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Private Capital Solutions

Credit fund currency sleeves

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Introduction

In order to attract investors who do not hold investable cash in the functional currency of the fund and who do not have the resources to manage foreign exchange (FX) risk themselves, European private credit managers often offer more than one currency for investors to choose from when investing in a fund.

European credit funds also usually invest across Europe and sometimes beyond and so are exposed to currency risk in relation to their investments that are denominated otherwise than in their functional currency. The return profile of credit investments cannot usually bear material FX volatility, such that this portfolio risk needs to be hedged.

In this article, we look at how private credit managers are structuring their funds to offer one or more additional currency option (aka “sleeve”) alongside their chosen functional currency, and how those managers are hedging FX risks at both the sleeve and portfolio level.

In what follows, we assume that the primary functional currency of the fund is euro and that the fund is also offering a sterling sleeve to investors. However, with a significant proportion of investors in European private credit funds being from the US, US dollar is also a regular currency sleeve offered to investors. We also sometimes see Japanese yen sleeves and the reduction in the value of the yen against both the euro and sterling over recent years is a good example of the challenges that offering currency sleeves can present to managers.

Structuring

We generally see one of three fund structures used to offer multiple currency sleeves to investors:

- 1. the direct parallel currency structure;**
- 2. the master-feeder currency structure; and**
- 3. the parallel aggregator structure.**

Whilst we focus on the use of segregated vehicles for currency sleeves below, it may be possible depending on the form of the fund vehicle to instead use currency share classes.

