MillTechFX
by Millennium Global

The MillTechFX UK FX Report 2023

The intensifying FX challenges for fund managers

Summary

Foreign exchange (FX) risk management has risen to the top of the agenda for many senior finance decision-makers at fund managers throughout 2023.

Although volatility has decreased since peaking towards the end of 2022, it is still a persistent threat due to a combination of rising interest rates, high inflation and geopolitical uncertainty.

Sterling hit a 15-month high in July, proving to be the best-performing major currency against the US dollar in 2023, rising 6.6%. In September, it dropped to three-month lows against the dollar.

Having reached a two-decade high against other major currencies in September 2022, the US dollar slid to a nine-month low in February 2023 and continued to dip until it rebounded again in September 2023. Meanwhile, the euro hit a six-month low in September 2023 after the ECB raised interest rates to a record high.

While fund managers are likely to welcome the drop in volatility in recent months, it hasn't gone away completely and they must not become complacent. This backdrop, in addition to the wider macro environment, could create **uncertainty for returns on fund managers with exposure to foreign currencies.**

Despite the rising importance of having a robust FX strategy in place, many fund managers have traditionally struggled with several issues when it comes to their FX setup.

The usual first pain point is **establishing an FX infrastructure that achieves best execution.** Fund managers tend to only work with a **small number of counterparties** for their FX due to the operational overheads associated with setting up multiple banking relationships and this could mean they're not achieving best execution. **Best execution is not only a fiduciary responsibility**, but the downstream benefit of a competitive FX environment can bring significant cost-savings.

Secondly, fund managers might be subject to **various operational inefficiencies throughout the end-to-end trade process**. FX processes can be manual, cumbersome and time-consuming for many fund managers.

Without the right supporting systems, **price discovery alone can take multiple phone calls or emails** and after a trade has been booked there are numerous steps in the post-trade workflow too such as settlements, payments, regulatory reporting, mark-to-market reporting and sharing trade information with administrators. **Manual processes can be highly inefficient and susceptible to human errors** which may place greater drag on operational resources.

Transparency and governance of cost management is another major issue for numerous fund managers. Transaction costs can be hidden in the FX spread, typically calculated as the difference between the traded rate at the point of execution and the mid-market rate at that time. Due to the opacity of the FX market, **many fund managers struggle to compare the market** and find it challenging to get a transparent oversight of their FX execution and costs.

Finally, **FX forward contracts can be a significant drain on capital for alternative investment managers**, with many banks requesting collateral to be posted upfront (initial margin) and on an ongoing basis (variation margin). This can lead to a cash drag on the funds, with committed capital being held back to meet margin calls instead of being invested.

With this in mind, MillTechFX surveyed 250 senior finance decision-makers at UK fund managers to review where they are on their FX journey and where they would like to get to. The findings offer a **unique window into fund managers' views on FX**, how they're adapting their FX risk management practices and their priorities in the year ahead:

Mapping FX exposure – The increase in cross-border investments has increased the exposure of fund managers to foreign currency fluctuations, meaning **FX risk management has become a key consideration.**

Lack of transparency in FX – The majority of UK fund managers believe there is a lack of transparency in the FX market. The FX market has historically been seen as **opaque due to hidden costs** and an inability to compare the market.

Adapting to lower volatility – Although there is widespread acceptance that volatility has dropped in recent months, **fund managers are still prioritising FX risk management**. Three-quarters hedge their currency risk while half plan on increasing their hedge window in the year ahead.

Automation drivers – Nearly eight out of ten **(79%) are exploring new technology platforms to automate their FX operations.**

The key drivers are improved returns (31%) and operational risk reduction (31%), followed by eliminating silos (29%), cost-savings (29%) and efficiency gains (23%).

Counterparty governance is a priority for CEOs – The banking crisis was a huge wake-up call to fund managers across the globe, highlighting the risks of relying on only one banking partner. As a result, **80% of senior finance decision-makers at fund managers are looking to diversify their FX counterparties**, with this rising to 100% amongst CEOs specifically.

ESG is more of a priority for bigger fund managers – The proportion of respondents citing ESG as an important factor when selecting their FX counterparties **decreased from 58% in 2022 to 44% in 2023**.[1] This figure rose to 56% for firms with more than 500 employees, compared to 30% for firms with 50-99 employees.

Ultimately, the research has highlighted that it is more important than ever that UK fund managers gain a transparent view of their FX execution, streamline their operational workflows and consider implementing a carefully thought-out risk management strategy to manage their currency exposures throughout the rest of 2023 and beyond.

[1] MillTechFX CFO FX Report 2022 – The intensifying FX challenges for Fund Managers

Part 1

Mapping FX exposure

For fund managers who trade FX for risk management or transactional purposes, **FX can be seen as second order**; they transact in FX not because they 'want to', but **because they 'have to'** due to international business activities.

This FX exposure comes from:

Management fees– It is not uncommon to see fund managers **raise a fund in one currency but have offices outside the jurisdiction of their fund's base currency**. This means the fund manager receives its management fees in one currency but then has to pay for certain fixed costs, such as salaries and offices, in one or potentially multiple different currencies. **FX rate movements can place a greater strain on management fee income** and for that reason, fund managers commonly look to lock in exchange rates on expected fee income for as long as possible.

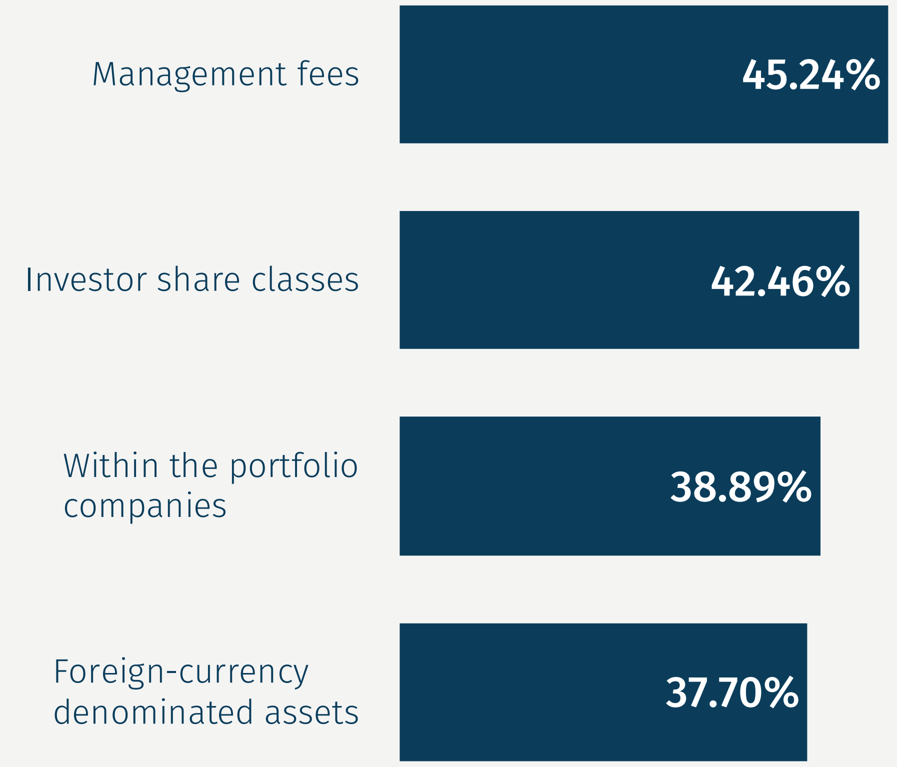
Investor share classes – As a fund manager matures, it becomes increasingly likely that they may see **foreign currency investors commit capital to their funds**. Some managers may take the stance of letting their investors manage their own FX risk, whilst others are more accommodative and implement share class hedging. **Share class hedging helps minimise FX risk when investors are considering which funds to commit to** and, in that way, can be a useful tool for managers to broaden their investor base and make their funds more marketable overseas.

Indirect, portfolio-level FX exposure – For some private capital strategies, such as private equity buyout, **the operational partners may want to overhaul how their portfolio businesses manage their FX exposure**. A fund manager may look to align their own setup and processes with those of their underlying portfolio and hold them to the same high governance standards.

Foreign currency assets - The more jurisdictions a fund manager's strategy allows for, the greater the number of investment opportunities.

However, considering annual movements in even G10 currency pairs can be significant, **FX rate movements have the potential to completely erode long-term value creation efforts**. This means that where practicable, fund managers may **explore hedging strategies to mitigate the impact of FX rate movements** on the portion of their portfolio that sits outside their funds' base currency.

Where does your FX exposure arise?



Part 2

Fund managers suffer from a lack of transparency in FX

Despite the significance of FX for fund managers, **73% believe that there is a lack of transparency in the FX market.**

The FX market has historically been seen as opaque for two main reasons:

Hidden costs

Pricing transparency is a recurring problem as **FX costs are typically hidden in the spread**. The transaction cost on any given trade can be calculated as the difference between the rate traded at, and the mid-market rate at that point. For example, if a fund manager buys €5m of USD at 1.1890 and the mid-market rate at the time was 1.1860, the transaction cost on the trade would be 0.25%, or €12,500.

This is not an explicit cost as the fund manager won't receive an invoice for this amount; rather, it's a hidden implicit cost. Let's make no mistake though: it's just as much of a cost.

Inability to compare the market

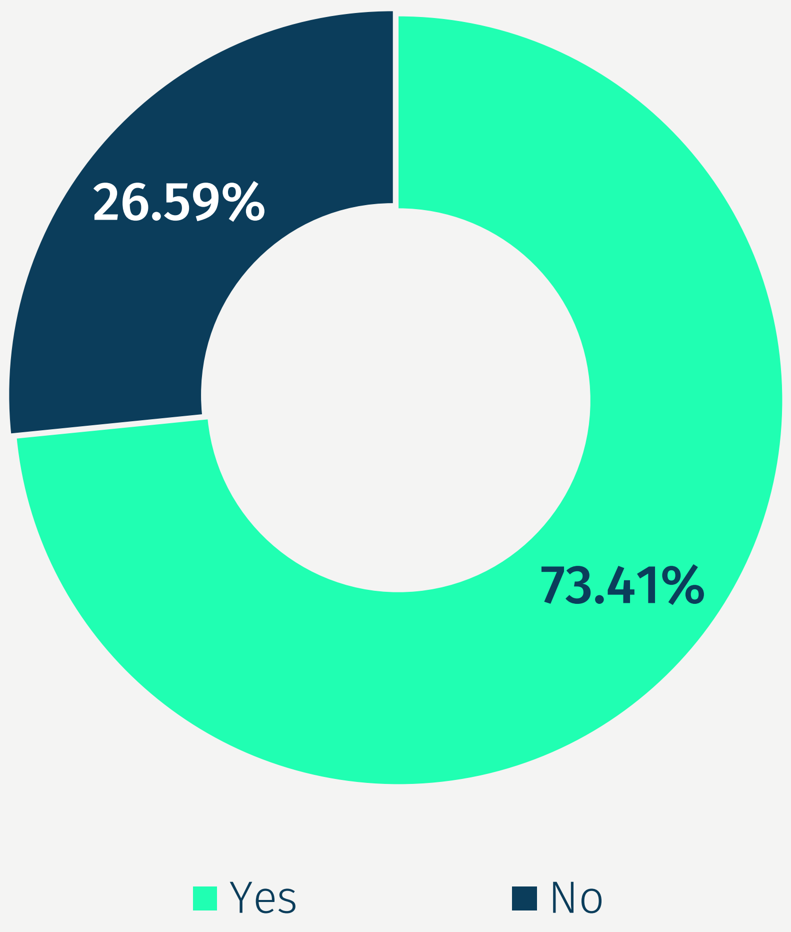
In addition, depending on the volumes they trade and their profiles, fund managers can have **limited choice on which and how many counterparties they trade with**. They tend to work with only a small number of banks for their FX hedging because of the operational complexity of setting up multiple banking relationships. This makes **it harder for them to compare prices in the market** because they have fewer access points and a smaller number of liquidity providers, meaning they may not get the best available rate.

