Foreign Exchange Services

Economic Development Committee for the
Prince William County Chamber of Commerce

Hedging FX Risk

M&T Bank Treasury Capital Markets

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Foreign Exchange Services

Why most every company today needs them

- Foreign Exchange ("FX") transactions allow clients to find new markets and import or export more competitively in the increasingly global marketplace

- FX hedging products help clients effectively manage the FX market risk that is always present when the invoicing and payment dates of foreign transactions are separated by time

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Foreign Exchange Rate Risk Management Products

- **Spot Trades or Wire Transfers**, currency trades for immediate wire delivery *(Two business days value except for Canadian dollar which is next business day value)*

- **Forward Contract Hedge**, currency hedge that eliminates exchange-rate risk by locking-in today's exchange rate for the purchase or sale of currency at some specific maturity date in the future

- **Forward Contract Hedge with a Maturity Window**, adds flexibility to forward contracts by allowing for a range of maturity dates

- **Option Hedging Strategies**- creates hedges that allow for regaining some or all of the opportunity costs associated with Forward Contracts, usually has up-front premium costs

- **Currency Swaps**- simultaneously buying and selling foreign currency at pre-specified exchange rates, where the maturities of the two contracts are separated in time.

- **Foreign Currency Loans**

- Using a **Portfolio Approach** of hedging strategies often provides a better balance

- **Stop Loss and Stop Profit Orders** protect clients in a 24 hour traded market

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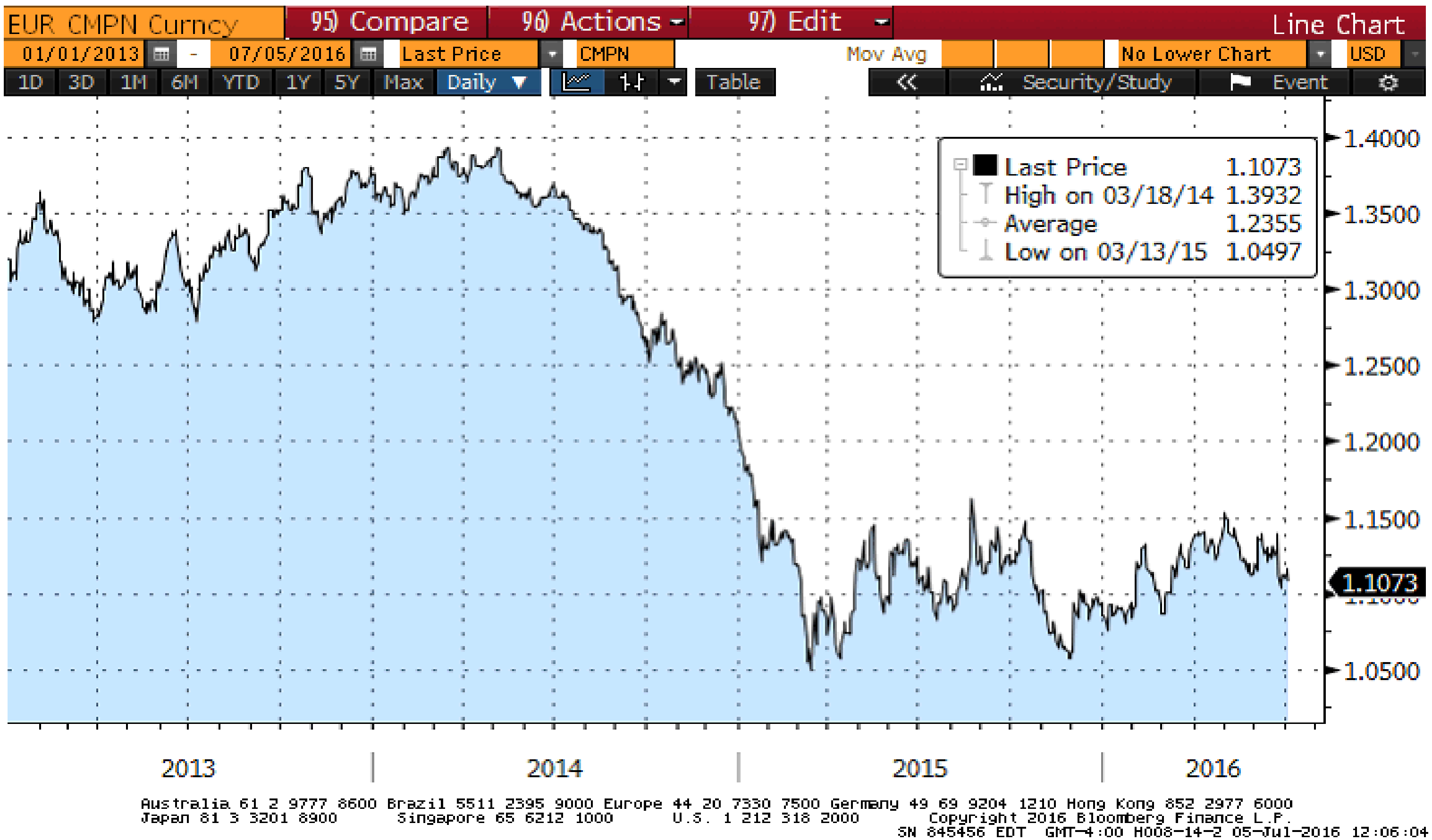
Foreign Exchange Market Risk Explained

