

Navigating the Opaque but
Evolving World of FX Execution

A Guide for **Private Equity Managers**



Introduction

The foreign exchange (FX) market is the largest financial market in the world with a daily trading volume of **\$6.6 trillion**. A series of market-moving events in recent years has placed the importance of having a FX strategy firmly back in the spotlight. It would be easy to think that these are one-off events, that geopolitical uncertainty and currency volatility will calm down. But, in fact, foreign exchange volatility is a constant.

Despite this significant risk, many private equity firms with currency exposures have given FX policy very little consideration. And those that have might still suffer from a lack of transparency when it comes to fees, as well as from improper infrastructure for best execution.

This paper is designed to highlight the importance of FX to private equity firms, shine a light on the issues they face in achieving best execution and provide them with practical steps to improve their FX processes and reduce their costs.



Why is FX important for private equity firms?

Private equity firms might find themselves exposed to FX risk in four different ways:

1

Foreign currency assets

The more jurisdictions a PE managers' 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 or create complications pre-acquisition and pre-disposal. PE managers commonly implement short-dated hedging to lock in rates during the purchase or sale of an asset, whilst others may even consider hedging asset value throughout the entire hold period.

2

Management fees

It is not uncommon to see PE managers raise a fund in one currency but have offices outside the jurisdiction of their fund's base currency. This means the PE manager receives their 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 PE managers commonly look to lock in exchange rates on expected fee income for as long as possible.

3

Investor Capital

As a PE 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 takes FX risk off the table 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.

4

Indirect, portfolio level FX exposure

As a PE manager grows its portfolio, their investment team may have to overhaul how their portfolio businesses manage their FX exposure. In a **recent HSBC corporate risk management survey** 57% of CFOs say they suffered lower earnings in the past two years due to significant unhedged FX risk (rising to 77% in EMEA). On the subject of FX risk management, the HSBC report cites that only 23% of CFOs view their treasury as “best in class” in this area. A PE firm may look to align their own set-up and processes with those of their underlying portfolio and hold them to the same high governance standards.





FX risk management considerations

With economic changes, such as further interest rate rises on the horizon, we believe private equity firms should prioritise FX risk management to improve performance, deliver sustainable growth and, ultimately, protect their returns.

But before committing to a particular hedging strategy, a fund manager might want to consider questions like:

- What percentage of my AUM is in foreign currencies?
- Can I forecast my requirement? (Hedging AUM in PE can be like hitting a moving target when considering how much to hedge)

- What is the portfolio's sensitivity to a movement in the currency pairs I'm exposed to?
- Do investors want exposure to the managers' chosen investment jurisdictions?
- Will the next fund vehicle be marketed to investors in new jurisdictions?
- Are my portfolio businesses managing FX risk effectively?
- How much of a buffer is there between management fee income and annual expenses?

Ultimately a PE manager may decide to implement a hedging strategy or to leave themselves open to market fluctuations and book in the spot market. Either way, as a fiduciary firm, there is one thing that fund managers must adhere to, and that is Best Execution.



For us, actively addressing currency exposure converts to better business performance and greater shareholder value.

PE Insider community member, CFO at a large mid-market GP



What is best execution?

There are many factors to take into consideration in the quest for FX best execution:

- **Price and cost**
- **Speed and likelihood of execution and settlement**
- **Size and other factors directly related to the execution of the order**

Often price or cost will be considered the highest priority, although for these to be the primary focus, there needs to be an operational robustness in all other components, such as settlement and speed.

Furthermore, considering the foreign exchange market is the largest and most liquid financial market in the world, it would be a fair assumption that transparency and best execution would come as standard, however, we believe this is not the case and some fund managers are still catching up.

How it's regulated and why it matters

Best execution is covered by various market principles and regulation originating from the FCA Conducts of Business Sourcebook and Principles of Business, the FX Global Code of Conduct and, most notably, MiFID II.

Combined, they stipulate that investment firms should:

- Treat customers fairly
- Deal with market participants in a consistent and appropriately transparent manner
- Take all 'sufficient' steps to obtain the best possible result for the client when executing orders.

However, any fiduciary firm should consider best execution as a core component of best practice and not simply a regulatory obligation to satisfy.

