Currency risk can be substantial but, thankfully, there are many ways to manage it.
TABLE OF CONTENTS

I  INTRODUCTION.................................................5

II  CURRENCY RISK..............................................7
  1. Definitions.................................................7
  2. Emergence...................................................7
  3. Importance of coverage...............................8
  4. Why some companies are still hesitant to hedge........9

III PRODUCTS.....................................................10
  1. Forwards....................................................10
  2. Currency swaps..........................................12
  3. Vanilla option...........................................13
  4. Option strategies........................................15

IV MANAGING CURRENCY RISK (STEPS) 19
  1. Defining needs...........................................19
  2. Choosing a strategy .....................................20
     a. No coverage...........................................20
     b. Systematic coverage.................................20
     c. Partial coverage.....................................21
     d. Natural coverage.....................................22
  3. Selecting instruments..................................23
  4. Implementation and review..............................23

V  CONCLUSION.................................................24

VI  NOTICE OF NON-RESPONSIBILITY....25
I INTRODUCTION

The onset of international trade has allowed Canadian businesses to develop many business ties with foreign partners. Although good in economic terms, this has prompted the emergence of a risk that many local businesses must now deal with on a daily basis: currency risk.

Currency risk can prove highly problematic for our businesses. Consider, for example, Canadian exporters, whose profits have plunged in recent years as the U.S. dollar declined. A number of businesses, highly profitable when the U.S. dollar (USD) was trading at 1.6000, have had to close their doors subsequent to the U.S. dollar’s slide.

More recently, the 2008 financial crisis generated extensive turbulence in the financial markets and the U.S. dollar stood out by appreciating substantially. The greenback’s surge in October 2008 gave Canadian importers many a headache, as they had overlooked this risk. At the time, the U.S. dollar appreciated from 1.0313 to 1.3019 in just over a month (a 26% increase!!).
These two examples demonstrate how the Canadian dollar (CAD) and the currency market in general can undergo periods of substantial volatility. We can also expect to see more periods of sharp movement at some time in the future. This means currency risk is a very real risk that must not be overlooked.

PURPOSE OF THE DOCUMENT

This document is designed to provide you with support in an area that could occasionally seem complex. The goals are to introduce currency risk and familiarize you with the various tools and strategies that exist for managing it.
II CURRENCY RISK

DEFINITIONS OF CURRENCY RISK

Currency risk involves the foreign currency payables or receivables generated as a result of contracts the company has signed (or will sign). It is the risk that the currency will fluctuate in a way that hurts the company, in that it will have to convert the foreign currency under terms that are not as good as originally budgeted. This is currency transaction risk.

• For an importer: the risk that the foreign currency will appreciate
• For an exporter: the risk that the foreign currency will depreciate

Companies may also face other types of currency risk: Currency conversion (or translation) risk and economic currency risk. Currency conversion risk affects the company’s balance sheet. For example, a Canadian firm with U.S. assets would be vulnerable to U.S. dollar depreciation.

Lastly, economic currency risk exists when a company becomes less competitive with respect to its foreign competitors subsequent to a rise by the local currency. For example, a Canadian exporter could see its foreign sales decline as a result of overly extensive appreciation by the Canadian dollar, which makes its products more expensive in the eyes of consumers.

This document deals with currency transaction risk.

EMERGENCE OF CURRENCY RISK

Currency risk can materialize well before the time when the currencies are actually converted. There are two types of companies:

1. Companies that publish a price list.
2. Companies that negotiate prices by the job, contract by contract.

Some companies must distribute a price list based on a rate budgeted at the start of the season (e.g. catalogue). For example, a ski apparel supplier will give its retailers a price list several months before the winter season starts. Currency risk materializes as soon as the price list is released, well before the client is invoiced.

During this time, some companies have the opportunity to negotiate a purchase or sale price contract by contract, based on the current exchange rate. For example, for an industrial equipment manufacturer, currency risk appears as soon as the sale contract is signed, even though shipment of the final product (and the U.S. client’s payment) will only happen in six months. Currency risk is much easier for these businesses to manage, as they know exactly what their foreign currency inflows and outflows are.
 Establishing a Hedging Strategy is Essential. Why?

