The World of Currency Risk Management Solutions

Corpay

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Use our guide to understand and explore the factors that can make it advantageous to embrace a risk management strategy for foreign exchange. We provide you with perspective on how to develop a strategy, using a proven program with an efficient process.

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**As you're reading, please note that this white paper is not intended as trading, investment or business advice. This paper also doesn't provide an exhaustive analysis on foreign exchange. Foreign exchange regulations vary by jurisdiction.*

Introduction

The foreign exchange market can be a highly complex task for small-to-medium enterprises to navigate when conducting business overseas.s.

It can also be one of the most crucial tasks of the business. Developing an effective risk-management strategy can be as critical for those businesses as having a viable business model. Indeed, in many cases a forex risk management strategy can be an integral component of the business model itself.

Globalization has created unprecedented opportunities for companies – small, medium and large – to expand internationally. More companies are venturing into foreign markets, buying and selling goods in places long considered out of reach for all but the largest multinationals.

These international ventures often create opportunities for growth, but they can also expose companies to foreign exchange risk. In a world where currencies are volatile and their movements hard to predict, profits can be wiped out in the blink of an eye.

Through no fault of their own, many businesses don't know where to start or how to develop and execute a strategy for managing foreign exchange risk. They have neither the market intelligence, the connections to major market players, nor the trading expertise required to participate in the market effectively, at least not without direction.

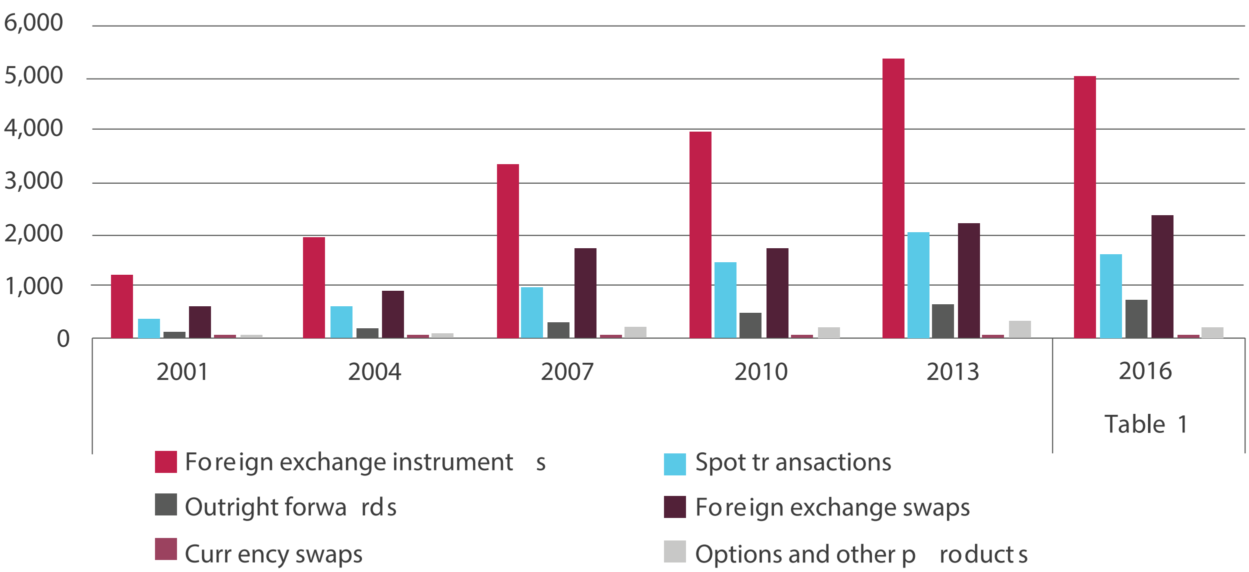
The purpose of this white paper is to explore the factors that make it beneficial to embrace a risk management strategy for foreign exchange, to offer some perspective on how to develop one, and explore Corpay's approach to risk management in foreign exchange.

The Foreign Exchange Market

The foreign exchange market is the largest financial market in the world. With a daily turnover estimated at about US$5 trillion, it dwarfs other asset classes such as equities and fixed income.

