Out of the Ordinary

Investec
Specialist Bank

Preparing for EMIR: funds and collateralisation

With the expansion of the far-reaching European Market Infrastructure Regulation (EMIR) to include FX Forwards fast approaching, alternative investment funds (AIFs) across Europe are preparing for the potentially costly implications on their foreign exchange hedging. However, many funds are unaware that there are alternatives to the traditional, and potentially more expensive, hedging tools in the market.

From 3 January 2018 EMIR, which impacts a wide range of entities ranging from banks to corporates and insurance companies, will require many AIFs to fully collateralise their FX hedges as part of its aim to lower the risks associated with derivatives.

Having reviewed the impact of the new regulatory change, Investec has developed an efficient solution that will allow funds to avoid causing further drag on returns compared to the traditional products available in the market such as a Revolving Credit Facility (RCF).

The rules, which define many AIFs as financial counterparties, and which capture vehicles of all kinds entering into derivative contracts, are expected to affect at least 60% of funds operating in Europe, according to a roundtable of investment banks attended by Investec earlier this year.

Such funds will need sufficient access to liquidity for any adverse changes to their mark to market positions. This is potentially a huge cost to the industry, for which total assets under management in the region stood at $1.651 trillion at the end of last year, according to researcher Preqin (2016).

According to Validis's *Currency Risk Management in the AIM Industry Survey* (2017), 83% of GPs hedge currencies in some form; forward contracts are the most used hedging instrument by all asset classes, although options are also used to a noticeable degree. Survey results show that 40% of funds cannot tolerate a negative impact to IRR (Internal Rate of Return) of more than 0.5% due to FX volatility, hence why they use such instruments. FX hedging protects funds and investors from the cost of volatility, but with the new collateral requirements, and funds feeling overwhelming liquidity restraints and operational issues, it seems EMIR could have a significant impact come 3 January 2018.

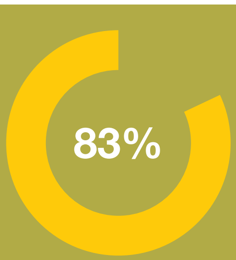
Michael Slane, Head of Fund Solutions at Investec, explains: "Comprehensive FX hedging programmes are no longer the preserve of only the most sophisticated AIFs. With returns under pressure and currency volatility higher we're seeing all kinds of AIFs turn to currency hedging in order to protect their IRRs. The new collateral rules can materially increase the cost of putting a hedging strategy in place with AIFs being forced to park expensive investor capital in bank collateral accounts."

How will EMIR affect funds?

Large numbers of AIFs are primarily concerned with ensuring that from January they have facilities in place to cover possible collateral calls under their hedging transactions, and bear the cost of placing their capital in low-return collateral accounts.

The rules will impact all strategies of AIFs that hedge at fund level but are expected to hit vehicles such as credit, direct lending, real assets, fund of funds and secondaries private equity funds the hardest.

The traditional solutions for posting collateral would likely be inefficient and command high fees. Investor capital – the natural pool of cash available to a fund – would normally carry a 'hurdle fee', typically 8%. A bank, meanwhile, would ordinarily recommend a RCF, typically up to a fifth of the nominal of a hedge, as a source of collateral for the life of the fund. Such a facility would only be fully used in the most extreme FX movements.