Gains/losses from currency market movements are ever present

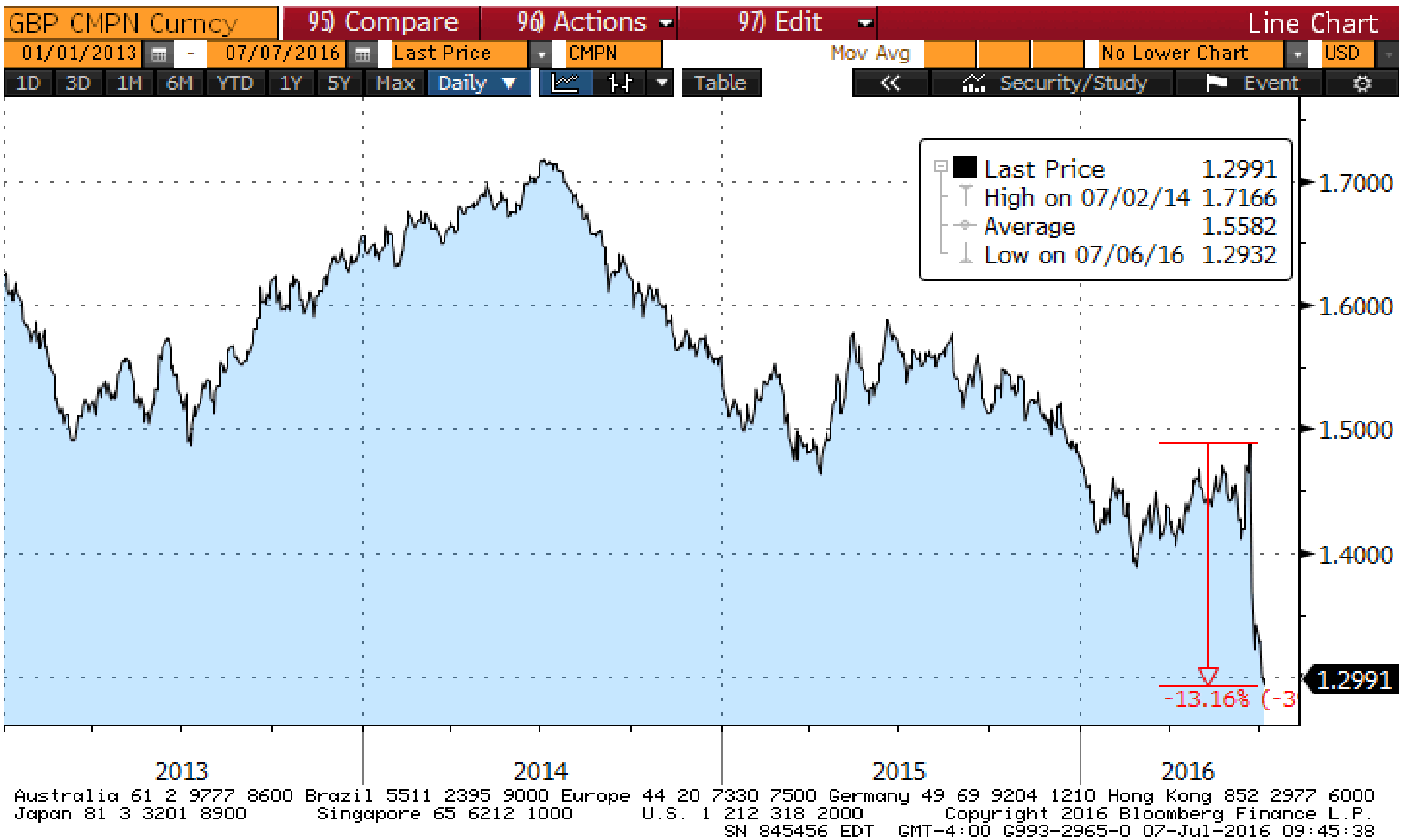
Euro / US dollar Exchange Rate – Quoted as US dollar amount per 1 Euro (EUR)