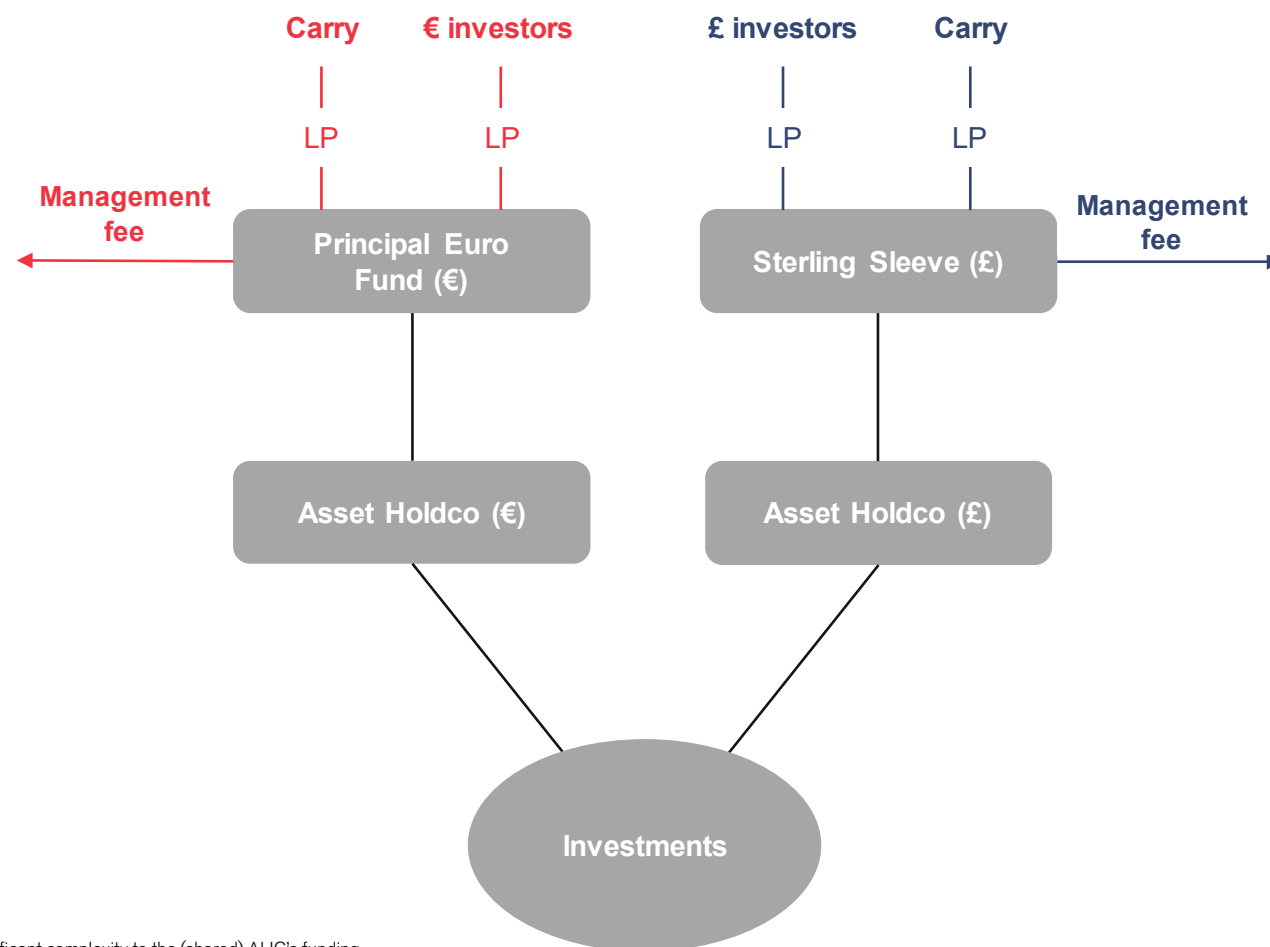
Structuring

Option one

Option one: direct parallel currency structure

Under this structure, the fund operates a principal sleeve in euro, and one or more parallel sleeve each with their own functional currency. In this example, there is a sterling parallel sleeve sitting alongside the principal euro denominated vehicle. The management fee and carried interest are taken from each sleeve by reference to their functional currency ensuring full FX alignment between the house and the investors. Each sleeve generally has its own asset holding company (AHC) which will typically have the same functional currency as its parent sleeve¹. Each sleeve takes commitments in their respective functional currency and draws down from investors and invests in its AHC, again in their functional currencies. Each time a sleeve makes an investment denominated otherwise than in its functional currency, the AHC will swap its currency for the currency of that investment and then hedge the resultant FX risk². Deals are allocated between the parallel sleeves pro rata to their outstanding commitments from time to time, calculated in euro. It would be standard to use the exchange rate at the time of calculation resulting in each AHC having different shares of each investment if the relevant FX rates move.

This structure may be the preferred option for managers who want to opt for less operational complexity (in terms of tracing cash flows through to feeders) or (in this example) where the investments to be made by the fund are expected to be denominated to a substantial extent in both euro and sterling, with sterling investors not wishing to bear hedging costs in respect of sterling investments (as sterling investments held at a euro master fund would need to be hedged to euro at the master level, with the sterling sleeve's share of those investments being hedged back to sterling³).



¹ It is possible for two parallel currency sleeves to "share" an AHC but it would mean introducing not insignificant complexity to the (shared) AHC's funding instruments to ensure investments are shared between the sleeves in the right proportions.

² We are assuming there is no leverage in the AHC. As noted below, if there is leverage, the finance provider will not want hedging to take place within the AHC.

³ Even if there is some netting in the pricing from the hedge counterparty, this double hedging could still involve some frictional cost.

