profit mentioned is based on the market conditions and assumptions detailed above, as at 15 May 2023. It should not be relied upon in making an investment decision. Actual results may vary.

Why enter forward-starting cross currency basis swaps?

1

Potential to earn additional yield

2

No upfront capital needed

3

No principal and interest payments during forward period

Receiving the AUD-USD basis can also be a diversifier during risk-off periods, which usually lead to an increased demand for USD and a decline in the basis spread. The latter is beneficial to the position and act as an offset to risk assets in the investor's portfolio.

The bottom line

Investors can earn carry by receiving the forward-starting AUD-USD cross currency basis, when the basis curve is upward sloping. They may also use forward-starting cross-currency swaps to take a tactical position on the tightening of the spread. The instrument does not require an upfront capital outlay or processing of cash flows during the forward period although variation margin needs to be exchanged.

QUESTIONS?

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