It's also become noticeably more volatile as the advent of globalization has increased the flow of money from one economy to another – and from one financial market to the next.

Forex Turnover



Source: Bank of International Settlements

Did you know?
The Canadian Dollar had the largest one day drop in markets in its history, in 1967.

Source: US Federal Reserve

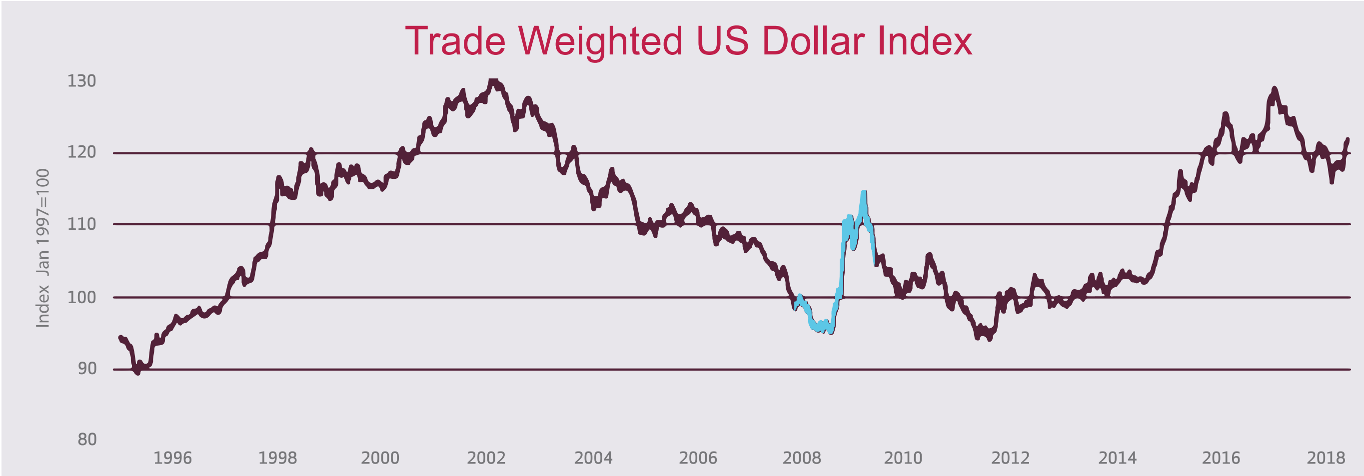
Shaded period indicates global financial crisis and recession

This flow increase is a key factor in why the trading range of the Canadian dollar in the last 18 years is essentially twice that of the 18 years before then.

Foreign exchange is also a relatively opaque market. Given its trans-national nature, it's lightly regulated in comparison with other financial markets. Price disclosure is less thorough than for exchange-traded assets, and liquidity in many currencies can fluctuate significantly, exacerbating the already high levels of volatility in the market.

Valuing currencies presents some unique difficulties, as well. The factors that impact currencies are usually broader and more complex than those affecting other assets such as equities. The valuation of a currency hinges to a large extent on an assessment of the strength of the economy it represents and the resulting trajectory of yields.

But buying a currency also means selling another – a feature that also distinguishes currencies from other assets. The valuation required is in an important sense a two-dimensional exercise; it must include some degree of understanding of the factors driving both the currencies involved.



Source: US Federal Reserve

Shaded period indicates global financial crisis and recession

Currencies are acutely sensitive to geopolitical developments and trends in the global economy as a whole, and often respond to them in counter-intuitive ways. The Canadian dollar suffered because it was perceived as a risk-sensitive currency during the global financial crisis and the subsequent European debt crisis. It lost about 30% of its value during the global crisis, even though the Canadian economy was one of the least affected of the advanced economies.

Even more counter-intuitive is the fact the US dollar rallied during that time, despite the fact the US was the epicenter of that crisis and its economy suffered a relatively severe recession as a result.

The choices that companies make about how to manage currency can shape their profitability in a material way. The positions they take are an intrinsic part of the functioning of their business, along with decisions about pricing, hiring and capital investments.

