MillTechFX
by Millennium Global

The MillTechFX North America CFO FX Report 2023

The intensifying FX challenges for Fund Managers

Summary

Over the past year, foreign exchange (FX) risk management has become an increasingly important priority for many fund managers across North America.

Driven by a combination of rising interest rates, high inflation, geopolitical uncertainty and well-documented turbulence across the banking sector, US dollar volatility, in particular, has posed a potentially mounting threat to North American fund managers.

Having reached a two-decade high against other major currencies in September 2022, it slid to a nine-month low in February 2023 before slightly rebounding. This backdrop, in addition to the wider macro environment, could ultimately **create greater uncertainty on returns for fund managers with an 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 set-up.

The 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 are manual, cumbersome and time-consuming for many fund managers. 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 North American fund managers to review where they are on their FX journey and where they would like to get to.

The 'MillTechFX CFO FX Survey 2023: The intensifying FX challenges for fund managers in North America' explores how many resources they dedicate to FX, the challenges they face, solutions they are exploring, how they have adapted their FX hedging strategies in the face of heightened volatility and the importance of ESG.

The major trends are:

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.

FX infrastructure: There is still a reliance on inefficient, manual processes and this has forced many fund managers to dedicate a significant amount of time and resources to their FX operations.

Operational challenges: Despite dedicating a large amount of time and resources to FX, fund managers still struggle with various issues including onboarding liquidity providers, securing credit lines, cost calculation and getting comparative quotes.

Turning to technology: The majority of fund managers are exploring new technology and seeking to embrace digitization in a bid to streamline operational processes.

The rising importance of ESG: The bulk of respondents said that ESG has grown in importance over the past year and that ESG credentials impact their selection of FX counterparties.

The changing face of FX hedging: Against a backdrop of market volatility, the majority of fund managers are now hedging their forecastable currency risk. They are also typically hedging a higher amount of their exposure and have longer hedge windows compared to this time last year.

Counterparty diversification: The recent banking crisis, involving banks such as Silicon Valley Bank, Credit Suisse, First Republic Bank and Signature Bank, has highlighted the potential risks associated with having only one or two banking partners. As a result, most fund managers are looking to diversify their FX counterparties.

Ultimately, the research has highlighted that it is more important than ever that North American 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.

Part 1

Mapping FX exposures

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:

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.

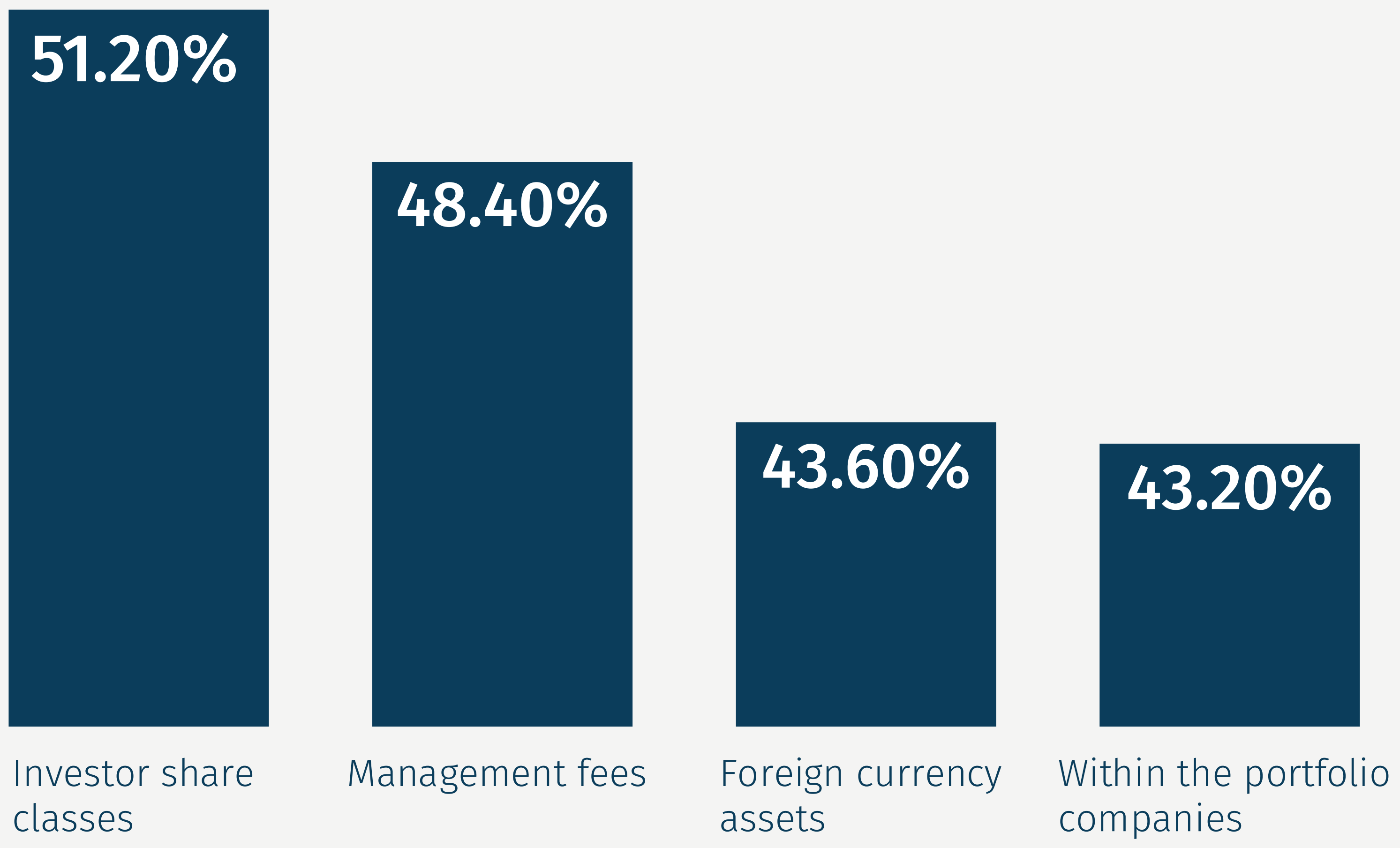
Management fees - It is not uncommon to see fund managers raise a fund in one currency but have offices outside the jurisdiction of their fund's base currency. This means the fund manager receives its management fees in one currency but then has to pay for certain fixed costs, such as salaries and offices, 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.

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.

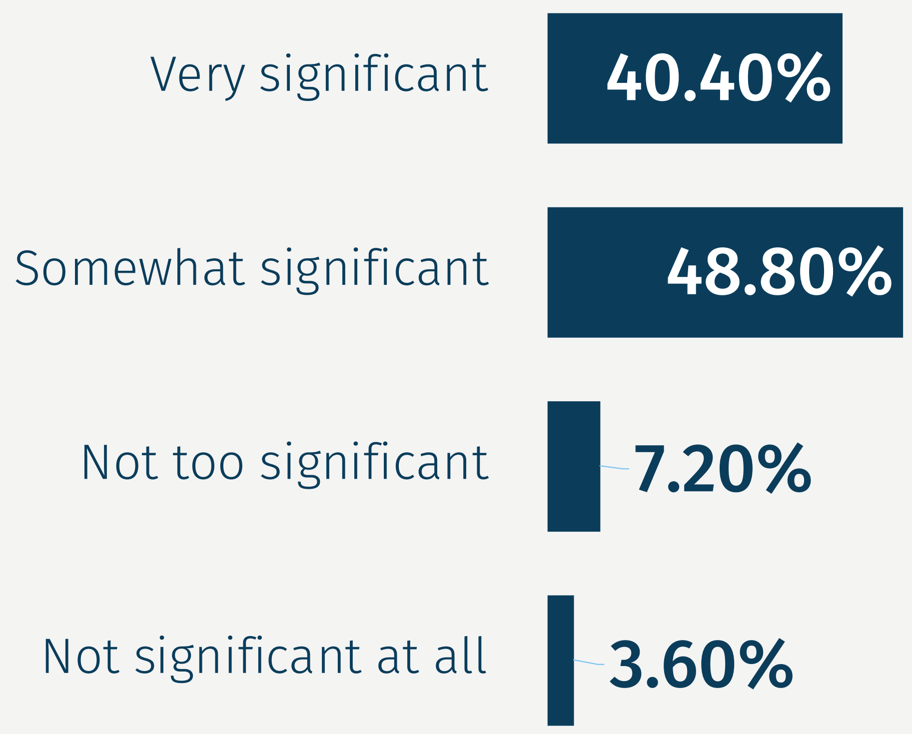
Indirect, portfolio-level FX exposure – For some private capital strategies, such as private equity buyout, the operational partners may want to overhaul how their portfolio businesses manage their FX exposure. A fund manager may look to align their own set-up and processes with those of their underlying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

Overall, our research reinforces the importance of FX for fund managers, with **89% of respondents saying that FX is significant to their business.**

Where does your FX exposure arise?



How significant, if at all, is foreign exchange (FX) to your business?



Significant (Net): 89.20%
Not significant (Net): 10.80%

Part 2

FX management is resource-intensive

For many fund managers, FX processes can be resource-intensive.

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 requires a team of people; calling, emailing and logging in simultaneously before they can collectively decide who offered the best quote.

