

Summary of the 2011 Survey on Canadian Foreign Exchange Hedging¹

NOTICE – Friday, 25 November 2011, 15:30 (ET)

Since 2004, the Bank of Canada has carried out a qualitative annual survey to assess the degree of activity in Canadian foreign exchange (FX) hedging. The survey participants² comprise banks that are active in Canadian FX markets, including the eleven members of the Canadian Foreign Exchange Committee (CFEC). The 2011 survey was divided into two parts, each separately covering the FX hedging activity of the banks' corporate and institutional accounts that have Canadian-dollar hedging requirements. This summary incorporates the written survey responses collected in July, as well as information gathered from in-person interviews and meetings conducted in August and September.³ The survey results provide only a broad picture of customer hedging activity, given the qualitative rather than quantitative nature of the survey.⁴ Although common themes emerge, there are differences in the findings, in part reflecting the composition of each bank's client base, both by region and by sector.

- Institutional customer volume continues to account for the majority of client hedging activity, but remains largely mechanical in nature and is driven by routine hedging and rebalancing activity. Exporter FX hedging activity continues to be the largest contributor to corporate customer volume and is driven primarily by the actual level of the currency.
- FX exposure for importers and exporters increased the most in U.S. dollars, whereas for domestic institutional investors, exposure increased the most in euros and Australian dollars. Overall emerging-market currency exposure also increased, with Latin American currencies reflecting the largest rise. Foreign institutional investors increased their exposure to Canadian assets.
- Across both corporate and institutional accounts, approximately half of the currency exposures are hedged. The majority of institutional accounts have a formal FX hedging policy, while fewer than half of the corporate accounts have any formal policy. The majority of institutional hedges are extended (rolled) to maintain the hedge on an underlying longer-term investment, whereas most corporate hedges are used to hedge specific cash flows and are therefore not rolled forward. For both client groups, the majority of hedges are conducted for terms of less than six months.
- The impact of the Canadian-dollar movements on corporate revenues has varied by client type. Banks estimated that Canadian importers were affected positively by the Canadian-dollar

¹ The views expressed here summarize comments from representatives of banks who responded to a survey on the Canadian-dollar hedging practices of their institutional and corporate client base and, as such, 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, Deutsche Bank, HSBC Bank Canada, JP Morgan, National Bank Financial Group, RBC Capital Markets, Scotia Capital, State Street Global Markets Canada and TD Securities.

³ Over the survey period, the CAD/USD range was 0.9974 to 1.0630. The average rate over the period was 1.0282.

⁴ Banks were asked to characterize customer activities as a whole, rather than provide a quantitative account of customer transactions. In addition, it may be very difficult, in some cases, for banks to distinguish the exact nature or purpose of an FX trade.

movements, with importers increasing both their hedging volumes and the duration of the FX hedges to take advantage of the stronger currency. The impact on Canadian exporters has been moderately negative. Exporters generally delayed hedging their exposures as the Canadian dollar appreciated. If they did hedge, only shorter durations were targeted, since exporters expected some future weakness in the Canadian dollar.

- Domestic institutional investors have slightly increased their foreign currency investments, taking advantage of the higher Canadian dollar, but there has been no change in their overall hedging ratio for their foreign assets.
- Banks estimated that the average 2011 and 2012 budgeted Canadian-dollar rates across their combined customer base are 1.0172 and 1.0109 respectively.⁵

A more detailed explanation of these themes is provided below.

What are the composition, FX exposure and hedging activity of bank clients?

Domestic institutional fund hedging activity continues to dominate overall bank FX hedging volumes. Institutional customer volume is driven by pension funds, followed by investment and speculative accounts, while exporter FX hedging activity continues to dominate corporate customer flow.