For that reason, deciding how to hedge foreign-exchange risk is generally not equivalent to making decisions about investments in other asset classes. Those decisions are important on their own account, but they are extrinsic to a business entity, not inextricably woven into their business model in the way that foreign-exchange positions usually are.

So, many businesses are confronted with a difficult dilemma: they have to develop a strategy for foreign-exchange risk but typically don't have the in-house capability to do so unaided.

Developing a Strategy: Corpay's Role

Because managing foreign-exchange exposure can be an integral part of a business's ongoing operations, it is paramount to take an approach that is strategic, flexible, and ongoing.

A business's hedging should be consistent with reducing its overall level of risk and shouldn't just transfer one form of risk for another. Hedging isn't a form of speculation, and it should be closely aligned to corporate cash flow.

Corpay is a bespoke provider of foreign currency trading, risk management and international payment services. We work with companies of all sizes and niches to help them execute day-to-day foreign currency transactions, as well as providing them with the tools they need to apply a unique risk management structure within their business. Typical goals of this structure are to mitigate their exposure, stabilize their cash flows, and protect their budgeted rates. We aim to deliver value by working collaboratively with our customers to identify opportunities and meet their desired business and financial goals.

As part of our process, Corpay aims to work in a consultative capacity; evaluating, managing and hedging risks in a coordinated and active way.

The role Corpay plays in helping organizations successfully manage currency risk varies depending on each individual customer's needs, but the following section provides a broad outline of how it works.

1. Identify the nature of your foreign exchange exposures
2. Develop a clear and simple risk management policy
3. Specify your budgeted rates and goals, and review as part of your financial planning process
4. Select tools and products that best achieve your overall goals
5. Execute your strategy
6. Evaluate your results and adjust your strategy accordingly

The overall approach of a strategy and the products deployed in any given situation are determined by a mix of both the budgetary parameters of what a company needs to achieve and the overall market environment. A strategy may include currency market derivatives, when appropriate. There are three types of instruments are available for hedging currency risk.

- **Spot trades**
  Spot trades leave companies fully exposed to currency moves in either direction.

- **Forwards**
  Forward (or swap)-based instruments fix an exchange rate today for delivery in the future. The cost of forwards is derived from the difference in interest rates between the two currencies being traded rather than forecasts of exchange-rate movements, and as a result can be some of the most cost-efficient and flexible financial tools in managing currency risk.

- **Options**
  Options are specific tools that are deployed depending on the situation.

  For instance, if a business is concerned about the downside risk to the US dollar or feels that the market has hit a near-term high, it could deploy a forward-like strategy to maximize the efficiency of its protection.

  Another example: Let's say a business is in a market with a risk of sustained US dollar strength, that business might make use of a zero-cost option strategy, such as a collar, that provides forward-like protection to the downside risk while still providing at least some ability to participate in a favorable markets.

Process

Surviving and thriving in today's global economy isn't a matter of eliminating every exposure. Instead, managing risk in a disciplined and sophisticated manner will put the foundation in place for sustainable growth.

1 Analysis

Our experts will work with you to identify the business activities that give rise to currency exposures, measure exchange rate sensitivity, and map out the processes and strategies that are currently in place.

2 Strategy

We will assist you in engaging with stakeholders across the organization, defining core objectives, and assessing risk tolerances. We will then work to design a simple, stable, and sustainable strategy that specifies instrument types, trading limits, designated currencies and other parameters that reduce risk and protect your operating margins.

3 Execution

Incorporating market analysis, technological tools, and deep experience, Corpay Cross-Border will use sophisticated tactics to optimize trade execution – mitigating the effects of short- term volatility while protecting against potentially devastating long-term moves.

Forex risk management can be a highly critical part of the business operations of firms with significant exposure to the market. For that reason, risk management strategies cannot be an external, “bolt-on” supplement to a corporation’s business model.

Corpay assists customers in implementing individually tailored – or “bespoke” – solutions. The hedging needs of a project management company that’s bidding on a major project at an offshore locale are entirely different from those of an investment fund manager seeking to mitigate the foreign exchange risk of an internationally diversified portfolio.

