Currency Hedging Programmes in Funds

Presented by

Ellen Lederman Non Executive Director
Mark Kieran Senior Vice President BBH
Sid Patel Vice President BBH

Currency Hedging Programmes in Funds – Regulatory Requirements

The rules are those related to UCITS and UCITS ManCos; for the most part the same rules apply to Irish AIFs and AIFMs.

(1) Irish UCITS Regulations (SI No 352 of 2011)

Rules in relation to the use of derivatives

- **Regulation 68(1)(g)** Eligibility (including that they must be subject to reliable, verifiable valuation on a daily basis and capable of being sold, liquidated or closed by an offsetting transaction at any time at their fair value, at the UCITS initiative.)
- **Regulation 69** Risk Management (including obligation to employ a process for accurate and <u>independent</u> assessment of the value of OTC derivatives and that risks are adequately captured. Other requirements include global exposure limit and those related to reporting.)
  - Schedule 9 to the Irish UCITS Regulations includes UCITS L2 obligations applicable to risk management including further obligations on valuation of OTC derivatives.)
- **Regulation 70** Risk limits (counterparty risk exposure limit – 10%/5%; 20% combined exposure limit)
- **Regulation 90** Disclosure (Prospectus to include a prominent statement indicating objective behind use of derivatives and impact on the risk profile.)
- **Schedule 5:** Conduct requirements including those related to **best execution.** (Paragraphs 13 – 21 are particularly relevant.
  - UCITS ManCos obliged to ensure best possible result and to establish and implement a policy in that regard. For each class of instruments, the entities with which orders may be placed must be identified. Effectiveness of the policy must be monitored and policy reviewed annually. ManCos must be able to demonstrate that orders have been executed in accordance with the policy.

Currency Hedging Programmes in Funds – Regulatory Requirements

The rules are those related to UCITS and UCITS ManCos; for the most part the same rules apply to Irish AIFs and AIFMs.

(2) Central Bank UCITS Regulations (SI No 230 of 2019)

- **Regulation 8** Financial Derivative Instruments (FDI) (including eligible counterparties and calculation of exposure)
- **Regulation 15** (FDI Cover Requirements)
- **Chapter 5 (Share classes): Regulation 26(3)** addresses currency hedging at share class level, including rules on over and under hedged positions and stress testing. (The Central Bank obligations relate to the 2017 ESMA Opinion on share classes.)
- **Regulations 42-43** (**Transactions involving Connected Persons**). Transactions with connected persons are prohibited unless they are at arms length and in best interests of the investors. If they are off exchange, the value must be certified by an independent and competent person, or the transaction is to be certified by the depositary (or UCITS ManCo if the depositary is involved in the transaction). Documentary evidence in relation to all connected party transactions is required.
    - **Regulation 71** requires that the prospectus discloses that connected party transactions may occur
    - **Regulation 81** requires that each annual and half-yearly report shall state whether the board is satisfied that arrangements are in place to ensure all obligations are applied to these transactions and that all transactions during the period complied with the obligations.
- **Schedules 7/8** – Disclosure obligations related to FDI (paragraph 5)

Currency Hedging Programmes in Funds – Regulatory Guidance

Central Bank Fund Management Companies guidance (CP86):

- The Central Bank guides Fund ManCos on their relationships with delegates. Tasks can be delegated but responsibility is retained.
    - *"A board should exercise skill, care and diligence when identifying and approving the appointment of a delegate for any task. It should satisfy itself as to the capacity of the prospective delegate to undertake such task to the required standard"*. Reporting from delegates should address compliance with relevant legal and regulatory requirements and with relevant reporting policies and operating procedures.
- If a Fund ManCo intends to rely on the substance of a delegates policies and procedures, the Fund Management company must be satisfied that it will ensure it is complying with its regulatory obligations and therefore must map those obligations against those of the delegate.
- Paragraphs 15 -18 of Part IV (Managerial Functions) provide that Fund ManCos must review all regulatory obligations and identify precisely the managerial function each one will fall under.
    - *"This systematic approach of allocating regulatory obligations to managerial functions will ensure that a fund management company has identified each regulatory obligation and that there is a Designated Person with responsibility for overseeing each such regulatory obligation. It will ensure that no obligations are unmonitored."* The annexes set out obligations under UCITS and AIFM Directives, allocating these to one of the six managerial functions or Organisational Effectiveness role. However this is guidance only and for example, best execution related responsibilities under AIFMD are allocated to regulatory compliance while in the case of UCITS best execution comes under the investment management managerial function.

Accordingly, in the case of currency hedging programmes, a Fund ManCo must work out what requirements apply and how they are going to be complied with - at the level of a delegate and within the organisation of the Fund ManCo.

Portfolio Hedging: Hypothetical Example

UCITS denominated in USD, with GBP exposure on the portfolio.

- Assume portfolio manager only wants to experience the local return of the asset purchased.

