Creating a foreign exchange risk management policy

Article summary

You are looking to draft a policy to help govern your management of foreign exchange risk and need some guidance as to what to include in the policy.

Some key areas to consider include:

What is your risk appetite/tolerance to risk?

What governance structure is appropriate for your organization?

What sorts of internal controls should you give consideration to?

This article, prepared by the Treasury and Capital Markets Committee of FEI Canada's Policy Forum, provides a number of questions to help prompt and assist you in developing a comprehensive foreign exchange risk management policy.

Risk appetite/tolerance to risk

1. What is the objective of the policy?

   - Mitigate short-term exchange impact (i.e.6 months, 12 months, 18 months) from sales or purchases in foreign currencies?
   - Give certainty to exchange rate impact on purchasing and/or sales and short term cash flows in home currencies?
   - Neutralize balance sheet impact on working capital and long-term capital (including debt)?

2. Is achieving hedge accounting a concern? Make sure to contact your auditor.

3. How does the hedging policy fit in with other policies and processes the company has to mitigate exchange impact?

   For example:
   - Short-term hedging policy – use foreign exchange contacts
   - Mid-term – adjust pricing to compensate for exchange movements.
   - Longer term – moving to alternative markets/currencies

Other strategies to manage foreign exchange risk:

- Diversifying the currencies and not being over-exposed to any single foreign currency
- Respond to exchange rate volatility by adjusting selling prices where possible;
- Borrowing in the foreign currencies,
- Entering into longer term contractual arrangements with customers to deal with currency fluctuation, where possible.
- Corporate entities operating/funding in foreign economic zones for foreign exchange risk neutralization

4. What is the target coverage? What do other companies in your industry do? What is your tolerance to risk? Is there a minimum or a range. For example, a rolling policy of up to 75% of expected net foreign currency inflows from future sales in each of the next 4 quarters for the major currencies in which a company does business.

5. How is mark to market risk and its impact on liquidity considered?

6. What types of contracts are allowed to be used and what types are prohibited. For example - plain vanilla forwards are within policy and purchased options are not.

7. Counterparty risk – what is the policy regarding financial institutions that can counterparties? I.e. Recognized banks that have sound credit ratings and an established business in derivatives (Canadian Schedule A Banks or similar from other countries). How often will this be reviewed?

Governance

8. How often will the policy be updated? To keep up with changes in the business it most likely should be updated once a year.

9. Who is required to review and approve the policy? Who is the owner of the policy, what role doe s the board play?

10. Who is are responsible to ensure compliance with the policy? CEO and CFO?

Controls

11. What are the procedures to get a hedging contract approved?

   a. Prepare the risk management strategy
      a. An individual document which addresses which specific risk the group of requests is to address, acceptable approaches to managing the risk, including risk products to be employed.

      b. Details: acceptable products, timeliness of action, implementation, documentation, key thresholds controls and reporting

      c. Usually signed by, the owner of the risk policy

   b. *Preparation of request* – how often are requests expected to be made? I.e. will the expectation be that once a contract rolls off a new one will be entered into? What sort of documentation is required to be submitted with a request? Forecast transactions and percentage to be hedged?

   c. *Pricing of contracts* – what is the policy re obtaining competitive pricing?

   d. *Approval of contracts* – Who can enter into contracts and who approves them?

12. Reporting/controls
   - How often will net positions be reported to senior management/the board?
   - What context will be reported when requesting approval to enter into hedge contracts? I.e. Forecasts of future FX transactions during the period contract cover?
   - How often will mark to market exposure on the outstanding contracts and its potential impact on liquidity be reported to senior management? Weekly? To the board? Quarterly?
   - Will third party calculations of mark to market exposure be obtained?

13. Training – does the person entering into the contracts have appropriate the appropriate background and training?

14. Timing – how often will contracts/positions be updated? This will most likely depend on the business?