Further, many fund managers **don't have access to third-party Transaction Cost Analysis**, which would help them to get a full diagnostic of their execution quality on an ongoing basis.

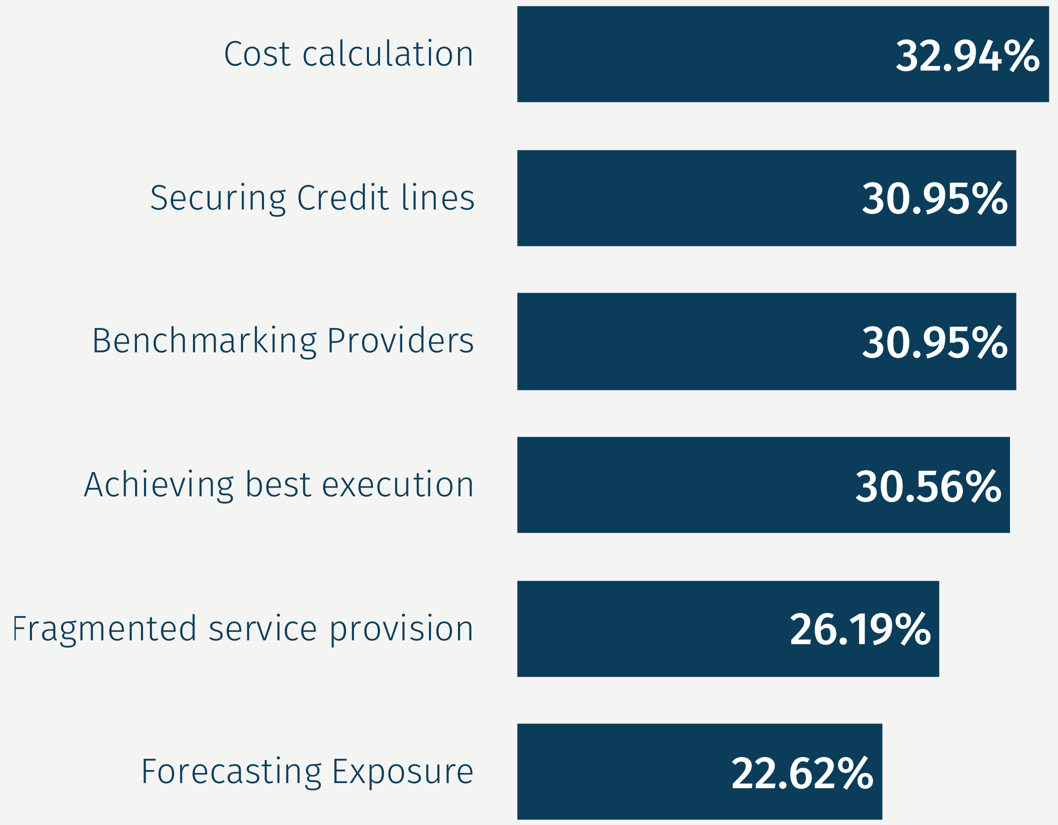
These factors combined mean that fund managers may often **experience a serious lack of transparency in the FX market**, with our research found that the biggest challenge they face when dealing in FX is cost calculation (33%). This was followed by securing credit lines (31%), benchmarking providers (31%) and achieving best execution (31%).

Aside from a lack of transparency, other FX operational challenges included manual processes (39%), onboarding liquidity providers (35%), getting comparative quotes (35%) and demonstrating best execution (33%).

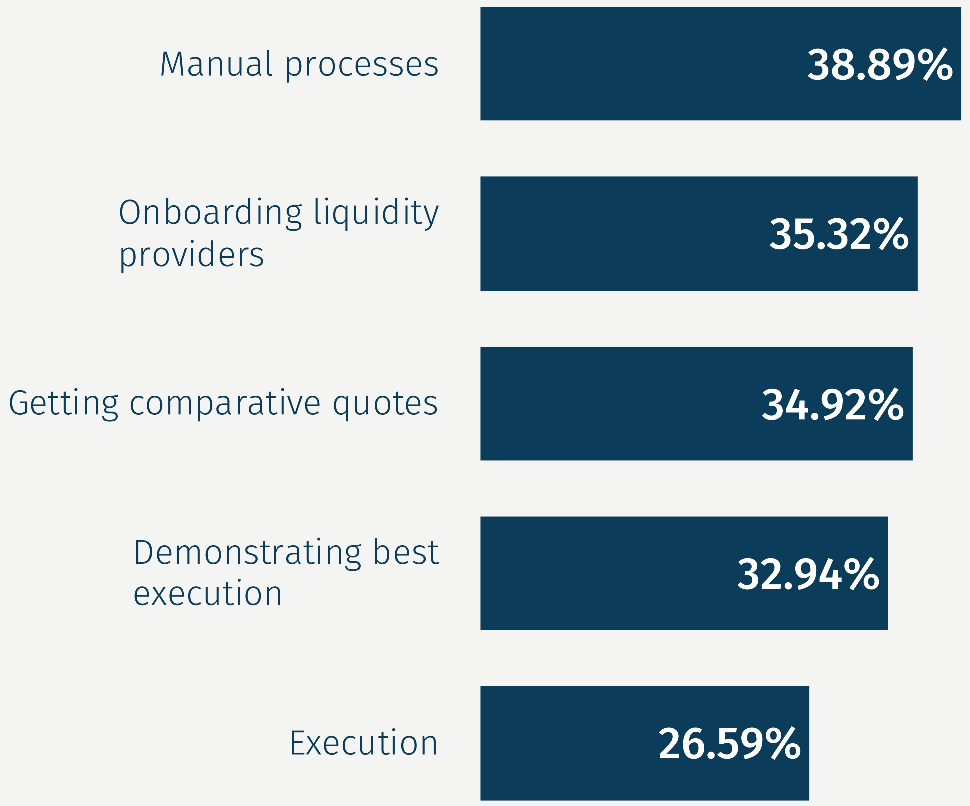
Do you think there's a lack of transparency in the FX market?



What are the biggest challenges you face when dealing with FX, if any?



What are the most challenging aspects of your FX operations, if any?



Part 3

Adapting to lower volatility

Although currency volatility has decreased since peaking towards the end of 2022, **it is still a persistent threat** due to a combination of rising interest rates, high inflation and geopolitical uncertainty.

Much of the recent focus has been on whether volatility will resurge in the coming months, but the more important factor at play is the uncertain economic outlook itself.

Hedging currency risk is one of the primary ways that fund managers can mitigate the risk posed by this uncertain financial climate, and while there will always be some that don't hedge their FX risk at all, the majority do to protect their bottom lines.

Our research found that three-quarters of fund managers hedge their currency risk and out of those that don't, **95% are now considering doing so given market uncertainty** (with 57% of those for the first time ever). 77% stated that their returns had been affected by GBP volatility.

Despite the recent calming of market volatility, the data revealed that the share of fund managers hedging a large proportion of their FX exposure grew from 46% in 2022 to 56% in 2023.[2] This figure rose to 65% for firms with over 500 employees, compared to 52% for firms with between 50-99 employees. This may be because as **a fund manager grows, the jurisdictional diversification of their assets and their investors base often increases too**, making FX risk management all the more important to larger firms.

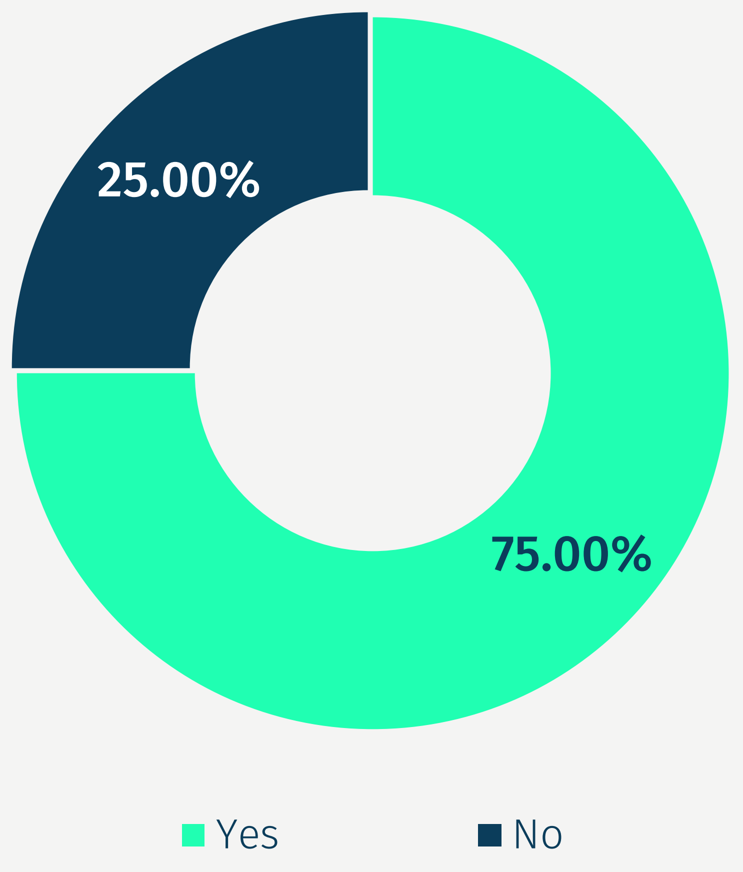
The average hedge ratio is between 40-49%, with 68% citing this as higher compared to this time last year. Similarly, the **average hedge length is 5.74 months**, with 58% citing this as longer compared to this time last year. Less than 1% have hedge windows longer than a year. This suggests fund managers are moving to hedge more of their exposure to protect their bottom lines from currency movements.

Looking ahead, **over half (51%) are increasing their hedge ratio to adapt to lower volatility**, while 50% plan on increasing their hedge window.

