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# Guideline

**Subject:** **Standards of Sound Business and Financial Practices -- Foreign Exchange Risk Management**

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## A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place and apply within its foreign exchange risk management program. It also defines the minimum criteria each company should use to prudently manage and control its exposure to foreign exchange risk.

Foreign exchange risk management must be conducted in the context of a comprehensive business plan. Although this guideline focuses on the responsibility of a company for managing foreign exchange risk, it is not meant to imply that foreign exchange risk management can be conducted in isolation from other risks or asset/liability management considerations, such as the paramount need to maintain adequate liquidity.

Multinational companies, in order to remain absolutely currency risk-neutral, would have to hold assets of a value in each country's currency sufficient to cover not only its debts and liabilities expressed in that country's currency but also its capital/surplus needs in that country's currency. To hold all surpluses for foreign operations in the parent company's currency could constitute the assumption of a very aggressive foreign exchange position if the foreign/home business ratio were to be significant. Foreign insurance regulation and common prudence combine to make it the norm that each country's debts and liabilities be covered by assets of a value equal thereto in its own currency. The covering of any country's surplus in another currency is generally what creates foreign exchange risk for most multinational insurers.

## B. DEFINITION

Foreign exchange risk is the exposure of a company's financial strength to the potential impact of movements in foreign exchange rates. The risk is that adverse fluctuations in exchange rates may result in a reduction in measures of financial strength.



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Foreign exchange risk arises from two factors: currency mismatches between (i) a company's assets and its liabilities (both on- and off-balance sheet), inclusive of capital, and (ii) currency cash flow mismatches. Such risk continues until the foreign exchange position is covered. This risk may arise from a variety of sources such as foreign currency transactions and services, foreign exchange trading, investments denominated in foreign currencies and investments in foreign subsidiaries. The amount at risk is a function of the magnitude of potential exchange rate changes and the size and duration of the foreign currency exposure.

## C. FOREIGN EXCHANGE RISK MANAGEMENT PROGRAM

Managing foreign exchange risk is a fundamental component in the safe and sound management of companies that have exposures in foreign currencies. It involves prudently managing foreign currency positions in order to control, within set parameters, the impact of changes in exchange rates on the financial position of the company. The frequency and direction of rate changes, the extent of the foreign currency exposure and the ability of counterparties to honour their obligations to the company are significant factors in foreign exchange risk management.

Although the particulars of foreign exchange risk management will differ among companies depending upon the nature and complexity of their foreign exchange activities, a comprehensive foreign exchange risk management program requires:

- establishing and implementing sound and prudent foreign exchange risk management policies; and
- developing and implementing appropriate and effective foreign exchange risk management and control procedures.

### Foreign Exchange Risk Management Policies

Well-articulated policies, setting forth the objectives of the company's foreign exchange risk management strategy and the parameters within which this strategy is to be controlled, are the focal point of effective and prudent foreign exchange risk management. These policies need to include:

- a statement of risk principles and objectives governing the extent to which the company is willing to assume foreign exchange risk;
- explicit and prudent limits on the company's exposure to foreign exchange risk; and
- clearly defined levels of delegation of trading authorities.

### i) Statement of Foreign Exchange Risk Principles and Objectives

Before foreign exchange risk limits and management controls can be set, it is necessary for a company to decide the objectives of its foreign exchange risk management program and in particular its willingness to assume risk.

The tolerance of each company to assume foreign exchange risk will vary with the extent of other risks (e.g., liquidity, credit risk, interest rate risk, investment risk) and the company's ability to absorb potential losses. As with other aspects of financial management, a trade-off exists between risk and return. Although the avoidance of foreign currency exposure or the hedging of such exposure may eliminate foreign exchange risk, such a position may not be desirable for other sound business reasons. Accordingly, the objective of foreign exchange risk management need not necessarily be the complete elimination of exposure to changes in exchange rates. Rather, it should be to manage the impact of exchange rate changes within self-imposed limits after careful consideration of a range of possible foreign exchange rate environments.

### ii) Foreign Exchange Risk Limits

Each company needs to establish explicit and prudent foreign exchange risk limits, and ensure that the level of its foreign exchange risk exposure does not exceed these limits. Where applicable, these limits need to cover:

- whether the company makes markets in foreign exchange or is committed to be an end-user only;
- the currencies in which the company is permitted to incur exposure;
- the level of foreign currency exposure that the company, if it is an active market maker, is prepared to assume including:
    - overnight and forward limits on each currency or pairing of currencies in which the company is authorized to have exposure; and
    - aggregate overnight and forward limits on all currencies in which the company is authorized to have exposure; and
    - the level of foreign currency exposure that the company, if it is committed to be an end-user only, is prepared to assume, including the maximum value of each country's surplus that may be held in a foreign currency and specifying which currency (or currencies). These limits are to be reported at least annually.

