PASSIVE CURRENCY OVERLAY—TRENDS AND CHALLENGES FACING THE FX HEDGING MARKET

Participants:
Jay Moore—Senior Vice President Foreign Exchange—Brown Brothers Harriman
Marc Tuehl—Global Head of FX Overlay—HSBC
Mark Hogg—Mark Hogg – Director, Head of Currency Overlay and FX Product Development, Treasury & Market Services, RBC Investor & Treasury Services (RBC I&TS)

Xavier Zaegel, Partner in the Advisory & Consulting at Deloitte and Simon Ramos, Partner and Regulatory Strategy Leader at Deloitte have asked BBH, HSBC and RBC I&TS about their view on the challenges in the Foreign Exchange Hedging Market.

Jay Moore is a Senior Vice President and the Global Head of Currency Administration at Brown Brothers Harriman. Jay joined BBH in 2012 to lead the firm’s Product Development efforts for Foreign Exchange and has since transitioned to run the Currency Administration business. Prior to joining the firm, he was the head of the Currency Management and Portfolio Solutions Strategy teams for State Street Global Markets. He has 15 years of experience in the foreign exchange industry, including time within operations, trading, research, sales and product development.

Marc Tuehl became Head of Currency Overlay Management at HSBC Trinkaus in 2004 before moving to London in 2013 as Global Head of FX Overlay. In this position he is responsible for the global FX Overlay platform of HSBC providing passive and dynamic hedging solutions. Prior to joining HSBC Marc became Head of German Desk at LCF Rothschild in Geneva. In this position he was responsible for the advisory of German and Pan-European clients within structured rates, FX and quantitative asset management.

Mark Hogg has global responsibility for Currency Overlay and FX Product Development for RBC I&TS. In addition, Mark maintains oversight of FX sales for North America. Prior to joining RBC I&TS in 2010, Mark spent 9 years with Fidelity International in various currency management roles. He is a graduate of Dublin City University holding a B.Sc. in Business and Finance and a M.Sc. in Investment and Treasury.

Since the start of the WMR scandal, the foreign exchange (FX) market has not left the news. FX hedging for investment funds is constantly increasing in size and scope as new trends emerge. Regulators recently touched on this topic as well with ESMA's consultation paper on share classes of UCITS and MiFID II.

In their consultation papers published in December 2014 and April 2016, the European Securities and Markets Authority (ESMA) outlined their view on the different types of share classes allowed in a UCITS fund. Their goal seems to limit the complexity and additional exposures at share class level in order to protect investors and avoid any spillover to other share classes. It could potentially restrict several products at share class level; some which create new exposures to exotic FX currencies in order to profit from their interest rates but also others which could reduce the level of risk of the investor such as the interest rate risk, duration hedging, or the market risk, beta/delta hedging.

Regarding MiFID II, the discussion about best execution requirements could change the view of the market and the expectations of clients on transparency. In light of this trend, we recently observed that several market players are currently assessing the suitability of their execution model, their level of reporting of FX trades and their pricing approach.
In this context, Deloitte convened a roundtable of market experts and providers of FX Overlay services to highlight how protection against FX risks in Investment Funds has changed to best respond to Asset Managers requests and regulatory pressure in terms of product capabilities, process alignment, transparency and risk monitoring.

FX overlay relates to the use of an FX strategy on top of the investment strategy to reach either the goal of additional alpha through new currency exposure, called active overlay, or the goal of protecting the investor against the FX risk or FX hedging through a passive overlay program. Furthermore, a passive strategy also adheres to the strict guidelines of the process, as no active management decision is made. In this roundtable, the focus will be on the passive programs.

In a recent survey on the matter, specific products were observed to be growing considerably, such as share class hedging (hedging the liabilities or share classes of the fund), and look-through hedging (a hybrid hedging methodology that helps hedge the asset at the level of the share class in one unified process).

In terms of asset and liability hedging, could you outline the different requests that you receive from your clients and the product trends that you see emerging?

Mark Hogg, RBC I&TS:
Currency hedged share classes that consider the fund basket of currency exposure for hedging purposes are becoming more common and, in some cases, are overtaking traditional currency hedged share classes that only mitigate the exposure between the fund and the share class base currency denomination. We are also seeing an increase in the use of Non Deliverable Forwards (NDFs) as an effective tool to mitigate currency exposure to emerging market currencies. We expect this trend to continue, particularly as the ASEAN passport initiative gathers momentum.

Marc Tuehl, HSBC:
We have seen a sharp rise in the demand for passive asset hedging, mainly from asset owners who have spread their assets across a handful of investment managers. Each investment manager is handed a specific investment mandate and in their course of business create FX exposures that each investment manager hedges independently. This tends to produce random results that can distort the objective measurement of a mandate's performance. In the new regulatory environment, investors and board directors demand transparency and clear accountability for each step in the investment process. Client investment committees now also work very closely with their operations teams, who are often responsible for managing the risk on the liabilities side (share classes).

Jay Moore, BBH:
I see three main trends emerging.

The first trend occurring in the market is a move toward outsourcing. We see investment managers closely scrutinizing their hedging services to decide if they should manage the program in-house or use an outsourced offering when hedging is not a core competency for which they are compensated.

Secondly, at BBH, we have seen clients, large and small, need assistance when it comes to program design and calibration. For many of the managers we work with, FX hedging may be the first and only foray into foreign exchange, making the quality of our services all the more important to their success.

Finally, the third trend is the need for more transparent, higher quality execution.

The final position of ESMA on their UCITS share class consultation paper is not expected until the end of year. Given that potential product restrictions could be imposed at share class level, we observed that Asset Managers have put various product developments on hold until the final decision of ESMA. For example, launch of duration hedging and passive FX exposure products are currently being postponed. As an Asset Servicer, what is your position?