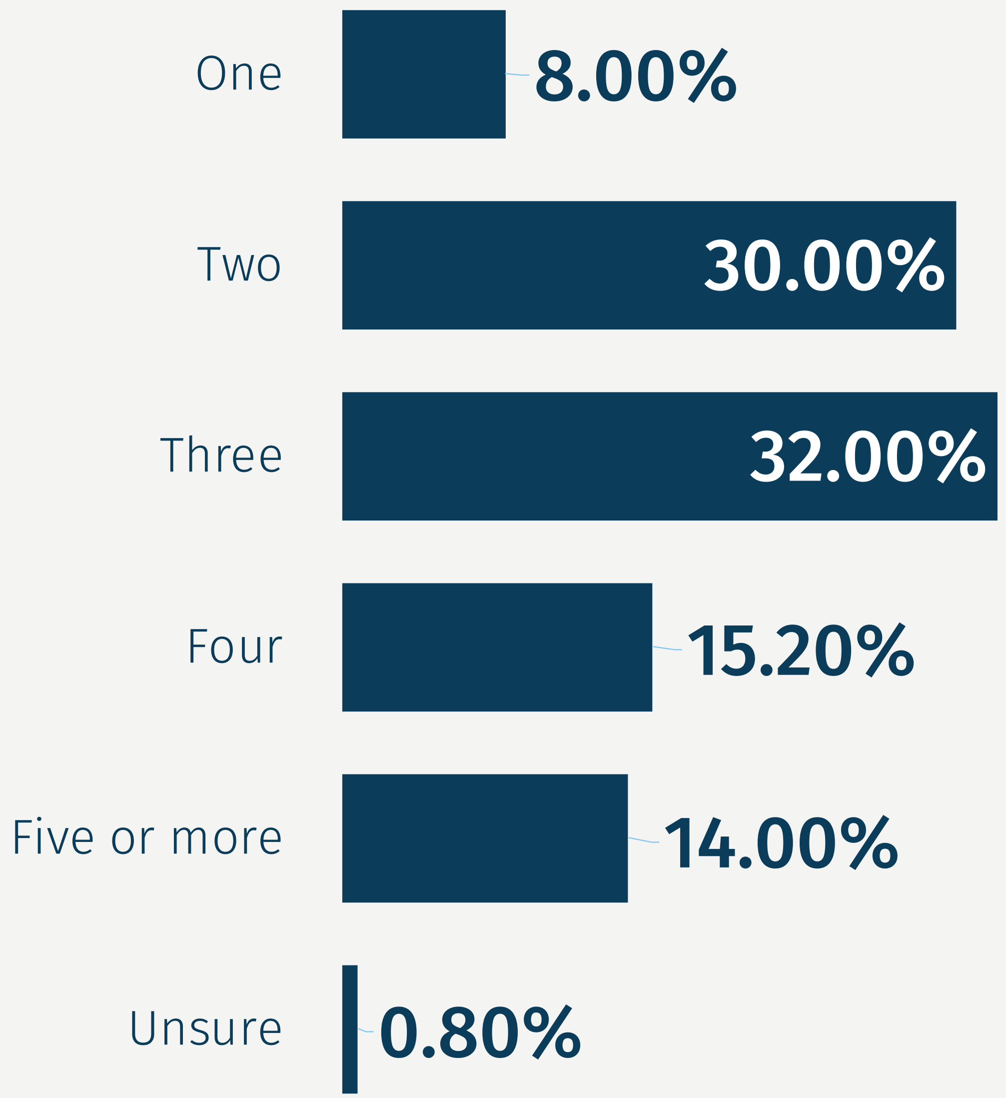
Price discovery is just the first step in the traditionally long-winded process of booking and settling an FX trade. Finance professionals typically have to get approval from different layers of seniority, wait for trade confirmations which usually arrive via email, process settlement, enter payment details and, in some instances, share trade information with third parties such as administrators or regulators.

All of this internal, manual and siloed communication is often **extremely inefficient.** And this is just for one, single trade. Many organizations execute tens or hundreds of trades every month with different products and mechanics.

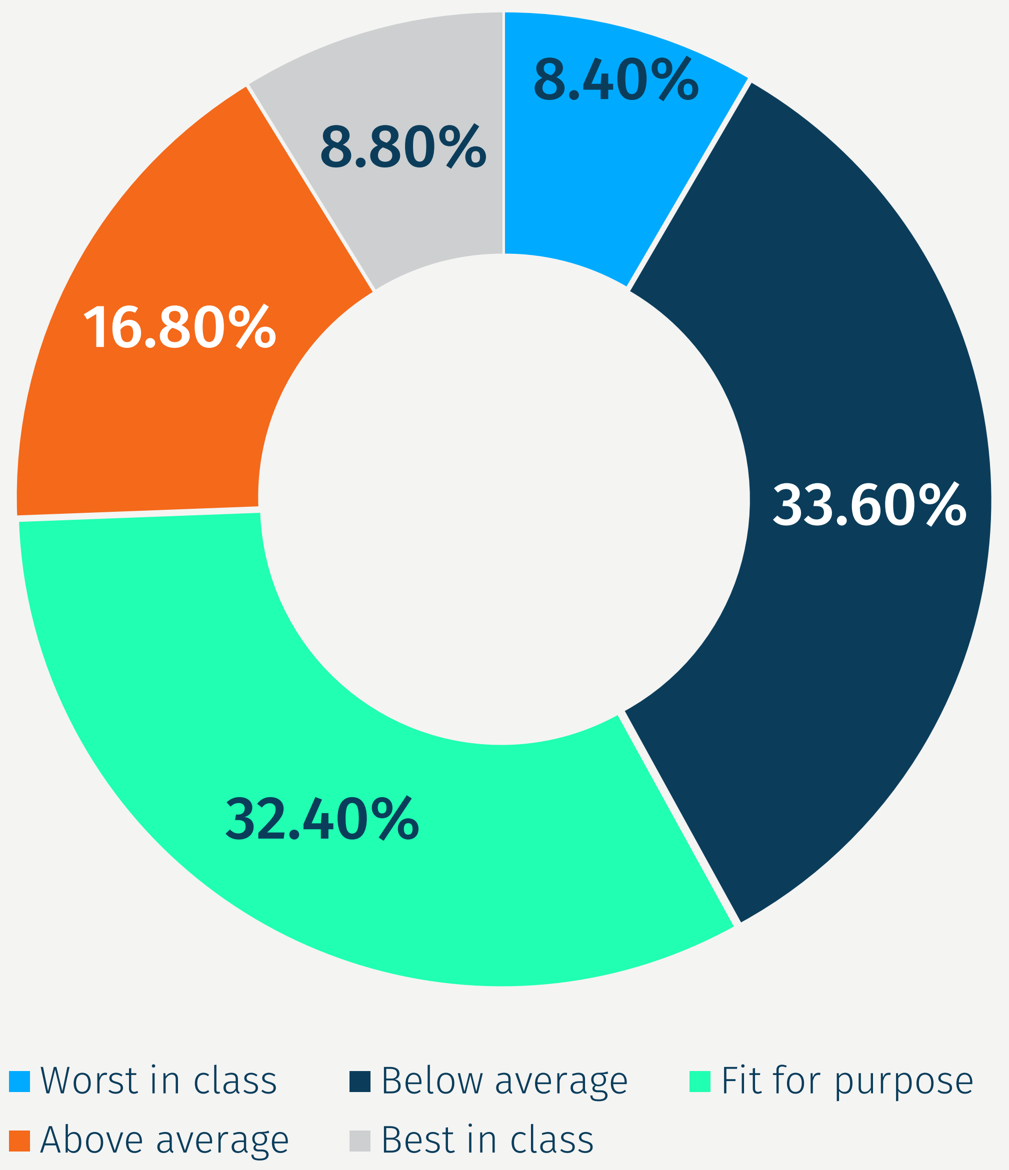
This entire process is **a huge drain on time and resources,** with our research finding that **61% of fund managers task three or more people** with FX-related activities.

Despite the resources dedicated to setting up and maintaining their FX processes, **only 9% of fund managers said their FX set-up was best in class, whilst 42% said it was either below average or worst in class.**

How many people in your team are tasked with FX-related activities?



How would you rate your current FX setup?



Part 3

Operational challenges

So, if FX is so significant to fund managers and they dedicate a large amount of resources, what's preventing them from having a best-in-class setup?

Administrative burdens

The **top challenges** facing senior finance decision-makers at fund managers in their FX operations are **onboarding new liquidity providers (34%) and securing credit lines (33%).**

The process of onboarding a new liquidity provider can be an operational headache for the finance function, involving large quantities of paperwork as well as securing ISDA agreements.

As a result, it can **take months to onboard a new liquidity provider.** If a fund manager can't secure credit lines, they have to place margin which impacts on the amount of capital available to invest.

Navigating hidden costs

Unsurprisingly, **transparency** is also a major issue for fund managers, with cost calculation **the third biggest challenge they face (33%).** The opaque nature of FX execution means that fund managers may often be plagued by hidden costs, particularly those that are hidden in the spread.

For example, if a fund manager buys €5m of USD at 1.0982 and the mid-market rate at the time was 1.0961, the transaction cost on the trade would be 0.19%, or €10,500. **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.

The search for transparency and best execution

Another big challenge for fund managers **is getting comparative quotes (31%).** Since fund managers tend to only work with a small number of counterparties for their FX due to the **operational complexity of setting up multiple banking relationships**, it is harder for them to compare prices.

