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Summary of the 2014 Survey on Canadian Foreign Exchange Hedging[1]

Since 2004, the Bank of Canada has conducted an annual survey to assess aggregate foreign exchange (FX) hedging activity in the Canadian market over the previous year. The survey participants[2] consist of banks that are active in Canadian FX markets, including the 12 banks represented on the Canadian Foreign Exchange Committee (CFEC).

The 2014 survey was conducted between 4 June and 27 June, with follow-up bilateral meetings held in July and August. This summary incorporates the written survey responses from banks on the aggregate FX hedging activity of their corporate and institutional clients that are subject to Canadian-dollar hedging requirements, as well as information gathered from the follow-up bilateral meetings.[3] These discussions provide a broader view of the issues that market participants face and complement the more quantitative nature of the survey questions.[4]

Some common themes emerged from the 2014 survey, in part reflecting the composition of the client base of the responding banks, both by region and by sector:

- Many respondents indicated that, similar to previous surveys, the level and volatility of the Canadian dollar were the major factors determining hedging activity among their clients. It was reported that the generally low level of realized volatility during the survey period had somewhat reduced incentives among the banks' clients to engage in hedging and had led to an overall decrease in discretionary hedging activity. However, the depreciation of the Canadian dollar in late 2013 and early 2014 led to some increased hedging activity by clients.

1 The views expressed in this report summarize comments from representatives of banks that responded to a survey on the Canadian-dollar hedging practices among their institutional and corporate customer base. As such, they do not necessarily represent the views of the Bank of Canada.

2 The following institutions participated in the survey: Bank of America Merrill Lynch, BMO Capital Markets, Barclays Capital, BNP Paribas, CIBC World Markets, Citigroup, Credit Suisse, Deutsche Bank, HSBC Bank Canada, JP Morgan, National Bank Financial Group, RBC Capital Markets, Royal Bank of Scotland, Scotia Capital, Société Générale, State Street Global Markets Canada, TD Securities, and UBS.

3 Over the survey period (4–27 June 2014), the Can$/US$ exchange rate ranged from 91.4 cents to 93.8 cents, with an average rate of 92.4 cents.

4 Banks were asked to characterize their customer activities in aggregate. However, it can be difficult for banks to determine the exact nature or purpose of a customer's FX trade.

- Institutional customer volume continues to account for the majority of client activity; it remains largely driven by routine hedging (rolling of existing positions) and rebalancing activity. FX hedging activity by exporters remains the largest contributor to corporate customer volume and continues to be primarily driven by the level of the currency.
- Banks estimated that the average budgeted Canadian-dollar rates across their combined customer base in 2014 and 2015 are 91.2 cents and 89.9 cents, respectively.[5]
- Survey respondents noted a continued shift by customers to the use of electronic dealing platforms, specifically multi-bank platforms, with clients moving away from single-bank platforms and voice dealing.
- Regulatory developments, domestically and abroad, continue to be an important focus for both banks and their clients, with regulatory compliance occupying an increasing amount of time and effort.

A more detailed explanation of each of these themes is provided below.

Determinants of hedging activity: For both corporate and institutional clients, the level and volatility of the Canadian dollar continue to be the major factors determining client hedging activity. The depreciation of the Canadian dollar in late 2013 and early 2014 saw some increase in the length of the term of hedges, especially from Canadian-dollar buyers. However, banks also noted that many accounts did not increase their hedge ratios and tenors, since they expected further weakness in the Canadian dollar (which was in line with the consensus forecast of private sector economists at the time). The more recent low rates of realized FX volatility have been accompanied by a decrease in client hedging activity. This lower volatility also led to a slight decrease in the average duration of their hedges, since clients saw less incentive to pay a forward premium to lock in specific exchange rate levels. The majority of the hedging by both corporate and institutional clients continues to be for terms of less than six months.

The composition of hedging activity: Canadian pension funds and foreign speculative accounts are responsible for the largest share of institutional activity, followed by domestic investment funds and foreign pension accounts. Canadian exporters account for more than two-thirds of the corporate hedging flow. While overall hedging ratios did not change much, on average, during the survey period, there were nonetheless some shifts at the margin in the currency exposures of clients.

- For most corporate accounts, the U.S. dollar accounted for the largest rise in FX exposures, followed by the euro and some currencies of Latin America and Asia (excluding Japan). Corporate exposures declined the most for the British pound, followed by Eastern European currencies.
- Canadian-based institutional clients reported a slight rise in exposure to the U.S. dollar and to Asian currencies (led by the Chinese renminbi), while exposure to the Japanese yen and Eastern European currencies declined.

