FX and Interest Rate Risk Considerations for Fund Managers[1]

By Deborah Low and Karina Oshunkentan

This panel focused on hedging from the perspective of sponsors, hedge providers and hedge advisors. The discussion focused on the different approaches to risk mitigation utilized by funds and how current market conditions have impacted strategy. Key takeaways from the panel are as follows:

1. For many sponsors, hedging was initially an afterthought. Funds were employing a decentralized approach where deal teams were managing hedges independently. Recently, however, more sponsors are moving hedging and risk mitigation into a centralized function which the panel agreed is proving to be more efficient and effective in developing hedge relationships and weathering the current volatility.

2. With a centralized approach, it is important that the risk mitigation team have strong internal partnerships with the deal teams from the start. Sponsors will also benefit from having a strict policy regarding trading to serve as a guidepost but retaining flexibility to allocate discretionary power and allow for strategic pivoting as needed. This allows for a balancing act in which the deal team has room to consider the specific asset classes in determining how best to approach hedging, while still being mindful of general parameters. Certain funds and banks may also benefit from having guidance from a hedge advisor with specialized knowledge of the market.

3. Determination of a hedging scheme is based on various factors, such as the type of fund, strategy, and mandate. For example, on the currency side, certain funds employ a more option-based approach for private equity funds and deploy forwards for evergreen funds. Meanwhile, on the interest rate side, funds approach hedging in a less formulaic way. As far as the amount hedged, this also depends on the type of mandate; it may not be necessary to eliminate all risk and instead opt to only hedge 50% of the investment. Another consideration is that certain transactions have a natural hedge in place internally through operations, balance sheet, and income statement and therefore may not require any structured hedges. The consensus is that a more programmatic approach to hedging also prepares the funds for market volatility.

4. The panel discussed the rising prevalence of open-ended funds, noting that they come with certain benefits for equity investment purposes including the ability of the fund to hold assets for a longer period of time. However, certain challenges arise with respect to open-ended funds and its different risk structure. Some of the key considerations are redemption dates, regular hedging settlements and liquidity needs, and recourse to main funds in the case of feeder funds. These questions trigger the need for more diligence regarding liquidity management to settle hedges that are typically shorter in duration for open-ended funds.

5. Hedging activity has ticked up in recent years, which requires closer monitoring of the portfolio and liquidity management. More and more funds are also requesting not to post collateral for hedges or to include a higher credit support threshold, resulting in higher costs for the funds and riskier positions for the banks.

[1] The panelists were Bryan Cohen, Managing Director, Head of North American Client Coverage at Validus Risk Management, Georgia Curtis, Vice President, Financial Sponsors FX Sales at Lloyds Bank, Shirley Liu, Head of Derivatives Risk Solutions at Mizuho Bank, James McDonald, Principal at TPG, Inc., Brett Morrell, Head of Risk Solutions at Derivative Path, and Jasjit Singh, Partner at Apollo Global Management.

However, from the fund’s perspective, the increased cost of uncollateralized hedges or higher thresholds does not materially impact the internal rate of return.

6. The panelists anticipate a number of trends and concerns in 2023. There will be more focus from sponsors on how hedges are being implemented across funds given the market volatility and high interest rates. The panel also emphasized a stronger need for technology solutions to address hedging questions and provide visibility, monitoring, and reporting from both the portfolio companies and the limited partners as hedging activity not only reflects the risk mitigation strategy but also the liquidity exposure. Finally, the panelists raised concerns of the possibility of a “stagflation” (a stagnant economy coupled with high inflation), which could create hedging issues for funds if asset valuations and liquidity decrease.

© 2023 Haynes and Boone, LLP