““We sleep a lot better when we’re covered.””

Here are some reasons for instituting a hedging strategy:

• **To protect against unfavourable currency movements.** The main reason it is important to use a hedging strategy is that it helps offset the negative impact of exchange rate fluctuations on your foreign currency expenditures or revenues.

• **To eliminate uncertainty about exchange rates.** Eliminating uncertainty makes it easier for the company to institute budget planning.

• **To focus on the company’s core activities.** Monitoring currency movements takes too much of your time. The time you invest in it is unfortunately time you can’t spend on your primary activities; it can also be a source of distraction.

• **To avoid the complexity of forecasting rate movements.** The currency market is one of the most difficult financial markets to predict. A few years ago, former Fed Chair Alan Greenspan even stated that predicting exchange rates was just as random as predicting the results of a coin toss.¹

“A company should be indifferent to a gain or loss arising from the currency market. Instead, it should focus on protecting its cost or profit structure.”

DESPITE THIS, SOME BUSINESSES ARE STILL RELUCTANT TO HEDGE. WHY?

Unfortunately, some businesses are still hesitant today about covering their currency risk. An initial poor experience, ignorance or lack of knowledge about the products, and the media are often used as reasons for not hedging. However, here is why these reasons SHOULD NEVER PREVENT a company from protecting itself from currency risk.

- **Poor first experience**: A company may decide never to hedge again as a result of a bad experience. For example, it realizes that the market rate is better than the rate in its forward contract. The company should see managing currency risk as a kind of insurance. It must be sure that it can achieve a certain profit margin. Opting not to hedge would be like deciding to drop one’s car insurance after a trouble-free year, saying that the premium has been a waste of money.

- **Media**: People often look for expert opinions to justify their decisions and frequently turn to articles and interviews that appear in the media. For example, a Canadian exporter may decide not to hedge his U.S. dollar inflows after reading an article whose author was predicting that the U.S. dollar would rise. Remember, however, that many highly credible authors can have diverging opinions. People also tend to read articles that back up what they think, or at least what they are hoping for.

- **Ignorance or lack of knowledge about the products**: Some companies are still poorly informed about the various ways to hedge against currency risk. Thankfully, your foreign exchange dealer can teach you about the issue and find solutions that are tailored to your specific needs.

“Businesses take out insurance to cover their property and contingencies... But unfortunately they sometimes forget to protect their ultimate goal: PROFIT!”
III PRODUCTS

There are products that are specifically designed to reduce or even eliminate the risk posed by foreign currency fluctuations and thus allow businesses to get through highly volatile periods with more ease. These products are:

1. Forwards
2. Currency swaps
3. Vanilla option
4. Option strategies

1. FORWARDS

A forward contract is an agreement between two parties to buy or sell an amount at a rate and date that are established ahead of time. When the contract expires, the conversion rate will be the contract rate, regardless of what the market rate is. A forward contract thus allows a company to protect itself from unfavourable currency movements.

A forward can be open or closed. A fixed forward contract means you must use the entire amount only on the pre-established date. An open forward contract allows you to take delivery of the amount over a period of up to one month before the contract ends. The open forward is generally used more often due to its flexibility.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DRAWBACKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protection from unfavourable currency movements</td>
<td>Not possible to capitalize on a favourable currency movement</td>
</tr>
<tr>
<td>Flexible</td>
<td>Cannot be cancelled. The company must be sure of its needs</td>
</tr>
<tr>
<td>Simple</td>
<td></td>
</tr>
<tr>
<td>No disbursement</td>
<td></td>
</tr>
</tbody>
</table>

FORWARD RATE DETERMINANTS

Note that the forward rate has nothing to do with the financial institutions’ exchange rate expectations. The forward rate is determined based on the market conversion rate (spot rate) plus or minus forward points. Forward points depend on interest rate differential between the currencies involved.

TERM RATE = SPOT RATE +/- FORWARD POINTS

The forward is an obligation for both parties. Regardless of what the rate is at the end of the contract, both parties must keep their commitments.
CAN I CANCEL A FORWARD CONTRACT?