Structuring

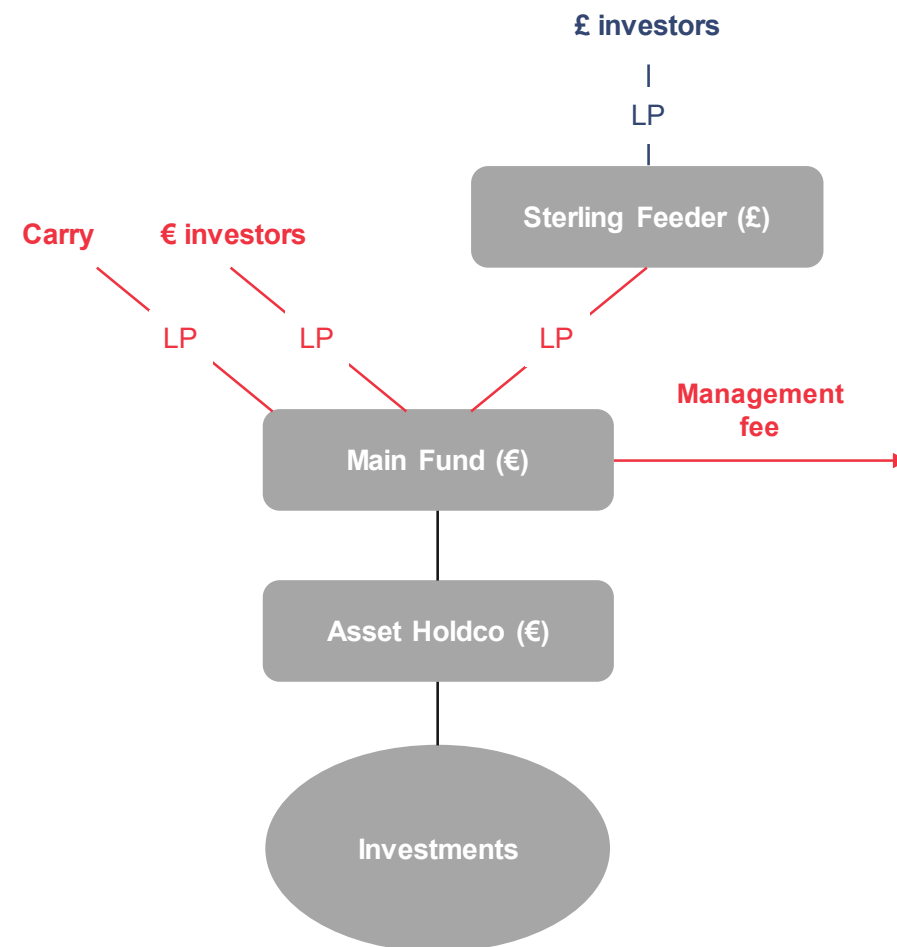
Option two

Option two: master-feeder currency structure

Under this structure, a euro master fund is established with its own (euro functional currency) AHC. Where the fund makes a non-euro denominated investment, the AHC swaps euro into the relevant currency and hedges its resultant FX exposure. Euro investors invest directly into the master fund while non-euro investors invest into one or more feeder fund (in this example, sterling investors into a sterling feeder). Like with option one, commitments to the sterling feeder fund are denominated in sterling with the sterling feeder making an (in effect) sterling commitment to the master fund which is drawn down in euro with the result that the share of each investment of the Master Fund which the sterling sleeve participates in will be determined by reference to the chosen sterling:euro FX rate at the time of the relevant drawdown. The feeder fund must therefore exchange sterling for euro upon each capital call. This immediately exposes the feeder fund to FX risk which is hedged in the manner we describe below.

Unlike option one, this option does not offer a full currency sleeve to the sterling investors. In particular, the carried interest is taken at the master fund level by reference to the euro performance of the master, not the hedged return of the feeder (which could be lower, or indeed higher). For example, for the past period, the US interest rate has been higher than the euro interest rate with the result that a US dollar feeder would generate a return hedging US dollar to euro (via the interest rate differential (IRD)⁴ which forms part of the pricing of a forward). Under this structure, the carried interest calculated at the master fund would not take this IRD driven return into account.

We generally see this structure chosen by managers to accommodate currencies where it was uncertain at the outset of the fund that such a sleeve would be offered and/or where the amounts being raised by the fund in that currency are not that material in the context of the fund as a whole.



