

# **Foreign Experience in the Application of Currency Derivatives for Hedging Purposes**

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## 1. Introduction

In previous work (PB/06/2015), we discussed the general reform steps necessary to establish a functioning market for foreign exchange (FX) derivatives in Belarus.

Later, in (PB/02/2016), we introduced selected issues concerning international experience.

This contribution to the seminar about FX hedging, organised by the National Bank of Belarus, is based on former documentation but will enlarge on, and deepen, most of its bullet points.

## 2. FX derivative markets

- In general
  - Over 80 % of turnover is generated off-exchange
  - 12 to 14 large banks dominate the world's electronic FX derivative market. Other banks get their liquidity and prices from them (can be expensive for customers)
  - Trading is largely automated (for “normal” bank to bank trades; different if companies need support or if products are complex)
  - Instruments traded:
    - forwards
    - futures
    - cross-currency swaps
    - options
    - exotic products

## 2. FX derivative markets (cont'd)

- Local markets / emerging markets
  - Off-exchange throughout
  - Cautious entry (e.g. in Croatia initially only forwards allowed, options only recently)
  - The market is usually only used by smaller banks (niche market!)
  - Higher risks, therefore higher spreads > a product mostly for hedge funds
- Trading platforms
  - Electric platforms – irrespective of whether trading takes place on an exchange or OTC – are usually connected to each other using FIX-Protocol
  - Example: The Deutsche Börse 360 T platform for FX products
    - used for spot market and derivatives
    - bilateral system: prime brokerage – corporate clients; less bank to bank business at the moment, but increasing
    - no CCP up to now, but planned for both spot market and forward products
    - “value chain” is the outstanding characteristic feature
    - use for foreign markets (i.e. Belarus market) to be clarified

### 3. The role of functioning complementary financial structures – international experience<sup>1)</sup>

- Complementary financial markets
  - The readiness of these markets plays a crucial role in the success of a FX derivative market
  - Most important markets are: FX-spot market, short-term interbank money market, repo-market and government bond market because the interest rate in these markets is vital for interest rate parity when pricing FX hedging instruments
  - However, even the stock market has an indirect influence on a well functioning FX derivative market
  - The pace of the exit (to a floating currency) is not, in most cases, a deciding factor in the functioning of an FX derivative market (i.e. fast exit, functioning markets: Brazil, Czech Republic; gradual exit, functioning markets: Chile, Israel, Poland; fast exit, badly functioning market: Uruguay; gradual exit, badly functioning market: Uzbekistan)

<sup>1)</sup> This chapter is mainly based on the IMF “Occasional Paper 256”: “Moving to Greater Exchange Rate Flexibility” by Inci Ötker-Robe and David Vávra

### 3. The role of functioning complementary financial structures – international experience (cont'd)

#### ■ Central Banks

- Central banks play a significant role in supporting – mostly indirectly – the FX derivative markets by
  - creating infrastructure and institutions conducive to market activities
  - setting standards and benchmark reference rates
  - controlling FX risk management capacity
  - controlling relationship between on-shore and off-shore markets (if any)
  - creating incentives
  - removing obstacles
- In some cases central banks create or stimulate market activity by actively participating in derivative actions (Israel, Uruguay), but only at the beginning

## 4. EU regulatory reporting requirements / market supervision perspective

- EMIR (European Market Infrastructure Regulation)
  - Not yet uniformly applied to FX derivatives in all EU countries, but in progress
  - Contents:
    - CCP should be used for all OTC-standardised products or products capable of being standardised
    - bilateral clearing systems should be used in all other cases
    - these clearing systems are authorised and monitored by ESMA
    - rules for the most important reporting obligations to supervisory authorities/central banks
- Supervisory authorities monitoring
  - National supervisory bodies
    - use reporting chains (which include the end customer)
    - have internal systems to check if reports make sense and take action in case of abnormalities
    - oblige market participants to report high risk trades
    - receive reports of bilateral OTC trades from (private) Trade Reporting Institutions



## 4. EU regulatory reporting requirements / market supervision perspective (cont'd)

- ESMA
  - receives data from each country's supervisory body insofar as the products concerned are subject to supervision by authorities of other EU states
  - passes this information on to other supervisory bodies (TREM = Transaction Reporting Mechanism)
- Central banks / EZB
  - receive the same information as the supervisory authorities
  - control in particular the risk positions of banks
  - can intervene if positions are too risky
- Development in reporting obligations according to EMIR
  - Regulation under revision
  - In some cases already extended by SFTR (Securities Financing Transactions Regulation)

