# Summary of the 2012 Survey on Canadian Foreign Exchange Hedging[1]

NOTICE - Friday, 23 November 2012, 15:30 (ET)

Since 2004, the Bank of Canada has carried out an annual qualitative survey to assess client activity in Canadian foreign exchange (FX) hedging as reported by banks. The survey participants[2] comprise banks that are active in Canadian FX markets, including the ten banks represented on the Canadian Foreign Exchange Committee (CFEC).

The 2012 survey covers bank responses as to FX hedging activity of both corporate and institutional accounts that have Canadian-dollar hedging requirements. This summary incorporates the written survey responses collected in June, as well as information gathered from bilateral meetings conducted in August.[3] The survey results provide a broad picture of customer hedging activity, subject to the qualitative rather than quantitative nature of the survey.[4] Some common themes emerge, with differences among institutions 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, and remains largely driven by routine hedging and rebalancing activity. The reduction in market volatility in the Canadian dollar relative to the prior year[5]has, in some instances, contributed to a decline in rebalancing activity.
- Exporter FX hedging activity continues to be the largest contributor to corporate customer volume and is driven primarily by the level of the currency. The narrow trading range of the Canadian dollar coupled with the uncertain outlook for commodity prices has however diminished overall hedging activity from exporters.
- Canadian corporate and institutional investor FX exposure increased the most in U.S. dollars, with exposure increasing also to the Australian dollar for domestic institutional investors. In contrast to the prior year exposure to the Euro declined for domestic institutional investors. FX

[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, Credit Suisse, Deutsche Bank, HSBC Bank Canada, JP Morgan, Morgan Stanley, National Bank Financial Group, RBC Capital Markets, Scotia Capital, State Street Global Markets Canada, TD Securities, and UBS Bank .

[3] Over the survey period (June-August 2012), the CAD/USD range was 0.9650 to 1.0142. The average rate over the period was 0.9882.

[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 a customer's FX trade.

[5] Over the past year (July 2011 to June 2012), CAD/USD traded in a narrow 0.94-1.02 range for the majority of the period, with the average rate slightly above 0.99. In contrast for the period covering the prior survey (July 2010 to June 2011) CAD/USD followed a steadily appreciating trend from 0.94 in July 2010 to 1.05 in June 2011, with the average rate closer to parity. The relatively narrower trading range over the past year contributed to the decline in rebalancing activity.

exposure to Latin American and Asian emerging-market currencies increased for all Canadian accounts, while exposure to Eastern European currencies continued to decline.

- Foreign institutional investor exposure to Canadian dollar assets was generally unchanged from last year.
- Consistent with prior surveys, approximately half of currency exposures are hedged, with the majority of institutional accounts having a formal FX hedging policy. Roughly 60-70% of corporate accounts have a formal policy compared to 40-50% last year.
- The majority of institutional hedges are regularly extended (rolled) to maintain the hedge on an underlying longer-term investment, whereas most corporate hedges are used to hedge specific cash flows. The majority of institutional hedges are for terms of less than six months, with banks reporting that the recent narrow trading range for the Canadian dollar together with uncertainty over global economic developments has contributed to a further shift towards more shorter-dated hedging, with average hedging duration declining relative to last year. Increased credit costs were also cited as a reason for the decline in longer dated hedging[6].
- The impact of Canadian dollar movements on corporate revenues has varied by client type. Banks estimate that the impact of Canadian dollar movements on Canadian importers was neutral, with importers maintaining the levels of their hedging volumes and only slightly reducing the term of their FX hedges to continue to take advantage of the high absolute level of the Canadian dollar. The impact on Canadian exporters was reported as being moderately positive because the CAD has been weaker than in the prior year. Exporters somewhat increased their hedging and lengthened their hedge duration as the Canadian dollar weakened from the higher levels a year ago. Domestic institutional investors have on balance left their foreign currency investments unchanged, with no change in their overall hedging ratio for their foreign assets.
- Credit considerations, which emerged as a significant factor for banks in the 2011 survey, became more important over the past year. All banks have generally introduced a Credit Valuation Adjustment[7] (CVA) to their pricing, despite some concerns in the previous survey over its impact on pricing competitiveness. While last year most banks were beginning to introduce a CVA for transactions greater than two years , to comply with the upcoming Basel III regulatory requirements, most banks are now incorporating a CVA charge for much shorter time horizons, in some cases starting at three months.
- Banks estimated that the average 2012 and 2013 budgeted Canadian-dollar rates across their combined customer base are 0.9926 and 0.9882 respectively.[8]

A more detailed explanation of these themes is provided below.

**What is the FX exposure and hedging activity of bank clients?**

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[6] The broad usage of credit charges (Credit Valuation Adjustment) to foreign currency pricing contributed to a decline in longer dated hedging. These charges increase with the term of the transaction.