The lack of transparency is compounded by a **concept called "tailored pricing"** – in which clients are provided rates in different capacities depending on what kind of client they are. As a result, the **best rates are reserved for the largest institutions that transact the highest volumes,** meaning mid-sized fund managers may be left in the dark over whether they are getting the best possible rate.

Other challenges facing fund managers in their FX operations include forecasting exposure (31%), fragmented service provision (31%), benchmarking providers (31%), demonstrating best execution (26%) and manual processes (25%). Interestingly, not a single respondent stated they had no big challenges in particular.

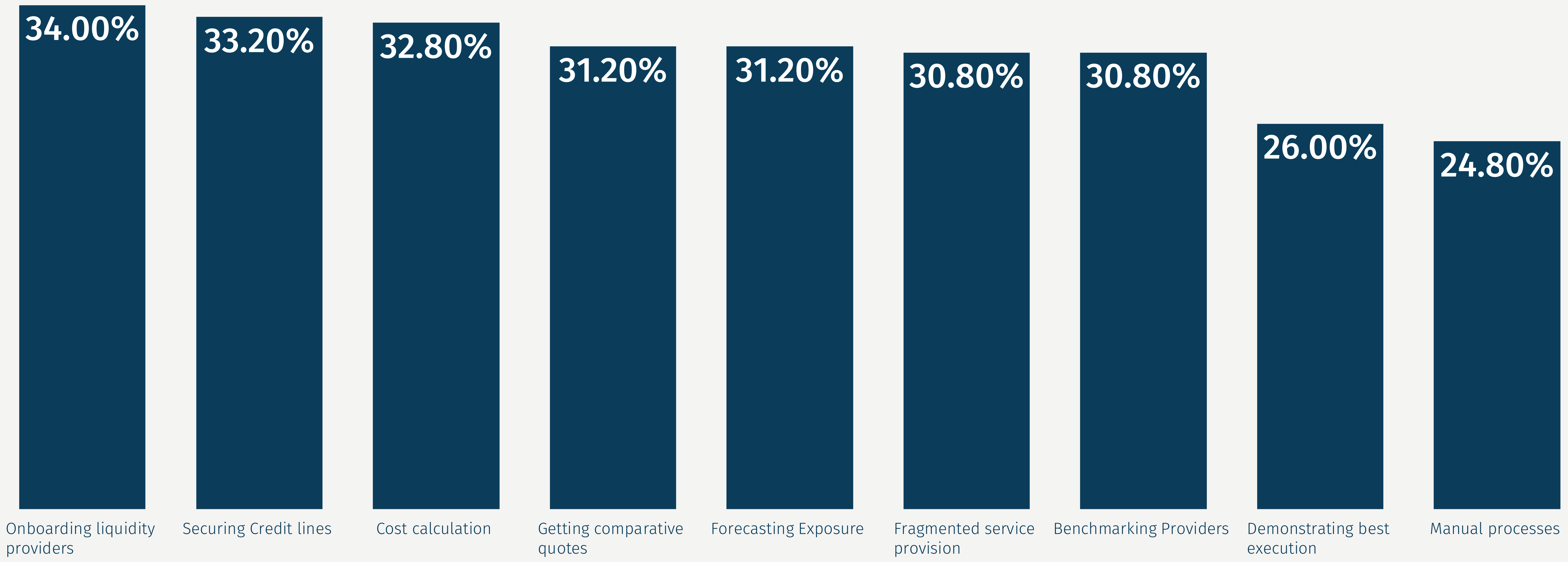
Hedging collateral

One of the challenges fund managers face when hedging is **the margin required to be posted against that position as collateral.** 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.**

Just under a third (30%) of fund managers said uncollateralized hedging was the most important of their FX processes. With no margin hedging, fund managers can better forecast future cash flows as they are not at risk of daily margin calls. They can therefore focus on the core task at hand, maximizing returns.

What are the biggest challenges you face when it comes to your FX operations, if any?



Part 4

Turning to technology

Automation and Digitization

As a result of the challenges mentioned above, many fund managers are beginning to **consider moving away from traditional providers and legacy infrastructure.** Instead, many are embracing tech-enabled solutions which **digitize the FX process** from initial price discovery right through to reporting at the end of the trade lifecycle.

78% of those surveyed said they were **looking into new technology and platforms to automate their FX operations,** while automation of manual processes was the most important factor for fund managers in FX.

The benefits of automated digital solutions include:

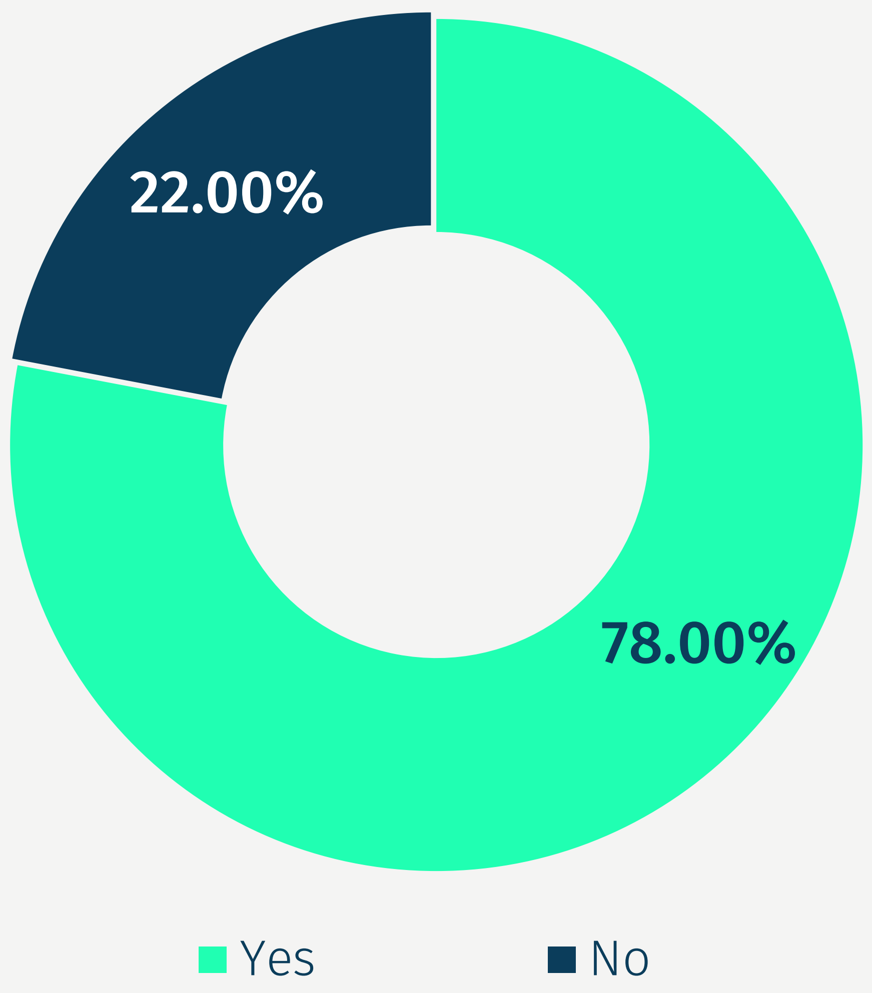
Centralized price discovery - Automated solutions enable firms to **compare prices from multiple liquidity providers on a single marketplace.** Not only does this bypass the onerous phone call and email exchanges, but it also allows firms to get the best available price and lock it in with the simple 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 **saves much-needed time and resources,** enabling fund managers to focus on core business matters.