Interestingly, **75% believe that the cost of hedging has gone up over the past year.**

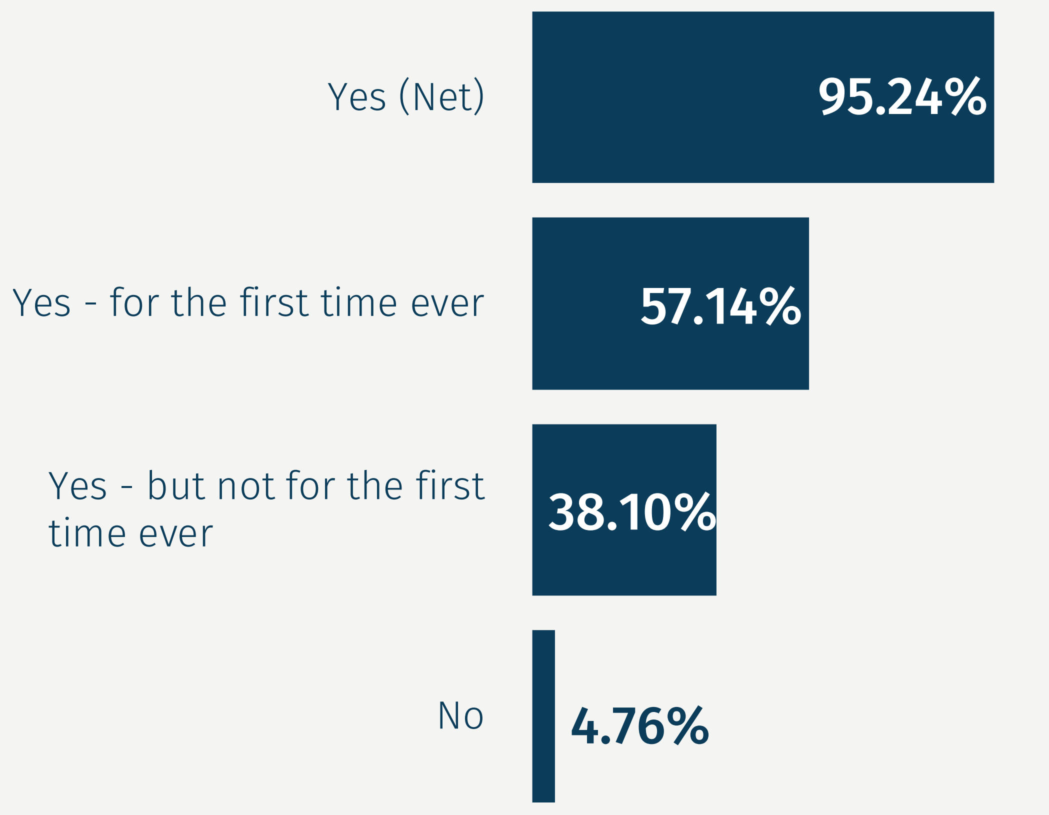
This means that fund managers should consider balancing the cost of hedging against the risk of not hedging and the potential impact this may have on their returns.

Do you hedge your forecastable currency risk?

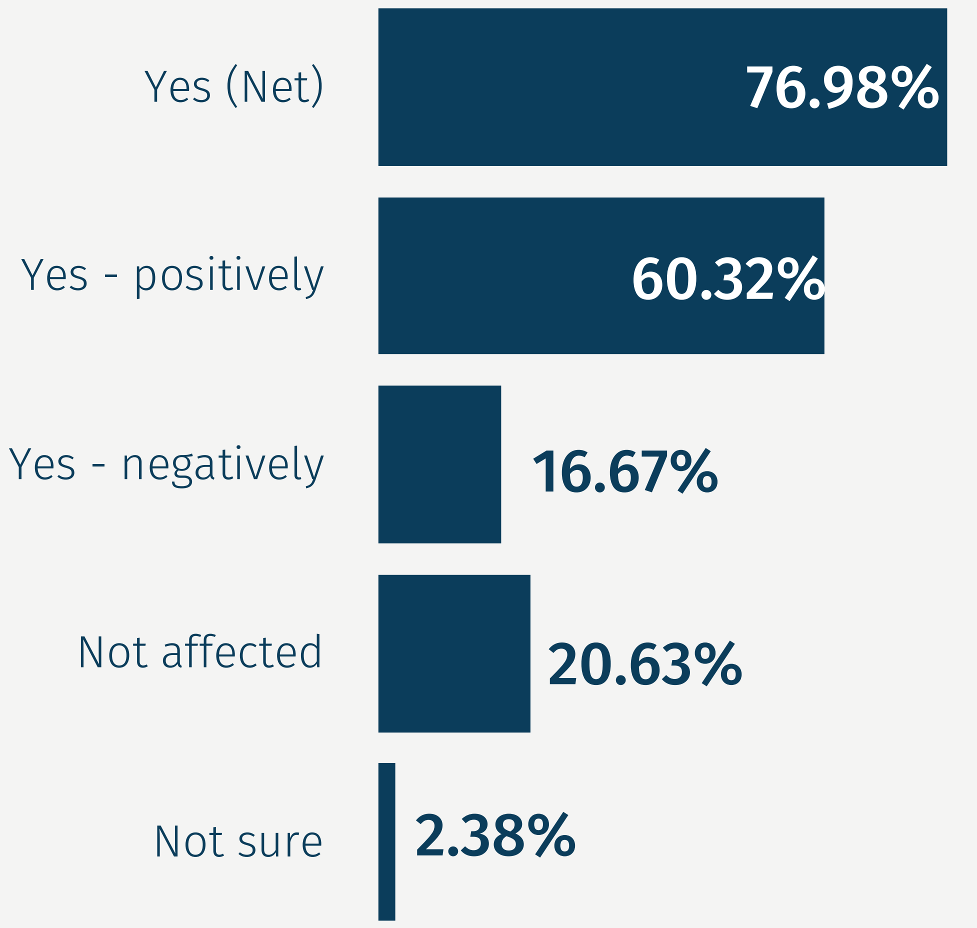


[2] MillTechFX CFO FX Report 2022 – The intensifying FX challenges for Fund Managers

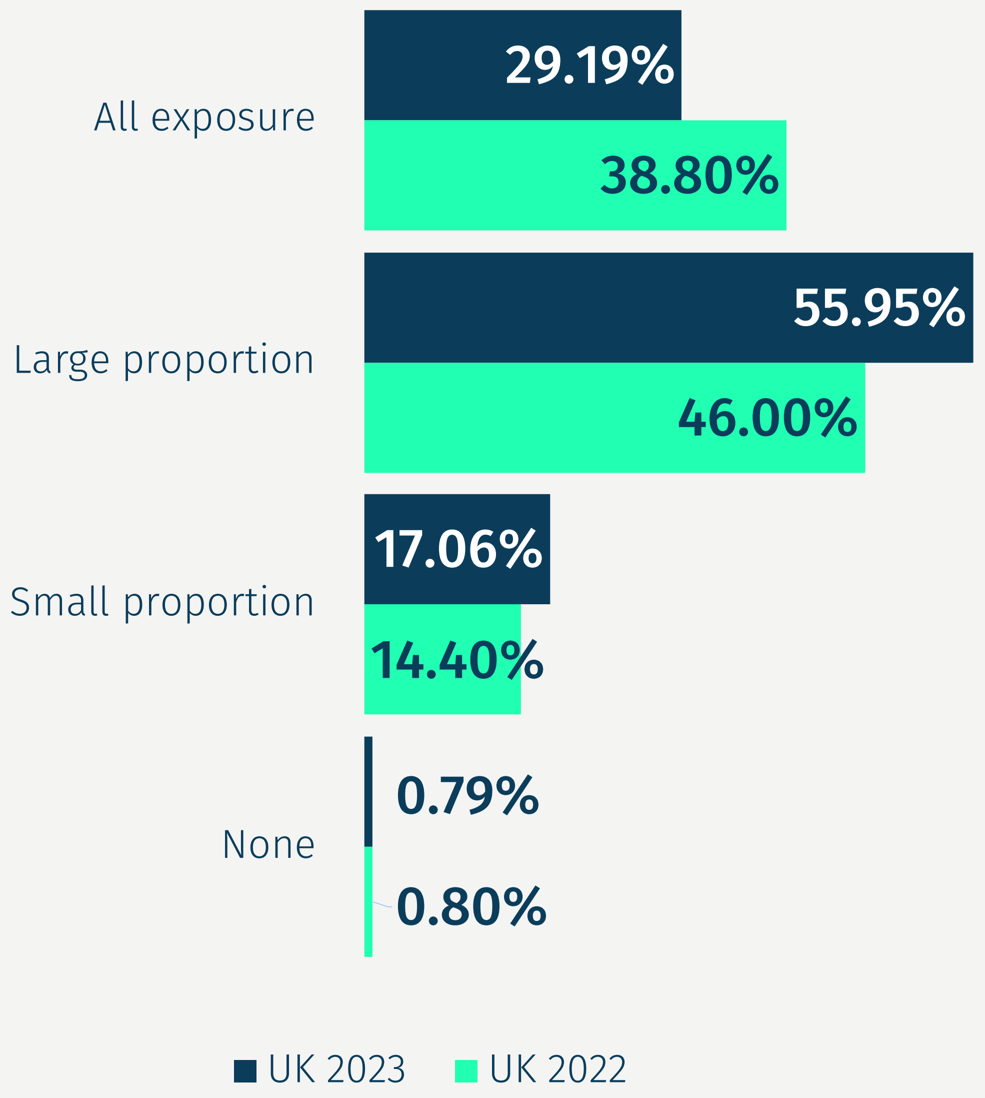
Are you now considering hedging given market uncertainty over the past 12 months? *Respondents who do not hedge their forecastable currency risk



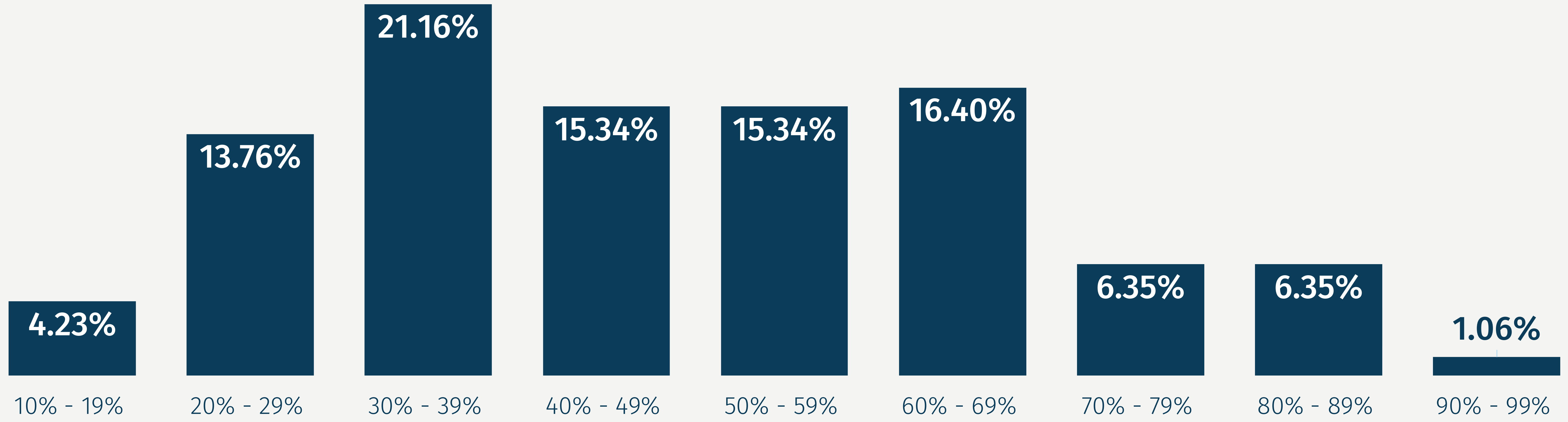
Have your returns been impacted by GBP volatility?