[7] Credit Valuation Adjustment is an incremental charge added to the transaction to cover the cost of counterparty credit risk.

[8] The CAD/USD estimates range from 0.9443 to 1.0351 for 2012 and 0.9332 to 1.0389 for 2013.

Domestic pension funds account for the largest share of institutional hedging activity, followed by investment and speculative accounts, while Canadian exporters on balance account for two-thirds of the corporate hedging flow.

Overall, for most corporate accounts, the U.S. dollar accounted for the largest rise in FX exposure, while exposures declined across a wide range of other currencies including the Euro, Japanese yen, Australian dollar, and British pound. Canadian-based institutional clients have generally left the cumulative percentage of their foreign currency exposure unchanged. However, the composition has changed and they have shifted the weights of their currency exposures, with the U.S. dollar and the Australian dollar increasing, and the Euro currency decreasing, reversing last year's weightings. For both corporate and institutional accounts exposure to Latin American and Asian emerging market currencies increased, while exposure to Eastern European currencies continued to decline, similar to last year. International exposure to Canadian assets by foreign pension funds and foreign speculative accounts is relatively unchanged over the period after increasing the prior year. However, sovereign wealth funds have maintained or continued to increase their Canadian exposure.

Both institutional and corporate clients continue to hedge approximately half of their currency exposure, which is little changed from the previous surveys. A significant proportion of institutional accounts have a formal FX hedging policy, similar to last year's responses. Corporate clients have over the last year, increased their implementation of a formal hedging policy with the proportion of those with formal policies rising to 60-70% from 40-50%. In addition, the hedging strategies of corporate clients have become more homogeneous over the past year as the Canadian dollar has held a narrow range. Exporters tend to hedge on any Canadian dollar weakness while importers tend to hedge when the Canadian dollar strengthens; creating offsetting flows around the trading range which coupled with expectations that the currency would remain steady have in turn contributed to keeping the Canadian dollar in its narrow range over the period. Both Canadian importers and exporters maintained their overall hedging ratios, but exporters increased the average duration of their hedges. Importers slightly decreased the maturity of their hedges over the year from the longer maturities seen last year, which was aimed at taking advantage of the stronger Canadian dollar. Banks suggested that importers were also utilizing some of their existing unmatured hedges from last year. [9]

On balance, the majority of hedging is for maturities of six months or less (the same as last year). For Canadian pension and investment funds, the majority of hedges are due to rebalancing which contributed to the substantially larger trading volume reported for institutional accounts. For corporate clients, only about one-third of hedges are rolled, since the majority of corporate hedging is done against specific cash flows. During the follow-up interviews, banks also noted that corporate hedging activity had significantly declined in recent weeks, and any hedging had been limited to very short durations. The narrow trading range of the currency and uncertainty over the global economic outlook were cited as reasons behind this decline in hedging. According to banks, many of their exporter clients

[9] Some importers over-hedged their immediate requirements in 2011 to take advantage and lock-in the high absolute level of the Canadian dollar.

were more reluctant to hedge, largely due to their uncertainty as to the outlook for commodity prices and the global economy which could impact their future cash flows.

Generally, the level of the Canadian dollar was the highest-ranked factor behind the shift in hedging activity for both corporate and institutional accounts. For corporate clients, underlying market volatility and the price level of an underlying commodity were also cited as factors impacting the hedging decision[10]. For institutional clients, and Canadian pension funds in particular, the second key factor behind a shift in hedging was month and quarter-end rebalancing activity. However, for Canadian investment funds and speculative accounts, as well as for foreign accounts, market volatility was the second most important factor behind a change in their hedging behaviour.

The use of FX options continues to decline and remains relatively low among all customer types. For exporters and importers, the narrow trading range of the currency has substantially reduced the impetus to use options to hedge. In addition, the decline in implied option volatility over the past year has decreased demand from Canadian institutional clients who previously utilized option structures to generate income by selling volatility.

There remains a divergence in the use of foreign currency fixes[11] by institutional and corporate customers. Similar to responses received last year, institutional accounts primarily use the London closing fix (11:00 ET). The corporate customer base is more focused on the Bank of Canada noon rate fix (12:00 ET) with over 50% of accounts using the fix, with most usage coming primarily from the oil and gas sector. A number of banks noted that there has been a shift away from using a single month-end fix by institutional clients to rebalance their portfolio and they are increasingly staggering their “month-end” hedging activity around the month-end date.