No. A forward cannot be cancelled. If you no longer need the contract, you would have to do the reverse transaction at the market rate. Depending on rate movements, this could result in a gain or a loss. **This is why it is essential to be certain of what you need the forward contract for.**

However, a forward can be extended or shortened if a payment or receivable were to be delayed or moved up. At that time, the company would have to do a **currency swap** (See the next section).

<table>
<thead>
<tr>
<th>EXAMPLE - IMPORTER</th>
<th>EXAMPLE - EXPORTER</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SITUATION</strong></td>
<td><strong>SITUATION</strong></td>
</tr>
<tr>
<td>You must send your supplier US$100,000 in three months to pay for raw materials. You set the price for the final product in Canadian dollars according to the day’s exchange rate.</td>
<td>You will receive US$100,000 from your U.S. client in three months for the sale of your products. You set the sale price based on an expected profit in Canadian dollars and the day’s exchange rate.</td>
</tr>
<tr>
<td><strong>OBJECTIVE</strong></td>
<td><strong>OBJECTIVE</strong></td>
</tr>
<tr>
<td>To hedge against USD appreciation and protect your profit margin.</td>
<td>To hedge against USD depreciation and protect your profit margin.</td>
</tr>
<tr>
<td><strong>MARKET PARAMETERS</strong></td>
<td><strong>MARKET PARAMETERS</strong></td>
</tr>
<tr>
<td>Spot rate: 0.9725</td>
<td>Spot rate: 0.9725</td>
</tr>
<tr>
<td>3-month forward points: + 28 points</td>
<td>3-month forward points: 13 points</td>
</tr>
<tr>
<td>Forward rate: 0.9725 + 0.0028 = <strong>0.9753</strong></td>
<td>Forward rate: 0.9725 + 0.0013 = <strong>0.9738</strong></td>
</tr>
<tr>
<td><strong>IN THREE MONTHS</strong></td>
<td><strong>IN THREE MONTHS.</strong></td>
</tr>
<tr>
<td>You will pay C$97,530 and receive US$100,000, regardless of the rate on that day.</td>
<td>You will receive C$97,380 and must ship US$100,000, regardless of the rate on that day.</td>
</tr>
</tbody>
</table>

Why not take out forwards only when the company expects unfavourable currency movements and do nothing when it expects currency movements to be favourable?

It is extremely difficult, even impossible, to predict currency movements accurately. Also, a company should focus on its area of expertise and eliminate risks in which it does not have any expertise.

2. CURRENCY SWAPS

A currency swap is a cash flow management tool that is very popular with businesses that have foreign currency inflows and outflows at different or unexpected dates. It involves two opposite transactions that are done simultaneously for the same notional amount.
Currency swaps are used for:

1. Matching cash flows
2. Moving up or extending a forward
3. Financing

For example, suppose you need US$500,000 today and expect to get receivables for that amount six months from now. Instead of buying U.S. dollars at the spot rate and waiting for your receivables to come in so you can resell them, a currency swap can be used. The strategy involves buying US$500,000 at the spot rate and simultaneously reselling that amount using a six-month forward contract. The difference between the two rates will only come from the forward points (see forward contract). This strategy prevents pointless exposure to exchange rate fluctuation.

A currency swap thus combines a spot transaction with a reverse forward contract. (A spot purchase and a forward sale or spot sale and forward purchase.)

---

<table>
<thead>
<tr>
<th>SWAP</th>
<th>ADVANTAGES</th>
<th>DRAWBACKS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Resolves problems with the synchronization of foreign currency flows</td>
<td>Not possible to capitalize on favourable currency movements</td>
</tr>
<tr>
<td></td>
<td>Makes it possible to extend or move up a forward</td>
<td>Cannot be cancelled. The company must be sure of its needs</td>
</tr>
<tr>
<td></td>
<td>Prevents unproductive surpluses and onerous debits</td>
<td></td>
</tr>
</tbody>
</table>

---

<table>
<thead>
<tr>
<th>EXAMPLE – EXTENDING A FORWARD</th>
</tr>
</thead>
</table>

SITUATION
You have a forward sale contract for US$100,000 at 1.000 which expires today. Your client’s payment is late and you expect to get it next month. You are therefore unable to hand over US$100,000 as agreed.