Increasingly, investors are also questioning fund managers around their FX execution policy and requesting ongoing transaction cost analysis. Pursuing best execution has other positive impacts too, notably the reduced transaction costs as a result of increased competition between counterparties.



A history of controversy

Since the 2008 Global Financial Crisis, the FX market has had its fair share of negative press. The forex rate-rigging scandal grabbed the major headlines in 2014 and significant fines were handed down to some of the world's largest banks. However, in the background, stories relating to a lack of transparency and poor FX execution practices were rife.

- In the US, a series of high-profile lawsuits were filed by pension funds against their custody banks, claiming that the banks had charged excessive fees for FX trades, deriving from a lack of transparency around how, and when, trades were being executed.

- One such lawsuit alleged that for more than a decade the custodian in question had conducted FX transactions in “an unfair and deceptive” way to maximise its profits at the expense of its customers.[i]

- Closer to home, in 2014 the FCA published a press release titled ‘FCA finds firms unable to deliver best execution’. The article looked at 36 firms, finding that many “do not understand key elements of the rules and are not adequately controlling client costs when executing orders.”[ii]

*In 2017, the FCA highlighted that investment managers **had not been particularly engaged with assuring best execution for their clients.***

According to the FCA, some firms had been addressing the issue and are showing “good practice”, however the bulk of the industry is trailing behind.

With all the controversy and regulatory intervention relating to FX best execution in recent years, fund managers know what is required of them – so, what’s stopping them?

The short answer, in our opinion, is that it’s labour intensive and difficult. Fund managers may need to identify and approach new FX counterparties, form new relationships, put ISDAs in place and set up new trading systems – It can be exhausting! The whole process, from start to finish, could take anything up to a year (in some cases longer) which can be time consuming, especially when FX might not be a core business operation.

The fun doesn’t stop there. Let’s say a fund manager has gone through all the necessary steps and now has a multi-bank panel at their disposal for FX execution. Each counterparty might have different trade processes and systems to navigate – for this reason the fund manager might have to make an additional investment in an aggregator platform to centralise price discovery.

After all that, the fund manager might not see a fully transparent breakdown of FX transaction costs and may need to perform transaction cost analysis (TCA) through an independent TCA provider to evidence best execution - this too can come with its own costs.

Lack of transparency for PE firms

Comparison websites are all the rage and it's easy to understand why. In a sea of choice for home insurance, holidays, TVs, there is often little to differentiate one from the other. When products and services become highly commoditised, often the deciding factor for the consumer is price or cost. If there isn't much to differentiate between multiple purchase options in terms of the product or service that's delivered, why would you pay more?

Fund managers are often spoiled for choice when weighing up service providers such as banking partners, subscription line lenders and fund administrators, meaning decisions are often made on fine margins.

Unnecessary costs should be avoided (at all costs!) because investors expect that every single Pound, Euro or Dollar generates a return and partners are aiming to surpass their performance hurdle.

Both investors and partners have significant skin in the game, so when they kick the tyres and look under the bonnet of the finance function, they might expect a rigorous audit trail of how costs are being managed and objective decisions are made.

This seems straightforward enough – manage and monitor costs to help maximise returns, who wouldn't do that? It turns out that a large percentage of the investment community cannot convey explicitly what their annual FX costs are.



Managing FX costs

FX is highly commoditised – a US Dollar is a US Dollar whichever bank you buy it from – so assuming certain basic delivery and service standards are met, price, or the most competitive exchange rate, wins most of the time.

Fund managers also have a fiduciary responsibility to pursue best execution for their clients so they must have multiple FX counterparties at their disposal every time they enter the market to execute a trade. This means they'll need to consider the number and quality of FX counterparties competing for trades. When a fund manager implements an FX policy, they should also take into account the following:

1

If notional / credit thresholds are of sufficient size

2

The credit terms of the facility are in line with their liquidity profile

3

If trade tenors match their desired hedging strategy

Many CFOs and COOs can articulate their FX strategy, best performing counterparties and associated credit limits however, few can they say with certainty what their costs are explicitly, and relative to what may have been agreed upfront.