Foreign Exchange Market Risk Explained

Gains/losses from currency market movements are ever present

GBP / US dollar Exchange Rate – Quoted as US dollar amount per 1 Pound (GBP)



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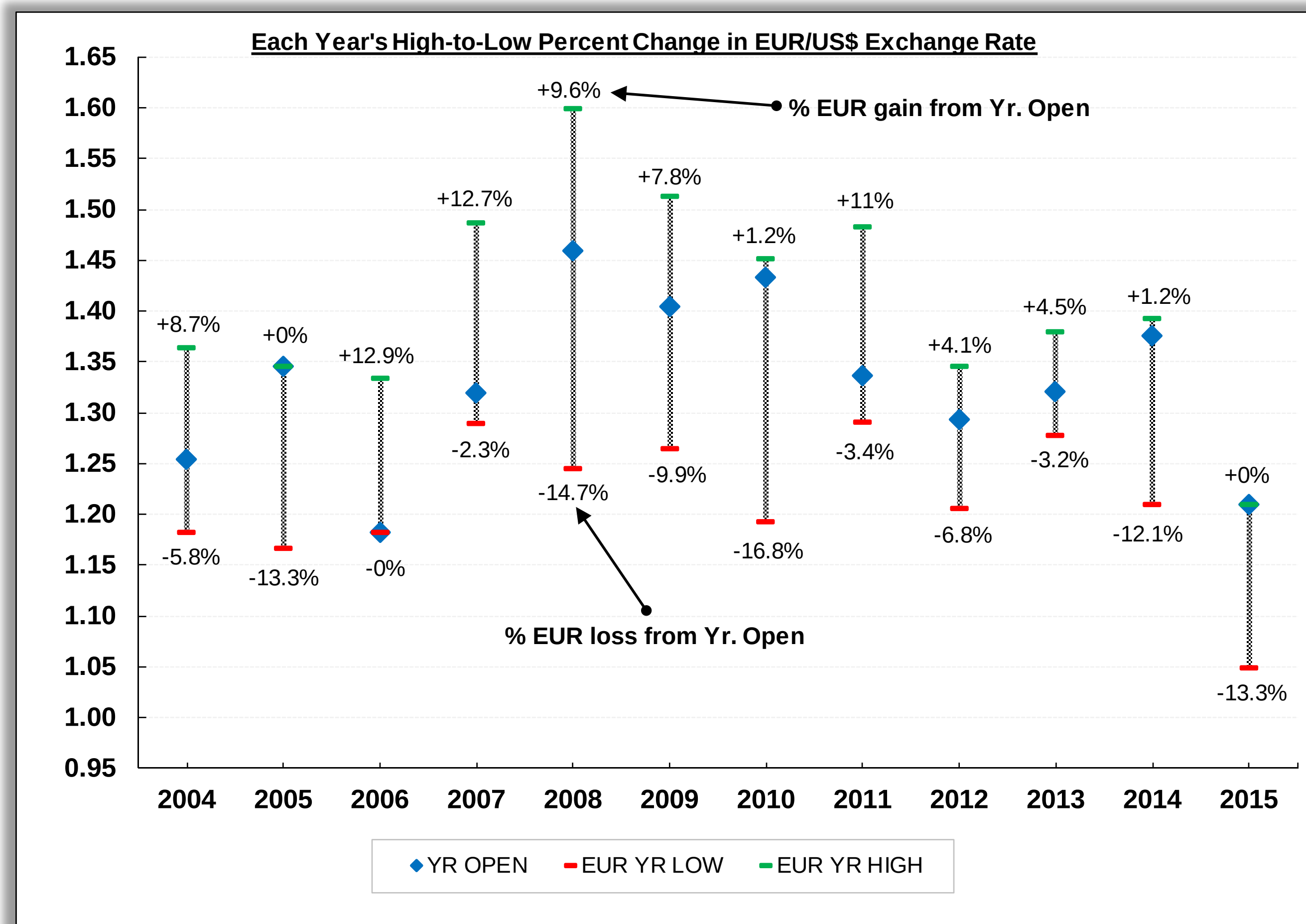
Currency Rate Risk Illustrated