You have two options:

1. Pay out US$100,000 by borrowing it from your U.S. credit line and paying it back when you get your receivables
2. Do a currency swap

CURRENCY SWAP PROCEDURE
1. Buy US$100,000 at the spot rate: the purchase will make it possible to honour your sale contract.
2. Simultaneously take out a new one-month forward contract. Your new sale rate will be based upon the same spot rate as your purchase, adjusted based on the term points: the new forward makes it possible to maintain the hedge acquired when you originally took out the forward.
EXAMPLE – EXTENDING A FORWARD

When setting up a swap, an amount can be credited to or debited from your Canadian account. There will be a credit if the purchase rate is less than the rate on your sale contract. In contrast, an amount will be debited from your Canadian account if the purchase rate is higher than the rate in the forward contract.

It is not a gain or a loss in either case. You will recoup much of the loss or lose the gain in relation to the rate budgeted at the outset, depending on the rate in effect at the time the swap was set up.

For example, let’s say the rate was 1.0500 when your forward was up. You must therefore buy US$100,000 on the spot at 1.0500 (allowing you to make the delivery). An outflow of C$5,000 will result. However, you will get most of this back when your new forward sale contract expires, as it is established at the day’s spot rate, which is 1.0500. The rate you initially budgeted is thus protected.

3. VANILLA OPTION

The vanilla option allows buyers to purchase or sell a foreign currency amount at a date and rate that are established ahead of time. The option’s seller is obliged to buy from or sell to the option’s buyer if the buyer exercises the option.

The option buyer thus guarantees a floor or cap rate, while providing for the opportunity to capitalize on a favourable currency movement. To get this right, the option buyer must pay a premium to the option seller.

A sale option (put) gives the holder the right to sell the foreign currency at a price set in advance. The party that sold the option is obliged to buy the currency if the option holder excises his right.

A purchase option (call) gives the holder the right to buy the foreign currency at a price set in advance. The party that sold the option is obliged to sell the currency if the option holder exercises his right.

In a way, an option is insurance against unfavourable currency movements. A call option protects importers from potential currency appreciation. Conversely, a put option protects exporters from currency depreciation.

PREMIUM DETERMINANTS

As with an insurance policy, the option buyer must pay a premium to hedge against unfavourable movements. The value of the premium depends on such things as the duration, amount to cover, and anticipated market volatility. The higher these variables are, the bigger the premium will be.
The amount of protection desired (the exercise price) also influences the value of the option. The more favourable the exercise price is to the market level, the more expensive the option will be.

**Premium determinants**

- Term of the option
- Amount of protection desired with respect to the market rate
- Expected volatility
- Amount to cover

*Note that the premium is a business expense and not reimbursable, whether or not the option is exercised.*

<table>
<thead>
<tr>
<th>VANILLA OPTION</th>
<th>ADVANTAGES</th>
<th>DRAWBACKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protection from unfavourable currency movements</td>
<td>The premium paid is not reimbursable, regardless of whether the option is exercised</td>
<td></td>
</tr>
<tr>
<td>Potential for unlimited gain in the event of favourable currency movements</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### EXAMPLE - IMPORTER  EXAMPLE - EXPORTER

**SITUATION**
You must send your supplier US$100,000 in three months to purchase raw materials. The spot rate is 0.9700.

**OBJECTIVE**
- Set a cap
- Be able to capitalize on U.S. dollar depreciation

**CALL OPTION DETAILS**
- Notional amount: US$100,000
- Exercise price: 1.0000
- Premium: C$1,200

**IN THREE MONTHS... TWO POSSIBLE SCENARIOS**
1. **Spot rate > 1.0000:** you exercise your call option and buy US$100,000 at 1.0000.
2. **Spot rate < 1.0000:** you do not exercise your call option and buy US$100,000 directly from the market.

**SITUATION**
You are expecting a receivable of US$100,000 in three months subsequent to a new sale. The spot rate is 0.9700.