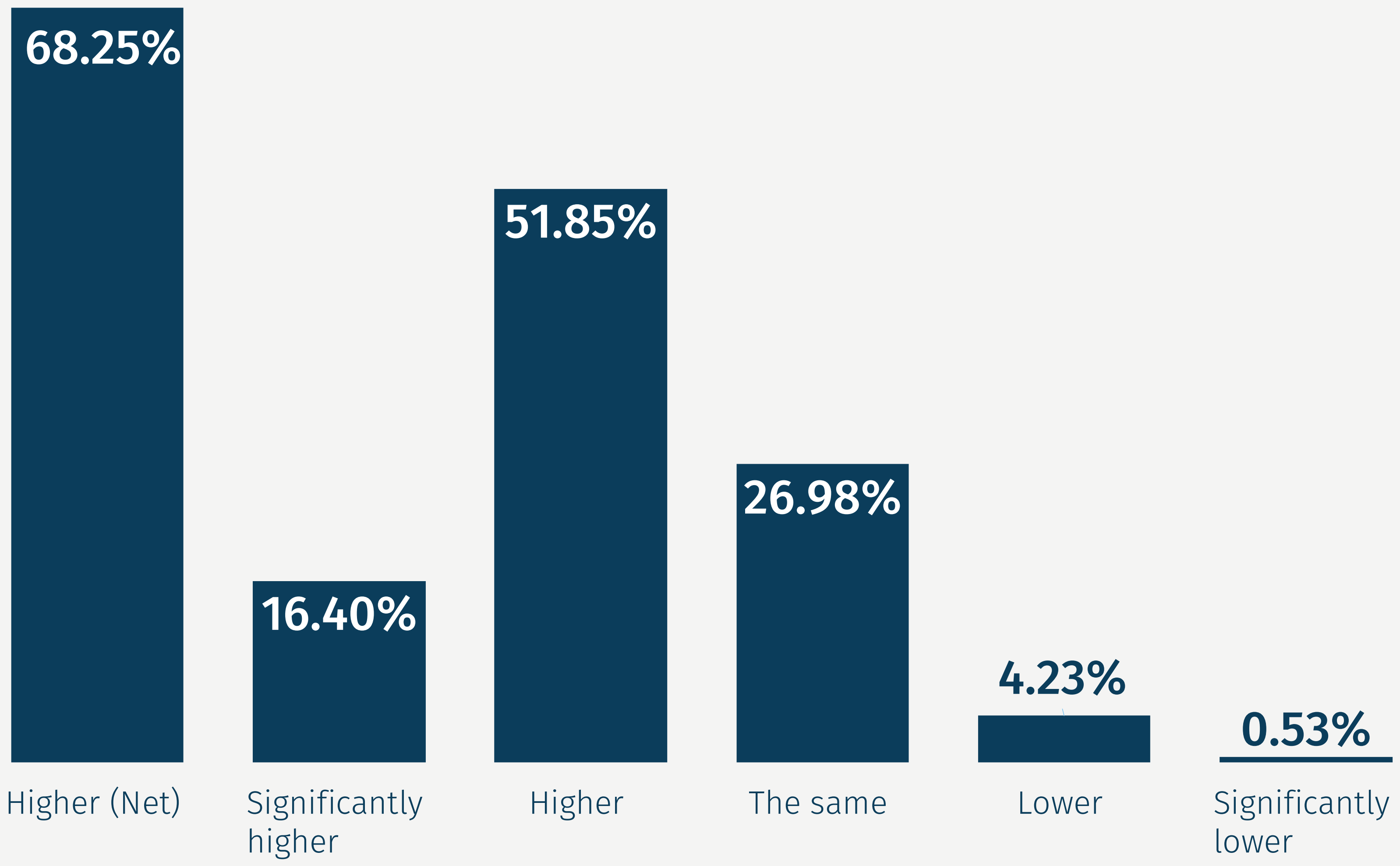
How much of your FX exposure do you hedge, if at all?



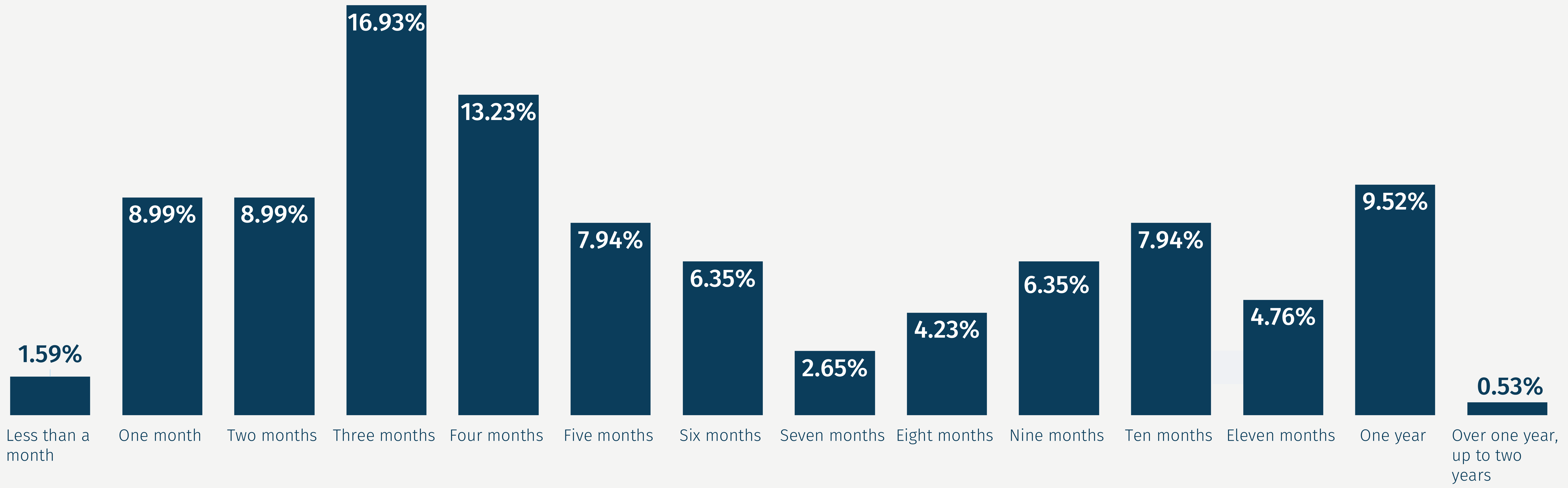
What is your current hedge ratio? *Respondents who hedge their forecastable currency risk



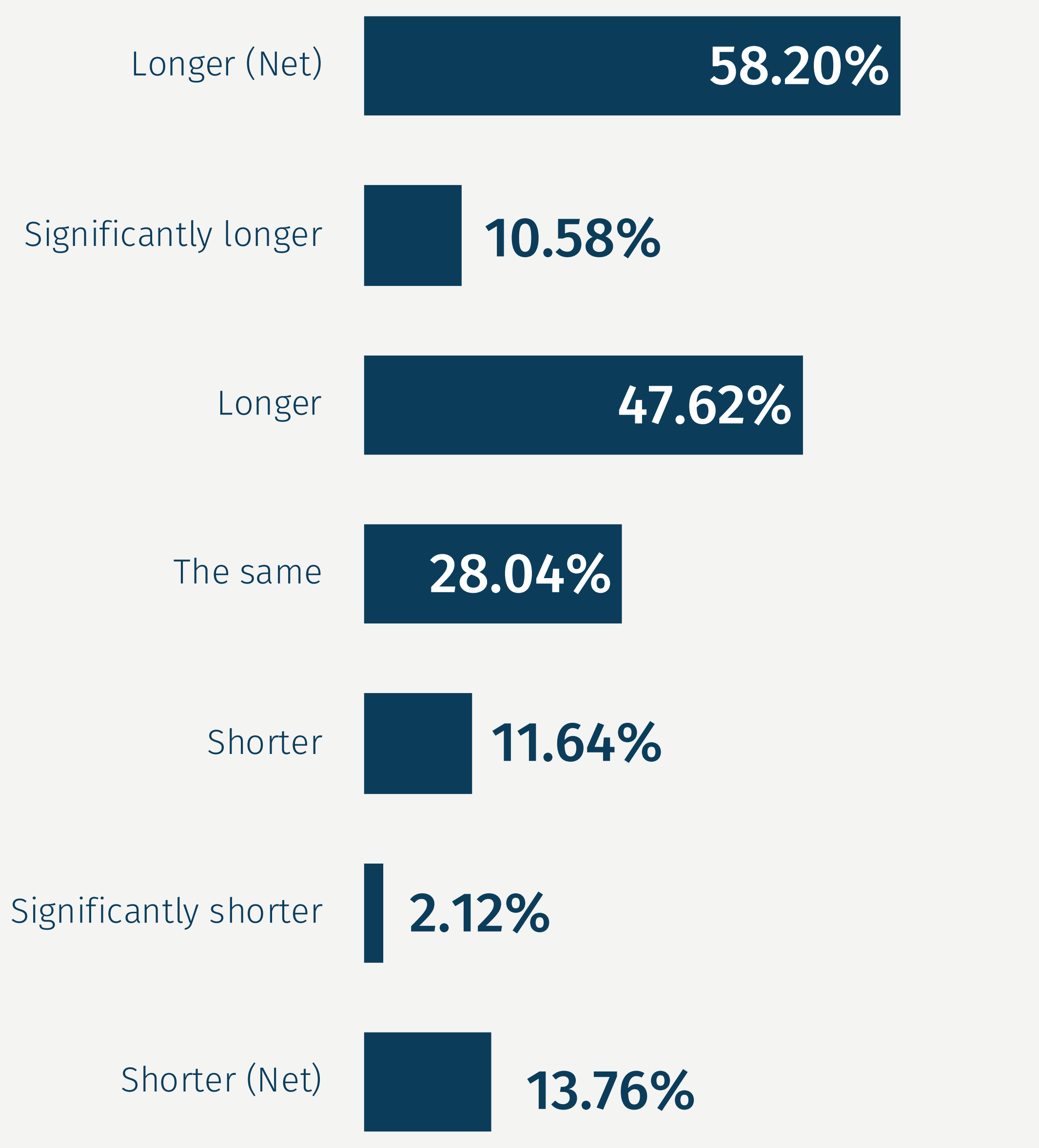
How does your hedge ratio this year compare to last year? *Respondents who hedge their forecastable currency risk