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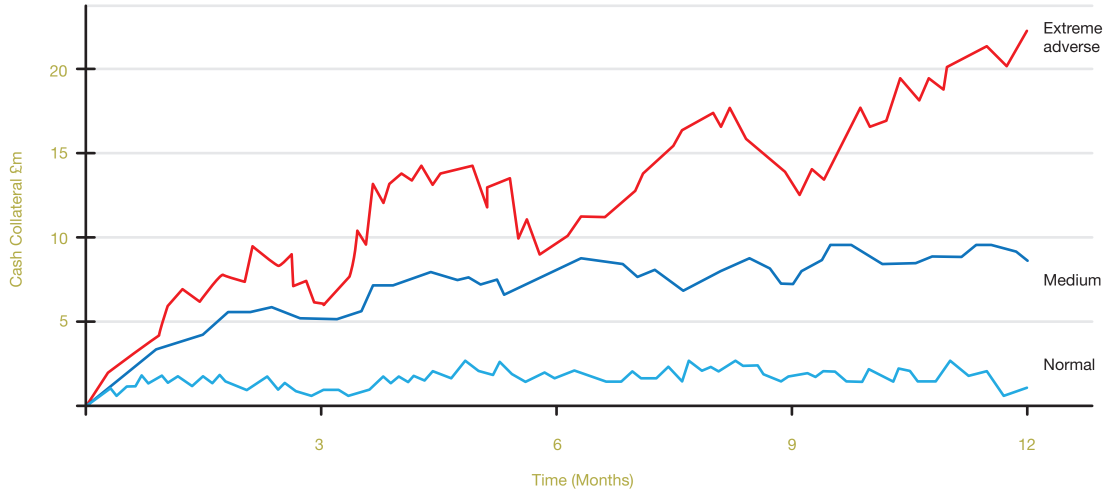
3 market scenarios

Three example market scenarios which could significantly impact the amount of cash collateral required by funds.



This chart is intended for illustrative purposes only, the data shown is not a representation of historic or future levels but is intended to show how the product might perform in a created scenario

Benefit from a unique, bespoke solution

If funds are unprepared for the implementation of the new regulation at the start of the new year, the high costs associated with putting in place a traditional revolving credit facility will create an additional drag on returns. Should funds fail to post at all, they will be in breach the rules, potentially resulting in the termination of their hedges as well as regulatory repercussions.

Investec is working with firms to implement a unique and bespoke solution that would significantly reduce commitment fees. This product solution stems from a hybrid of the revolving credit facility commonly used by funds to provide liquidity ahead of capital calls.

Investec's solution splits the facility into two parts, making sure all clients' short term liquidity requirements are met while keeping overall facility commitment costs down.

Part one is the credit approved but uncommitted portion, the size of which is designed to cover worst-case collateral requirements over the fund's life.

The second part of the product is a smaller, committed facility. Investec works alongside external treasury advisers such as Validus Risk Management, JCRA and Chatham to deliver funds committed funding only on what they are likely to need in the short term – i.e. the next three to six months. The size of this committed part is then constantly reviewed, increasing in size only when needed.
This flexible structure allows funds to budget for lower commitment fees, to be determined on a case-by-case basis as the FX market develops, rather than paying for a committed facility to cover a worst-case requirement that may never arise.