Euro / US$ Yearly Open Rate, High & Low and Percent Changes



Over the past twelve years, the euro has moved- from its yearly high to its yearly low- an average of 14.6% each year; with the largest change being 24.2% in 2008

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US Dollar Denominated Importing and Exporting

How companies can be more competitive

Companies that export, but believe they avoid FX risk by requiring US dollar payment, are just transferring that risk to their competitiveness

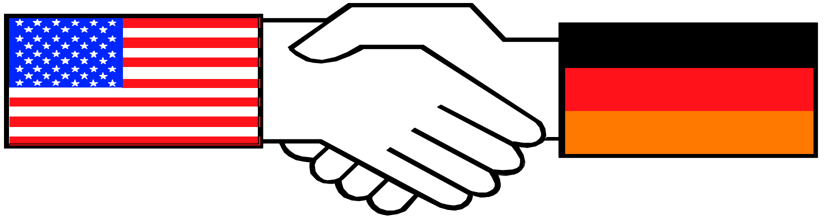
US exporters now run the FX risk of how much the US dollar will cost them over time. As the US dollar appreciates, these foreign customers will look for other sources of product priced in their home currency, or will demand price reductions from the US exporter

<u>Companies gain a competitive advantage by accepting foreign currency for their exports, then use FX hedging products to guarantee the final US dollar price earned– which both achieves the original goal, and satisfies their foreign customer</u>

Companies that import, but only make payments in US dollar, often pay a premium for the ability to pay in dollars

Foreign exporters selling to US importers now runs the FX risk that the US dollar will depreciate over time. To protect themselves, the foreign exporter will often add arbitrary premiums to their prices. A simple dual pricing exercise, combined with FX hedging products, can eliminate unnecessary premiums