## 5. Corporate FX hedging decisions

- International experience of appropriate degree of risk exposure covered
  - No exact answer to the question due to lack of “hard data”
  - However, there are surveys and case studies by investment banks and other agencies on this question (results often not publicly available)
  - Some stylised facts can be distinguished
    - Degree of coverage depends on company type and FX exposure (e.g. domestically-oriented, classic exporter/importer, multi-national company (MNC))
    - Even among similar groups of companies differences are possible due to different financial risk management policies or difficulties in forecasting FX exposure (e.g. cash-flow stream)
    - However, due to increased FX volatility and a growing trend of internationalisation in many companies, the topic of FX hedging becomes more pressing. (For many companies, FX risk is considered a “non-core” risk that shareholders try to avoid.)
    - Companies with FX exposure in sectors that have narrow margins (e.g. commodities such as agricultural products) typically hedge most of their exposure

## 5. Corporate FX hedging decisions (cont'd)

- A survey (Greenwich Treasury Advisors 2008) among clients collected the following responses:

	Domestic Company	MNC	Exporter
% who do FX hedging	10-15%	85-95%	90-95%
Hedging time horizon	Fiscal year	1-2+ years	1-3+ years

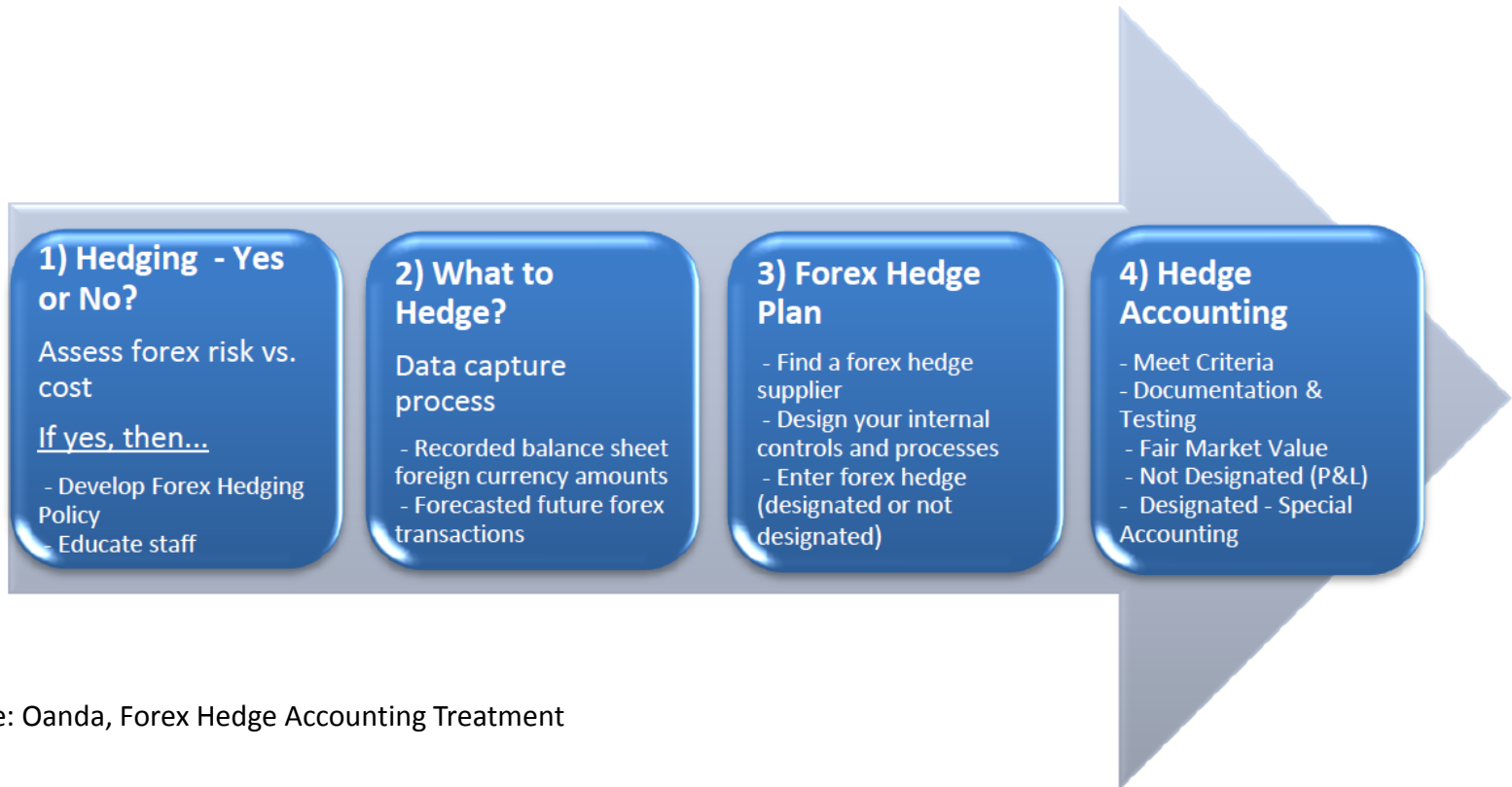
- In MNCs that operate in many countries, typically only the net FX exposure versus the reporting currency (USD, EUR) is (fully) hedged
- Instruments used:
  - The main hedging instruments used are forwards and/or futures and cross-currency swaps; less so options or more sophisticated (exotic) structures
  - Bigger companies are more likely to use options and exotic structures than smaller companies