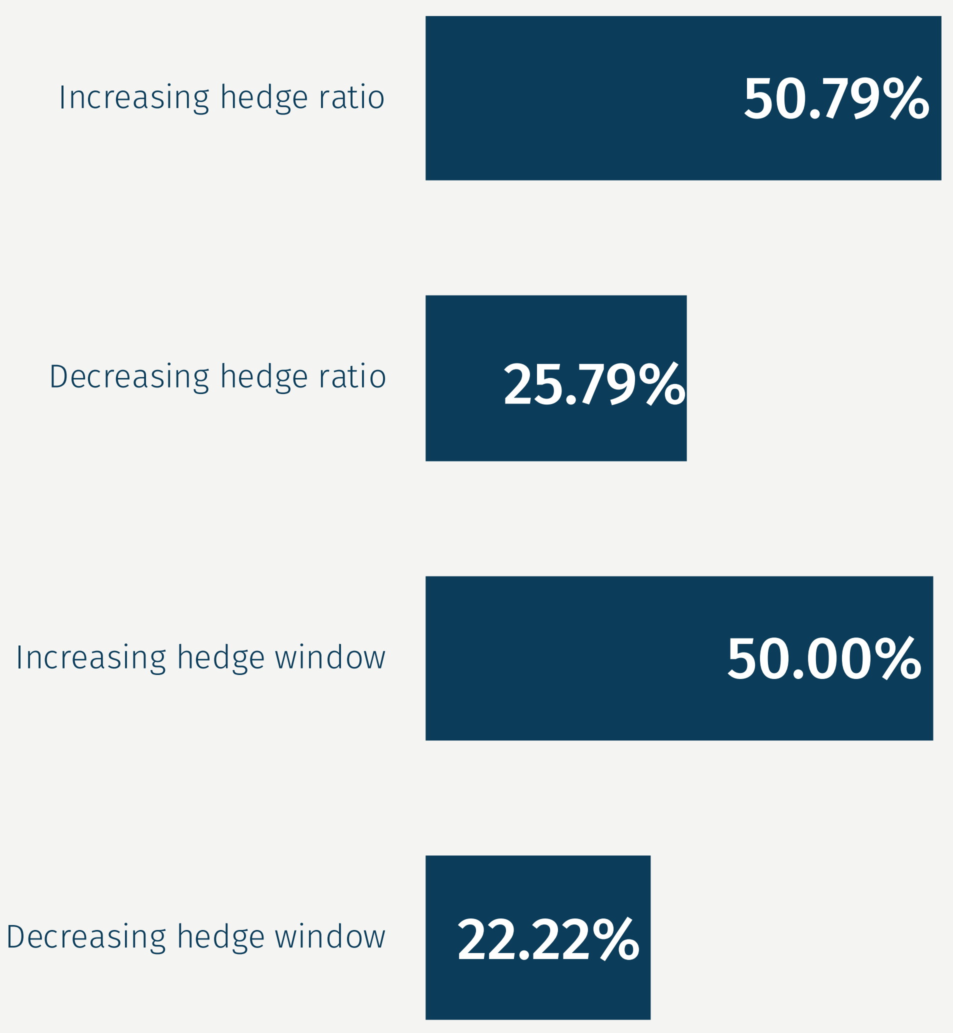
How far out, on average, do you currently hedge FX risk? *Respondents who hedge their forecastable currency risk



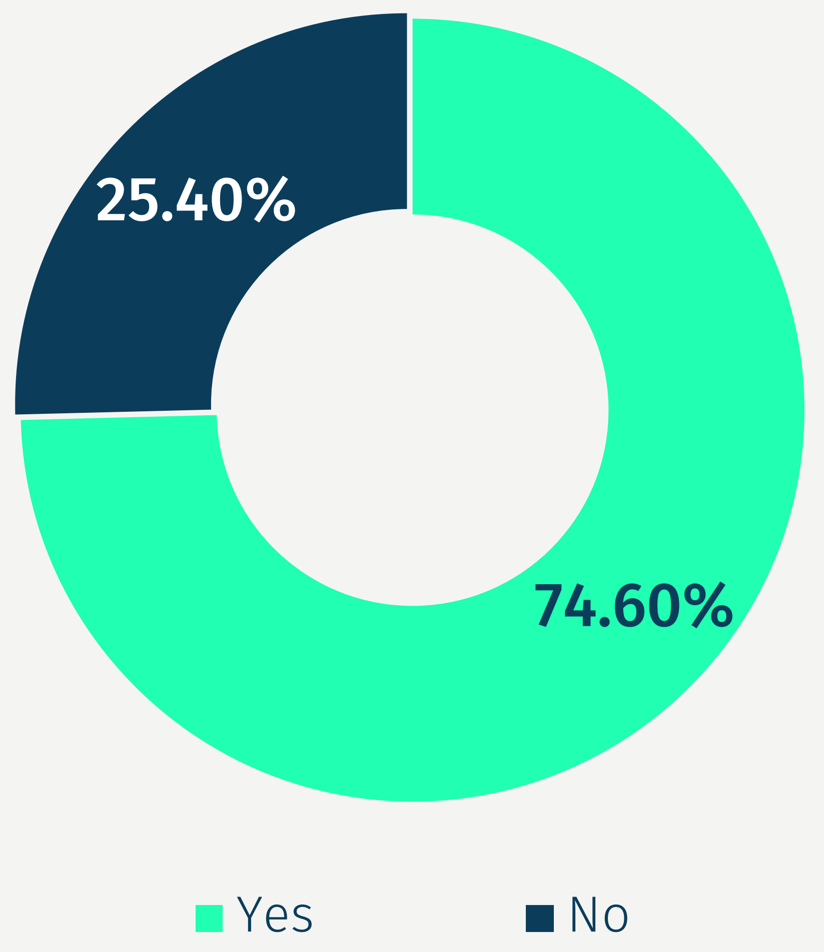
How does this compare to last year? *Respondents who hedge their forecastable currency risk



How are you primarily adapting your hedging to lower volatility in the FX market?



Has the cost of your hedging gone up over the past year?



Part 4

Automation drivers

For many fund managers, FX processes can be manual, cumbersome and time-consuming.

FX price discovery can often involve multiple phone calls, emails, or online platforms to log in to just to get comparative quotes from your counterparties. Because the market is constantly moving, price discovery often requires a team of people calling, emailing and logging in simultaneously before they can collectively decide who offered the best quote.

As a result of these challenges, CFOs at fund managers are beginning to consider moving away from traditional providers and legacy infrastructure.

Instead, **many are embracing automated, tech-enabled solutions which digitise the FX process from initial price discovery right through to reporting** at the end of the trade lifecycle.

Our research found that **79%** of senior finance decision-makers at UK fund managers **are looking into new technology/platforms to automate their FX operations.** This is a slight drop from 84%[5] in 2022, potentially[6] suggesting that over the past year, **more businesses have begun to implement technology** into their FX operations and therefore less are looking into new technology-driven solutions.[3] Interestingly, in 2023 this rose to 96% amongst CEOs, compared to just 65% of treasurers. This might indicate that although **C-suite executives view automation as a strategic priority,** there may at times be a reluctance to adopt unfamiliar technology amongst the treasurers who are charged with implementing it.

The top drivers for automation are improved returns (31%) and operational risk reduction (31%), followed by eliminating silos (29%), cost savings (29%) and efficiency gains (23%).

[3] MillTechFX CFO FX Report 2022 – The intensifying FX challenges for Fund Managers

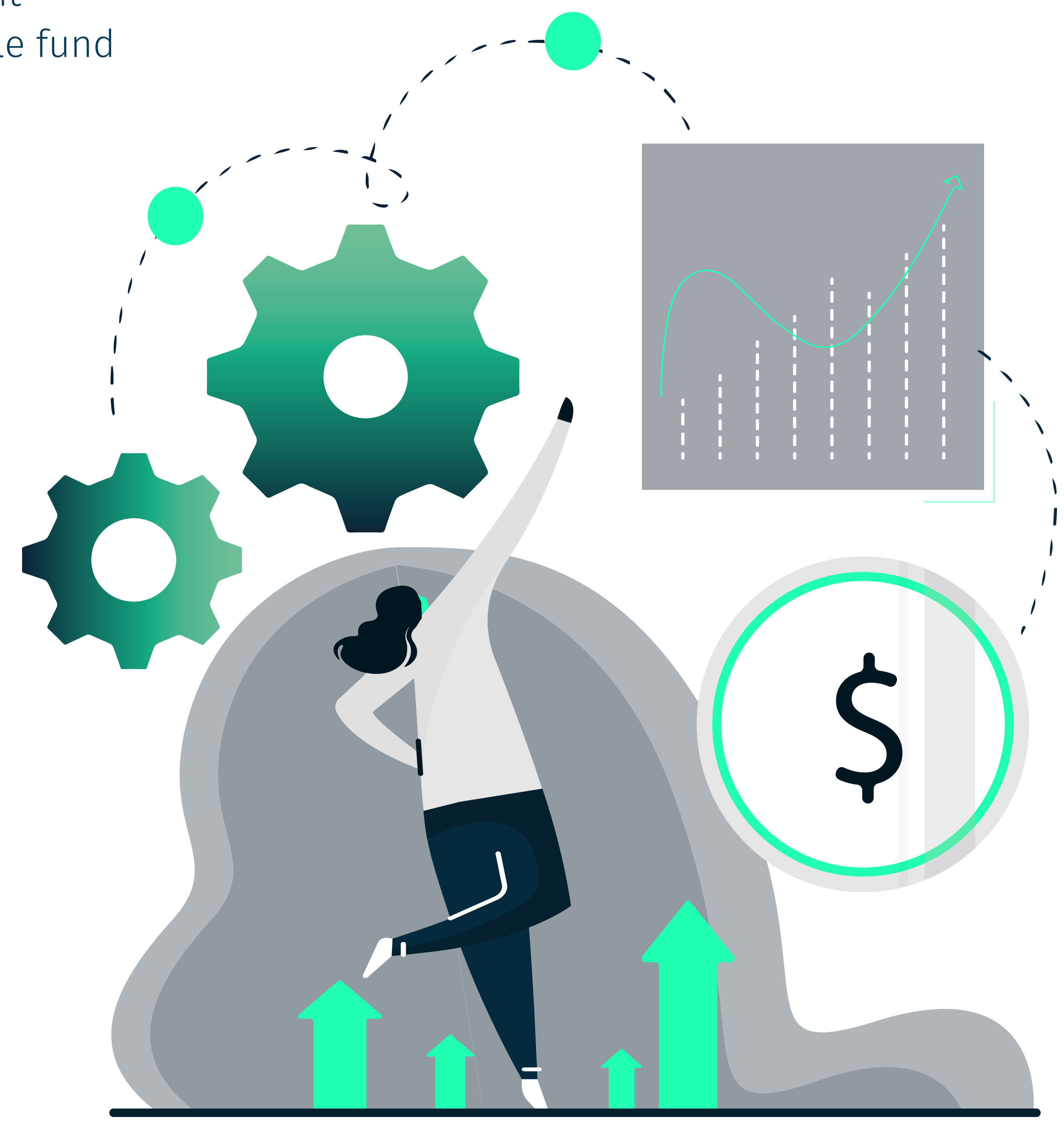
The benefits of automated digital solutions include:

Centralised price discovery - Automated solutions enable fund managers to compare prices from multiple liquidity providers on a single marketplace. Not only does this bypass onerous phone calls and email exchanges, but it also allows firms to get the best available price and lock it in with the simple click of a button.