⁴ This is explained in further detail below.

Structuring

Option three

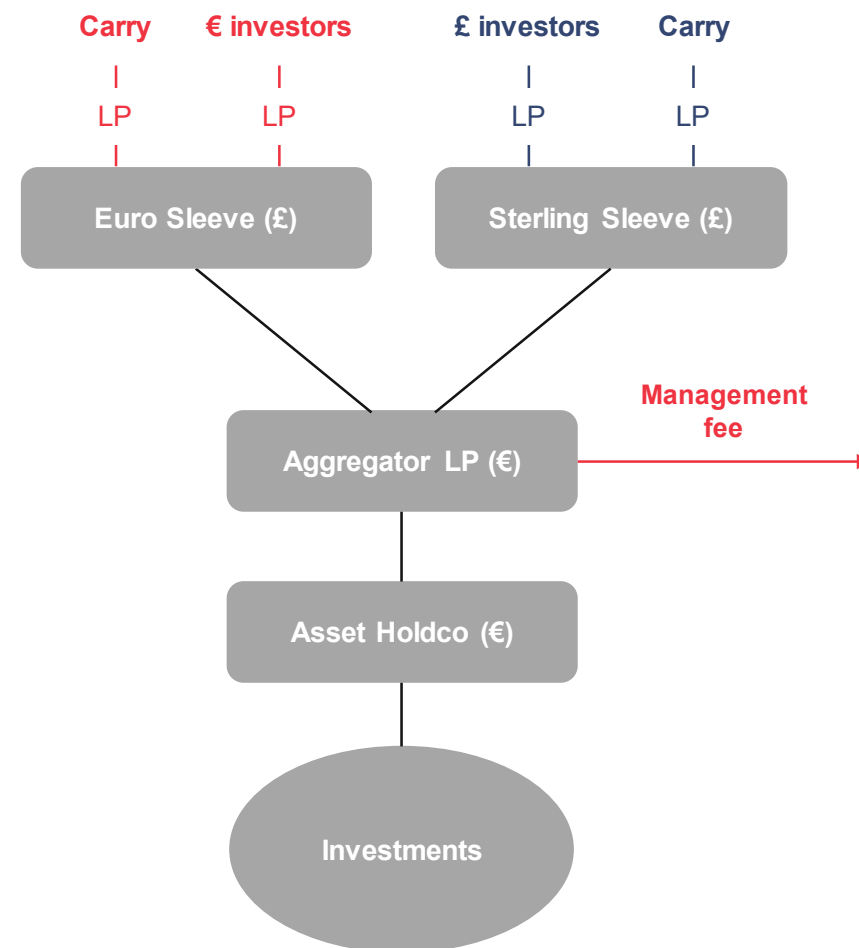
Option three: parallel aggregator structure

This structure has features of both options one and two. In effect, it is option one, with an aggregator to avoid the need to have multiple AHCs and to split deals between parallel structures. In this case, parallel feeder funds are established for each investor currency, including the “principal” currency of the fund, meaning that no investor invests directly into the (in this example, euro) master fund. However, the master fund is not a master fund as under option two, it more serves as an aggregator. Beneath the aggregator sits one AHC, which (like under option two) hedges non-euro denominated investments back to euro. As with option two, the feeders receive and draw down commitments in their respective functional currency with the sterling feeder making an (in effect) sterling commitment to the aggregator which is drawn down in euro. As such, the non-euro feeders need to exchange the currency of their commitments to satisfy each capital call. Under a purist approach, investments would be allocated on a look through basis to each feeder based on the respective FX rates at the time of the relevant drawdown into the aggregator. However, in practice and to avoid this tracing complexity, funds sometimes split investments between the sleeves on a fixed basis according to the respective FX rates at, say, final close. The issue of adopting this fixed approach is that, if the respective FX rates move materially over the investment period, one of the feeders will run out of money before the other. Whatever the allocation method chosen, each sleeve's share of the investments of the master fund (all in effect in euro, after the hedging at the master fund level) is hedged against its functional currency. Where this sleeve hedging is undertaken is considered below.

