

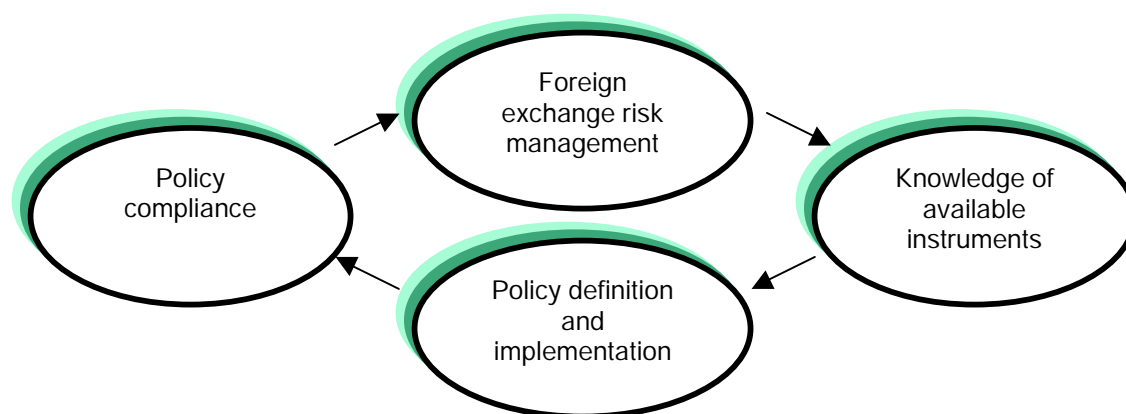
Managing Foreign Exchange Risk

As evidenced in recent years, the value of the Canadian dollar is unpredictable over time. The profitability of exporters and importers has taken a hit from the loonie's fluctuations. However, the impact our dollar has on business profitability can be reduced by what is referred to as foreign exchange risk management.

In fact, numerous trends are increasingly forcing Canadians to consider foreign exchange risk management, notably, globalization and market interdependence. The first should come as no surprise given that in the past, few companies had the opportunity to open their doors to the rest of the world. Today, a vast number of them are doing business internationally. Such is the case for many SMEs, which are trying to leverage free trade between Canada, the U.S. and Mexico. Indeed, these SMEs are growing faster by selling goods and services abroad or by importing less costly raw materials and better quality parts. Consequently, since the early '90s, Canadian businesses have become more interested in international currency trading.

The second trend, market interdependence, is due to the fact that currency markets can generate chain reactions that affect the value of the Canadian dollar. The perfect example is rising oil prices caused by widespread and excessive uncertainty and speculation about the U.S. dollar. Since Canada has little influence on the level of confidence of the main players on the international monetary market, it is therefore wise for Canadian companies to take control of foreign exchange risk.

The purpose of this guide is to familiarize you with this risk and explain the various hedging options available to offset it. The Desjardins International Service Centre can help you develop strategies in this regard. The last section provides the contact information for the international services development managers in the different regions of Canada.



STEP 1: Defining your needs

Based on the situation, you will have to determine whether you need to hedge and, if so, which instrument is the most appropriate. Answering the following questions may make it easier for you to decide:

- In relation to sales, what percentage of your receivables and/or payables is in foreign currency?
- How sensitive is your company to foreign exchange fluctuations, and at which point will the exchange rate affect your profitability?
- Can you match the due dates of your receivables and payables in a given currency?
- Are your export amounts and dates totally accurate?
- Can you pass on a currency loss to your customers by increasing prices?
- Do you have major investments to make in the short term (Do you need a stable cash flow?) or will you be making equipment or other purchases abroad in the short term?
- Can you reach an agreement with your customers to share foreign exchange risk both in terms of losses and gains?

Based on your answers to these questions, go to Step 2 to decide what is right for you.

STEP 2: Hedging overview

Managing foreign exchange risk involves taking the appropriate measures to eliminate or hedge against these risks. You can therefore choose one of the following three policies based on the needs defined in Step 1.

No hedging

You decide not to act and accept the foreign exchange risk. However, in so doing, you are adopting a potentially risky position. For a company, not hedging is generally based on a misunderstanding of the risk or on the hope that it will gain from it. This lack of control (deliberate or not) can have unfortunate consequences on the company's profitability. Of course, hedging is not necessary if international transactions make up just a small part of your business. In short, if the percentage of your foreign currency receivables and/or payables is very low in relation to sales, or if, for example, you can match the due date of your receivables and payables in a given currency, you do not need to think about hedging.

Selective hedging

In this case, you adopt a policy that sets out when and how you hedge against foreign exchange risk; for instance, you decide to hedge only some of your foreign transactions. This policy assumes that you have determined your risk tolerance and that you have an idea as to the direction the currency in question will take. You can also adopt the principle that any hedging resulting in a plus or minus value of x dollars must be closed (profits or losses taken).