FX costs are usually hidden as an all-in rate which is discounted from the mid. However, it can be hard for fund managers to identify where the mid is and therefore calculate what their costs are on a trade-by-trade basis.

Let's not forget that post the 2008 Global Financial Crisis, a series of high-profile lawsuits were filed by pension funds against their custody banks, claiming that the banks had charged excessive fees for FX trades, deriving from a lack of transparency around when trades were being executed and the mid at that time.



Monitoring FX costs

Fund managers can always check what they're being charged on FX transactions by conducting regular Transaction Cost Analysis (TCA).

TCA goes hand-in-hand with best execution and can be used as an ongoing audit of FX practices as well as hold existing FX counterparties to account.

One major goal of TCA is to gain oversight of trading costs, but additionally it helps to comply with best execution policy, regulation and strong governance expectations from investors and internal stakeholders.

Nothing revolutionary here:

- 1 Find FX counterparties that can meet your requirements
- 2 Compare pricing on a trade-by-trade basis
- 3 Capture trade data for regular, post-execution cost analysis i.e. TCA

However, these straightforward steps are often overlooked.

A recent survey titled 'The Grey Costs of FX' drew feedback from various FX industry specialists – 45% were investors, 25% asset owners and 20% either banks or brokers. It found that 39% of the industry is not tracking any TCA for FX.

Why might that be?

A lot of the market still use manual processes to compare pricing, execute trades, and reconcile trade information - namely trade timestamps - which are sometimes not reported accurately by their FX counterparties.

For many fund managers, FX is a non-core business activity so they commonly get set up with a handful of FX counterparties, with the hope that increased competition bypasses the need to agree upfront costs and monitor them on an ongoing basis – this simply isn't the case.

However, it is important to remember that TCA typically comes with its own costs so fund managers could explore selecting an FX partner that has TCA built into their offering. Fund managers should check that any offer of TCA is carried out by an independent provider who can assess trade costs in an unbiased manner.

What do I need for TCA?

To perform a TCA, historical trade data is required:

- **Currency pair**
- **Nominal trade volumes**
- **Product (spot, forward etc)**
- **Trade date and value date of the trade**
- **Time stamps**
- **Direction i.e. buy/sell**
- **Executed rates**

To calculate the transaction cost on a trade, the actual rate the trade was executed at is compared to an independent mid-market rate at the time of execution.

What does a TCA show?

- **The cost on a trade by trade basis or the total portfolio cost of a dataset**
- **Cost inconsistencies across product, currency pair, tenor and counterparty**
- **Evidence of best execution**

Ongoing, quarterly TCA analysis can also be embedded to ensure consistent FX execution performance.



Efficient use of capital


We already know that having the ability to put trades up for competition is typically central to best execution. However, FX pricing shouldn't be the only thing a fund manager considers – credit facilities for FX trading should also be taken into account.

Fund managers who hedge, using forward contracts for example, must also consider that placing a hedge typically requires margin to be posted against that position as collateral. Further, if the initial margin no longer covers the mark-to-market of a hedge, due to movements in the spot rate, the GP may be required to post additional, variation margin. **Any capital posted as collateral, sitting dormant in a margin account and not invested, potentially earning higher returns, can cause a drag on fund performance.** The FX risk, being mitigated with forward contracts, has been replaced with a potential liquidity risk.

One way around this issue is to trade via an uncollateralised FX facility so that the GP can hedge (using forwards) and not worry about posting margin. If the facility is uncollateralised up to a pre-determined figure, there is a cap on how far in the red your mark-to-market can go before your counterparty has no further appetite to trade with you and starts calling for variation margin. This can result in fund managers spreading trades between different counterparties, with FX rates being a secondary consideration, to keep sufficient headroom on trading facilities and eliminate the need to post margin altogether.

To get set up with an uncollateralised hedging facility, fund managers can expect to share similar background information to that required for a subscription line, after all, the bank involved will have to cover any negative mark-to-market themselves.

Typically, it's easier to setup facilities early on in a funds' lifecycle because your counterparties can take comfort from a large pool of committed capital. For a late-life fund, uncollateralised facilities that take comfort from a pool of assets instead, might not be every bank's cup of tea as they'll need to do a larger amount of credit work for a much shorter FX relationship (assuming the fund is closed-end).