Canadian-dollar expectations: Survey participants were asked to estimate their clients' budgeted Canadian-dollar exchange rate for both 2014 and 2015 (see **Tables 1 to 3**). Overall, both institutional and corporate clients expected the Canadian dollar to weaken from the levels seen during the survey period, with average expectations falling at the lower end of the

5 Estimates for the Can$/US$ exchange rate range from 83.3 cents to 97.4 cents for 2014 and from 81.1 cents to 99.0 cents for 2015.

trading range for the Canadian dollar over the past year (to August 2014). These estimates are significantly lower than in the 2013 survey, largely reflecting the lower trading range for the Canadian dollar in 2014. The difference between the highest and the lowest estimates for 2014 was 13 to 14 cents, and 15 to 17 cents for 2015, both considerably wider than the ranges reported in the 2013 survey, potentially reflecting higher uncertainty around likely future spot values.

Table 1: Average estimate by survey participants of the exchange rate for the Canadian dollar in 2014 and 2015 budgeted by both *corporate* and *institutional* clients

Estimate (U.S. dollar cents)*	2014	2015
Average	91.2 (1.097)	89.9 (1.113)
High (Low)	97.4 (1.027)	99.0 (1.010)
Low (High)	83.3 (1.20)	81.1 (1.233)
Range	14.1 (17.3)	17.9 (22.3)

*Canadian dollars per U.S. dollar are shown in parentheses.

Table 2: Average estimate by survey participants of the exchange rate for the Canadian dollar in 2014 and 2015 budgeted by *corporate* clients

Estimate (U.S. dollar cents)*	2014	2015
Average	91.7 (1.090)	90.5 (1.101)
High (Low)	97.1 (1.030)	99.0 (1.010)
Low (High)	84.3 (1.187)	82.3 (1.215)
Range	12.82 (15.67)	16.71 (20.50)

*Canadian dollars per U.S. dollar are shown in parentheses.

Table 3: Average estimate by survey participants of the exchange rate for the Canadian dollar in 2014 and 2015 budgeted by *institutional* clients

Estimate (U.S. dollar cents)*	2014	2015
Average	90.7 (1.103)	89.3 (1.120)
High (Low)	97.4 (1.027)	96.2 (1.04)
Low (High)	83.3 (1.20)	81.1 (1.233)
Range	14.07 (17.33)	15.07 (19.33)

*Canadian dollars per U.S. dollar are shown in parentheses.

Changes in hedging tools and market structure: Most dealers noted very little change in the use of FX options for hedging despite the historically low implied volatility throughout the survey period. Several banks also noted the increased difficulty in using hedge accounting for more complex structured products, which has reduced the willingness of some clients to employ exotic options in regular hedging activities.

According to the surveyed banks, the use of single-bank trading platforms among their clients continues to decline, since both institutional and corporate customers prefer the perceived increase in price competitiveness provided by multi-bank platforms. The penetration rate of multi-bank platforms among institutional accounts is greater than for corporate accounts, but this gap is narrowing as the latter shift away from single-bank platforms. The use of phone trading has fallen over the past year across both client types, continuing a multi-year trend. Clients prefer to use trading platforms that have straight-through-processing capabilities, especially when dealing on multi-bank platforms. Other factors cited for the greater use of electronic trading platforms include higher price transparency, the perception of more competitive pricing and ease of use.

Regulation: Similar to the 2013 survey, the impact of regulation on FX activity continues to be a recurring theme among banks in Canada and the United States, as well as their clients. Regulatory considerations have increased legal and compliance costs for banks and led to a more complex and time-consuming process for taking new clients on board. Trading volumes for customers and banks declined ahead of the key implementation dates for the new regulations, but as more clients signed the required new legal documents, trading volumes recovered. Nonetheless, many survey respondents noted that the requirements for compliance and information systems under the new regulations were still absorbing significant resources, including management time, of both banks and their clients. Banks said that they were already well positioned to ensure the compliance of their larger clients with the new Canadian regulatory reporting requirements for over-the-counter derivatives transactions[6] that came into effect on 31 October 2014.

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6 Canadian trade-reporting requirements state that each trade counterparty must obtain a unique LEI (Legal Entity Identifier) and that each trade in a relevant class of FX derivatives product must be reported to an authorized trade repository.