Selective hedging can be illustrated with the following example. Let us assume 80% of your revenues or receivables are generated in the U.S. In this case, you could decide to hedge only half of these accounts with a hedging strategy. One of the reasons for doing so might be your expectations regarding short-term exchange rates. In fact, assuming that all your receivables are due within the next three months and that your foreign exchange expectations for the same period are to your advantage, you could decide to cover only half of these receivables. Here again, this strategy depends on the business needs defined in Step 1.

Systematic hedging

This involves automatically hedging as soon as foreign currency commitments or assets are involved. In reality, very few companies fully hedge their position. As a general rule, the more a company relies on foreign exchange cash flow to grow or pay its debts, the more it will hedge against risk.

STEP 3: Selecting currency instruments

The following is a brief description of the various instruments that exist to reduce the impact of foreign exchange fluctuations.

A) Natural position

The natural position is the company's fundamental position. It determines the company's exposure to a certain currency. Every company that conducts business transactions in a foreign currency has a natural position. However, natural hedging is a situation in which the company's operations are covered against foreign exchange risk. For example, this type of risk is not a factor when a company uses an inflow of U.S. currency to pay a supplier the equivalent amount in the same currency.

B) Forward contracts: foreign exchange forward contracts and swaps

The forward contract is an instrument of choice for hedging against foreign exchange risk, offering flexibility and liquidity in the current currencies. The amount and dates can be matched with a commercial transaction, thus eliminating any residual risk. Conversely, forward contracts do not allow a company to benefit from favourable currency moves.

- 1) The foreign exchange forward contract is an agreement to convert one currency into another. The amount of the transaction, the exchange rate used for the conversion and the future date on which the conversion will be made are fixed when the contract is purchased. Certain contracts allow partial deliveries made during an optional period that can reach 30 days.
- 2) The swap involves simultaneous spot and period transactions of one currency against another. This type of currency transaction is frequently used by companies with receivables and payables in the same currency, but whose due dates are not matched.

C) Call and put options

By paying a premium, the option gives you the right but not the obligation to buy or sell currencies at a predetermined date and rate. The option (used for hedging and not speculative purposes) acts as a form of insurance policy, allowing you to make a profit when exchange rates shift in your favour and protect you when the opposite occurs.

- 1) Call option: Two scenarios are possible with call options. In the first, the exchange rate when the option expires is above the strike price, and the option holder can therefore exercise his right and purchase the currency at the predetermined advantageous rate. In the second scenario, the exchange rate on expiration of the option is below the strike price, and the holder therefore has no advantage in exercising this right, because he can purchase the currency at a lower price on the market. As a result, he only loses the premium paid when purchasing the option.
- 2) Put option: Two scenarios are also possible with put options. In the first, the exchange rate when the option expires is above the strike price, and the holder has no interest in selling at the strike price because he can do better on the market. The premium he paid initially is therefore lost. In the second, the exchange rate on expiration of the option is below the strike price, and it is therefore in the holder's interest to exercise this option, because he can sell the currency at the strike price, which is advantageous.

D) Other options

Other options are available and are offered by our currency traders. In fact, a varied range of options adapted to the needs of each company is available. The advantage of foreign exchange risk hedging products is their flexibility. A customized strategy is always possible, and there are no limits to the possibilities. Here are a few examples of options available on the market.

Collar: A collar is a combination of two contracts to obtain a very specific profit diagram. There are two ways to create a collar. The first involves buying a call option and selling a put option, while the second involves buying a put option and selling a call option. In both cases, the company guarantees that its purchase or selling price of U.S. currency will not go beyond a range between the two strike prices of the options in the collar. The price of this structure is generally equivalent to the amount paid to buy one of the options less the price received for selling the second option.

Zero cost collar: This is the same principle as a regular collar but the structure is redesigned to ensure that the price of the option is zero. However, to do so, the holder must sacrifice a part of the potential gain so as to receive a greater premium on the option sold. Consequently, the holder guarantees that his exchange rate will be limited to a certain range, but the potential gain will be lower.

Example of a zero cost collar:

A company exporting medications to Europe wishes to protect itself against a depreciation of the euro but does not want to disburse any funds. This company has a variable amount of euros in its portfolio. Assume that the euro is currently trading at 1.45 for the purpose of the example.

- ❑ To meet its specific requirements, the company decides to use a zero cost collar as the hedging strategy. It purchases a three-month put option at a strike price of 1.4350 and sells a three-month call option to the Caisse centrale Desjardins at a strike price of 1.4650.
- ❑ The premium on the option purchased is \$1,500, and the premium received on the option sold is \$1,500. Consequently, the structure entails zero cost for the company.
- ❑ The company therefore succeeds in guaranteeing that the selling price of the euros will not go beyond the range of (1.4350-1.4650) for a period of three months, thus eliminating a source of risk.