Unlike option two, under option three, carried interest is paid out at the level of each feeder fund, rather than at master fund level. Like under option one, the returns to the manager are therefore fully aligned with the performance of the investors in each sleeve. This structure therefore offers the benefits of the full currency sleeve of option one, without the proliferation of entities and the need to split investments between parallel structures.

One drawback of this option is that there are potentially double hedging costs for a non-euro investor. For example, a sterling investor would see its sterling exposure versus the euro master fund being hedged while sterling investments are also hedged separately against euro at the AHC. Whilst favourable pricing can be obtained by keeping all hedging at the same level (which we discuss further below), there may still be some frictional cost which might, as noted above, lead to option one being preferred where both a significant proportion of investors and investments will be in that non-euro currency.

The other drawback with this option, in a case where the FX rates of the sleeves change materially over the investment period of the fund, is the choice between operational complexity of investments being held in different proportions on a look through basis, and potentially one sleeve running out of money before the other. If the second “poison” is chosen, potential mitigants can include leveraging the feeder which runs out of money towards the end of the investment period or reserving the right for an equalisation between feeders towards the end of the investment period.



Hedging

Three-month forward

What is a three-month rolling forward?

- **Contract initiation:** two parties agree to exchange currencies at a specified rate three months from the contract date.
- **Rolling over:** upon reaching the maturity of the contract (after three months), instead of terminating, the contract is extended or “rolled over” for another three months at the new forward rate.
- **Continuous hedging:** this process can be repeated, providing a continuous hedge against currency fluctuations, with flexibility to adapt the size and duration as needed.

One of the most simple transactions to hedge currency risk for a fund is a physically settled forward.

For example, under option two or three (assuming hedging is taking place at feeder level), when the euro master fund draws down from the sterling feeder, the sterling feeder will execute a spot FX trade in order to convert its sterling into euro. The sterling feeder would then fix the rate at which it converts euro back into sterling by entering into a physically settled forward to sell back that euro amount in exchange for sterling at the relevant forward rate after a fixed period. In the credit fund context, for the reasons set out below, that period is typically three months.

“Rolling” forwards

The rolling mechanism works as follows. Shortly before the forward matures, a manager will put on the following trades:

- a spot FX transaction, in the same size but opposite direction to the existing three-month forward, to settle on the same date as the forward; and
- a new three-month forward, with a notional amount equal to the current value of the feeder fund's investment and at the prevailing forward rate. The difference between the new forward rate and the previous forward rate will generate a gain for one party and a loss for the other party.

This process is referred to as “rolling” and can be continued indefinitely. Gains or losses on each forward are accumulated and added to, or deducted from, eventual distribution proceeds. When a distribution is due back to the investors, the fund allows the existing forward to terminate without rolling. The settlement amount received under the forward provides the right currency to make the distribution.

Interest rate differential

The forward rate available for the relevant tenor of the hedge will be determined by reference to the difference between the interest rates applicable to each currency. The aim is to preserve the ratio of the two interest rates, so as to ensure that when the currencies are delivered on settlement, each party receives the same amount of currency they would have received had they been holding that currency and earning interest on it for the duration of the forward.

The result is that when the forward settles (unless both currencies have identical interest rates), the party receiving the stronger currency will receive a greater amount compared with the equivalent amount of weaker currency it delivers. This will represent a gain to that party and a loss to the other party.

Advantages

The following are key drivers for using three-month rolling forwards.