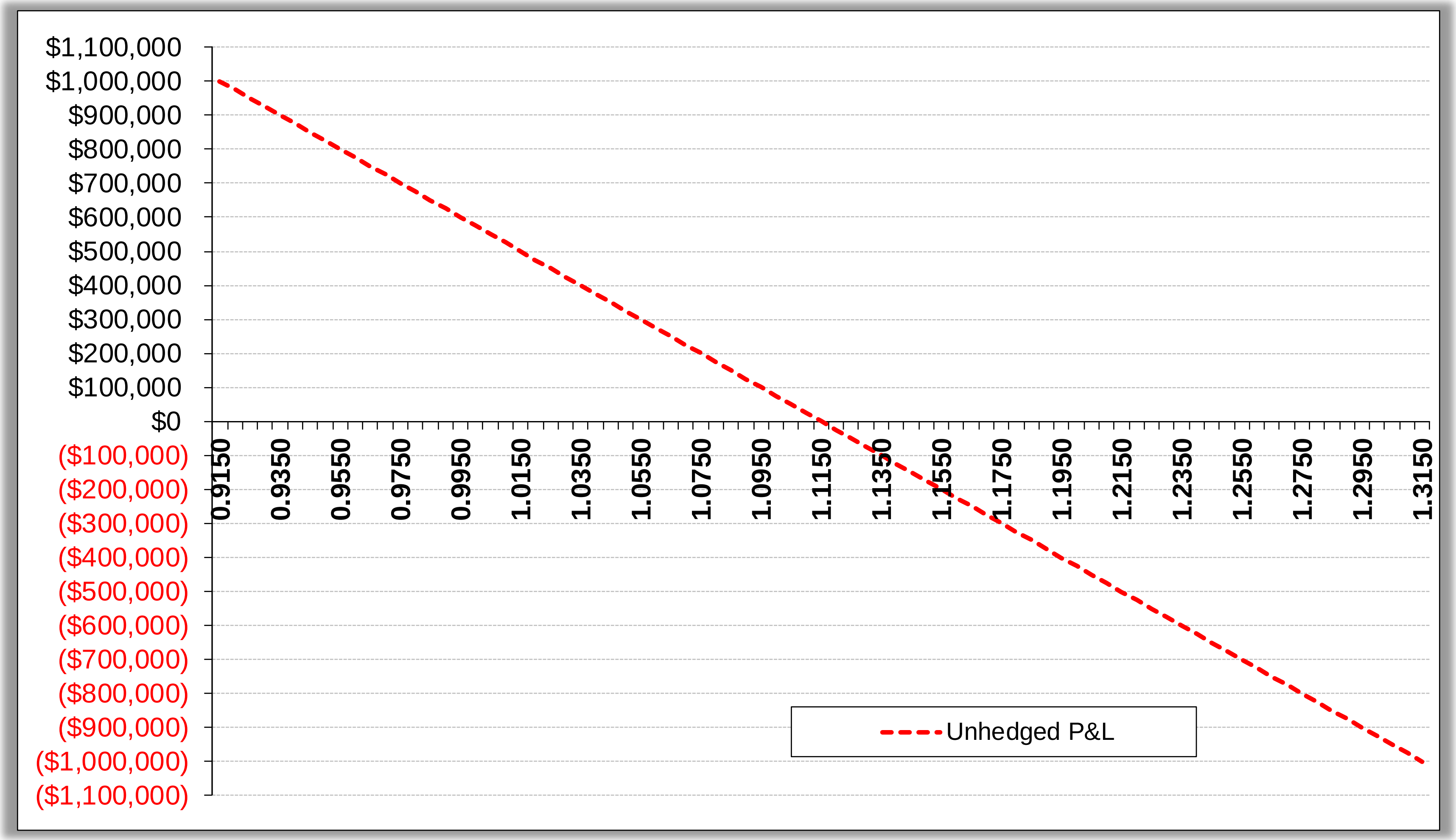
An Example of Contract or Transaction Exposure



- On July 5th a company negotiated to buy a machine from a German manufacturer. The German manufacturer will only accept payment in euros; EUR 5MM for the machine. The company accepts the price; and they use the July 5th spot rate of 1.1150 to set a $5,575,000 budgeted cost. The machine will be shipped January 5th 2017 and the payment in euros will be made at that time.

- What can the company do to protect their final US dollar cost?