**OBJECTIVE**
- Set a floor price
- Be able to capitalize on U.S. dollar appreciation

**CALL OPTION DETAILS**
- Notional amount: US$100,000
- Exercise price: 0.9500
- Premium: C$1,200

**IN THREE MONTHS... TWO POSSIBLE SCENARIOS**
1. **Spot rate < 0.9500:** you exercise your call option and sell US$100,000 at 0.9500.
2. **Spot rate > 0.9500:** you do not exercise your call option and sell US$100,000 directly to the market.

The options are a **right for the holder.** However, they are an **obligation for the party that sold them.** If the option purchaser exercises his right (to sell or purchase), the option seller must meet the request.
OPTIONS CAN BE AN EXCELLENT TOOL IN THE CONTEXT OF A TENDER

Options are especially suitable in a call for tenders situation. Unlike a forward, the company does not have to hand over or buy the foreign currency when the option expires. It only does so if it is better for the company; there is no obligation.

For example, an exporter can bid based on a conversion rate and protect that rate by buying a put option. If the company does not get the contract, it has no obligation to deliver. However, if it had used a forward, it would have to deliver the amount of the contract.

4. OPTION STRATEGIES

As mentioned earlier, the disadvantage of vanilla options is the premium paid when buying the option. The premium can be fairly high, especially for an option with a distant expiry date, sizeable notional amount and favourable exercise price.

Thankfully, it is possible to create option strategies that do not involve a premium. Option strategies with no disbursement give you protection from unfavourable currency movements, while letting you take advantage of a favourable currency movement. However, as with anything that is free, there are limits. The strategies provide you with limited potential for gains.

Note that there are a variety of option strategies that can be adapted to your needs. The strategies introduced here are included because of their simplicity.

“AHEAD OF” VS. “BEHIND” BUDGET

The strategies below are designed for businesses that are “ahead of budget,” i.e. businesses where the market rate is better than their budgeted rate.

For example, an importer is “ahead” if he has a budgeted rate of 1.0000 for the next year and the current market rate is 0.9700. Conversely, this company would be “behind” if the currency was trading at 1.0200.

A) ZERO-COST COLLAR

A collar involves buying and selling two options simultaneously. The expiry date and notional amount are the same for both options. However, the two options have different exercise prices. The term “zero-cost” is used when no disbursement is needed to implement the strategy.
For example, an exporter who wants to hedge against depreciation must buy put options to protect its risk. To avoid paying the premium, the company could sell call options to generate revenue. The strategy can be structured so that the revenue generated fully finances the put options purchased.

### SELF-FINANCED COLLAR

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DRAWBACKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protection from unfavourable currency movements</td>
<td>Limited potential for gains</td>
</tr>
<tr>
<td>No disbursement</td>
<td>Worst scenario not as good as a standard forward</td>
</tr>
</tbody>
</table>

### DETERMINANTS OF COLLAR CAP AND FLOOR LEVELS

The *amount of protection you want* will determine the size of the collar and thus the potential for gains. The closer the protection is to the current level of the market, the smaller your potential for gains will be. Conversely, as your level of desired protection moves away from the market, your potential for gains increases.

### EXAMPLE - IMPORTER  
**SITUATION**
You need US$100,000 a month to buy raw materials for the next twelve months. Your budgeted rate is 1.000 (C$1.000). The spot rate is 0.9700.

**OBJECTIVE**
- Hedge against USD appreciation and protect your profit margin
- Benefit from USD depreciation
- Pay no premium

**COLLAR DETAILS**
- Cap: 1.000 (budgeted rate)
- Floor: 0.9525
- No disbursement

### EXAMPLE - EXPORTER
**SITUATION**
You expect to receive US$100,000 a month for the next twelve months. Your budgeted rate is 0.9500 (C$95,000). The spot rate is 0.9700.