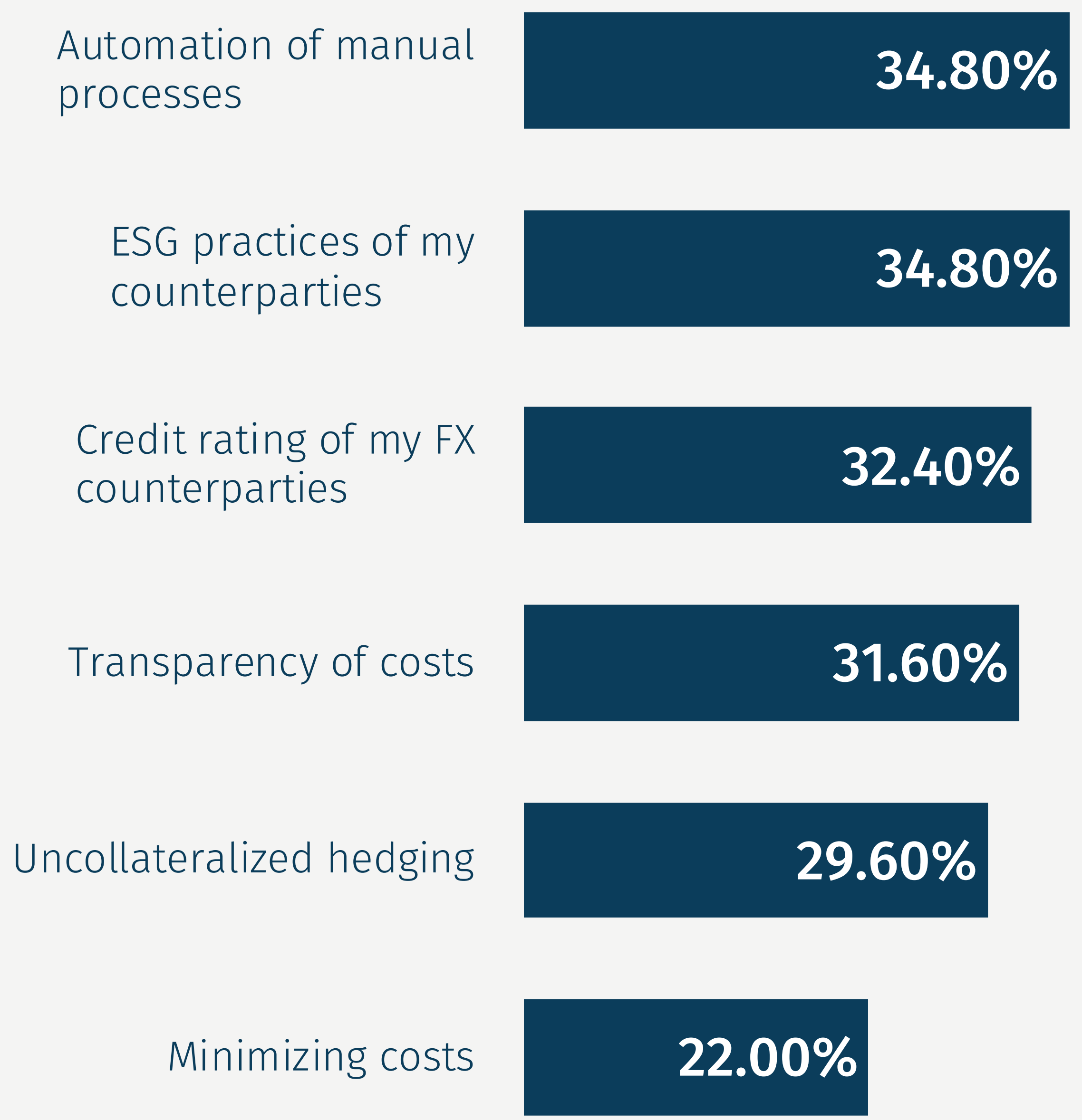
Transparency - By embracing digitization, fund managers can benefit from **complete transparency through real-time reporting and FX transaction cost analysis (TCA).** TCA can be used to help them understand how much they are being charged for the execution of their FX transactions, in addition to **demonstrating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

Fast onboarding - Rather than spending months setting up multiple FX facilities with different counterparties, FX marketplaces with fast onboarding processes enable fund managers to **begin transacting within weeks.**

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



Which of the below, if any, are the most important?



Part 5

The rising importance of ESG

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.

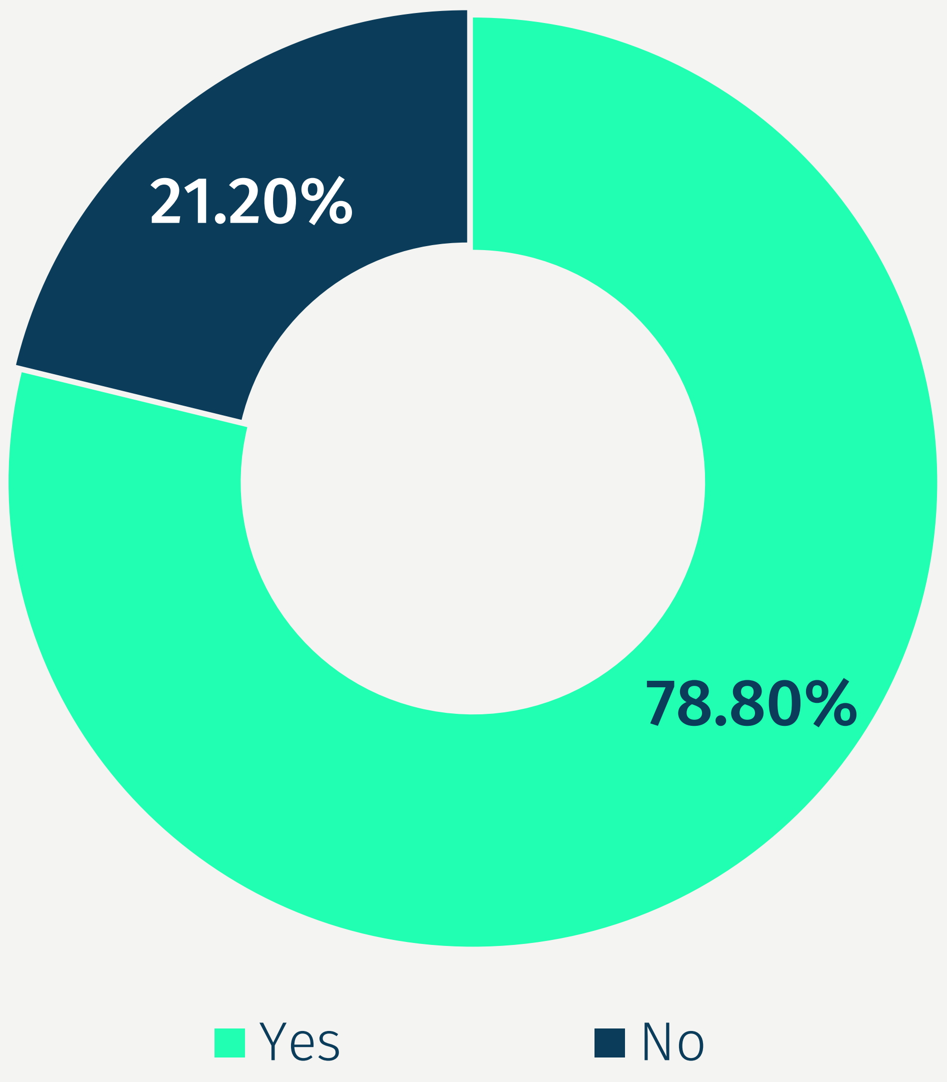
Almost eight of ten (79%) said that ESG has grown in importance to their business over the past year, whilst 35% said that the ESG practices of their counterparties were the most important factor in FX. Almost half (48%) said that their FX counterparties must have strong ESG credentials.

As businesses become increasingly driven by ESG criteria, **it is vital that fund managers have the right processes in place** to meet this demand. When transacting in FX, firms can take the following steps to enhance their ESG credentials:

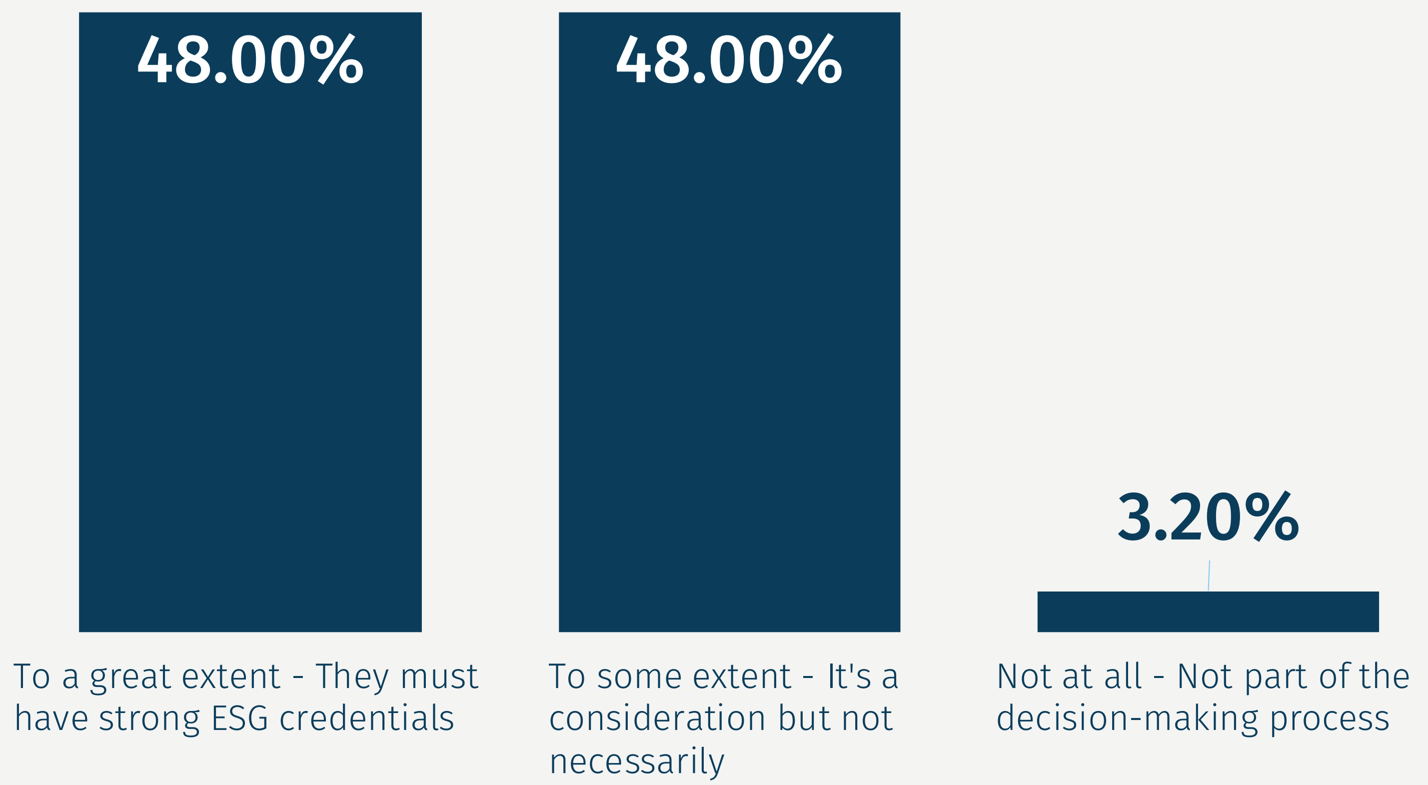
Adopting the FX Global Code (FXGC) - The BIS Foreign Exchange Working Group published the FXGC in 2017 to set out best practices across the wholesale FX market and is beginning to **embed the code into firms' ESG practices.** Its members recently supported the possibility of a partnership with rating agencies so that anyone who signs the code can be recognized 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 organization. When transacting in FX, fund managers should **consider seeking to use FX providers which adhere to internationally recognized ESG standards,** such as the Principles for Responsible Investment (PRI).