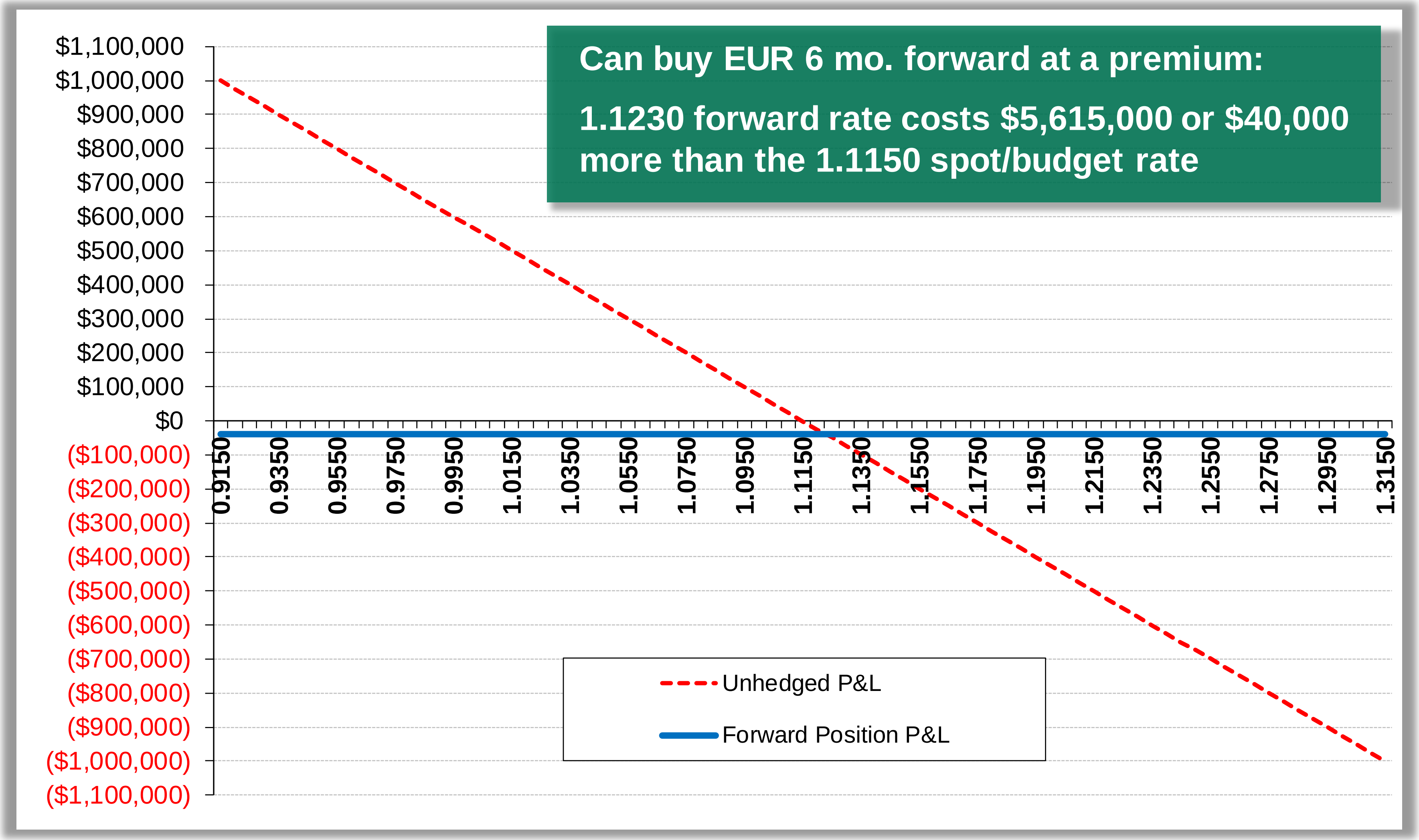
Position P&L When Unhedged vs. 1.1150 Budget



Hedging the Position With a Forward Contract

- A binding agreement to exchange US$ for euros at a rate set today for some future date: January 5, 2017 in our example
- No principal is exchanged until the forward date
- A premium or discount is attached to the spot exchange rate to determine the forward exchange rate
- The forward rate is not a predictor of exchange rates; but accounts for the interest rate cost of carry between the two countries
- The forward exchange rate for our example is 1.1230 EUR/US$
- Forward Contracts have credit exposure

Position P&L When Hedged With a Forward vs. 1.1150 Budget



Hedging the Position With a Forward Contract

Advantages

- The Forward Contract gets rid of any uncertainty about the exchange rate the company receives in the future.
- Forwards allow the company to budget accurately and to concentrate on their business, not the FX market.
- Forwards are flexible and can be easily delivered earlier or later than originally agreed using Currency Swaps.

