Summary of the 2013 Survey on Canadian Foreign Exchange Hedging[1]

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 2013 survey covers bank responses to FX activity of both corporate and institutional accounts that have Canadian-dollar hedging requirements. This summary incorporates the written survey responses collected in late May, as well as information gathered from bilateral meetings conducted in June.[3] These discussions provide a much broader view of the issues facing the market and complement the more quantitative nature of the questions.[4]

Some common themes emerged in part reflecting the composition of each bank's client base, both by region and by sector. Key themes from this year's survey included:

- Survey respondents felt that regulatory issues – which had been accorded only minimal attention in prior surveys – had become an important focus for their and their clients' FX activity.
- Many respondents indicated that, similar to prior surveys, the level and volatility of the Canadian dollar were the major factors determining hedging activity among their clients. Given the relative stability of the Canadian dollar's exchange rate, there had been no major changes in client hedging activity compared to last year's survey.
- With regard to the composition of hedging activity, institutional customer volume continues to account for the majority of client hedging activity; it remains largely driven by routine hedging and rebalancing activity. Exporter FX hedging activity continues to be the largest contributor to

[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 customer 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, 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 Bank .

[3] Over the survey period (May 15th –June 15th, 2013), the CAD/USD range was 0.9596 to 0.9864 with an average rate of 0.9731.

[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 for banks to distinguish the exact nature or purpose of a customer's FX trade.

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corporate customer volume and remains driven primarily by the level of the currency. Although on average there was no major shift in hedging activity, nonetheless exposures to individual currencies shifted at the margin for both corporate and institutional clients. This reflected changes in both business flow and hedging parameters for individual currencies.

- Banks estimated that the average 2013 and 2014 budgeted Canadian-dollar rates across their combined customer base are 0.9901 and 0.9853 respectively.[5]
- At the margin there was an increased use of derivatives for hedging, especially currency options. Survey respondents also noted a continued shift to the use of multi-bank dealing platforms, away from single-bank platforms and voice dealing.
- Credit considerations have maintained importance over the past year. All banks have generally continued to add a Credit Valuation Adjustment[6] (CVA) to their pricing, despite some concerns over its impact on their pricing competitiveness.

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

Regulation:

While there was a wide distribution of participants' responses to the impact from the financial market regulation on FX activity, overall it showed the biggest increase in interest relative to last year. Regulatory impact on FX activity remains a low to medium priority for Canadian corporate customers, however, it became a medium to high priority for Canadian pension funds and speculative accounts. The impact thus far on clients' FX hedging decisions has been mixed. Regulatory uncertainty and the high legal and compliance costs initially contributed to reduced volumes ahead of key implementation dates, but as more clients signed the required legal documentation, trading volumes recovered somewhat. Nonetheless, many survey respondents indicated that the ongoing uncertainty as to how the regulations would ultimately be interpreted and implemented, and the heavy compliance and information system requirements, were still absorbing an inordinate amount of management resources at both banks and their clients. This was felt to be, at the margin, still suppressing trading activity. This was particularly the case when dealing with entities the Dodd-Frank legislation defines as "U.S. persons"[7], and not surprisingly, the New York-based banks in the survey cited a higher level of concern and market impact amongst their customers especially since some aspects of U.S regulation had been implemented over the past year.

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[5] The CAD/USD estimates range from 0.9426 to 1.0293 for 2013 and 0.9251 to 1.0280 for 2014.

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

[7] For the most recent definition of "US Person", see http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf.

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 stability of the Canadian dollar through the 2013 survey period meant that there were no major changes in how clients managed their hedging programs. On average, both Canadian importers and exporters maintained their prior hedging ratios. However, as a result of the lower volatility, there was a tendency to decrease at the margin the average duration of their hedges (less need to "lock-in" to specific exchange rate levels). These same patterns were observed for institutional clients as well. On balance, the majority of hedging for both corporate and institutional clients remains for maturities of six months or less.