Foreign exchange risk limits need to be set within a company's overall risk profile, which reflects factors such as its capital adequacy, liquidity, credit quality, investment risk and interest rate risk. Foreign exchange positions should be managed within a company's ability to quickly cover such positions if necessary. Moreover, foreign exchange risk limits need to be reassessed on a regular basis to reflect potential changes in exchange rate volatility, the company's overall risk philosophy and risk profile.

Authorized currencies will normally include currencies in which the company may be called on to settle foreign exchange transactions. These are predominantly the currencies in which the company conducts its business.

Limits on a company's foreign exchange exposure should reflect both the specific foreign currency exposures that arise from daily foreign currency dealing or trading activities (transactional positions) and those exposures that arise from a company's overall asset/liability infrastructure, both on- and off-balance sheet (structural or translational positions). The establishment of aggregate foreign exchange limits that reflect both foreign currency dealing and structural positions helps to ensure that the size and composition of a structural position and a foreign currency trading position are appropriately and prudently managed and controlled and do not undermine a company's overall foreign exchange exposure.

Usually, risk limits are established in terms of a relationship between the foreign exchange position and earnings or capital, or in terms of foreign exchange volume, such as total dollars or numbers of transactions.

Except in situations where a company uses the clearing and settlement services of a central or common clearing organization that also serves as a guarantor for all outstanding contracts, the policies of companies having foreign currency trading operations also need to contain settlement limits for each counterparty. Although the overall assessment of foreign exchange counterparties is an integral component of any foreign exchange operation, this may be conducted by a company's credit risk management function, thus obviating the need for separate counterparty assessment within the company's foreign exchange operations.

### iii) Delegation of Authority

Clearly defined levels of delegated authority help to ensure that a company's foreign exchange positions do not exceed the limits established under its foreign exchange risk management policies. Authorities may be absolute, incremental or a combination thereof, and may also be individual, pooled, or shared within a committee.

The delegation of authority needs to be clearly documented, and must include:

- the absolute and/or incremental authority being delegated;
- the units, individuals, positions or committees to whom authority is being delegated;
- the ability of recipients to further delegate authority; and
- the restrictions, if any, placed on the use of delegated authority.

The extent to which authority is delegated will vary among companies according to a number of factors including:

- the company's foreign exchange risk philosophy;
- the size and nature of a company's foreign exchange operations; and
- the experience and ability of the individuals responsible for carrying out the foreign exchange risk management activities.

**Foreign Exchange Risk Management and Control Procedures**

Each company engaged in foreign exchange activities is responsible for developing, implementing and overseeing procedures to manage and control foreign exchange risk in accordance with its foreign exchange risk management policies. These procedures must be of a level of sophistication commensurate with the size, frequency and complexity of the company's foreign exchange activities.

Foreign exchange risk management procedures need to include:

- accounting and management information systems to measure and monitor foreign exchange positions, foreign exchange risk and foreign exchange gains or losses;
- controls governing the management of foreign currency activities; and
- independent audits.

**Measurement of Foreign Exchange Risk**

Managing foreign exchange risk requires a clear understanding of the amount at risk and the impact of changes in exchange rates on this foreign currency exposure. To make these determinations, sufficient information must be readily available to permit appropriate action to be taken within acceptable, often very short, time periods.

It is only through the accurate and timely recording and reporting of information on exchange transactions and currency transfers that foreign currency exposure can be measured and foreign exchange risk controlled. Accordingly, each company engaged in foreign exchange activities needs to have an effective accounting and management information system in place that accurately and frequently records and measures:

- its foreign exchange exposure; and
- the impact of potential exchange rate changes on the company.

Each company should have in place monitoring and reporting techniques that measure:

- the net overnight and forward positions in each currency or pairing of currencies in which the company is authorized to have exposure;
- the aggregate net overnight and forward positions in all currencies; and
- transactional and translational gains and losses relating to trading and structural foreign exchange activities and exposures.