**OBJECTIVE**
- Hedge against USD appreciation and protect your profit margin
- Benefit from USD depreciation
- Pay no premium

**COLLAR DETAILS**
- Floor: 0.9500 (budgeted rate)
- Cap: 1.0020
- No disbursement
THREE SCENARIOS ARE POSSIBLE EVERY MONTH

1. Spot rate > 1.0000: you exercise your call option and buy US$100,000 at 1.0000.
2. Spot < 0.9525: we exercise our put option. You are obliged to buy US$100,000 at 0.9525.
3. 0.9525 < Spot < 1.0000: neither option is exercised. You can then buy US$100,000 at the market rate.

THREE SCENARIOS ARE POSSIBLE EVERY MONTH

1. Spot < 0.9500: you exercise your put option to sell US$100,000 at 0.9500.
2. Spot > 1.0020: we exercise our call option. You are obliged to sell US$100,000 at 1.0020.
3. 0.9500 < Spot < 1.0020: neither option is exercised. You can then sell US$100,000 at the market rate.

The collar lets you know in advance what the best and worst scenarios will be. Ideally, your worst scenario should be established based on your budgeted rate.

B) “PARTICIPATING” FORWARD

This strategy is created when you simultaneously buy or sell two options with the same expiry date and exercise price. Here, the difference is that the two options’ notional amounts are different.

This is an ideal strategy for a business that wants to hedge against unfavourable currency movements while seeking unlimited benefits from some of the foreign currency amount.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DRAWBACKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protection from unfavourable currency movements</td>
<td>A portion of the total amount to be traded is set at conditions that are less favourable than a forward</td>
</tr>
<tr>
<td>Potential for unlimited gains on a portion of the amount traded</td>
<td></td>
</tr>
<tr>
<td>No disbursement</td>
<td></td>
</tr>
</tbody>
</table>
**EXAMPLE - IMPORTER**

**SITUATION**
You need US$200,000 a month to buy raw materials for the next twelve months. Your budgeted rate is 1.000 (C$200,000). The spot rate is 0.9700.

**OBJECTIVE**
- Hedge against USD appreciation and protect your profit margin
- Benefit from USD depreciation
- Pay no premium

**STRATEGY DETAILS**
- You buy 12 call options
  (Notional: US$200,000 Exercise price: 1.0000)
- You sell 12 put options
  (Notional: US$88,000 Exercise price: 1.0000)
- No disbursement

**TWO SCENARIOS ARE POSSIBLE EVERY MONTH**
1. Spot rate > 1.0000: you exercise your call option and buy US$200,000 at 1.0000.
2. Spot < 1.0000: we exercise our put option. You are obliged to buy US$88,000 at 1.0000. The difference, 112,000, can be bought at the market rate.

**EXAMPLE - EXPORTER**

**SITUATION**
You expect to receive US$200,000 a month for the next twelve months. Your budgeted rate is 0.9500 (C$190,000). The spot rate is 0.9700.

**OBJECTIVE**
- Hedge against USD appreciation and protect your profit margin
- Benefit from USD depreciation
- Pay no premium

**STRATEGY DETAILS**
- You buy 12 put options
  (Notional: US$200,000 Exercise price: 0.9500)
- You sell 12 call options
  (Notional: US$80,000 Exercise price: 0.9500)
- No disbursement

**TWO SCENARIOS ARE POSSIBLE EVERY MONTH**
1. Spot < 0.9500: you exercise your put option to sell US$200,000 at 0.9500.
2. Spot > 0.9500: we exercise our call option. You are obliged to buy US$80,000 at 0.9500. The difference, 112,000, can be sold at the market rate.

A “participating” forward contract gives you complete protection from unfavourable currency movements. Moreover, if the currency goes up, some of your needs can be met at the market rate. In other words, this strategy allows you to benefit fully from a favourable movement for some part of the amount to be traded when the rate fluctuates in your favour.
IV  CURRENCY RISK MANAGEMENT

STEPS TO FOLLOW

Now that you are more familiar with currency risk and the various hedging instruments, here are four steps to help you manage this risk:

1. Define your needs and properly evaluate your exposure to currency risk.

2. Choose a hedging strategy to manage these risks.

3. Become familiar with the array of instruments available (see Products section).

4. Apply and review your policy regularly as your needs evolve.

STEP 1
DEFINE YOUR NEEDS by answering the following questions:

- What percentage of my accounts payable and receivable is in foreign currency?
- What is my tolerance for exchange rate fluctuation? At what point is the company's profitability in jeopardy?
- Can I get a match between the expiry dates and payable and receivable amounts when they are denominated in the same currency?
- Can I bill clients for losses incurred due to exchange rate fluctuation by raising my prices?
- Do I intend to make major foreign investments in the near future?