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



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



Part 6

The changing face of FX hedging

Volatility across currency markets is expected to persist throughout 2023 and beyond, and if managed ineffectively, has the potential to erode fund managers' bottom lines.

This is a particular risk for North American fund managers transacting in the US dollar, with **82%** of those surveyed **stating US dollar volatility impacted their business.**

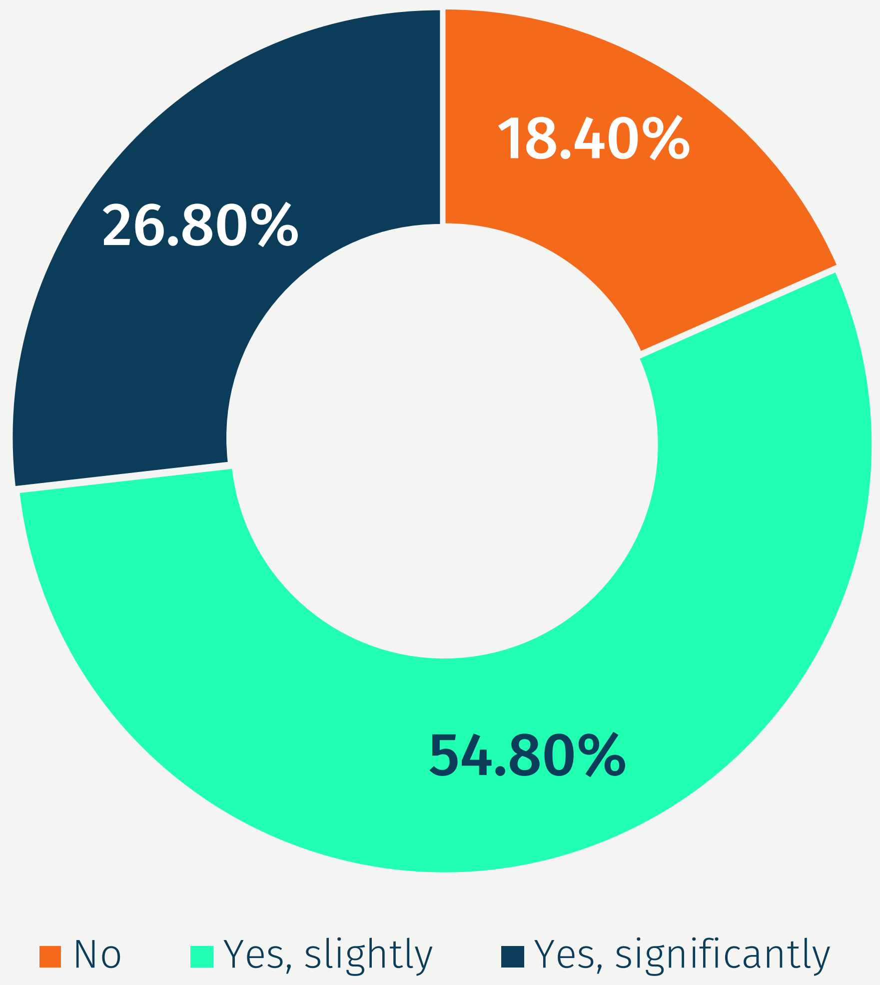
FX risk management has therefore become a top priority for fund managers with many renewing their focus on hedging. **72% of fund managers already have a hedging program in place,** and out of the 28% that do not, over half **(54%) are considering doing so** given market volatility.

Our research also found that the average hedge ratio was between 50-59%, with almost seven out of ten **(69%) fund managers stating their hedge ratio as higher compared to this time last year.** The average length of hedges was just under five months (4.96), with 55% of fund managers citing their hedge length as longer compared to a year ago. This suggests that fund managers are moving to hedge more of their FX risk to protect their bottom lines from currency movements.

Looking ahead, 47% of fund managers plan on shortening their hedge window over the next 12 months, whilst 46% plan on increasing their hedge ratio.

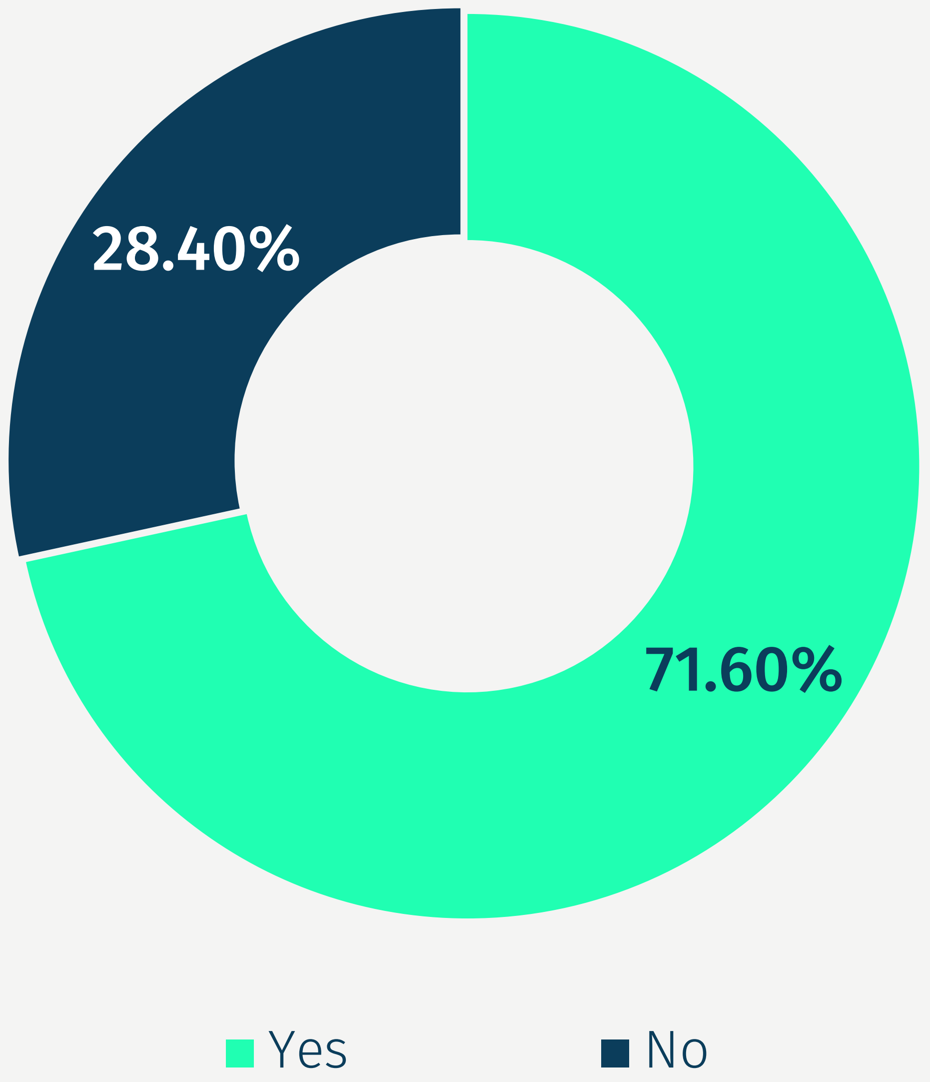
Interestingly, over two-thirds **(67%)** of those surveyed said that **the cost of hedging has gone up over the past year.**

Has USD volatility impacted your business?