## ii) Control of Foreign Exchange Activities

Controls over foreign exchange activities provide safeguards to protect a company from potential losses by ensuring that unauthorized exposure does not occur and that foreign exchange activities are conducted according to the policies and procedures of the company. Control over the foreign exchange function ensures that the company is not exposing itself to a risk resulting from an improper or uncontrolled foreign exchange strategy.

Although the controls over foreign exchange activities will vary among companies depending upon the nature and extent of their foreign exchange activities, the key elements of any foreign exchange control program are well-defined procedures governing:

- organizational controls to ensure that there exists a clear and effective segregation of duties between those persons who:
  - initiate foreign exchange transactions; and
  - are responsible for operational functions such as arranging prompt and accurate settlement, and timely exchanging and reconciliation of confirmations, or account for foreign exchange activities;
- procedural controls to ensure that:
  - transactions are fully recorded in the records and accounts of the company;
  - transactions are correctly settled; and
  - unauthorized dealing is promptly identified and reported to management; and
- controls to ensure that foreign exchange activities are monitored frequently against the company's foreign exchange risk, counterparty and other limits and that excesses are reported.

Moreover, each company needs to ensure that employees conducting foreign exchange trading activities on behalf of the company do so within a written code of conduct governing foreign exchange dealing. Such a code of conduct should include guidance respecting trading with related parties and transactions in which potential conflicts of interest exist. These should include trading with affiliated entities, personal foreign exchange trading activities of foreign exchange traders, and foreign exchange trading relationships with foreign exchange and money market brokers with whom the company deals. Each company should ensure that these guidelines are periodically reviewed with all foreign exchange traders.

The use of hedging techniques is one means of managing and controlling foreign exchange risk. In this regard, many different financial instruments can be used for hedging purposes; the most commonly used, however, are derivative instruments. Examples include forward foreign exchange contracts, foreign currency futures contracts, foreign currency options, and foreign currency swaps.

Generally, few companies will need to use the full range of hedging techniques or instruments. Each company should consider which ones are appropriate for the nature and extent of its foreign exchange risk activities, the skills and experience of management, and the capacity of foreign exchange rate risk reporting and control systems.

Financial instruments used for hedging are not distinguishable in form from instruments that may be used to take risk positions. Before using hedging products, companies must ensure that they understand the hedging technique and that they are satisfied that the instrument meets their specific hedging needs in a cost-effective manner.

Further, the effectiveness of hedging activities should be assessed not only on the basis of the technical attributes of individual transactions, but also in the context of the overall risk exposure of the company resulting from a potential change in asset/liability mix and other risk exposures such as credit, interest rate and position risk.

In this context, hedging activities need to take place within the framework of a clear hedging strategy, the implications of which are well understood by the company under varying market scenarios. In particular, the objectives and limitations of using hedging products should be uniformly understood, so as to ensure that hedging strategies result in an effective hedge of an exposure rather than the unintentional assumption of additional or alternate forms of risk.

It should be noted that foreign exchange swaps involve the replacement of foreign exchange risk by credit risk (the risk that the counterparty to the swap may be unable to fulfil its obligations). It is important that the company consider the extent to which credit risk in the company's overall operations could impact the company as a whole.

Companies that begin to make use of derivatives as limited end-users and companies that commence or expand dealing or active position-taking must have the appropriate policies and procedures in place as well as the capability to implement them.

The process of risk management for derivatives activities should be integrated into the company's overall risk management system to the fullest extent possible, using a conceptual framework common to the company's other activities.

Companies should base their derivatives policies and procedures on two guidelines issued by OSFI, and any subsequent amendments to those guidelines (i.e., the Derivatives Best Practices Guideline and the Guideline on Derivatives Disclosure).

### iii) Independent Audits

Independent audits are a key element in managing and controlling a company's foreign exchange risk management program. Each company should use them to ensure compliance with, and the integrity of, the foreign exchange policies and procedures. Independent audits should, over a reasonable period of time, test the company's foreign exchange risk management activities in order to:

- ensure foreign exchange management policies and procedures are being adhered to;

- ensure effective management controls over foreign exchange positions;

- verify the adequacy and accuracy of management information reports regarding the company's foreign exchange risk management activities;

- ensure that foreign exchange hedging activities are consistent with the company's foreign exchange risk management policies, strategies and procedures; and

- ensure that personnel involved in foreign exchange risk management are provided with accurate and complete information about the company's foreign exchange risk policies and risk limits and have the expertise required to make effective decisions consistent with the foreign exchange risk management policies.

Assessments of the foreign exchange risk operations should be presented to the company's board of directors on a timely basis for review.

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