The composition of hedging activity:

Domestic pension funds account for the largest share of institutional hedging activity, followed by domestic investment funds and foreign speculative accounts, while Canadian exporters account for two-thirds of the corporate hedging flow. Although on average overall hedging ratios did not shift much during the survey period, there were nonetheless some shifts at the margin in clients' currency exposures.

- For most corporate accounts, the U.S. dollar accounted for the largest rise in FX exposure, followed by the Euro then Latin America and Asia ex-Japan. Corporate exposures declined the most for the Japanese yen and the British pound, followed by Central and Eastern European currencies.
- Generally, Canadian-based institutional clients have left their foreign currency exposure unchanged. However, at the margin U.S. dollar and Latin American currency exposure increased; exposure to the Japanese yen and Central and Eastern European currencies dropped. Changes in exposure to Asia ex-Japan currencies varied widely among different institutional clients, but in aggregate there appeared to be no change.

Canadian dollar expectations:

The impact of Canadian-dollar movements and its level on revenue was relatively neutral due to the range bound trading of the currency over the past year, although responses varied across client categories. Banks estimate that the impact of Canadian dollar movements on Canadian exporters has been neutral, whereas the impact on Canadian importers has been slightly positive.

Survey participants were also asked to estimate the budgeted Canadian-dollar rate used by their clients for both 2013 and 2014 (see Tables 1 to 3). The average expectations are slightly lower than the middle of the Canadian dollar's trading range over the past year, with institutional clients having the weakest expectations for the currency. Average estimates of corporate and institutional clients for the Canadian dollar are relatively unchanged from last year's survey. The range between the highest and the lowest estimates for 2013 was 5 to 9 cents and for 2014 it was 8 to 10 cents, reflecting the range-bound behaviour of

the currency.[8] The Canadian dollar is largely anticipated to trade within a 0.9500-1.0100 range (US dollars per Canadian dollar), a slightly lower range than last year.

Table 1: Survey participants' average estimate of their clients' budgeted Canadian-dollar rate for 2013 and 2014 (**corporate** and **institutional**)*

	2013	2014
Average	0.9901 (1.0100)	0.9853 (1.0149)
High (Low)	1.0267 (0.9740)	1.0253 (0.9754)
Low(High)	0.9540 (1.0482)	0.9325 (1.0724)
Range	7.27 (7.42)	9.28 (9.70)

*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 2013 and 2014*

	2013	2014
Average	0.9981 (1.0019)	0.9879 (1.0122)
High (Low)	1.0235 (0.9770)	1.0280 (0.9728)
Low(High)	0.9681 (1.0330)	0.9434 (1.0600)
Range	5.55 (5.60)	8.46 (8.72)

*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 2013 and 2014*

	2013	2014
Average	0.9832 (1.0171)	0.9833 (1.0170)
High (Low)	1.0293 (0.9715)	1.0234 (0.9771)
Low(High)	0.9426 (1.0609)	0.9251 (1.0810)
Range	8.67 (8.94)	9.83 (10.39)

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

[8] This compares to the range in 2012 of 5 to 9 cents for 2012 and 6 to 11 cents for 2013.

Changes in hedging tools and market structure:

The marginal increase in the use of FX options for FX hedging was attributed to: taking advantage of historically low implied volatility, demand for extra returns provided by selling options, greater pricing transparency and improved understanding of the underlying products.

According to the banks the use of electronic trading is increasing, 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 rising at a faster pace although from relatively lower levels, 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. Other factors cited behind increased use of electronic trading include higher price transparency, more competitive pricing, and ease of use.

Credit Valuation Adjustments (CVAs):

Credit considerations have maintained their importance over the past year. All banks surveyed have a charge for a CVA, which is now being applied to shorter duration transactions than last year (as short as three months for institutional clients). For corporate clients CVA is still mostly charged on transactions with duration of six months or more. However, there remains variation among banks as to the charges for CVAs.

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