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Thought leadership series: Currency hedging for Private Market GPs

Currency hedging is far more common in public markets funds than in their private markets equivalents.

In this piece, we seek to understand the reasons why, and what solutions are available for private equity and private credit funds.

Overview of FX Forwards

For institutional investors, currency hedging is typically done with a combination of Spot and rolling FX Forward contracts entered into under an ISDA Master Agreement.

In funds, the FX Forward contracts generate profits for the fund if the currency being hedged decreases in value, and losses if the currency increases.

A fund will enter into a Spot FX contract to purchase the Investment Currency against delivery of the fund's Base Currency. The FX Spot and more important the Forward notional, the Net Open Position (NOP) will be sized to the asset(s) being hedged.

Prior to expiry of the FX Forward, a Spot FX is entered into to settle on the same day as the old FX Forward to NET the cash settlements to generate only the FX Profit or Loss from that period. At the same time a new FX Forward will be entered into (the roll). While technically separate contracts, a simultaneous Spot and Forward is often referred to as an FX Swap, but is not to be mistaken with a Cross Currency Swap.

The length of the contract (frequency of the roll) requires careful consideration. For liquid funds, a short contract, typically a month, will give a more accurate hedge, allowing the NOP of the FX Forward to be sized correctly to the value of the Investment Asset. However shorter contracts mean more contracts per year, and with each contract paying away a fee in the form of bid/offer spread, too short and there is too much fee drag on performance.

While monthly rolls are popular, Funds sometimes choose to roll their FX hedge inline with the valuation cycle of their Fund, be it quarterly, semi-annually, or even annually although the longer roles are not as common, possibly for reasons outlined below.

Public markets / liquid funds

If the asset being hedged is liquid and tradable, profits from the FX Forward can be re-invested in the asset being hedged. Losses will be met by selling part of the asset being hedged.

This way, the allocation to the asset, in the fund's base currency, has not changed.

> "FX Forward contracts generate profits for a fund if the currency being hedged decreases in value"

Because private markets funds often cannot reinvest FX Forward profits (or sell the asset to meet losses), the FX hedge will not be as effective over time, especially if there are large currency movements, although still far more effective than not hedging at all.

Margin - the big problem

FX Forward Contracts are derivative contracts, which means one important thing, Margin. The way that Margin is agreed and posted is defined within the Credit Support Annex (CSA)

Margin - worked example

- Example, €1bn fund, with €200m (20%) assets in GBP, requiring FX hedging.
- Fund buys a €200m rolling FX Forward to sell GBP and buy EUR.
- If GBP/EUR starts the month at 1.19, and moves up 5% to 1.25. The fund will need to find cash of 5% of €200m (€10m) to post as margin (intra-month) and/or settle the FX Forward.
- If this 5% move is over several months, the €10m will be paid over multiple margin calls and rolls.

of the ISDA agreement. Generally FX Margin has two components. Firstly, there will be an Initial Margin (IM) which is a function of the 2 day volatility of the currency pair plus a factor for Credit Risk, and this is negotiated and fixed within the terms of the CSA. Secondly, there will be Variation Margin (VM) which is simply the market value of the FX Forward.

Every minute of the day, currency markets move, and with it, the market value (or mark-to-market) of the FX Forward contract.

> "What happens if you can't meet a margin call? Legally this is serious, you have defaulted on your ISDA Master Agreement"

It is the combination of the two that is required to be posted, and more often than not it is not a true 2-way CSA meaning that in margin terms the Fund will not fully benefit from FX Profits and would have to post at least the IM to their FX provider whereas all losses need to be posted to the provider.

This means that if the hedging currency rises, the Fund's FX Forward will generate a negative mark-to-market, and ordinarily, the counterparty (typically a bank) will want cash posted to it, typically on 2 days' notice. While not impossible, a bank will very rarely post FX Margin to a fund.

For private market funds without assets able to be sold in this timeframe, this is obviously a huge problem. Even for those that do generate cash (such as credit funds), there can be no guarantee enough cash will be available to meet a margin call.

While you only need to settle the FX profit and loss when the Forward "rolls", margin needs to be posted in between. When you consider the potential movement of FX over a month then it can be seen that the VM could become not insignificant. Furthermore, if the term of the Forward is longer, at 3 months, or 6 months, or even longer then the probability of the potential margin requirement becoming significantly large (over 25%) is greater than it would be for 1 month rolls.

FX providers need to make margin calls (over a de minimis threshold) for actual risk reasons (they have credit exposure) but more importantly (if they are banks) to avoid costly capital treatment therefore funds need to have access to 2 day liquidity cash to cover these margin calls.

FX Providers can waive the requirement for margin, but broadly, if margin calls are waived, the fund is implicitly being given a Credit Line. For bank FX providers, this costs them actual money, as a credit line is a real cost in terms of Risk Weighted Assets (RWA) the bank needs to hold against it which can only be mitigated if the Fund is large and rated, or already has significant collateral with the bank somewhere else that can be "cross collateralised".

What happens if you can't meet a margin call? Legally this is serious, you have defaulted on your ISDA Master Agreement. Practically, your FX hedge can be unwound by the FX Provider, and you will no longer be hedged.

Solutions to Margin

For private markets managers who cannot sell assets to meet 2-day margin calls, there are essentially two types of solution:

1. **Credit Facility**, a committed revolving credit facility secured on the fund's assets to draw on to meet margin calls, from your FX counterparty or a third party.

2. **Credit Lines** directly from your counterparty.