Most bank participants indicated that pricing has become more competitive over the past year, although the number of participants in customer banking panels has remained largely unchanged. Factors seen contributing to increased competitiveness included the lower level of volatility in the currency which resulted in narrower pricing margins. More competition from multi-bank pricing platforms was also cited as a factor behind the narrower margins. The use of electronic trading is increasing according to the banks, with the greatest penetration of trading platform use, including single and multi-bank platforms, by institutional accounts. However, the penetration rate among the corporate clients by these pricing platforms is also rising, with the use of the phone falling over the last year and the use of multi-bank platforms increasing. Institutional clients primarily use platforms that have the straight-through-processing capabilities that allow clients to distribute a single trade to multiple accounts.

Credit considerations became more important over the past year. In the 2011 survey, most banks were considering the introduction of a Credit Valuation Adjustment (CVA) for transactions greater than two

[10] In contrast, in the 2010 survey, the level of the underlying commodity asset appeared to be the key factor behind the shift in hedging activity for corporate clients and it was the second most important factor in the 2011 survey.

[11] A foreign currency fix refers to a foreign currency rate that is calculated at a specific point in time using transacted or quoted foreign currency rates, depending on the calculation methodology.

years, in anticipation of the upcoming regulatory requirement from Basel III.[12] This year, all banks have generally introduced a CVA charge, which is also being applied to much shorter duration transactions than last year, in some cases for transactions as short as three months. Banks noted that the widespread use of a CVA by banks no longer hampered competitiveness in most transactions. However, banks also noted that for longer term transactions (three years or longer), the CVA charge, the calculation of which varies by term and potentially by bank, is relatively large and may hamper competitiveness. Customers were also more focussed on the credit status of their counterparties, which influenced the composition of their banking panels. Customers were noted to selectively use their banks depending on their specific comparative advantage, either in specific products or currencies. International clients have also increasingly added Canadian banks to their banking panels due to their strong credit ratings. It was also noted that during times of market stress, there is a greater focus on counterparty (interbank) credit limits which could impact the pricing for longer dated forward transactions and contribute to increased illiquidity.

The potential impact from the pending financial market regulation of FX activity, including Dodd-Frank, remains a low to medium priority for Canadian corporate customers. It has had little impact thus far on clients' FX hedging decisions, given the uncertainty over the scope of any regulatory change and the uncertainty related to the timing of its implementation; while for Canadian pension funds and speculative accounts, these regulatory changes are a medium to high priority. Not surprisingly, the New York-based banks in the survey cited a higher level of concern amongst their customers as U.S regulation implementation deadlines are more immediate.

**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 positive, whereas the impact for Canadian importers has been neutral.

Survey participants were also asked to estimate the budgeted Canadian-dollar rate used by their clients for both 2012 and 2013 (see Tables 1 to 3). The average expectations correspond to the middle of the Canadian dollar's trading range over the past year. The range of average estimates of corporate, as well as institutional clients for the Canadian dollar has narrowed considerably relative to last year's survey, with a range for 2012 of 5 to 9 cents and for 2013 of 6 to 11 cents, reflecting the range-bound behaviour of the currency. [13]

The Canadian dollar is largely anticipated to remain little changed over the next year with banks noting that most accounts do not expect the Canadian dollar to trade significantly outside a 0.98-1.03 range. They noted that their customers felt little pressure to hedge due to expectations that the currency would remain steady, with clients choosing to wait for a more opportunistic level to hedge, within the anticipated range. As a result of that view, many corporate clients were choosing to cover exposures in the spot market, or hedge for less than one month.

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[12] Basel III has introduced the concept of a CVA into the capital calculation for counterparty credit risk.
[13] This contrasts with much wider expectations in 2011 of 10 to 14 cents for 2011 and 13 to 17 cents for 2012.

**Table 1:** Survey participants' average estimate of their clients' budgeted Canadian-dollar rate for 2012 and 2013 (**corporate** and **institutional**)*

| | 2012 | 2013 |
|---|---|---|
| **Average** | 0.9926 (1.0075) | 0.9882 (1.0119) |
| **High (Low)** | 1.0282 (0.9725) | 1.0315 (0.9694) |
| **Low(High)** | 0.9537 (1.0485) | 0.9436 (1.0598) |

*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*

| | 2012 | 2013 |
|---|---|---|
| **Average** | 0.9928 (1.0073) | 0.9886 (1.0116) |
| **High (Low)** | 1.0170 (0.9832) | 1.0196 (0.9807) |
| **Low(High)** | 0.9697 (1.0312) | 0.9613 (1.0403) |

*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*

| | 2012 | 2013 |
|---|---|---|
| **Average** | 0.9925(1.0076 ) | 0.9880 (1.0120) |
| **High (Low)** | 1.0351 (0.9661) | 1.0389 (0.9626) |
| **Low(High)** | 0.9443 (1.0590) | 0.9332 (1.0715) |

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

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