- **Liquidity:** there is typically more liquidity for trades with a three-month term, making it easier for the hedge counterparty to hedge its own position, thereby bringing costs down.
- **Flexibility:** rolling contracts provide flexibility for both parties to adjust the arrangements to market conditions and the timing of distributions without committing to a long-term position.
- **Forecasting accuracy:** shorter time horizons generally allow for more accurate forecasting of cash flows and currency needs.
- **Cost efficiency:** while longer-term hedges can lock in rates, they may also require a larger premium due to the increased uncertainty over a longer period.

Historic rate roll

An additional strategy used is historic rate roll. Here, there is no net settlement when each three-month forward expires. Instead, the next three-month forward is struck at the original rate, meaning it is automatically “out of the money” for one of the parties. This has the advantage of being more efficient from a liquidity management perspective (as no quarterly settlement payments are needed from the fund) but the FX broker will charge additional fees in return.

Where exposures build up, it is typical for brokers to charge variation margin (VM) above an agreed threshold to cover their credit risk on the fund. If this is the case, this would negate any benefit to the historic rate roll, meaning that this strategy only makes sense if the hedge counterparty is willing to trade without VM.

Structuring considerations

Considerations for the FX hedging will differ depending on which structure has been selected.

Option one: direct parallel structure

In a direct parallel currency structure, investments are generally held by each sleeve in their own AHC which has the same functional currency as its parent sleeve. This means that hedging will only be required for the relevant sleeve when an investment is made by that sleeve in a currency other than its functional currency. This has the advantage of isolating the FX risk within a given sleeve, which also facilitates reporting for investors in the currency in which they are invested. As no FX risk is incurred at the sleeve level, hedging is not required at that level.

However, maintaining separate hedging arrangements for each currency sleeve is operationally burdensome and can be inefficient from a liquidity management perspective as it is not possible to net out-of-the-money hedges sitting in one sleeve against in-the-money hedges sitting in another sleeve.

Options two and three: master-feeder and parallel aggregator structures

Under both these structures, in the examples given, the master fund AHC will hedge its non-euro investments against euro and separately the sterling feeder fund will hedge its share of the euro investments in the master fund against sterling (although there are drawbacks to hedging separately at feeder level, which are discussed further below).

Drawbacks of feeder level hedging

For both the master-feeder and parallel aggregator structures, maintaining a separate hedge at the feeder level comes with several drawbacks. For example, the feeder would need to make ongoing net settlement payments to the hedge counterparty if the hedge is out-of-the-money, but the sources of cash available to the feeder will be limited to the investors in that feeder and the subscription facility. This places a more onerous operational requirement on effective liquidity management to ensure that cash is available at the feeder level when required.

Further, the size of any feeder vehicle will necessarily be smaller, both in terms of assets available to meet payment obligations and the volume and size of the hedging transactions. This in turn reduces the credit profile of the feeder which could worsen the terms offered by hedge counterparties, making the arrangements more expensive to maintain.

One way to mitigate this risk is to undertake feeder-specific hedging at the level of the master fund or its AHC. Administratively, this requires more complicated tagging of hedging costs within the structure to ensure that they are properly allocated to those investors whose exposure was hedged. However, it means the feeder can benefit from netting at master fund level by positive mark-to-markets on some currencies offsetting negative mark-to-markets on other currencies, thereby reducing the need for quarterly net settlement payments. From a liquidity management perspective, it is also helpful to have wider sources of cash to meet payments under hedging transactions which in turn raises the fund's credit profile. This, plus the ability to offer hedge counterparties larger volumes and transaction sizes, is helpful for price negotiations. Finally having a sole hedging entity within the structure makes it easier to increase the panel of hedge counterparties (as onboarding costs are borne once only) which also plays into price negotiations.

Other key considerations

When implementing any multi-currency structuring option, there are a number of key legal, operational, tax and regulatory considerations.

Legal and operational

Investment returns. Even an effective hedging policy will incur additional costs and expenses for investors and so it is important to consider who bears the burden. Differing views are taken here depending on the context, as some fund managers may consider that offering multi-currency strategies is key to achieving the optimum fund size for their investment pipeline, and therefore the expenses should be borne by the fund as a whole. Others take the view that this expense should properly be allocated to the investors who benefitted directly from the hedging.