## 5. Corporate FX hedging decisions (cont'd)

- International accounting rules
  - Companies are free to use FX hedging transactions to reduce (eliminate) FX exposure
  - Using FX hedging instruments can result in inequalities in the balance sheet and profit and loss accounts (especially with regard to non current assets). To avoid this, nearly all international accounting standards provide special accounting treatments (e.g. German GAAP, IFSR, US GAAP)
  - Such treatment is called “hedge accounting” (see IFRS 9 / IAS 39: “Financial Instruments: Recognition and Measurement”)
  - The hedging transaction must meet certain criteria outlined in the applicable accounting standards, such as
    - the underlying transaction must at least be (firmly) intended
    - the FX instruments must serve only as a hedging instrument
    - there must be a valid relationship between underlying transaction and FX transaction
    - the amounts and time limits of both transactions must largely correspond
    - documentation of all the above

## 5. Corporate FX hedging decisions (cont'd)

- Steps towards hedge accounting:



Source: Oanda, Forex Hedge Accounting Treatment

**Note: Hedge accounting is only the last in a series of steps!**

## 6. Summary

- The FX market in general is characterised by the domination of 10 to 12 major players and a relatively small number of products. Emerging markets ( niche markets) are the “playing ground” for smaller (local) players
- Orderly complementary financial structures (markets and measures) are crucial for developing a functioning FX derivative market. Here the Central Bank plays a significant role
- EU regulations set countless standards concerning reporting obligations and market structures. Legal development is ongoing
- Corporate FX hedging decisions are complex. There are only a few surveys available detailing experiences of the appropriate degree of risk exposure covered. These surveys show that the degree of coverage depends on company type (domestic, import/export, MNC). Overall: due to a growing trend of internationalisation the topic of FX hedging becomes more pressing.

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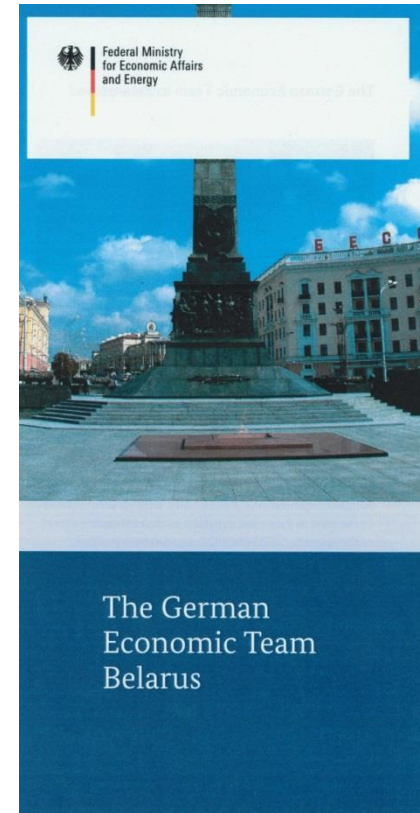
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