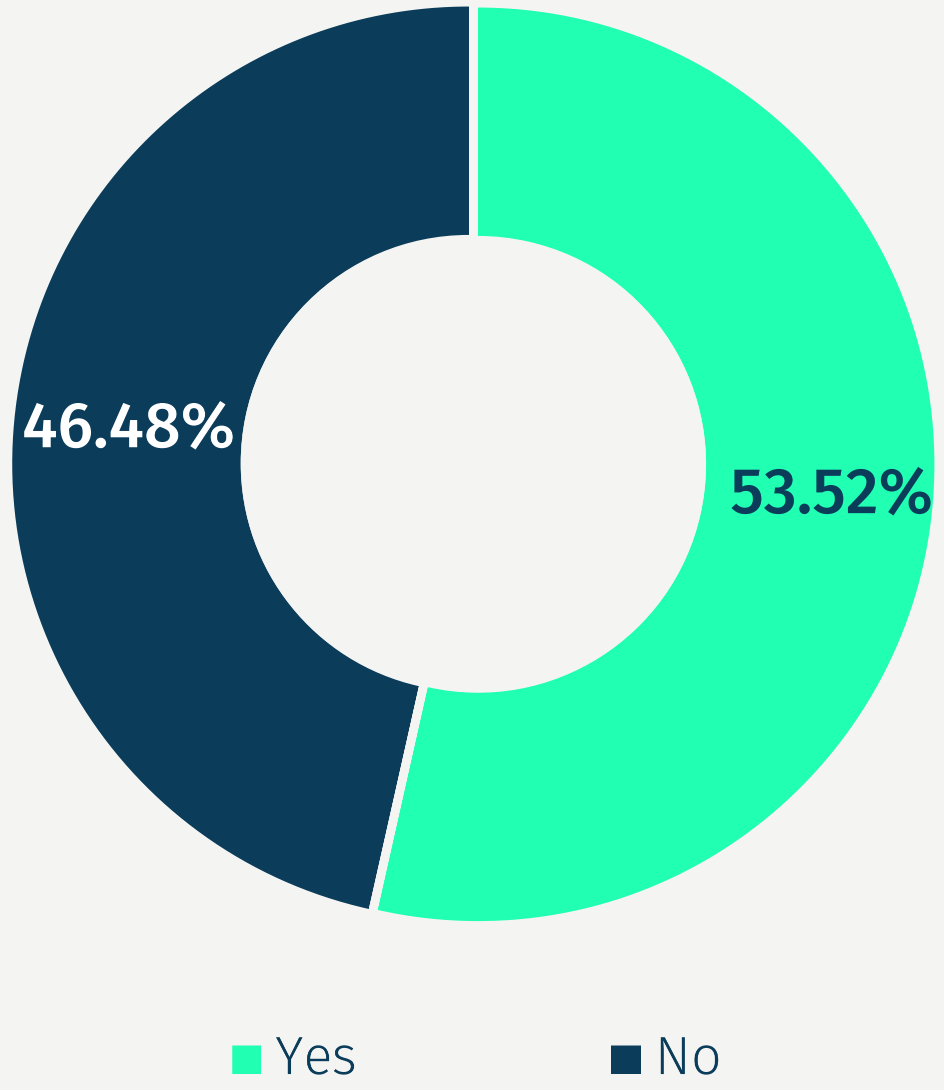


Yes (Net): 81.60%

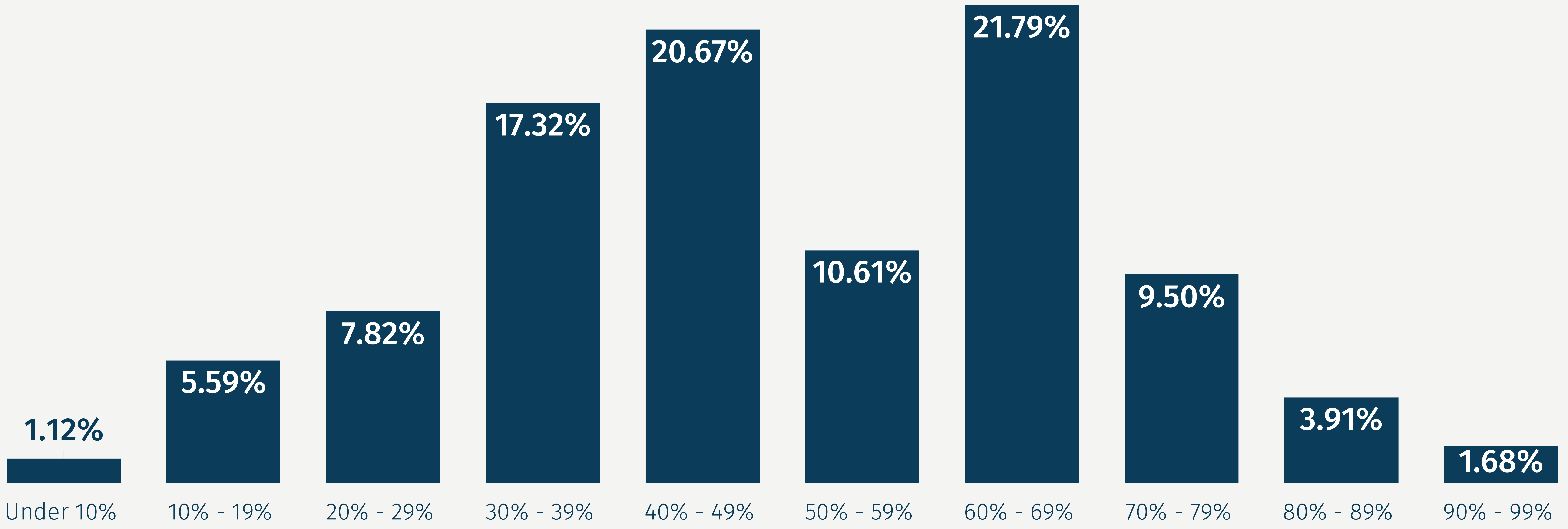
Do you hedge your forecastable currency risk?



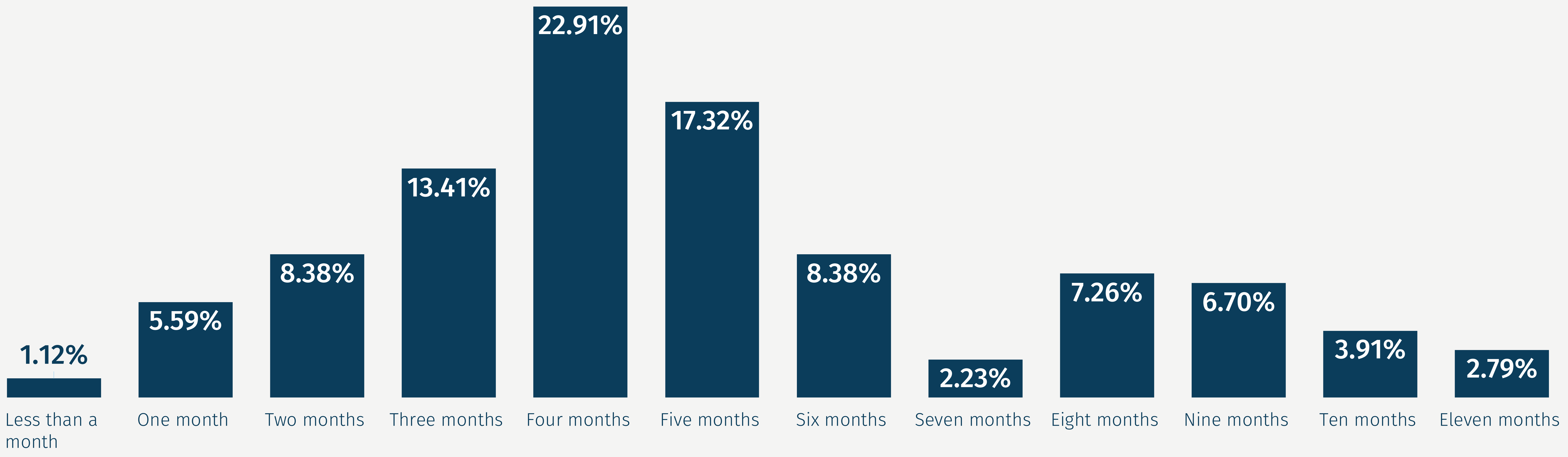
Are you now considering hedging given market volatility? *Respondents who do not hedge their forecastable currency risk