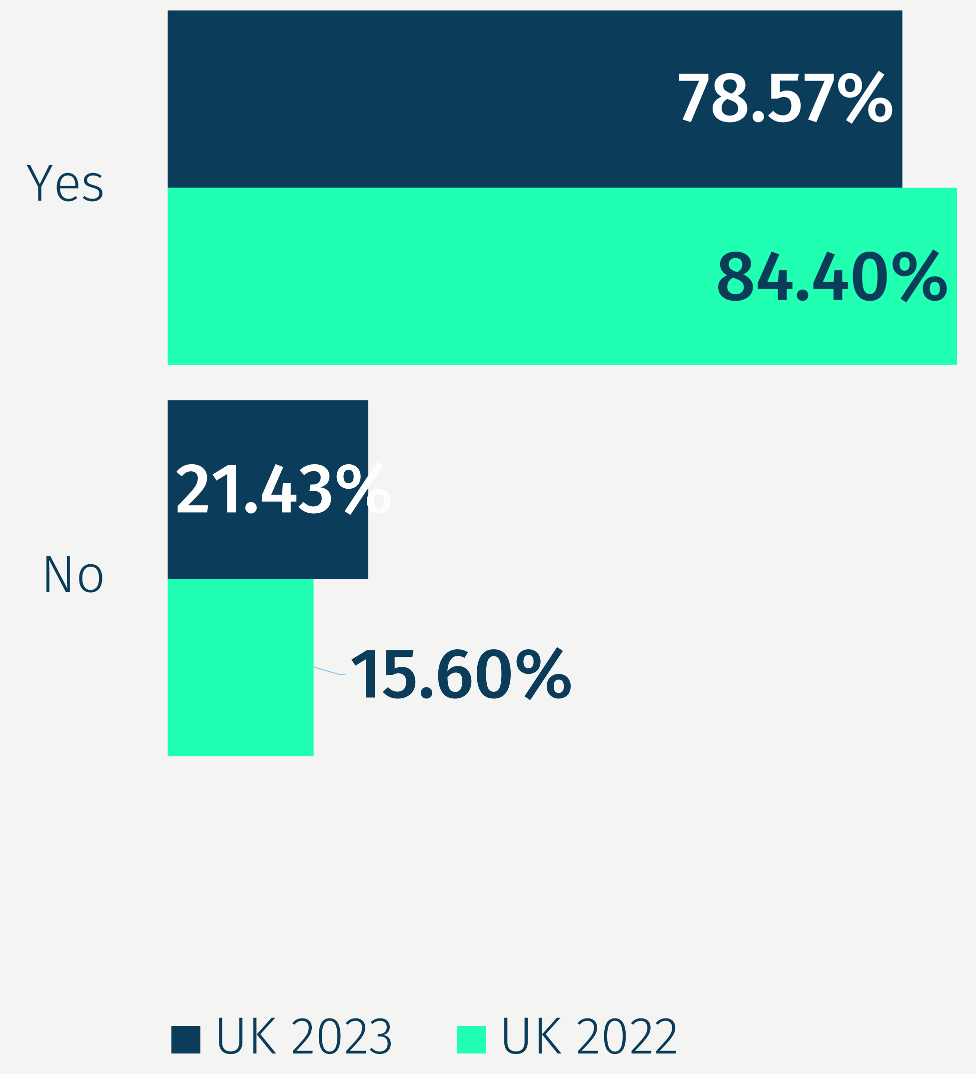
End-to end workflow - Post-trade execution processes can **be fully automated, from settlement to onward payment, regulatory reporting or sharing trade data with third parties.** This can save much-needed time and resources, enabling fund managers to focus on core business matters.

Transparency - By embracing digitization, fund managers can benefit from **complete transparency through real-time reporting and FX transaction cost analysis (TCA).** TCA can be used to help fund managers understand how much they are being charged for the execution of their FX transactions, in addition to **demonstrating good governance** to internal stakeholders.

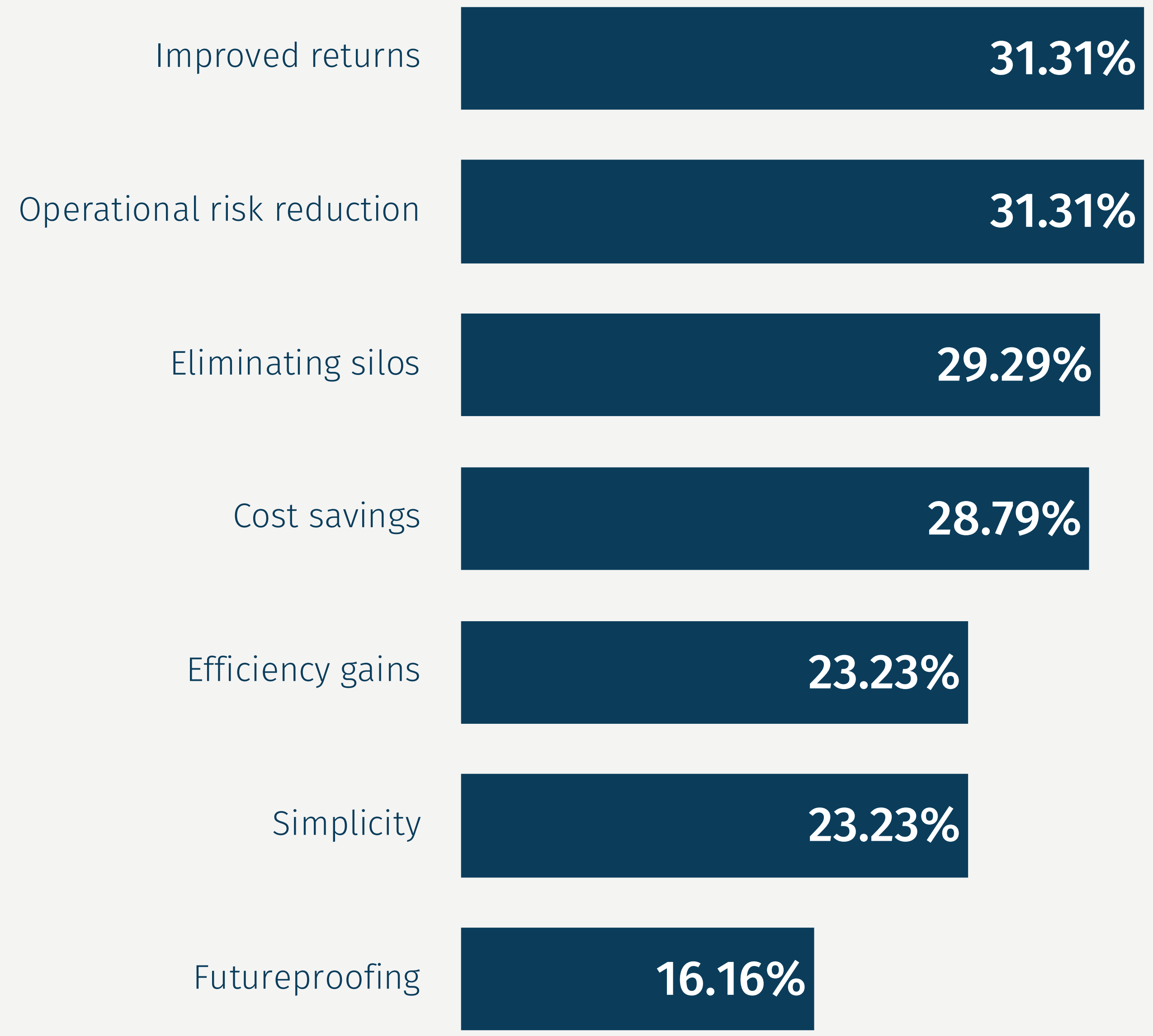
Fast onboarding - Rather than spending months (even years) setting up multiple FX facilities with different counterparties, **a digital FX marketplace** can enable fund managers to **begin transacting within weeks.**



Are you looking into new technology/platforms to automate your FX operations?



What are the key drivers behind wanting to increase your level of automation?



Part 5

Counterparty governance is a priority for CEOs

The collapse of Silicon Valley Bank, UBS's takeover of Credit Suisse and the closure of Signature Bank has shone a light on many vulnerabilities in the banking industry, particularly the **risks associated with only having one or two banking partners.**

It is now widely known that a bank's failure can cause serious short-term liquidity issues. Should a banking counterparty no longer be able to function as an FX provider, then this can affect vital expenditures such as payroll and supplier invoices, even if it's only for a few days. Other risks include:

• **In-the-money FX hedges** – if a fund manager has open FX forwards with a failing counterparty and those positions have a positive mark-to-market (i.e. they make a profit if they were to be sold back into the market today at the prevailing spot rate), then **the fund manager might be at risk from not realising that mark-to-market gain.**

• **Loss of collateral** – if a fund manager has had to post collateral with their counterparty to book an FX forward, then **that collateral may be at risk, in a similar way to cash deposits.**

• **Not being able to maintain the FX hedge** - crucially, there is **a risk that any pre-existing forward contract will not be honoured**. If the purpose of that forward was to mitigate the effect of FX volatility on a portfolio of foreign currency assets, then fund-level returns could be negatively impacted.

Whilst the banking sector has seemingly stabilised since the turmoil of the Spring, **many senior finance decision-makers at UK fund managers are taking lessons from the crisis on board.**

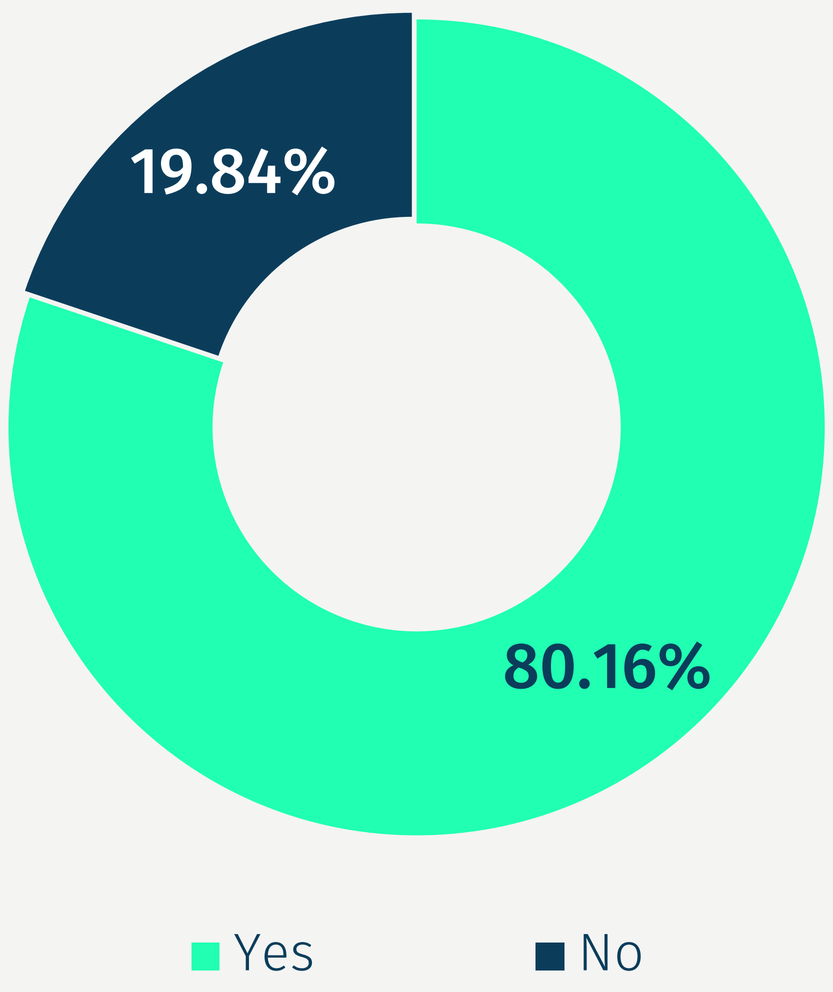
Our research found that **80% of UK fund managers are exploring diversifying their FX counterparties,** with this figure rising to 100% for the job title of CEO specifically. This suggests that CEOs in particular are reviewing their banking setup **to make sure they have the right systems in place** to mitigate the impact of any future crisis.