Operational efficiency

A common theme in private capital right now is seeking out opportunities to outsource non-core activities. Even for those processes that would be considered 'core', there may also be opportunities to automate and improve efficiency.

A fund manager should also consider future-proofing their finance function – in five years' time, there may have been more than two new funds raised, new strategies, new jurisdictions, new investors, new employees in the team. **Archaic processes might be a minor annoyance today but become a severe operational overhead in the future.**

Many private capital fund managers, particularly those in credit, infrastructure or real estate adopt the same, vanilla hedging strategy. Whether its share class hedging or a rolling NAV hedge, using quarterly rolls is commonplace, leaving many managers thinking 'surely this can be automated?'

For a fund manager, we know that best execution requires multiple counterparties, but before price discovery comes the search for eligible FX counterparties. Incumbent banking relationships are the logical place to start, and custodians, prime brokers or lenders may be able to offer FX trading services too. Where it could get challenging is establishing new relationships for FX only, as there is no guarantee a counterparty will want to onboard a client that only requires one of their services.

And then there's the setup phase. After negotiating the finer points of a non-disclosure agreement, a GP must fill out paperwork, locate and share 'know-your-customer' documents and then go through a credit approval process. Credit approval can be particularly challenging; you can expect your chosen counterparties to look through investor commitments and underlying assets with a fine-tooth comb. Respective legal teams will need to work through ISDAs, CSAs and any other trading agreements before setup can even begin.

Once setup is complete, the process of price discovery can happen in a number of different ways – telephone dealing, onscreen quotes, chat messages and e-mails. With multiple counterparties at a fund managers' disposal, it can soon turn into a time-consuming team operation to get the best available price from your chosen counterparties. Depending on how a fund manager goes about price discovery, there may be a trade-off between inefficient booking systems versus the number of counterparties.

For all of these reasons and more, the private capital market is moving towards solutions that assist in onboarding the fund manager with multiple banking counterparties and obtaining credit facilities with each bank simultaneously. Fund managers might also consider more centralised, digitised solutions that consolidate price discovery in one place at one time.



The case for outsourcing

Research published by the investment consultant Russell Investments **“Still Overpaying for FX”** analysed 173,000 FX trades conducted on assets totalling approximately \$76 billion.

It concluded that for an average \$1 billion fund, savings of \$330,000 per annum would have been achievable from the adoption of an agency approach where FX trading is outsourced to a third-party specialist. In some cases, funds could have saved much more.

The Russell study explicitly suggested the consideration of a model whereby a third-party specialist agent is appointed to manage FX trades and pursue competition among a panel of counterparties to achieve the best possible price.

Given that no one bank will be able to offer the best price on all currency pairs at all times, there are significant advantages to transacting with a provider that can offer the best price among a “panel” of banks, rather than with one bank on a bilateral (and fundamentally uncompetitive) basis.



How MillTechFX can help

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

Its end-to-end solution automates the FX workflow and ensures transparent best execution – saving clients time and costs. It offers a fixed fee service model, including third-party transaction cost analysis to ensure total transparency.

MillTechFX harnesses the purchasing power of Millennium Global, one of the world's largest currency managers with c. \$16.3bn AuM, which transacts over \$760bn in annual FX volume*. Via the MillTechFX marketplace, clients can directly access preferential FX rates and credit terms from up to 15 Tier 1 counterparty banks.

MillTechFX has raised \$30m from investors since launching in 2019, and clients executed approximately \$50bn in FX volume in 2021 on its easy-to-use platform.

Headquartered in London, the world's largest FX hub, MillTechFX is authorised and regulated by the UK's Financial Conduct Authority (FCA), registered with the USA's National Futures Association (NFA) and Canada's Financial Transactions and Reports

Analysis Centre (FINTRAC). Our European subsidiary, MillTechFX (Europe) SAS is authorised as an Investment Firm by The Prudential and Resolution Control Authority (ACPR in France) and authorised and regulated by The Financial Markets Authority (AMF).

To speak to us directly please reach out to Joe McKenna at jmckenna@milltechfx.com.



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