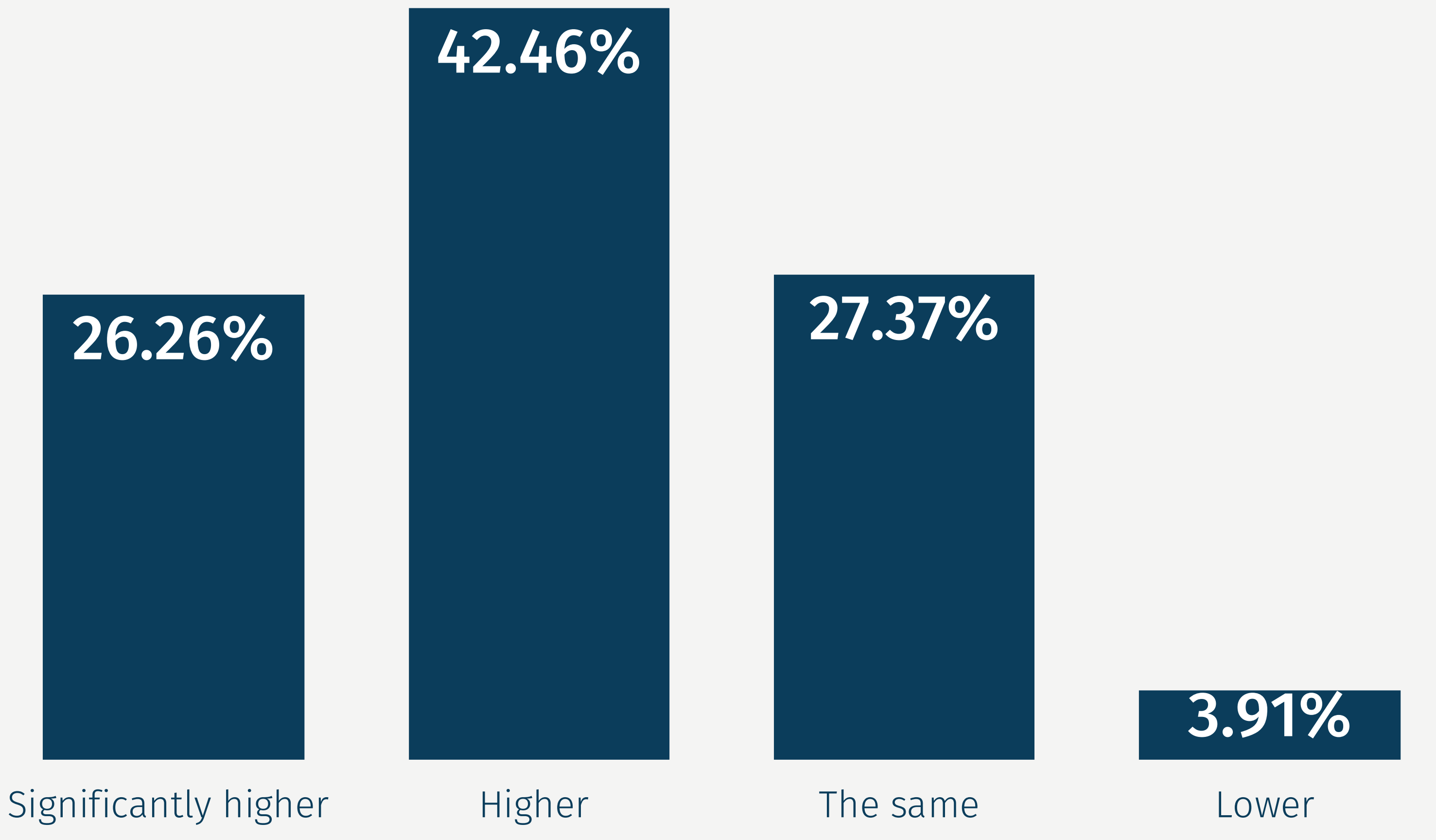
What is your current hedge ratio? *Respondents who do hedge their forecastable currency risk



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

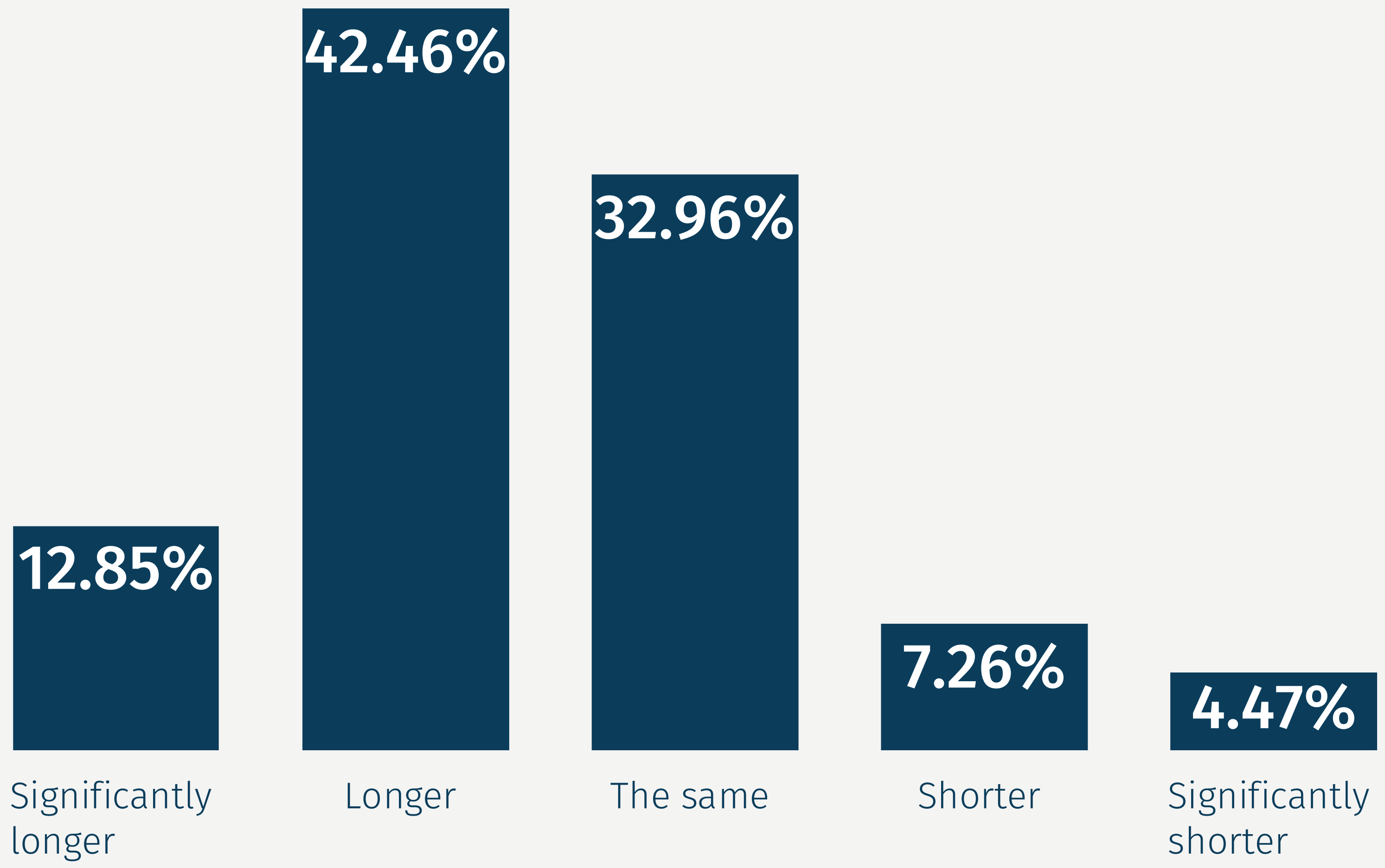


How does your hedge ratio to last year? *Respondents who do hedge their forecastable currency risk