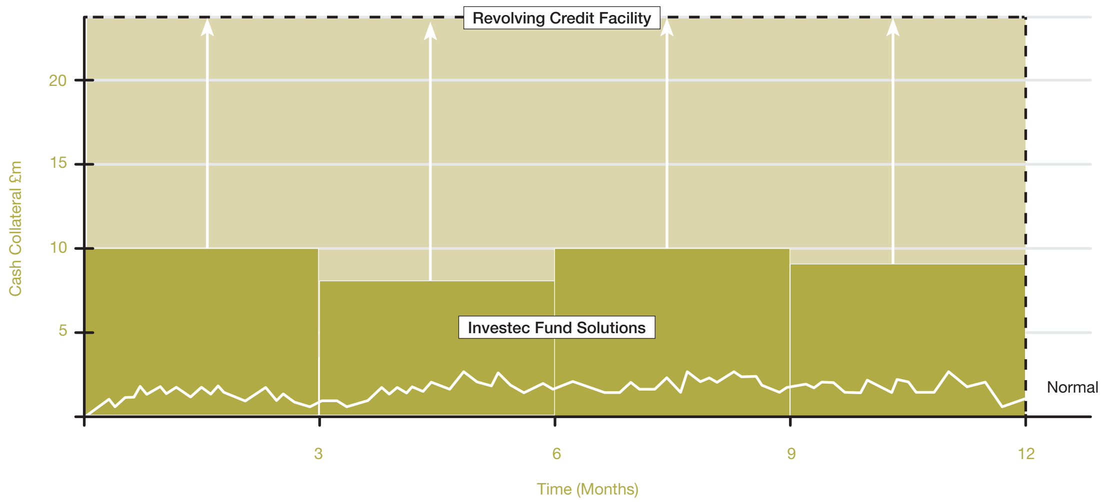
Investec Fund Solutions model

The Investec model requires you to have committed, and pay commitment fees, only for what you need in the short term. Traditional RCFs are expensive because they cater for your maximum potential requirements, even though you may not need it. See the graphs below for the difference in committed facility required in a normal market and an extreme adverse market.

Normal market scenario

What you pay for

Amount not required during shorter time period



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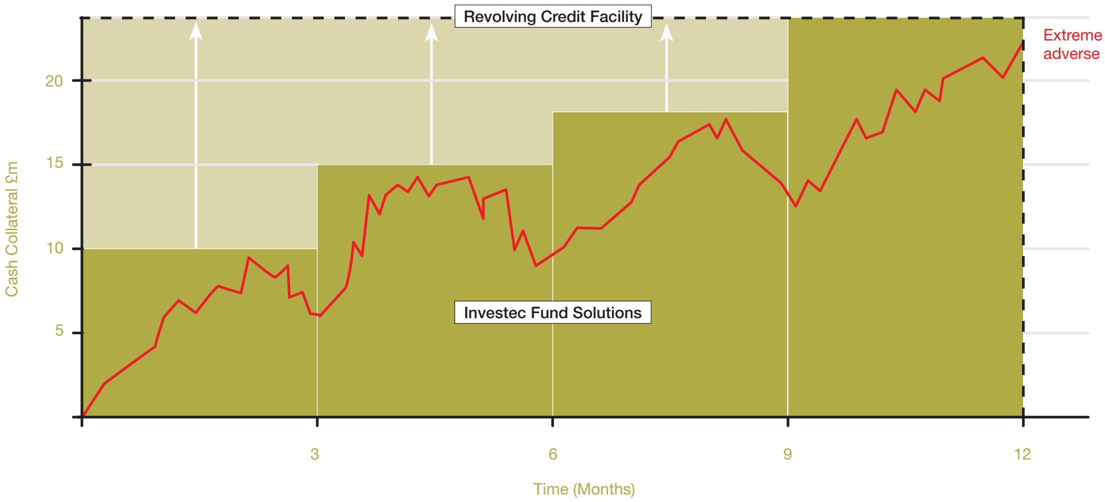
Extreme adverse market scenario

What you pay for

Amount not required during shorter time period



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Funds can use risk models and seek guidance from advisory firms to continuously monitor their requirements and increase or decrease the committed facility as appropriate. Determining the appropriate mix of the credit approved and committed portions of the facility would involve analysis of broader market activity and the time it would take to seek approval for any increase in the product's size. Investec will use a dedicated rapid turnaround credit process to deliver swift execution when increasing the size of any committed facility.

Funds that have yet to prepare for the regulatory requirements should speak to advisers now to establish their needs and the most appropriate course of action.

Investec Fund Solutions

With detailed understanding of the funds sector, Investec's Funds Solutions is able to support you with specialist currency and market risk management. Working with funds based globally, we can assist with the simplest of spot lines or develop bespoke security and legal deal solutions to suit your funds.

Michael Slane
michael.slane@investec.co.uk
+44 207 597 3684

Sebastian Wright
seb.wright@investec.co.uk
+44 207 597 5543

Devonshi Mody
devonshi.mody@investec.co.uk
+44 207 597 5341