As well as enhancing risk management, having multiple counterparties can also **have a positive impact on pricing.** Due to the opacity of the FX market, it can be incredibly difficult to compare prices without having access to multiple banks. At any given time, fund managers may not be able to trade at the best available rate as they have no other access points to the market.

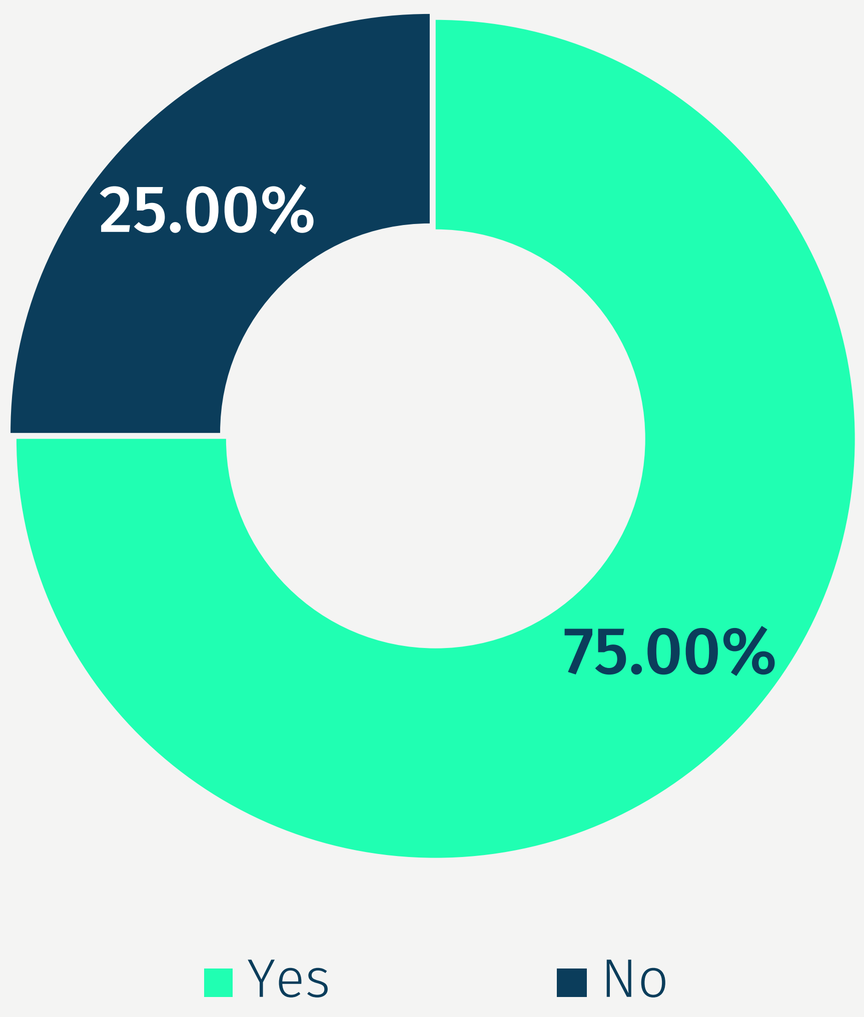
Getting competitive quotes from multiple counterparties can enable fund managers to compare the market so they can ensure they get the best rate and achieve best execution.

Three-quarters of respondents said that they regularly monitor their FX counterparties' credit ratings. We believe that fund managers should consider establishing a robust counterparty risk evaluation framework that considers a range of risk factors. These include monitoring realised and unrealised profit and loss for each counterparty, credit rating from reputable rating agencies, credit default swaps as well as regular counterparty review and monitoring activities.

Have you looked to diversify FX counterparties since the recent banking crisis (involving banks such as Silicon Valley Bank, Credit Suisse, First Republic Bank and Signature Bank)?



Do you regularly monitor your FX counterparties' credit ratings?



Part 6

ESG is more of a priority for bigger fund managers

Driven by pressure from investors, governments and consumers, ESG criteria are now central to the decision-making process for many businesses. **Our survey found that the trend has also begun to play an increasingly important role in FX.**

72% of senior finance decision-makers at UK fund managers believe that ESG has grown in importance to their business over the past year. This figure rose to 100% amongst the job title of CEOs compared to just 48% of Treasurers.

Despite the growing importance of ESG, only 44% of respondents said that their FX counterparties must have strong ESG credentials, down from 58% in 2022.[4] This suggests that whilst there is rising pressure to make ESG investments, **there is less awareness of the importance of evaluating the ESG credentials of service providers as part of a firm's ESG strategy.**

Interestingly, this figure rose to 56% for firms with more than 500 employees, compared to 30% for firms with 50-99 employees, perhaps showing larger fund managers are taking the lead on the ESG front. Overall, 89% of respondents and 100% of CEOs and COOs said it was a consideration.

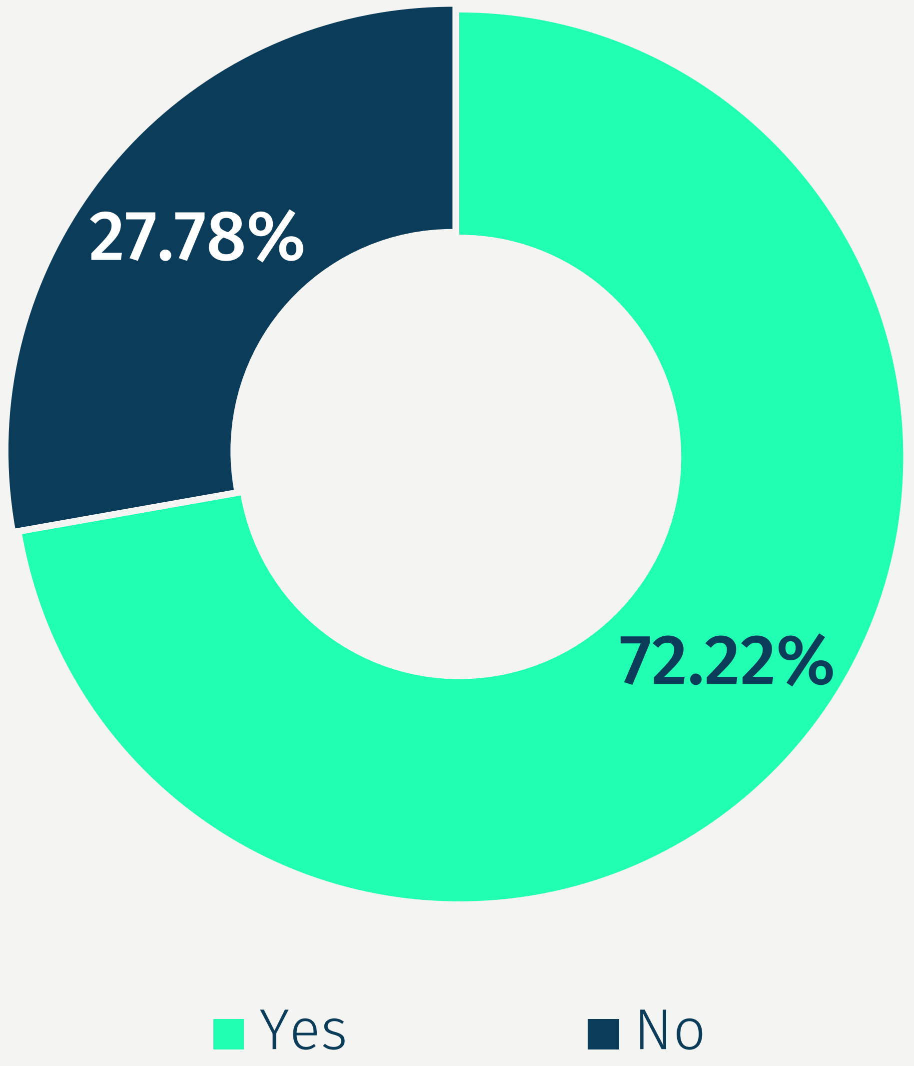
As businesses become increasingly driven by ESG criteria, we believe fund managers must have the right processes in place to meet this demand. When transacting in FX, fund managers can take the following steps to enhance their ESG credentials:

Adopting the Global FX Code (GFXC) - The BIS Foreign Exchange Working Group published this in 2017 to set out **best practices across the wholesale FX market** and is beginning to embed the code into firms' ESG practices. Its members recently supported the possibility of a partnership with rating agencies so that anyone who signs the code can be recognised as having fulfilled the governance element of their ESG commitments. Signing up to the code is therefore a key step for fund managers seeking to demonstrate their ESG credentials.