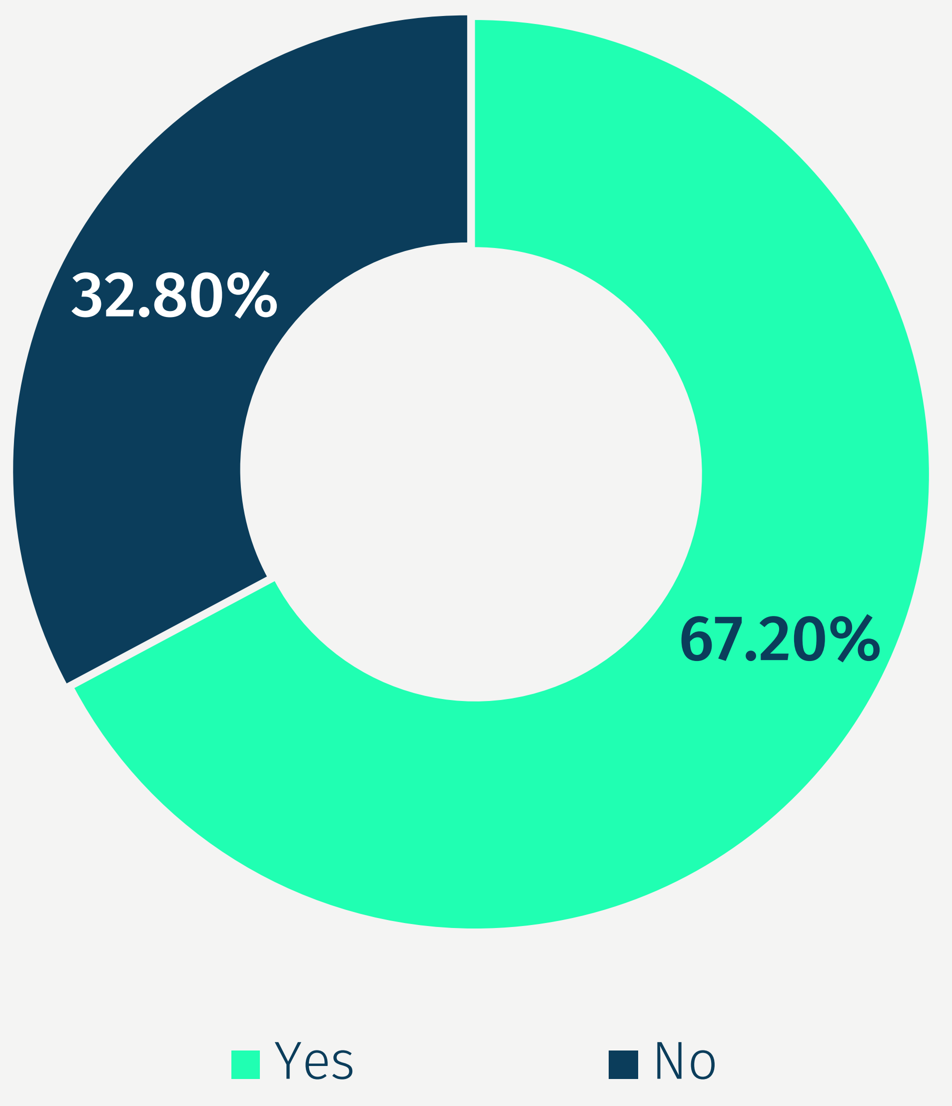
Higher (Net): 68.72%
Lower (Net): 3.91%

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

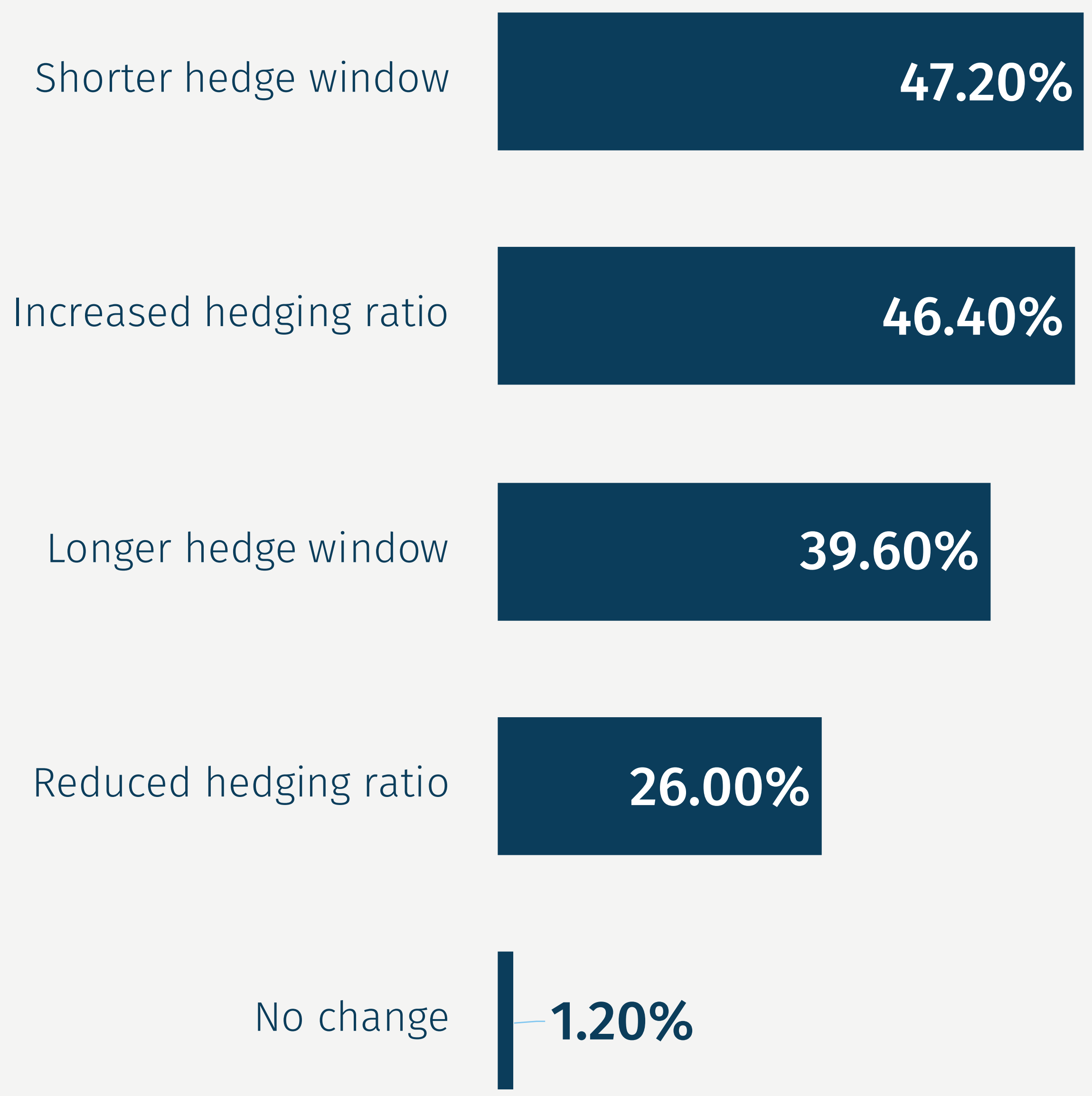


Longer (Net): 55.31%
Shorter (Net): 11.73%

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



What changes are you planning on making to your hedging strategy over the next 12 months?



Part 7

Counterparty diversification

One of the big lessons for fund managers from recent events in the banking industry is **the importance of having access to multiple counterparties.**

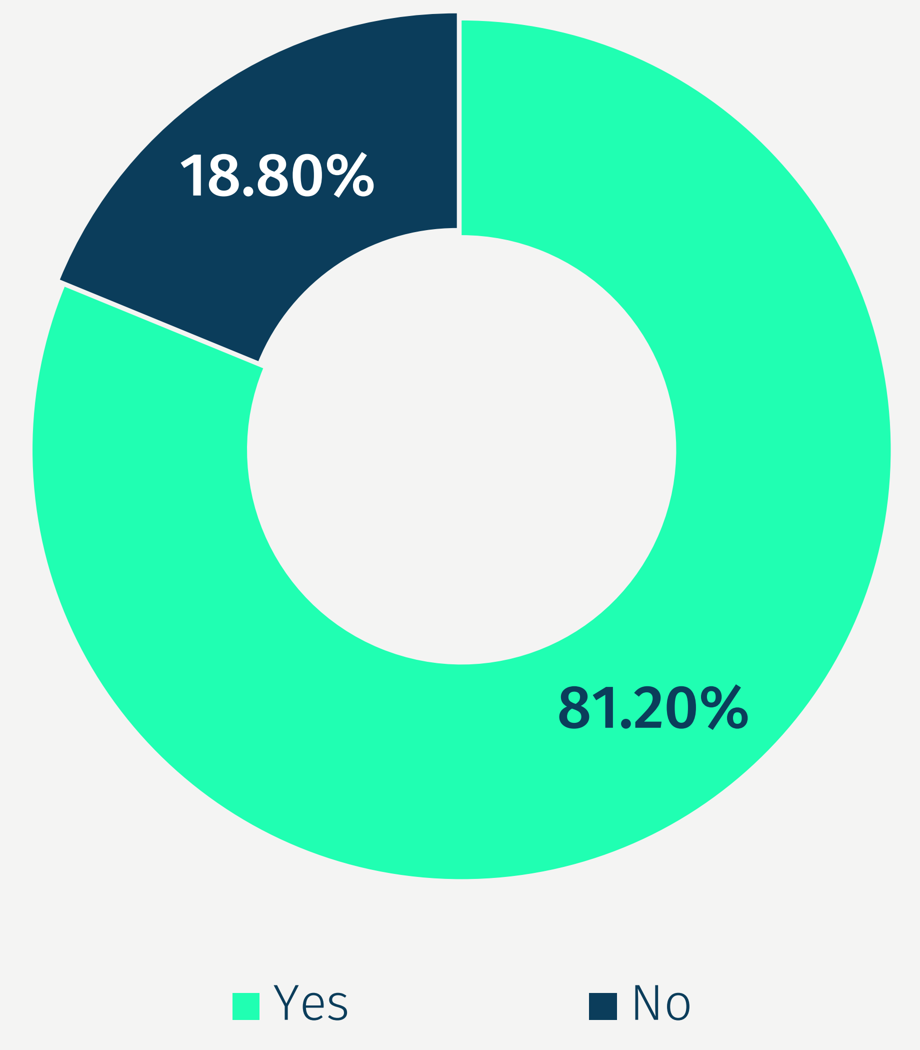
Counterparty diversity is a **pre-requisite for FX best execution** and we believe best execution should be a priority for any fiduciary firm. By having a panel of banks at their disposal, fund managers can ensure they have access to a variety of liquidity providers, which can improve the efficiency and execution of their trades.

Our survey found that **81% of fund managers are now subsequently looking to diversify their FX counterparties.**

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.

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)?



Conclusion

It is likely currency volatility will be prevalent for the foreseeable future, meaning **the management of FX currency risk should be a top priority** for fund managers across North America.

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

Transaction Cost Analysis (TCA) - TCA was specifically created to **highlight hidden costs** and enables firms 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. A new generation of fintechs is tackling this problem, enabling fund managers to access rates from multiple banks whilst reducing the operational burden 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 reduce errors, future proof and build for scale, 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.

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.

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, centralizing price discovery and navigating the post-execution phase requires a team of people and often have their own complications. **Harnessing solutions that 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 impa of currency volatility. **Harnessing automated solutions can offer end-to-end workflow, greater transparency and faster onboarding, helping finance departments streamline their FX functions.**

Uncollateralized hedging - If FX hedging is margined, then a fund manager isn't necessarily reducing risk – they may just be replacing one risk with another one, the challenge of finding liquidity at short notice to set margin. Using uncollateralized or margin-free hedging solutions **removes the need to post initial** or **variatio margin on FX forwards, without jeopardizing best execution, freeing up important capital.**

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 31st December 2022, is a combination of USD 17,869 million in notional AUM for unfunded managed accounts, and USD 115 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 in May 2023 based on a survey of 250 CFOs, treasurers and senior finance decision-makers at mid-sized asset management firms (described as those with assets under management ranging from $500m to £20bn) in North America.

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