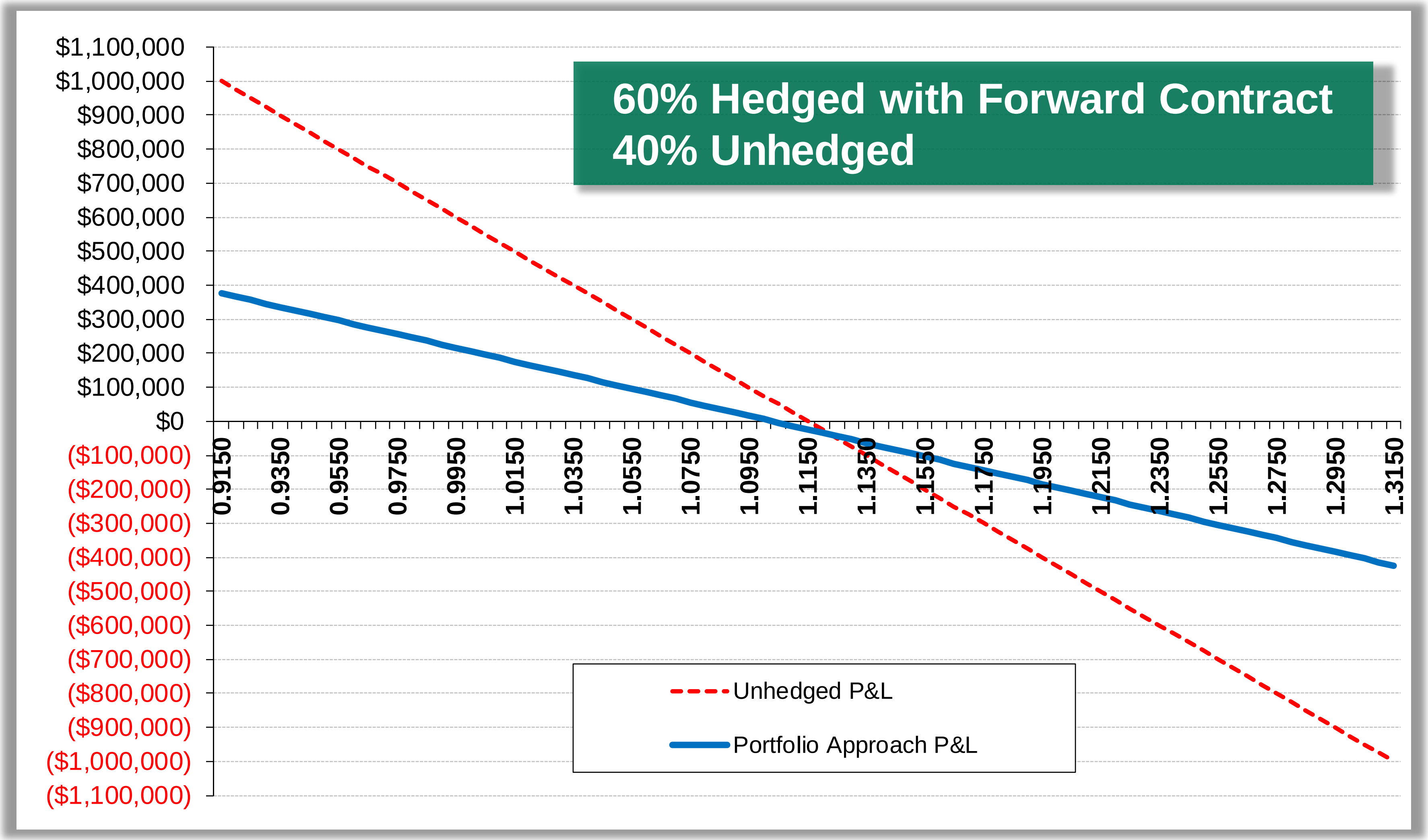
Disadvantages

- If the actual exchange rate at maturity is better than the one arranged under the Forward Contract, the company will not receive the benefit of the move and will incur an opportunity cost.
- If the trade agreement or underlying need for which the Forward Contract is based should fall through, the Forward Contract may need to be unwound at the prevailing exchange rate- creating either a gain or a loss.

