RESEARCH REPORT

The Currency Risk Management Practices of Canadian Firms

Fluctuating exchange rates is a problem for trade-engaged businesses because it can result in unpredictable profit margins, says the results of EDC's Research Panel survey conducted in June. Three out of four respondents said they would accept lower profits to minimize risk. Most firms that manage foreign exchange risk are doing so to protect profit margins on export sales. In fact, 85% said protecting profit margins was their primary objective; followed by increasing the predictability of profits which was a key objective for 55% of respondents.

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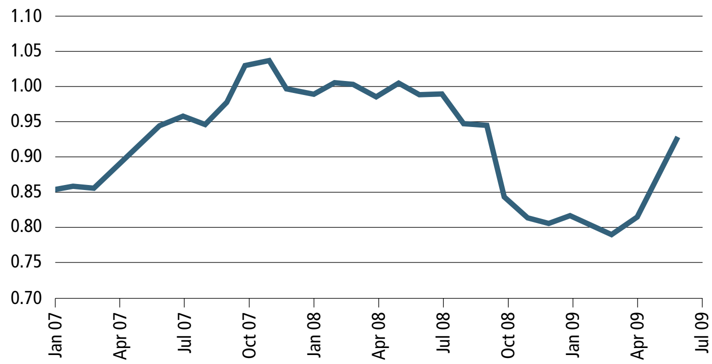
Currency Volatility is Back on the Radar

Figure 1: A New Round of CAD Volatility



Source: Bank of Canada

Canadian exporting firms are relatively risk adverse. The results of EDC's June Research Panel survey[1] indicate that three out of four respondents would accept lower profits to minimize risk.

Therefore it is not surprising that foreign exchange volatility has been shown to constrain Canadian trade activity. Two exporter surveys[2] cited exchange rate risk as the top constraint to export development.

It is expected that the recent volatility in the Canadian dollar against the USD (see chart 1) will bring currency management back to the forefront of Canadian business agendas. In fact, 67% of survey respondents said that their business is significantly impacted by currency volatility.

Exchange Rate Fluctuations Result in Unpredictable Profits

Fluctuating exchange rates is a problem for trade-engaged businesses because it can result in unpredictable profit margins. In industries where profits margins are tight, (e.g. wood products, automotive, textiles) short-term swings in the value of the Canadian dollar can easily lead to losses. Furthermore, profit volatility negatively impacts the firm's ability to access bank lending, since it increases risk for bankers analyzing a firm's income statements.

Most firms that managed foreign exchange risk are doing so to protect profit margins on export sales. In fact, 85% said this was their primary objective in managing foreign exchange risk; followed by increasing the predictability of profits which was a key objective for 55% of respondents.

[1] The survey was conducted through EDC's Research Panel which surveyed 260 exporters.Although results provide valuable insight into the needs attitudes and opinions of Canadian Exporters, the results cannot be deemed to be representative of a wider population than those who participated due to the sampling framework and the opt-in nature of the respondent base.

[2] *Fall 2008 EDC Export Monitor Survey* (which collects data from 800 Canadian exporters) and the *Canadian Manufacturers and Exporters 2008-2009 Management Issues Survey* (which collected data from 1,200 Canadian business leaders)

To Hedge or Not to Hedge

Overall 57% of firms performed at least one form of hedging activity. The remainder does not currently hedge against currency risk. Typically these firms lacked the knowledge and necessary resources to do so (see table 1).

Alternatively some firms elected not to hedge because they were risk tolerant. These firms feel; 1) the gains and losses will net each other out over time; 2) that they may miss out on favourable movements in the exchange rate by hedging against currency fluctuations.

Table 1: Reasons Why Companies aren't actively managing foreign exchange risk.

	% of Firms
We lack internal resources that can dedicate their time managing this risk	61
We lack internal knowledge on how to manage foreign exchange risk	57
The amounts we gain or lose to exchange rate fluctuations will net each other out	38
We may miss out on favourable movements in the exchange rate	32
We find foreign exchange products too expensive	21
We find foreign exchange products too speculative	17
Our bank restricts further borrowing if we purchase foreign exchange products	11

Large firms are more likely to actively manage currency risk than small firms. Just under half of small firms (sales <5mn) engaged in at least one activity to hedge currency risk (see table 2). This compared to 79% of mid sized firms (sales of 5-25mn) and 70% of large firms (sales >25mn).

Furthermore, mid to large firms typically use at least two different hedging activities compared to small firms that tend to use only one.

By industry, manufacturers and resource firms were more likely to hedge against currency risks compared to technology and service firms. This is likely due to the fact that these industries tend to have higher profit margins and can accept the risks associated with currency fluctuations more easily.

Overall studies have shown that companies of all size and in any industry can and should hedge at least some of their currency risk. Nonetheless the first step in currency risk management is for the firm to plan out its currency risk management approach.

Table 2: Does your company perform any of the following activities to manage foreign exchange risk?

	% of Firms
Increase expenses incurred in a foreign currency to match earnings in that currency	59
Change product prices to reflect changes in the value of the CAD dollar	50
Purchase foreign exchange forward contracts	41
Invoice foreign buyers in CAD dollars	25
Purchase currency options	17
Match the due date of receivables in a foreign currency to payables in that currency	17
Transfer or share foreign exchange risk through the commercial contract	14
Enter into foreign exchange swaps	13

Companies that have a Formal Currency Risk Management Approach achieve Greater Success in Managing Risks

Developing a formal currency risk management strategy is a critical step in managing a firm's currency exposure. The survey found that only 17% of respondents had policies in place for managing corporate foreign exchange risk. Consequently, companies that had objectives and policies in place were almost twice as likely to say they were successful at reaching their currency risk management objectives. Intuitively it makes sense that companies who are proactive in planning their risk management approach will have greater success mitigating the risks.

