Managing Foreign Exchange Risk

Many Canadian companies have international aspects to their businesses and are therefore faced with risks stemming from fluctuations in currency exchange rates. The impact of these fluctuations can severely impact their operations, profitability, and even business models. The sources of FX risk are varied and, to name a few, can stem from:

- Using foreign suppliers
- Revenues generated outside of Canada
- Having foreign assets and liabilities on the balance sheet
- Paying or receiving dividends in a foreign currency
- Cross border M&A

A sound risk management framework with clear objectives is an important tool to successfully manage risks presented by foreign exchange. This document explores some of these key concepts.

Identifying and Understanding the Exposure

It sounds self-evident, but identifying the source and nature of FX risks is the first step to developing a risk management programme. There are two main categories of FX risk:

- Translational risk refers to the variation in value of foreign assets and/or liabilities on the company's Canadian dollar balance sheet because of changes in exchange rates between reporting periods. This non-cash accounting treatment is typically of higher concern for public companies in reporting their financial statements.
- Cash flow risk arises from future foreign currency receipts or payments - the value of which in Canadian dollar terms is uncertain because of variations in the exchange rate. The most common sources of cash flow risk relate to foreign purchase orders/invoices and receivables.

Understanding the nature of each exposure is also important. For example, FX risk starts at the moment a purchase order is signed, not when an invoice is issued. In some cases, prices may be defined by the average of FX rates over a number of days or weeks and not the prevailing rate on a particular day.

Quantifying the FX Risk

Evaluating the impact of each source of FX risk on the company will allow management to prioritise each risk. The evaluation can start at a micro level (are the thin margins of a manufactured product incorporating foreign components such that a small change in FX rates will reduce them or even turn them into a loss?) with the summation of risks defining the potential impact at the enterprise level. One-off exposures also need to be evaluated - e.g. at what FX rate does the IRR of an equipment purchase priced in foreign currency become unacceptable?

Many companies set FX budget rates each year. Part of this process may include defining expected, optimistic and pessimistic FX scenarios. There are many ways of choosing budget rates: current spot, current forward curve, or a bank forecast to name a few. Using the pessimistic scenario to gauge the impact of FX moves is another way to quantify FX risk. The challenge, however, is developing sensible FX rate forecasts.

1 Identifying and Understanding the Exposure

Management will first need to define the objectives of the risk management programme. This may include:

- how to deal with different types of risk (one-off contracts vs ongoing exposures)
- setting priorities across different currencies (emerging markets vs G10, or low and high impact currencies)
- defining the degree of tolerance for volatility in results from FX
- considering the level of administration to execute and manage the hedging programme
- understanding and addressing the costs involved (implementing explicit premium budgets or accepting implicit cost of carry)
- deciding on the degree of freedom to monetise a view
- deciding which tenor mandates are sensible for the business
- evaluating impact relating to accounting considerations

It is important that the objectives are realistic and have buy-in from key stakeholders.

2 Quantifying the FX Risk

Once the FX risks are well understood and the hedging objectives clearly defined, a hedging toolkit can be formulated. Some companies have a prescriptive list of products that can be used with new additions requiring approval before implementation. Other companies allow discretion to use any hedging solution that makes sense at the time. There exists a large and diverse array of hedging instruments, each of which come with benefits and disadvantages.

Following are some factors that may influence the choice of solutions:

- availability and tenor of credit lines
- required degree of protection
- ability to participate in favourable markets
- costs
- ratio/leverage limits
- market liquidity
- feasibility of reset and cancellation features

The method of implementing hedging solutions can be as important as the solutions themselves. Should the entire year be hedged in one go, or should a layered strategy be employed to smooth rates period to period? What hedge ratio should be targeted if not 100%? What combination of forwards, outperformance, and participation makes sense? Do market conditions favour longer or shorter tenors, the buying or selling volatility? If hedging a mean reverting currency pair (as many G10 currency pairs are), are we in a period of over- or under-valuation?

3 Setting Risk Management Objectives

The effectiveness of a hedging programme should be monitored on an ongoing basis and evaluated against management's objectives. The programme should evolve, with changes introduced if necessary. Revising the objectives on an annual basis ensures the programme will continue to serve its purpose effectively.

About Commercial FX

As a leading provider of Foreign Exchange solutions, we offer deal execution, ecommerce channels and tailored risk solutions corresponding to your specific hedging requirements and risk tolerances. Our FX professionals provide dedicated account coverage to deliver client-focused advice and foreign exchange solutions.

Should you have any questions about Foreign Exchange risk management, speak with your RBC Capital Markets Commercial FX representative or contact us at rbcdxaccess@rbccm.com or 416.842.9656

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