Hedging the Position With a Portfolio Approach

- Hedging with a Forward Contract eliminates downside risk- but also eliminates upside potential
- To avoid some of the potential opportunity costs of a Forward Contract- companies often take a portfolio approach
- Companies hedge part of the exposure with a Forward, possibly use Options strategies, and leave a portion unhedged
- This is a risk vs. reward decision for companies
- Companies can potentially “average-in” Forward Contracts at better exchange rates

Position P&L When Hedged With a Forward vs. 1.1150 Budget



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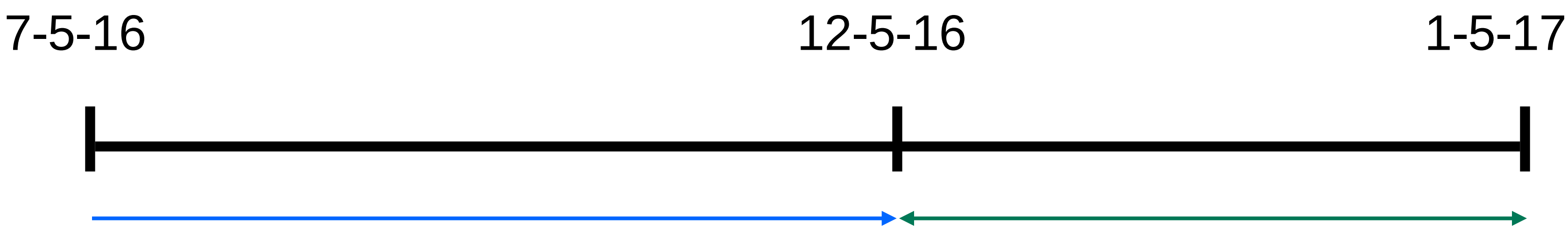
Using a Forward Contract with a Maturity Window



On 7-5-16 the company buys euros for delivery in partial amounts, or in whole, anywhere between and 12-5-16 and 1-5-17 @ 1.1230.

Any unused balances of euros must be offset or swapped by 1-5-17, the end of the contract.

Client Benefits of FX Rate Risk Hedging

- The key benefit of FX hedging is eliminating the losses due to currency fluctuations; and creating budget certainty when the invoicing and payment of foreign goods and services are separated by time

- Clients reduce earnings volatility and gain margin certainty

- Clients who import/export, where the business is denominated in US dollars, can often find competitive advantages and cost savings by first accepting the currency risk and then hedge away that risk with FX products that will guarantee their US$ price

- Expands foreign sales and or profitability

- Integrates well with Letter of Credit and other Trade Finance Products

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The M&T Bank Foreign Exchange Advantage

Variety of Services. The Foreign Exchange desk provides an array of FX products and services.

Worldwide Scope. M&T's trading desk provides competitive pricing, and a global network of correspondent accounts for making and receiving foreign payments. The Bank deals in all of the major currencies and has the ability to make payments in many emerging market currencies as well.

Relationship Driven. M&T builds long-standing client relationships by providing key ingredients clients ask for in FX servicing: product education, competitive exchange rates, quality wire delivery, quick turn-around in tracing wire problems, 24-hour order taking, market knowledge, morning commentary reports and timely delivery of currency trend information.

Step-by-Step Assistance. Whether your company is a large sophisticated entity dealing in a variety of countries, or a small company looking to expand into new markets, the foreign exchange desk is there to assist you every step of the way.

Contact Sean Fitzgerald on the M&T Bank FX Desk at 800-341-4193 or sbfitzgerald@mtb.com

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