It is important to understand that both come at a cost to the fund (in the case of credit lines, often embedded in bid/offer spreads), and both require careful thought as to the amount of credit facility

Case study: Private Equity Funds

- Currency hedging is a tool infrequently used in private equity funds.
- But with cost effective solutions now out there to make it possible, shouldn't this now be reconsidered?
- If there is an investment, maybe a portfolio company operating in a single region, where there is a stable source of EBITDA in a different currency to the funds other investments, why should LPs be exposed to currency fluctuations.
- Why should the GP have to show under performance on a key asset purely because the currency of this EBITDA source depreciates during the life of the fund?
- But what will the lifetime costs be of the hedge? How will this be calculated?

Cost Comparison - solutions to Margin

NAV Facility

A NAV facility can be used for multiple purposes, but if just used for margin calls on FX facility, the costs can be broken down as follows:

1. Fixed costs, legal and upfront fees, typically 1-2%
2. Commitment fees, typically 1% per annum
3. Borrowing costs (Sonia plus spread)

(1) & (2) can be thought of as fixed sunk costs, and directly proportional to how much you decide you need (see earlier discussion). Over say a 5 year fund life, they will cost 6-7% of the credit line (the other hedging cost being bid-offers charged by your FX provider).

(3) is only spent when your base currency has appreciated. It is an moot discussion as to whether (3) are real costs or not. They clearly do cost real money, and with base rates still high, this is an all-in cost of maybe 7-9% p.a.. But this is only charged when your target currency has appreciated, at which point there is more of your your asset (in your base currency) to generate returns.

Credit line

Some providers will charge an explicit amount for a credit line, others do not.

But the trading costs (bid-offers) can be much higher for a provider that gives you a credit line.

Or you may need to hit agreed volumes (payment in kind).

Non-banks can have an advantage as providers here in that credit lines do not have the same internal costs (regulatory capital).

or credit line needed (see section below).

How much credit facility or credit line do I need?

This is the 64 million dollar question, best answered with our proprietary FX crystal ball!

There is a cost to having too much, but also a potential worse cost to having too little.

In our example fund, €1bn, with 20% (€200m) of assets in GBP, the risk (for margin calls) is a continuous or sudden increase in GBP/EUR.

In private markets, fund lifetimes are long, and hedges might be needed for 3-4 years (credit funds) or 7-8 years (equity funds). Currency markets can move a lot in that time!

If you decided that you wanted to cover a 25% move, in this example this means a credit facility, or credit line of 25% of 20%, or 5% of the fund commitments/NAV (€50m).

The problem is if you under estimate. In this example, if you had secured such a line, and it was not enough (GBP increased by 30%), practically you have to stop hedging. But that might be at the time worst possible time to stop hedging - markets often rebound after a large movement. Having lost €50m on the hedge as GBP went up, you are relying on making it back if GBP rebounds down, and if you can no longer currency hedge, you can't do this.

> "There is a cost to having too much, but also potentially a worse cost to having too little"

Maybe you will have enough time to increase your facility to resume (or prevent cessation) of hedging, but currency markets can move very quickly as we saw at the time of GFC in 2008, and then in 2015 when the swiss franc depegged from the euro and jumped 20% overnight.

Credit funds that generate cash are better placed to deal with gradual movements over many months, but they too will struggle with sudden movements.

A related issue, especially if you need to make back losses, is that for private markets funds, hedging is needed for a long time, but credit lines and NAV facilities can be pulled, or rely on consensual rolling say annually.

Other instruments

There are other methods of hedging such as Exchange Traded Currently Futures, or CFD's which essentially do that same but without large Spot movements, but Margin is still required.

Another possible hedging method would be to use Currency Options in place of rolling Spot and Forwards. Whilst the complexity imbedded in the use of FX Options are outside the scope of this paper, FX Options act as an insurance policy where the Fund can decide on how much FX risk it is willing to take before it wants FX protection.

Essentially, the Fund pays an Option Premium to purchase a Put or Call with a Strike Price set to the loss level on the FX Rate that the Fund is willing to accept. A bit like an insurance excess, the more the Fund is willing to lose on FX movements the lower the fee they will pay for the Option, and the longer they want the cover to last the more it will cost.

Final thoughts

Funds need to balance the cost of their hedging versus the costs of not hedging. Historically, some Funds considered FX Hedging to be an "Operational Function", or just didn't consider it important.

As shown above, there is a real cost to hedging, both in terms of the fee paid at each hedging point, usually in FX Bid/Ask spreads, and in terms of the requirement for cash to be at hand, or available via credit facility or credit line. We have seen that credit facilities and credit lines cost, but similarly holding for example 25% of the value of an FX hedge in cash equivalent assets can cause a drag on the performance. But then an unhedged 20-25% FX move in the wrong direction will create a much larger drag on performance.

At Ganymede, we believe that with the wider availability of FX Hedging solutions for illiquid assets, and large FX moves in recent years, now is the time for those responsible for the investment returns of private credit and private equity funds, to perhaps re-evaluate their FX hedging strategy.

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How can Ganymede help with FX Hedging

We speak to many different FX providers in the market, both Bank and Non-Bank and we can help you understand the differences between these two groups.

We can help you navigate to a solution, helping you find FX Providers, and helping you arrange Credit Lines or Credit/NAV Facilities to match your requirements.

We:

> Are independent and solely represent the interests of our clients in seeking and negotiating innovative financing structures to meet requirements;

> Utilize the breadth of our network to seek the most cost effective and streamlined solutions for our clients;

> Promote competition amongst providers to ensure that our clients can duly claim to have fulfilled their fiduciary responsibilities of seeking the most appropriate terms with respect to a given financing and hedging situation; and

> Work with our clients at all stages of the process – seeking appropriate counterparties, negotiating terms, running competitive bid processes, executing a structured transaction and helping clients navigate the post execution landscape.

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