Risk management needs can also vary across time for any given company as transactions vary and projects evolve. Consider the example of a film company while developing an overseas project that hasn’t yet received the green light for production. In that case, currency risk can – and likely should – be hedged, but only according to the estimated likelihood of the project going ahead.

Corpay doesn’t look at hedging in a vacuum. Rather, we aim to incorporate both your targeted budgets and goals, as well as the risks and opportunities inherent to each strategy. This is to ensure you are setting yourself up for the best possible business results over the long term.

Of course, it’s impossible to forecast market movements in the long term, but we can certainly help you to identify probabilities and manage risks on a dynamic basis. Ultimately, Corpay’s aim is to take on much of the work in terms of monitoring the market for trading opportunities, alerting its clients to market news, price action, and risks and rewards that we see developing, both actively and proactively.

We can also enable you to employ a variety of different market order types that will allow you to capitalize upon short-term volatility to get the most out of the currencies you trade.

These order types can usually all be deployed across spot, forward and option trades, thereby improving the efficiency of trade execution regardless of trade type.

Around the world, global currency markets provide the opportunity to trade 24 hours a day, seven days a week. Tapping into that availability, Corpay’s market orders can provide its clients with access to some foreign currency markets outside of local trading hours.

The global network of Corpay’s locations can also assist you and your corporate subsidiaries in several time zones and provides customers with the support and information they require to make informed decisions when managing their foreign exchange requirements.

A Currency Risk Management Case Study

Authentic T-Shirt Company/SanMar Canada

The Authentic T-Shirt Company/SanMar Canada (ATC) is a wholesale distributor to the imprintable apparel industry – headquartered in Vancouver, BC. ATC has been in business since 1989.

ATC provides a variety of apparel products to screen printers, embroiderers, and promotional groups to customize items for organizations of all sizes, from little league teams to Fortune 500 companies. ATC products are globally manufactured, then marketed and sold throughout Canada.

Over the years, ATC cultivated global touchpoints throughout their supply chain and operations, which meant they had a need to hedge their purchases in order to protect budgeted rates and limit FX losses.

ATC was looking for support in structuring their FX hedging strategy and optimizing their market position, as well as identifying and managing increasingly complex currency exposures. To meet these various needs, ATC has, since 2013, partnered with Corpay Global Payments to devise a hedging strategy. The strategy effectively helped ATC meet all its overall corporate goals.

What process did Corpay follow to assist ATC with its hedging strategy? Corpay began by identifying the nature and degree of ATC's FX exposure through the analysis of financial statements and cash flow projections, in order to align proposed solutions with ATC's organizational needs.

From this analysis, Corpay recommended a staggered and opportunistic market entry to first obtain protection to lock in profit margins, and then to mitigate risk through the evaluation of each solution at execution to minimize transaction costs. To achieve this more favorable risk/reward ratio, Corpay and ATC implemented a dynamic hedging strategy including the following solutions.

The approach ATC adopted on Corpay's suggestion allowed ATC to manage their liquidity and solvency. It also protected ATC from the risk of price increase caused by a hike in the value of the currencies that ATC's inputs are priced in. The approach also gave ATC the opportunity to profit from any decline in those currencies, which was ideal for accomplishing ATC's corporate goals.

This strategy enabled ATC to take advantage of favorable market movements, enhancing efficiency and flexibility, with minimal risk. Together, this diversified portfolio strategy and the ability to add to the hedged positions throughout the year has ensured that market-to-market performance of ATC's hedges are materially more favorable than in previous years.

Are you ready to embark on your hedging program?

Within this guide we have taken you through some of the key aspects of hedging. Foreign exchange hedging carries risks with it and we recommend speaking with a specialist or seeking professional advice when undertaking any hedging strategy.

If you would like a free hedging consultation please contact one of our team by visiting us.Corpay.com/connect or email us at connect@Corpay.com.

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1 "Corpay" in this document refers to one or more of the following legal entities (all of which use the trade name Corpay): Cambridge Mercantile (Australia) Pty. Ltd.; Cambridge Mercantile Corp.; AFEX Offshore Ltd.; Associated Foreign Exchange (Singapore) Pte. Ltd.; and Cambridge Mercantile Corp. (U.S.A.).