STEP 2
CHOOSE THE APPROPRIATE HEDGING STRATEGY

These are the main hedging strategies that companies use:

A. No hedging – Spot transactions only
B. Systematic and complete hedging
C. Selective and partial hedging
D. Natural hedging
A) NO HEDGING

Some companies choose not to act and they accept the currency risk. They opt to trade at the day’s rate only when the need arises. The lack of coverage usually comes from an expectation of gain or a lack of knowledge of the risks incurred.

The strategy is good for the company when the exchange rate movement is favourable in relation to the budgeted rate. However, the company runs the risk of seeing its profit margin shrink if the rate fluctuates unfavourably.

B) SYSTEMATIC AND COMPLETE COVERAGE

Some companies opt to hedge their risk completely and systematically. This is usually the case with companies that negotiate sale prices individually for every contract.

This strategy allows the company to guarantee its profit margins, regardless of how the foreign currency moves. However, this strategy does not allow the company to profit from favourable currency movements.

---

**EXAMPLE - SYSTEMATIC COVERAGE**

**SITUATION**

- You distribute trailers and are about to win a contract with a dealer in the region. The dealer commits to buying five trailers, deliverable in six months.
- You have to set a sale price in Canadian dollars, and will be paid upon delivery in six months.
- Your U.S. supplier wants to be paid in U.S. dollars in six months. He charges you US$500,000 for the five trailers.

**IMPLEMENTING THE STRATEGY**

- You call your foreign currency dealer and request the exchange rate for buying U.S. dollars with a six-month forward.
- You call your client to submit your final price in Canadian dollars, based on the exchange rate and desired profit margin.
- As soon as your client accepts your price, you call your dealer to take out a six-month forward so as to fix your exchange rate.

***Note that the currency market is a dynamic one and rates can fluctuate rapidly. The rate could thus be different when the transaction is concluded, depending on how much time elapses between the time the bid price is set and the time the client accepts your proposal. This is why it is best to reduce the time between the bid and the client’s answer.***

You have thus guaranteed your profit margin upon signature of the contract and won’t have any surprises for six months. Once the contract is signed, you are indifferent about how exchange rates move. **Note: you are in business to generate profits on your daily operations, not on exchange rates!**
Systematic coverage can allow the company to be more aggressive and offer a much more competitive price when making a bid, thus allowing it to win more contracts.

Companies that don’t have a hedging strategy will often include a “cushion” between the day’s conversion rate and budgeted rate to protect themselves from unfavourable currency movements. The less competitive price that results from this additional margin could cost the company contracts.

For its part, a company that has the good habit of systematically covering itself upon the signature of the contract does not need as big a “cushion” when bidding. It is more competitive and can win more contracts.

C) SELECTIVE AND PARTIAL HEDGING

This strategy is frequently used by companies that have a hard time predicting their exact foreign currency needs with any assurance. This is the case with companies that issue a price list at the start of the season or year (catalogue) and makes sales on a daily basis.

Since the total value of the sales is not certain, a company in this situation could risk being “overprotected.” It could thus have to do the reverse transaction when the forward expires and incur a loss. To reduce this risk, companies often opt to partially hedge their needs.

These are some examples of methods used by companies. Note that these are examples. The list is not exhaustive.

- Protect 50% of the needs expected each month over a one-year period and convert the difference at the spot rate.
- Protect 75% of the needs forecast for the next three months, 50% for months 4 to 6, 25% for months 7 to 12, and convert the difference at the spot rate.
- Protect 90% of the needs forecast for the next month, 75% for months 2 to 6, 50% for months 7 to 12, and convert the difference at the spot rate.