According to Treasury Strategies, there are five key steps[3] a firm should take to develop its currency risk management approach.

1. **Risk Definition –** Define the type of currency risk to be managed (ie: economic exposure, forecast exposure, translation exposure, transaction exposure)
2. **Measurement Methodology –** Create a model to measure the currency exposure to be managed
3. **Exposure Gathering –** Gather data and calculate exposure
4. **Covering Strategy –** Determine to what extent and how exposure will be hedged
5. **Hedge Execution –** Hedge exposure through trade execution and other techniques

The hedging technique your firms uses will depend on the type of currency risk the firm is exposed to, your firm's tolerance for risk, and the objectives of your currency risk management approach. For this reason it is important to develop a formal strategy before you select hedging techniques.

[3] *Five Steps to Successful Currency Risk Management,* Treasury Strategies, Inc. www.treasurystrategies.com,

How Firms Manage Currency Risk

There are two primary ways in which companies can protect themselves from currency risk. The first is through **natural hedging** and the other **is financial hedging**. Although, natural hedging is an important tactic for firms of all sizes, the survey found that small firms are particularily drawn to the use of natural hedging strategies. Natural hedging is when a company attempts to match revenues in a foreign currency with payments in that same foreign currency.

Mid to large size firms, on the other hand, were more likely to use financial products to hedge against currency risk (see table 3). Financial hedging involves the purchase of foreign exchange hedging products from banks or foreign exchange brokers. The instruments that are customarily used are: foreign exchange forward contracts, currency options and swaps.

Table 3: Top Hedging Activities Used by Size of Firm

	1st	2nd	3rd
(Sales <5mn)	Match expenses incurred in a foreign currency to earnings in that currency (25%) Natural Hedging	Change product prices to reflect changes in the value of the CAD dollar (23%)	Invoice foreign buyers in CAD dollars (14%)
(Sales 5-25mn)	Match expenses incurred in a foreign currency to earnings in that currency (55%) Natural Hedging	Purchase foreign exchange forward contracts (49%) Financial Hedging	Change product prices to reflect changes in the value of the CAD dollar (44%)
(Sales >25mn)	Purchase foreign exchange forward contracts (44%) Financial Hedging	Match expenses incurred in a foreign currency to earnings in that currency (38%) Natural Hedging	Purchase currency options (24%) Financial Hedging

Exporters Feel a Lack of Information and Resources is Hindering their Firms Success in Managing Currency Risk

Two thirds of firms admit their firm should improve how it manages currency risk. The survey found that lack of information and resources not only deters companies from actively managing currency risk, but it is also is cited as a key challenge for firms who are already managing foreign exchange risk (see table 4).

Table 4: What challenges does your firm face in managing its foreign exchange risk?

	% of Firms
Cannot dedicate as much time as we would like to in order to manage this risk	42%
Difficulty measuring our company's foreign exchange risk exposure	40%
Lack of information on how to manage foreign exchange risk	31%
Absence of clear corporate foreign exchange policies and guidelines	21%
Not a business priority	18%
Other, Please Specify	18%

External foreign exchange risk management experts can provide valuable information and advice on currency risk management techniques. Consultant can go so far as to help your firm develop a comprehensive currency risk management strategy.

The survey found that exactly half of firms approached an external party for information on managing foreign exchange risk. Of those firms, the majority approached their bankers for advice (see table 5).

Table 5: Which of the following parties has your company approached to obtain information on managing foreign exchange risk?

	% of Firms	% Satisfied	% Somewhat Satisfied	% Not Satisfied
Banker	72%	15%	73%	9%
Foreign Exchange Broker	40%	18%	67%	12%
Accountant	31%	15%	65%	12%
Export Development Canada	25%	44%	50%	3%
Foreign Exchange Consultant	18%	17%	74%	4%
Internal Experts	14%	16%	68%	5%
Management Consultant	12%	33%	67%	0%

EDC's Role in Supporting Canadian Exporters with Currency Risk Management

The survey asked respondents to select one product or service they would like EDC to offer. Very few firms wanted EDC to provide fee-based consulting services or financial products. Most respondents want EDC to provide value-added services such as information on currency management and seminars on how to manage foreign exchange risk (see table 6). Only 6% said they would like EDC to refer them to an external party. EDC has already developed a whitepaper[4] on managing this type of risk and as a result of your feedback EDC is developing a free webinar that will be made available late summer/early fall.

In sum, currency risk management can be a daunting task for exporters. However, there are numerous resources that can be leveraged to facilitate the learning process. EDC is committed to supporting the trade-related needs of Canadian exporters and will work toward establishing more resources in this area.

Table 6: If EDC were to provide one of the following services, which would you value most?

	% of Firms
Provide information on managing foreign exchange risk	50%
Organize seminars on foreign exchange risk management	26%
In my view there is no role for EDC in this area	7%
Identify external parties that specialize in foreign exchange risk management	6%
Provide fee-based consulting services on foreign exchange risk management	6%
Other	5%

[4] For more information on these products please see the EDC whitepaper titled "Managing Foreign Currency Risk". It can be found in the Newsletter section of EDC's Research Panel Portal.

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