Acme Holdings GBP

Units Purchased	10,000		
Original cost per unit (GBP)	£100	Current Price GBP	£110
Original cost GBP	£1,000,000	Current Value GBP	£1,100,000

FX Rate at purchase	0.8532	Current FX rate	0.8569
Original Cost USD	$1,172,058	Current Value USD	$1,283,697

Security Unrealized Gain (URGL) GBP	£100,000
USD equivalent @ today's FX rate	$116,700
Actual USD URGL	$111,639
Currency URGL	($5,061)

The manager is experiencing ($5,061) of unwanted FX P&L. Sell GBP 1,000,000 forward, buy USD:

Units	Forward rate on trade date	Original Cost USD	Current forward rate	Current Value USD	Currency URGL
(£1,000,000)	0.8530	$1,172,333	0.8570	$1,166,861	$5,472

Net currency impact post hedge: $411

Conceptual examples to illustrate hypothetical performance only.

MM/IS-07185-2021-03-31

Share Class Hedging: Hypothetical Example – Day 1

UCITS denominated in USD, with AUD hedged shareclass.

- Australian investor injects AUD15,000,000 into the fund @ launch NAV per share of **AUD100**
- AUD is converted by spot FX to USD for the fund manager to use.
- Core portfolio experiences -29 basis points (bps) of performance on day 1.
- At Fund Accounting, NAVs are calculated in the base currency of the fund, and then converted to local using the prevailing FX rate.

Day 1	Launch or Prior Day NAV Per Share	Launch or Prior NAV in USD	Base Class Return (bps)	Current NAV USD	Trade Date FX Rate	Current FX Rate	Current Local NAV Per Share	Local Class Return
USD Unhedged	111.22	111.22	-29.41	110.89	1	1	110.89	-29.41
AUD **Un**hedged	**100.00**	77.56	-29.41	77.33	0.77555	0.7754	99.72	-28.13
							An unhedged AUD class performance diverges to the base USD class by 1.29bps:	**1.29**

To hedge the class, the manager sells USD and buys 15,000,000 AUD forward, as an offsetting transaction to the spot FX conversion of the AUD injection into the fund.
This forward FX, included in the NAV, is then valued at the valuation point of the fund.

Trade date of Subscription	Buy/Sell	Currency	Amount	Contra Currency	Spot Rate*	Forward Points**	Trade Rate	Contra Amount
Spot FX AUD to USD	S	AUD	15,000,000	USD	0.77555	0	0.77555	11,633,250
Forward FX	B	AUD	15,000,000	USD	0.77555	0.16	0.775566	11,633,490

	Valuation Rate	Difference to trade rate in bps
	0.775458	**-1.39**
	Net Impact for hedge (bps):	**-0.10**

*Note that having the same starting spot rate on the offsetting transactions can help reduce transaction costs and mitigate tracking error. The spot rate on these offsetting transactions should also ideally align with the trade date FX valuation point of the fund, including for subscription/redemptions confirmed after that point in time.

**Forward points reflect interest rate differential and other market factors. These are reflected in both the trade rate and valuation rates.

Conceptual examples to illustrate hypothetical performance only.

MM/IS-07185-2021-03-31

Share Class Hedging: Hypothetical Example – Day 2

UCITS denominated in USD, with AUD hedged shareclass.

Day "2"

- The total net assets of the class are monitored daily versus the notional hedge exposure.
- Assume that the manager has elected a 2% tolerance above or below fully hedged as an acceptable hedge so as not to have to trade every day and incur trading cost.
- Let's say after 5 days of market movement the NAV has moved by greater than 2%:

AUD Class Total Net Assets in USD	Current Forward Position (Short)	Current Hedge Ratio %	Target Hedge Ratio %	Current Variance	Tolerance Breach	Target Forward Position (Base)	Trade Currency	Trade to Execute	Buy/Sell	Contra Currency	Trade Rate	Contra Amount	Post trade hedge ratio
11,303,894	11,633,490	102.92	100	2.92	Y	11,303,894	USD	329,596	B	AUD	0.7695	428,326	100

Items for board's consideration:

- Are the tolerance bands in line with UCITS regulation?
- Do you have transparency into the 'trade rate' on the forward hedge, including spot and forward points?
- Are non-base subscriptions and redemptions being converted to base currency using the funds' valuation point, including adjustments for confirmed NAVs?
- How is the hedged class performing versus the base class over time?
- What is causing the divergence? Is performance attribution available detailing transaction costs, interest rate differentials etc?
- How frequently is the hedge being rebalanced, does the tolerance band make sense for the fund (performance v transaction cost).
- Are these impacts to the class being ring-fenced at accounting so as only to impact the class?

Conceptual examples to illustrate hypothetical performance only.

MM/IS-07185-2021-03-31

Currency Hedging Programmes in Funds – checklist for Boards

The following are items which could be usefully included in your board pack:

- A summary of:
  - the fund's hedging policy
  - the regulatory obligations that apply
  - What has been said to investors in relation to hedging policy and strategy
- The counterparties who are approved for hedging contracts
- A list of outstanding hedges and if appropriate distinguished by function (share class hedge, construction cost hedge, NAV hedge..)
- Relevant KPIs and RAG report tracking key aspects of programme
- Stress tests on currency movements to check how hedges would have performed including in the context of prescribed limits, tolerance levels, impact of volatility vs available cash /credit facility
- Annual oversight of programme as with other in house / delegated functions

Much of this information could usefully be included in a dashboard or standardised report for the board.

EMPOWER
ENABLE
EDUCATE

Disclaimer

Brown Brothers Harriman & Co. is not affiliated with the Institute of Banking in Ireland or University College Dublin.