D) NATURAL HEDGING

Depending on the nature of their activities, some businesses have natural coverage. Natural coverage occurs when a company has inflows and outflows in the same foreign currency.

Natural coverage is an excellent way to reduce currency risk, but rarely eliminates it completely. It is highly unusual for payables to exactly equal receivables in the same currency. Generally, the company is a “net” buyer or a “net” seller. Currency risk therefore exists for the company’s “net” exposure.
A lack of synchronization between cash flows can also be a problem for a company. For example, take the Canadian trailer dealer who has just sold a new trailer in U.S. dollars; the trailer is to be delivered in six months. The company must pay its U.S. supplier in just one month, but will only receive the client’s payment in six months.

Although it has natural coverage, the company is exposed to currency risk as the rate for purchase in one month and rate for sale in six months are unknown. In this case, a currency swap would be the solution. The company would buy U.S. dollars through a one-month forward and simultaneously sell the value of its sale in U.S. dollars using a six-month forward. This would guarantee the company’s expected profit margin.

<table>
<thead>
<tr>
<th>HEDGING STRATEGY</th>
<th>WHO NEEDS IT?</th>
</tr>
</thead>
</table>
| NO HEDGING                        | • Companies with a negligible percentage of sales affected by international transactions  
|                                   | • Companies whose same-currency inflows and outflows can be matched            |
| SYSTEMATIC AND COMPLETE HEDGING   | • Companies that negotiate each contract individually                         
|                                   | • Companies with very tight profit margins                                    |
| SELECTIVE AND PARTIAL HEDGING     | • Companies that issue a price list at the start of the season                
|                                   | • Companies with higher profit margins                                        |
| NATURAL HEDGING                   | • Companies with the flexibility of having inflows and outflows in the same foreign currency |

**STEP 3**

**SELECTING HEDGING INSTRUMENTS**

You must select the hedging instrument that suits your situation best to protect you from the risks of losses stemming from exchange rate fluctuations. See the section on the various products to see which would suit you best.

**STEP 4**

**IMPLEMENTING THE STRATEGY AND REVISING IT AS NEEDED**

The final step consists in implementing the strategy.

Note that managing currency risk is a dynamic process. The company must keep a close eye on changes to its needs and to market conditions, and adjust as necessary.
V CONCLUSION

Many companies are intimidated by currency risk and avoid international trade so that they do not have to deal with it. As you have seen, there are many strategies and products for protecting against currency risk. Currency risk should not be an obstacle to international trade.

In short, here are the main things to remember:

- Currency risk is a reality for many businesses.
- Currency risk can be substantial, putting the company’s survival at risk.
- Currency risk materializes well before invoicing.
- The company should focus on its operations (its area of expertise) and protect itself from risks in which it has no expertise (currency risk).
- There are many products and strategies for eliminating or reducing currency risk.

DESJARDINS AT YOUR SERVICE

The hedging products and strategies presented here represent only a few of the options available. Desjardins can also offer you a multitude of other options not covered by this reference guide.

Since every company’s situation is different, it is essential to establish a strategy that suits your specific needs. Desjardins is here for you to look at how to develop a made-to-measure solution for your company.
VI  NOTICE OF NON-RESPONSIBILITY

Any information on one or more financial instruments is provided as is, for information purposes, even though it has been established based on serious, respected and reliable sources.

It in no way constitutes an offer of purchase, sale, subscription or financial services by Caisse centrale Desjardins (especially banking or insurance products), or a solicitation of an offer to purchase or sell securities, derivatives or any other investment product.

Caisse centrale Desjardins refuses all responsibility with respect to any use that may be made of the information and the consequences resulting therefrom, in particular with respect to any decisions that could be made or actions undertaken based on said information. You remain solely liable for the use of the information and results obtained based on said information. You are also responsible for verifying the accuracy of the information received.

You acknowledge that the use and interpretation of the information requires specific and in-depth knowledge of the financial markets.

The past performance of a financial instrument is in no way a predictor of future performance.

You acknowledge that Caisse centrale Desjardins has not provided any advice and makes no recommendation or assertion as to the pertinence of a product, financial service, security or other instrument with respect to your specific needs or circumstances.