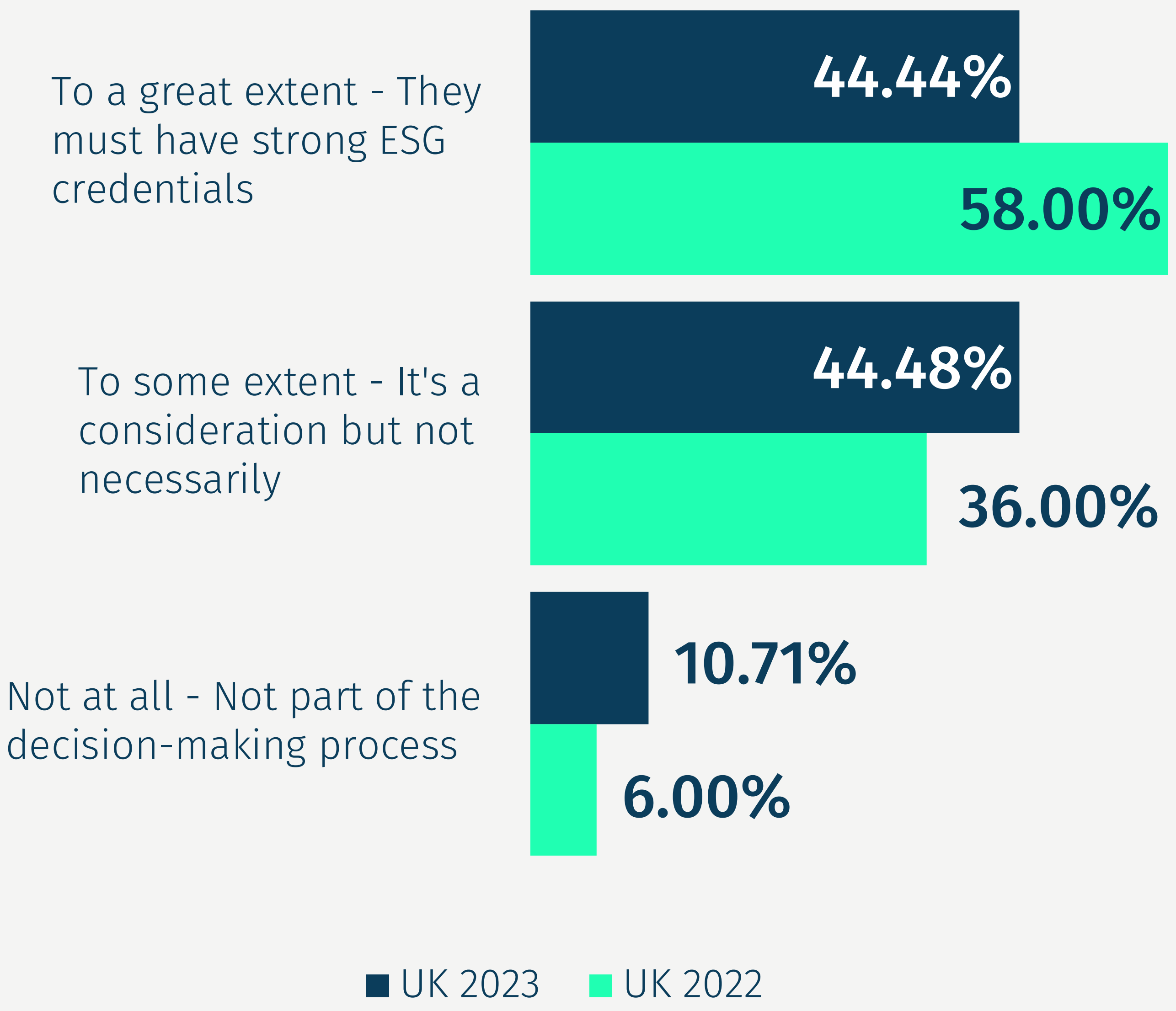
Consider ESG credentials of partners - It's not just a company's own infrastructure that reflects strong ESG credentials but also that of any partner or affiliate organisation. When transacting in FX, we feel fund managers should seek to use FX providers which adhere to internationally recognised ESG standards, such as the Principles for Responsible Investment (PRI).

[4] MillTechFX CFO FX Report 2022 – The intensifying FX challenges for Fund Managers

Has ESG grown in importance to your business over the past year?



To what extent do ESG credentials impact your selected FX counterparties?



Conclusion

With uncertainty set to stay, the management of FX currency risk should be considered a top priority for fund managers across the UK and beyond.

Fortunately, there are several ways fund managers can improve their FX risk management infrastructure and protect their returns in these uncertain times:

Transaction Cost Analysis (TCA) – TCA was specifically created **to highlight hidden costs and enables fund managers to understand how much they are being charged** for the execution of their FX transactions. Ongoing, quarterly TCA from an independent TCA provider can be embedded as a new operational practice to ensure consistent FX execution performance.

Comparing the market – Having the ability to **put trades up for competition is central to ensuring access to the best price, which is key to effective hedging.** However, many fund managers are hampered by their inability to access Tier 1 FX liquidity, meaning they often rely on a single bank or broker to meet their hedging requirements.

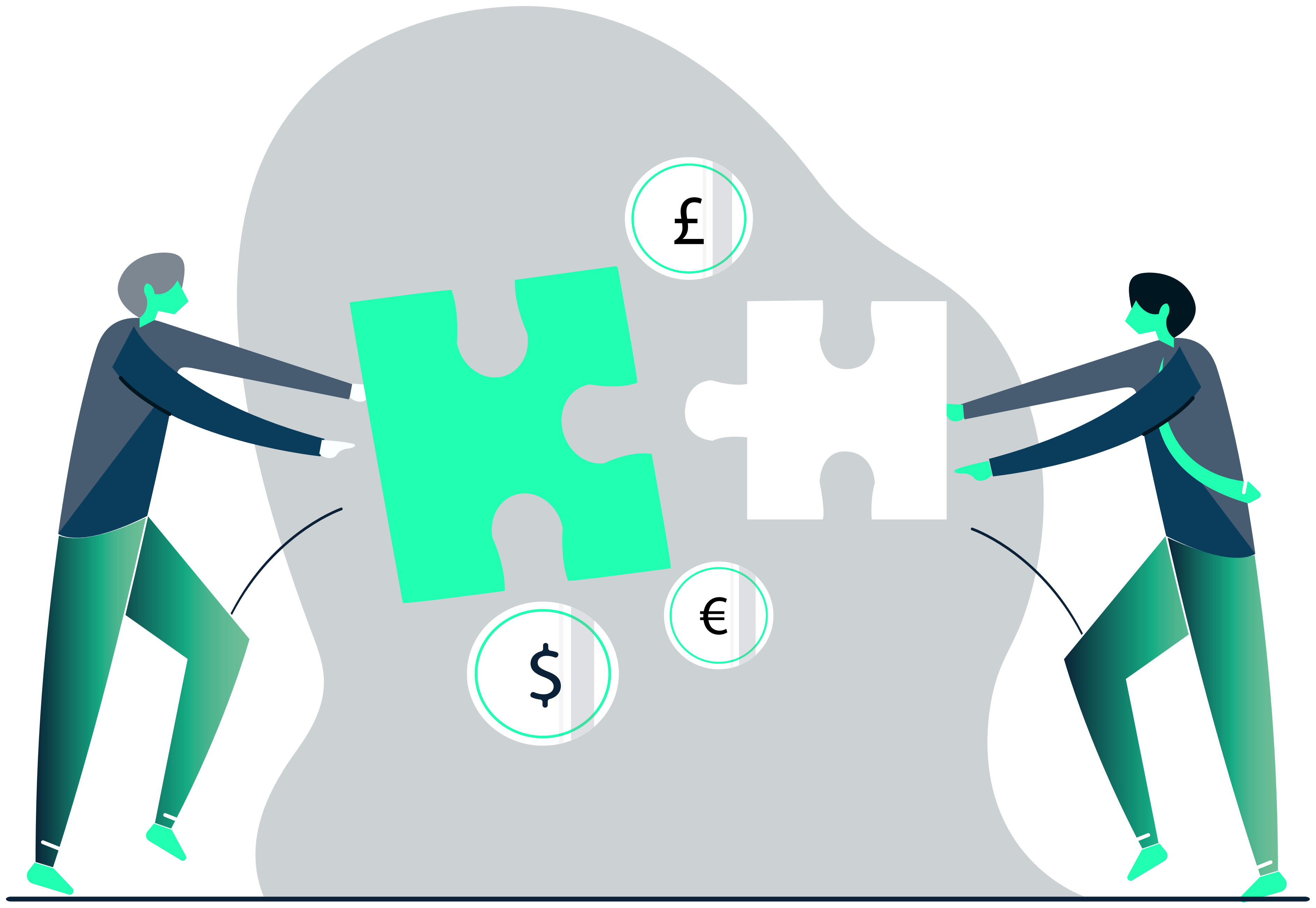
We believe that fund managers should seek alternatives to the traditional single bank-based approach. Instead, they should look for solutions that enable them access to live rates from multiple banks and execute at the best rate, all whilst reducing the operational burden traditionally associated with this kind of market access.

Outsourcing – There is a **growing recognition that outsourcing does not necessarily mean a loss of control, less transparency or reduced quality of FX activities**, but when using the right partner outsourcing can improve transparency and execution quality. Outsourcing can therefore enable fund managers to dedicate more time to core business matters, which is all the more important amidst inflationary and volatility pressures.

Strong governance – FX is one of the largest and most liquid markets in the world, but also one of the most complex. Setting up and onboarding new FX counterparties, centralising price discovery and navigating the post-execution phase requires a team of people and often have their own complications. **Harnessing solutions which can enhance transparency and governance can help fund managers improve the cost, quality and transparency of their FX execution.**

Diversification of liquidity providers – Recent events in the banking sector show that reliance on one or two counterparties can be an extremely risky strategy, as **the loss of a major FX counterparty could render firms unable to trade**. We believe fund managers should begin exploring technology-driven alternatives to the single bank-based approach that enable them to transact in FX in a way that addresses risks associated with a single point of failure.

Automation – Despite the rising threat of currency movements, many fund managers continue to rely on manual processes like phone and email to execute FX trades which may make it harder to mitigate the impact of currency volatility. **Harnessing automated solutions can offer end-to-end workflow, greater transparency** and **faster onboarding**, helping finance departments streamline their FX functions.



How MillTech FX can help

MillTechFX is an FX-as-a-Service (FXaaS) pioneer that enables fund managers to access multi-bank FX rates via an independent marketplace.

MillTechFX's **market access, pricing power and operational resource** enable it to deliver a tech-enabled integrated solution that **delivers transparency, cost reduction and operational burden reduction** for senior finance decision-makers at fund managers.

It is end-to-end **at no additional cost**, offering easy and quick onboarding, multi-bank best execution and hedging management, and connectivity into clients' bank accounts, internal systems, administrators or custodians.

FXaaS represents the evolution of currency management through automation, integration, and validation:

Easy and quick onboarding – Rather than spending months (even years) setting up multiple FX facilities with different counterparties, **firms can sign up to a multi-bank marketplace and transact within weeks** with up to 15 Tier 1 counterparty banks.

Best execution and hedging management – Clients benefit from multi-bank access **without having to manage multiple relationships and processes.** They can transparently compare and execute FX rates from multiple providers on a single marketplace and ensure best execution with a simple click of a button.

Cost savings – MillTechFX **has saved clients up to 70%** on their execution costs

Transparency – MillTechFX offers a fixed fee service, including third-party Transaction Cost Analysis (TCA) to ensure total cost transparency.

To speak to us directly please reach out to our Head of Institutional Solutions, Joe McKenna at jmckenna@milltechfx.com or request a free TCA here.

Find out more on **https://www.milltechfx.com**

*The AUM, managed by Millennium Global Investments Ltd as at 30th June 2023, is a combination of USD 17,969 million in notional AUM for unfunded managed accounts, and USD 83 million AUM in funded vehicles. **The 2022 annual traded volume refers to all Millennium Group activity. Millennium Group comprises Millennium Global Investments Limited, Millennium Global (Europe) SAS and Millennium Global Treasury Services Ltd.

*This white paper examines the data and results of a survey conducted by Censuswide on MillTechFX's behalf conducted between 18 August and 31 August based on a survey of 250 senior finance decision-makers at mid-sized asset management firms in the UK (described as those with assets under management ranging from £500m to £20b).

*The full list of job titles surveyed included within this report is as follows: Chief Financial Officers (CFOs), Financial Controllers, Finance Directors, Chief Operating Officers (COOs), 22 Chief Executive Officers (CEOs), Partners and 73 Treasurers.