Value of commitments for non-investment purposes.

Another consideration to bear in mind is that the value of commitments in different currencies are not just used for investment allocation purposes but are also relevant for co-ordinating other concepts under the fund documents across different sleeves e.g. determining investor voting percentages, calculating the hard cap and sponsor commitment, etc. As we note in our discussion of option three, there are advantages to using a “benchmark” exchange rate through the life of fund as adopting a variable exchange rate for concepts like voting would produce uncertainty. It is important the documentation governing the fund permits enough flexibility for the manager to: (i) adjust the benchmark rate for relevant purposes in case of significant FX movements; and (ii) prospectively adjust allocations between currency sleeves (if using the direct parallel or the parallel aggregator structure) to ensure amounts are

drawn rateably across the currency sleeves. As noted above, without adjustments in the case of material FX movements, one sleeve could run out of money before the other fund and so not participate in subsequent investments. As also noted above, the manager may wish to retain the right to equalise feeders after final close to achieve an even allocation.

Ability to incur indebtedness. For any manager that wants to utilise hedging as a tool for mitigating risk in multi-currency structures, it is also imperative that the fund documents expressly provide that this is a permitted power of the manager. Any hedging strategy will involve the fund incurring regular payment obligations to the hedge counterparty under the hedging transactions which could fall under restrictions on incurring indebtedness in the fund documents. It is, therefore, important to clarify that indebtedness incurred in connection with hedging is carved out from the calculation of leverage thresholds.

Further, if the currency hedging takes place at AHC level, a leverage provider for any asset-backed facility will not, in our experience, permit the vehicle entering into the leverage facility to enter into hedging transactions as well. This is because the leverage provider will want first-ranking security over all the assets of the borrower and will not want assets to be paid first to a hedge counterparty. In this situation, hedging will need to take place above or alongside the borrowing AHC.

Leverage under AIFMD. From a practical perspective, UK and EU-based AIFMs must pay particular attention to the amount of exposure to hedge counterparties their AIFs incur through currency hedging. Under AIFMD, AIFs that increase the exposure of underlying investors through leverage arrangements will qualify as “leveraged” AIFs, which are subject to heightened disclosure and reporting requirements. This is even more relevant in the context of direct lending funds that qualify as “loan originating” AIFs (namely, AIFs whose investment strategy is to act as a loan originator, or which have originated loans which comprise at least 50% of their NAV), as they are now also subject to a leverage cap of 175% (for open-ended AIFs) and 300% (for closed-ended AIFs) under AIFMD II calculated on the commitment method. Whether or not it is appropriate to classify FX hedging as “leverage” for these purposes is a nuanced question; either way, the overall impact of having FX hedging in the structure in these circumstances should be considered.

Open-ended structures. There may be added complexities to consider when offering multiple currency sleeves in open-ended structures. For example, managing FX hedging when meeting redemptions or continued subscriptions. Some of these complexities are discussed in further detail in our earlier piece on [evergreen credit funds](#).

Other key considerations

Tax

There are various tax considerations to take into account in operating a hedging strategy. These include:

- if hedging from an AHC, ensuring the funding instruments strip out any net profits from that AHC to avoid tax leakage within it; and
- if hedging from a transparent partnership within the structure, recognising that a UK individual investor will recognise gains and losses as the futures roll over. For example, a UK individual investor into the sterling sleeve under option three (assuming the sterling sleeve euro hedging takes place within the sterling sleeve partnership) could make a gain on that hedging which balances an FX loss on the portfolio at the underlying AHC. If that portfolio FX loss produced an overall sterling loss at the portfolio level, the investor would want to realise a capital loss on its funding instruments to the AHC to offset the FX hedge gain at the sterling feeder. This would require the funding instruments to the AHC to be structured in a way to allow a capital loss for UK tax purposes to arise in respect of them.