Overall, the U.S. dollar saw the largest increase in FX exposure for corporate clients, while clients have reduced their exposure the most to the Japanese yen. Canadian-based institutional clients have mostly increased their foreign currency exposure, with the euro and the Australian dollar showing the largest rise; however, according to the respondents, these accounts have reduced their exposure to the U.S. dollar. Overall exposure to emerging-market currencies continues to increase for both corporate and institutional accounts, with exposure to Latin American and Asian currencies increasing, while exposure to Eastern European countries has declined. Generally, market participants are more selective, by adding exposure to specific emerging-market regions and currencies rather than the emerging-market space as a whole. For example, Canadian corporate clients are increasing their infrastructure investments in Latin America. International exposure to Canadian assets has risen over the period, although some participants commented that a few international investors have recently been marginally reducing their Canadian asset exposure, given the subdued performance of the currency relative to other investment alternatives.

Both institutional and corporate clients continue to hedge approximately half of their currency exposure, which is little changed from the previous survey. A significant proportion of institutional accounts have a formal FX hedging policy, whereas the proportion is less than half for corporate clients. The FX strategy for hedging FX risk varied by corporate client type, with Canadian exporters decreasing both their overall hedging ratio and average duration. The slide in commodity prices, combined with the stronger currency, weighed on their performance. Exporters were seen to be reluctant to hedge because they were anticipating that the Canadian dollar would weaken.⁶ In contrast, Canadian importers

⁵ The CAD/USD estimates range from 0.9412 to 1.1008 for 2011 and 0.9335 to 1.1047 for 2012.

⁶ The heightened FX volatility in August that saw the Canadian dollar weaken to parity led a small number of exporters to increase their longer-term hedges to take advantage of the weaker Canadian currency.

increased both their hedging ratio and duration over the year to take advantage of the stronger Canadian dollar.

On balance, for the full customer survey, the majority of hedging is for maturities of six months or less. Almost all institutional hedging is under six months with the majority of hedges being rolled, through FX swaps, for terms of one to three months. This rolling of positions contributed to the substantially larger trading volume reported for institutional accounts.

For corporate clients, the majority of the hedges are for six months or under, although they are equally allocated to one-month, one- to three-month or three- to six-month periods. For corporate clients, only a small percentage of hedges are rolled, since the majority of corporate hedging is done against specific cash flows.

The level of the Canadian dollar was the highest-ranked factor behind the shift in hedging activity by corporate accounts, followed by the level of an underlying commodity asset. In contrast, in last year's survey, the level of the underlying commodity asset appeared to be the key factor behind a shift in hedging activity. For investment clients, the primary factors for a shift in hedging activity were the change in market volatility of the underlying asset, followed by month-end and quarter-end rebalancing activity. The level of the currency was considered to be of only secondary importance.

The use of FX options is still relatively low among all customers, mainly because of accounting rules and restrictions imposed by treasury mandate, rules or policies (with difficulty in obtaining board approval). The decline in implied option volatility over the past year did not affect option demand from corporate clients. However, it was cited as a factor in the increased use of options by some institutional investors. Increased marketing of options to institutional accounts also contributed to a slight rise in demand. Some participants also noted an increased use of structured FX products to increase client returns.⁷

The use of foreign currency fixes⁸ by customers still appears to be limited, with only a marginal proportion of corporate clients and less than a third of institutional clients using a fix to trade. Similar to responses received last year, institutional accounts primarily use the London closing fix (11:00 ET),⁹ whereas the corporate customer base is more focused on the Bank of Canada noon rate fix (12:00 ET).

Most participants indicated that pricing competitiveness has increased over the past year, although not as a result of any particular reason. For example, there has not been another broad-based increase in the number of participants in the banking panel that was seen after the Lehman crisis, although this was a factor stated by some banks. Other reasons cited included new entrants to the Canadian market, more competition from FX providers focusing on retail FX and increased use of electronic trading. These have led to tighter bid-offer spreads on electronic platforms, as well as increased efficiency in FX execution, which has also led to higher volumes. Electronic trading continues to be used primarily by institutional

⁷ Structured FX options are more complex option contracts (strategies) that are usually utilized to reduce the cost of the option.

⁸ An FX fix refers to an FX rate that is calculated at a specific point in time using transacted or quoted FX rates, depending on the calculation methodology.

⁹ Published by WM/Reuters.

accounts, while the penetration rate among the corporate clients is still low and influenced by the size of the company.