Marc Tuehl, HSBC:
According to the consultation paper, ESMA's view is that currency hedging at the level of a share class could be considered compatible with the principle of a common investment strategy. This means the objective of currency share class hedging is to ensure that investors in the share class receive nearly the same result of the investment strategy, even though the exposure is obtained through a different currency.
Employing a standard passive currency share class hedge could help with being fully compliant with the guidelines of the paper.

Jay Moore, BBH:
While there is significant client interest in the ESMA discussion, at BBH we have not seen any particular slowdown in product launches related to passive hedging, which may suggest optimism that hedging will remain acceptable and appropriate.

In my view, even if ESMA ruling were to prevent portfolio hedging at the share class level, new funds may emerge that would provide the hedged equivalent of existing investment strategies. While the ultimate result will largely be the same, efficiency may be lost, which could translate to higher costs to investors.

Mark Hogg, RBC I&TS:
We believe that EMSA's final ruling will confirm currency hedging at the level of a share class as compatible with the principle of a common investment strategy.

Whether EMSA will deem overlays not linked to currency to be incompatible with the UCITS framework remains to be seen. We do see some arguments in favour of share classes that provide investors with systematic hedging against other forms of market risk, for example interest rate risk.

Such share classes will need to be clearly demonstrated to participate in the same investment strategy of the sub fund and not to conflict with the principal of a common investment strategy.

Currently two FX execution models coexist for FX hedging: trades are either executed through a principal model where the execution desk is the counterparty or through an agent where the FX desk or platform will look for the best quote with multiple counterparties. With Markets in Financial Instruments Directive II (MiFID II) and the potential best execution requirements, the market seems to be evolving toward agency execution in order to produce more transparency. How do you position yourselves toward your clients on this topic of transparency in execution and pricing?

Marc Tuehl, HSBC:
When comparing agency to principal execution, in both of these cases it is important to recognize that price discovery is just a single element of best execution. When considering best execution, credit and access to liquidity need to be taken into consideration, particularly in dislocated markets. Any best execution policy must be fit for purpose in both normal and adverse market conditions.

In line with the 2014 Financial Conduct Authority (FCA) Thematic Review 14/13 on Best Execution, we know that benchmark execution and transaction cost analysis (TCA) may be an appropriate method for demonstrating transparency and applying greater control over FX execution. For the most part, when executing as principal, we reference an independently published FX benchmark—currently the WMR fix—although we anticipate the use of alternative benchmarks going forward.

Mark Hogg, RBC I&TS:
There is a place for both models in the future market landscape. Agency programs that can facilitate a clear audit trail of seeking risk prices in competition can be an appealing "best execution" tool on the surface, but average execution quality can suffer when in a large size, with predicable positioning, or in constrained liquidity environments. By comparison, principal execution models permit a more dynamic approach to liquidity sourcing, risk management, and price construction while still delivering upon a transparent best execution mandate.

A principal model is also more efficient to document and administer in comparison to negotiating and maintaining a large panel of bilateral FX trading relationships with the associated legal documentation and credit considerations.

Jay Moore, BBH:
In addition to our principal execution business, BBH developed an agency execution offering in 2012 to work alongside our currency administration business in anticipation of, among other things, our clients' needs for a higher standard.

By creating what we believe are the conditions that our clients would include in their definition of "best execution" we can better align with our clients' interests. In addition to the importance of trading experience, these conditions include access to multiple liquidity providers, the ability to negotiate actively in a non-captive structure, and anonymous trading on behalf of our clients.

However, for both principal and agency models, FX hedging faces a unique challenge as accurate forward FX rate data is more difficult to come by, making TCA much more challenging.

With respect to risk monitoring and reporting of FX hedging activities, market players are using more and more hedging analytics tools. This allows them to gain greater control and understanding of the underlying effects of their hedging process on performance, as no hedging policy will completely eliminate the FX risk. Deloitte recently developed Deloitte Hedging Analytics (DHA), a tool that monitors several FX hedging Key Performance Indicators (KPIs) and conducts a precise performance attribution of the different hedging impacts. We value DHA as a crucial step toward more transparency for the clients and more control over the risks linked to this process. As a service provider, do you concur on the need to demonstrate the quality of your hedging process with these solutions? In addition, do you receive requests from your clients for more transparency in the reporting of the performance of the passive currency overlay program?

Jay Moore, BBH:
While the standard reporting offered by any currency administrator provides evidence that it has fulfilled its service obligations, only those who can provide implementation and performance details can differentiate themselves. This differentiation comes from both the systems that produce reports and from the expertise to offer interpretation and insight to use that information properly.

There are a number of implementation decisions that influence performance and each decision should be made with the intention to optimize performance. As with any investment strategy, the realized results should be measured in multiple dimensions including return and risk (tracking error) with the relative differences fully explained. Understanding how these implementation decisions translate to performance provides insights for future operational or trading adjustments.

Mark Hogg, RBC I&TS:
Our goal is always to design a program that is both effective and efficient in the long term by ensuring there are no structural risks that would lead to a persistent bias in the process or hedge performance.
We agree that a thorough understanding of the risks and the ability to attribute and measure the individual components of performance are essential to long-term success.

Marc Tuehl, HSBC:
Offering client access to sound KPIs, which allows them to evaluate the efficiency of a hedge program, is critical to a good currency overlay service, whether passive or dynamic.

We provide comprehensive client reports in relation to FX execution, cash flows, hedge performance, and tracking error in order to help our clients satisfy these demands. Some of our clients engage with a third-party TCA provider to measure execution costs and can use specific tools that allow for independent analysis of the hedging efficiency.