Barrier options: These options have the same characteristics as standard options but include barriers. The barrier can be above or below the actual currency price and may be knock-in or knock-out.

- ❑ Knock-in: A knock-in feature causes the option to become effective only if the currency price first reaches a specified barrier level.

- Knock-out: A knock-out feature causes the option to immediately terminate if the currency price reaches a specified barrier level.

In both cases, the currency price can reach or exceed the barrier anytime before expiry to knock in/knock out the option.

Table 1: Pros and cons of forward exchange contracts and options

	Forward Exchange Contract	Swap	Option
Pros / Benefits	<ul style="list-style-type: none"> • Price known at time of hedging • \$20,000 minimum • Minimal cost • Hedging periods of two days to one year (longer term possible) 	<ul style="list-style-type: none"> • Allows you to match inflows and outflows in a given currency • Minimal cost • \$20,000 minimum 	<ul style="list-style-type: none"> • Insurance policy: allows you to hedge against risk while benefiting from a favourable currency move • \$20,000 minimum
Cons / Risks	<ul style="list-style-type: none"> • Cannot benefit from a favourable currency move • Guarantees may be required • Cannot be cancelled except by taking a reverse position 	<ul style="list-style-type: none"> • Cannot benefit from a favourable currency move • Guarantees may be required • Cannot be cancelled except by taking a reverse position 	<ul style="list-style-type: none"> • Premium required: varies based on such factors as the option term and foreign exchange volatility

Table 2: Pros and cons of other options

	Collar	Zero-cost collar	Barrier options
Pros / Benefits	<ul style="list-style-type: none"> • Strong gain potential • Limited loss potential • Lower premium than when only one option is considered 	<ul style="list-style-type: none"> • Good gain potential • Limited loss potential • No premium to pay 	<ul style="list-style-type: none"> • Same pros as a standard option • Lower premium
Cons / Risks	<ul style="list-style-type: none"> • Capped gain potential • Guarantees may be required 	<ul style="list-style-type: none"> • Capped gain potential • Guarantees may be required 	<ul style="list-style-type: none"> • Imperfect hedging

Strategy options

Depending on the answers you gave in Step 1, the financial situation of your company (ability to take risks) and your own risk tolerance, here are a few examples of generic strategies. Other more complex strategies, as seen in point D, are also available to meet specific situations.

Table 3: Examples of possible strategies

Corporate Objective	Desjardins Suggests
Setting the future price of my currencies today.	Forward contract
Optimize the management of my multi-currency cash flow.	Swap
Ensure a minimum/maximum price while benefiting from a favourable currency move.	Currency option
Ensure a ceiling and floor price on the currency in order to effectively manage my cash flow.	Collar

STEP 4: Keeping your strategy up-to-date

Once you have determined the right instruments for your needs, you need to decide on the hedge period. Three months is usually sufficient, but you may feel that one year is more appropriate. Here again, it is up to you to determine the period that will be covered by your foreign exchange risk hedging strategy.

However, you should know that any strategy you devise may need redesigning. The data used to establish your strategy will change over time. For example, your receivables and payables may no longer be the same, you may now have a better natural hedge, or you may have a different attitude to risk. In any case, a winning strategy must be revisited as often as possible to make sure it remains focused on your growth objectives, cash flow management and the current situation.

Desjardins at your service

The foreign exchange risk hedging products presented in this document are but a few of the many options available. The Caisse centrale Desjardins also offers many other possibilities not covered in this reference guide. We develop customized solutions because we know that each company's financial situation is unique.

The Desjardins International Service Centre and its team of international service development managers are here to handle your requests and answer your questions on this topic. Our team of currency traders is another important resource to help you find the right solution. Desjardins provides you with all the tools you need to make smart decisions that will help your company succeed. Below is the contact information for our international services development offices and financial risk management advisers for international operations.

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MONTREAL 300 Léo-Pariseau, 18th floor Montréal, Québec H2X 4B3 Tel.: 514-281-2818 option 1-3-1 Toll free: 1-800-707-2305 option 1-3-1	QUÉBEC CITY 5600 Boulevard des Galeries, Suite 140 Québec City, Québec G2K 2H6 Tel.: 418-634-5775 Toll free: 1-866-634-5775 option 3
TROIS-RIVIÈRES 2000 Boulevard des Récollets P.O. Box 1000 Trois-Rivières, Québec G9A 5K3 Tel.: 819-374-3594 extension 202 Toll free: 1-800-567-294 extension 202	