Regulatory

EMIR. Funds that are incorporated in the UK or EU, or which have fund managers or AIFMs in those jurisdictions, are subject to regulatory requirements regarding their hedging transactions. These include the following:

- **Trade reporting:** details of each FX trade must be reported to an approved trade repository no later than the working day following the conclusion, modification or termination of the contract. Trade reporting can be delegated to the FX counterparty or outsourced to a third-party provider where fund vehicles do not have operational resources to report directly, however it should be noted that buy-side entities have duties to oversee and monitor reporting done by its delegates and must report significant errors to its regulator in certain circumstances.
- **Risk mitigation:** the fund must have procedures in place to ensure various risk mitigation requirements are complied with, including timely confirmation of each FX transaction, carrying out portfolio compression exercises in respect of large portfolios, reconciling portfolios with its FX counterparties at specified regular intervals and establishing agreed dispute resolution procedures. These are all well-established operational procedures and there are market-standard protocols which can be adhered to in order to document these procedures.
- **Exchange daily variation margin:** EU and UK AIFs are classified as “financial counterparties” under EMIR/UK EMIR. This means that if FX hedging is being executed via an option strategy and the hedging is put in place at master fund level, then the AIF will be required to exchange daily cash variation margin under a zero-threshold credit support annex, thereby incurring significant liquidity drag. It is rare that we see this because the vast majority of FX hedging is carried out via spot and physically settled FX forwards which benefit from an exemption from this requirement.

ERISA. The use, and level, of currency hedging can also have a significant regulatory impact on credit funds that accept US benefit plan investors. Because the VCOC exemption is not generally available, to avoid becoming treated as an ERISA fiduciary, managers of credit funds must typically rely on benefit plan investors holding less than 25% of each equity class within each applicable fund vehicle (the “25% test”). Where multi-currency structures utilise feeder vehicles in different currencies, the dollar sleeve is most likely to receive commitments by ERISA plan assets investors, and therefore on the face of it is less likely to be able to comply with the 25% test. However, there is an accepted practice that if a vehicle does not have any investment discretion and invests all of its assets into an underlying vehicle (commonly referred to as “hardwiring”), investors can be deemed to hold an interest in the underlying vehicle rather than the feeder (alongside all the other investors in that underlying vehicle), increasing the denominator on which to base the 25% test.

That said, hedging can interfere with this analysis. If hedging arrangements are conducted at the level of the master fund (or underlying AHC), the associated profits and losses will need to be streamed to the currency sleeve to which the transaction relates. If these amounts are up-streamed via the master fund in accordance with the fund documents, it could be argued that the specific allocation of profits and losses to a given vehicle negates the “hardwired” feeder analysis, as it would suggest that there is a distinct equity class at the level of the master fund corresponding to each feeder. One solution is to enter into contracts directly between the master fund (or investment holding vehicle) and the relevant feeder vehicle in order to transfer the profits and losses associated with the hedging directly to those feeder vehicles. However, to the extent that commitments to the feeder vehicles are used to finance these arrangements, these would also fall outside of the hardwiring analysis and so reduce the denominator at the master fund level. In a structure under option three with euro, dollar and sterling feeders and sleeve hedging at the dollar and sterling sleeves, it would mean that part (perhaps 25%) of the commitments of the sterling sleeve would not count towards the ERISA denominator at the master fund level (to the extent those commitments could not be hardwired as they needed to be kept available for hedge liabilities at the feeder level).

Conclusion

An effective FX hedging strategy has become a critical facet of any successful credit fund with a global strategy or a global investor base. Implementing an FX hedging programme is technical and requires expertise across multiple disciplines, from treasury and cash management to tax, legal and regulatory. The operational burden should not be underestimated; it takes time, resource and is costly. It is also increasingly essential.

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