Credit considerations are a rising factor in the pricing of FX products. There is a growing tendency for banks to pass down the cost of credit (credit valuation adjustment) to their clients, especially for longer-dated FX products, even in an environment of more competitive pricing. However, many banks noted that the competitiveness of the market precluded the ability to include the cost of credit in the overall pricing for shorter-dated transactions of two years or less.

Overall, pending financial market regulation of FX activity is having little impact thus far on clients' FX hedging decisions, given the uncertainty related to the timing, consistent delays in implementation and uncertainty over the scope of any regulatory change. Some banks noted that clients expect transactions costs to increase as a result of the financial regulatory changes being currently discussed. The degree of concern is dependent on the size and sophistication of the entity, with larger U.S. corporations committing resources to analyze the potential impact from any changes in financial regulations.

What are the expectations of participants for the Canadian dollar and for its impact on bank clients?

The impact of Canadian-dollar movements and its level on revenue has varied by client category. For Canadian exporters, the impact has been moderately negative, whereas the impact for Canadian importers has been moderately positive.

Survey participants were also asked to estimate the budgeted Canadian-dollar rate used by their clients for both 2011 and 2012. The average estimate of corporate as well as institutional clients for the Canadian dollar for both 2011 and 2012 corresponds to the middle of the Canadian dollar's trading range over the past year (see Tables 1 to 3 for the estimated Canadian-dollar rates). However, the range of average estimates was relatively wide, 10 to 14 cents for 2011 and 13 to 17 cents for 2012. Also, in contrast to last year's survey, the Canadian dollar was expected to depreciate slightly next year relative to the current year's budgeted rate.

During the bilateral interviews, banks were asked what they felt were the key inflection levels that would have an impact on corporate behaviour toward hedging their exposures. For exporters, who were viewed as largely unhedged, further Canadian-dollar appreciation to 1.10 was generally cited as an important level that would prompt a reconsideration of hedging coverage and possibly force these corporate clients to hedge. Many exporters had anticipated Canadian-dollar weakness and, as a result, had reduced their hedging during periods of Canadian-dollar strength. The recent move in the Canadian dollar toward parity has sparked an increase in exporter hedging flows, some of which have increased their hedging duration.

Banks did note, however, that over half of their Canadian exporter clients are U.S.-dollar-based since they are mainly commodity producers with receipts primarily in U.S. dollars. Many of these exporters only buy Canadian dollars for their Canadian expenses, often using their U.S.-dollar proceeds to fund other global operations. While exporters are generally seen to be better placed to deal with Canadian-dollar strength than they were during 2007, many exporters last year were counting on rising

commodity prices to offset the appreciation of the Canadian dollar. However, the recent weaker commodity performance has forced exporters to be more sensitive to Canadian-dollar movements and eroded the effectiveness of their natural hedge to offset Canadian-dollar strength. The 0.99 to 0.95 level was cited as a key catalyst for importers to further increase their hedging against Canadian-dollar weakness, although most importers were seen to be more than adequately hedged. Of note were comments that the Canadian-dollar strength had allowed some corporate customers to fully hedge or repay their foreign currency debt at attractive levels.

Table 1: Survey participants' average estimate of their clients' budgeted Canadian-dollar rate for 2011 and 2012 (**corporate** and **institutional**)*

	2011	2012
Average	1.0172 (0.9833)	1.0109 (0.9893)
High (Low)	1.1008 (0.9084)	1.1047 (0.9053)
Low (High)	0.9412 (1.0625)	0.9335 (1.0713)

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

Table 2: Survey participants' average estimate of their **corporate** clients' budgeted Canadian-dollar rate for 2011 and 2012*

	2011	2012
Average	0.9929 (1.0071)	1.0198 (0.9806)
High (Low)	1.0397 (0.9618)	1.0665 (0.9377)
Low (High)	0.9412 (1.0625)	0.9346 (1.0700)

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

Table 3: Survey participants' average estimate of their **institutional** clients' budgeted Canadian-dollar rate for 2011 and 2012*

	2011	2012
Average	1.0294 (0.9714)	1.0065 (0.9936)
High (Low)	1.1008 (0.9084)	1.1047 (0.9053)
Low (High)	0.9577 (1.0442)	0.9335 (1.0713)

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

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