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Silicon Valley Bank

UK Guide to Foreign Exchange Policy



Table of Contents

- 3 Introduction
- 4 Components of Foreign Exchange Policy
- 5 Foreign Exchange Hedging Policy Template

Introduction

Companies that operate in the global marketplace should be prepared for the inevitable risks associated with fluctuations in foreign exchange rates such as cost competitiveness, profitability and valuation of a company's international operations.

Silicon Valley Bank can provide a suite of bespoke market risk solutions – forwards, options, non-deliverable forwards and foreign currency accounts – which can help mitigate the exposure that fluctuations in foreign exchange rates create, and can help mitigate economic risk.

However, before you outline a hedging plan you should consider creating a formal, auditable policy that sets a framework for the management of your international exposures. This process will help you formalise your corporate goals, performance measurement, risk tolerance and governance and provides an approved basis to examine the accounting and cash flow implications to your business.

Components of Foreign Exchange Policy

Most policies include these six common components:

1. Objectives

Objectives should be clear, concise and relevant. They should include the financial goals, exposures to be hedged, management's tolerance for risk, and may even specify amounts to be hedged. Certain questions should be addressed, such as whether to hedge cash flow, balance sheet re-measurement risk, or earnings, and what the scope of the program is intended to be.

2. Definitions

Companies can use the risk management policy as an internal communication tool to ensure a consistent understanding of the program. Outlining clear definitions of terms is critical in ensuring a consistent approach.

3. Strategies

This section typically includes the sources of exposure and the types of products that can be used to mitigate them. Can you only use forwards, or options as well? Can you use a combination of options to reduce premiums? How will the economics of hedging be evaluated? Will risk reduction targets or hedge amounts be programmatic or allow discretion within a range? All of these parameters should be defined and explicitly approved.

4. Responsibilities

This section should specify which individual(s) in the organisation are authorised to hedge on behalf of the company. Many companies have been shifting to a centralised approach to risk management to ensure a holistic picture of the risk and consistent application of any hedging programmes. You also should identify: 1) who the members of the foreign exchange committee are and how often they meet; 2) who reviews derivatives and when they are reviewed; and 3) what levels of management approval are needed for the hedging of various exposures (ie short-term versus long-term risk) and trades.

5. Controls and monitoring

The policy should define key operational aspects of the program such as reporting responsibilities, mark-to-market valuations, when and who should inform management of FX activity, how trades are confirmed and by whom, how effectiveness will be monitored, and whether the FX manager is within defined counterparty credit limits. You may also include documentation for hedge accounting purposes as required under IAS39 (or IFRS9 for accounting periods commencing Jan 2018) although often accounting will be addressed in a separate, comprehensive procedures document that addresses the nuances that are specific to the accounting realm; these two documents should be fully aligned and should address the application of hedge accounting, the supporting documentation, and the ongoing requirements tied to your hedging program.

6. Regulatory considerations

The policy should recognise key regulatory requirements and also allow flexibility to adapt to the ongoing changes in the regulatory environment. The attached draft Foreign Exchange (FX) Hedging Policy is intended to provide a risk management framework that can be customised to meet individual company needs. Policies can vary substantially between companies, based on the nature of the business model risk, the degree of flexibility required in meeting risk management objectives, and the desired level of specificity. Basic policy considerations are included in the attached, addressing each key element of policy at a high level, as well as language supporting basic regulatory requirements for the jurisdictions in which you operate.

Note that a company's policy is an internal document that it and its employees must manage. Third parties such as banks follow the directions of the company's employees and not the policy itself.

Foreign exchange transactions can be highly risky, and losses may occur in short periods of time if there is an adverse movement of exchange rates. Exchange rates can be highly volatile and are impacted by numerous economic, political and social factors, as well as supply and demand and governmental intervention, control and adjustments. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. Before entering any foreign exchange transaction, you should obtain advice from your own tax, financial, legal and other advisors, and only make investment decisions on the basis of your own objectives, experience and resources. Opinions expressed are our opinions as of the date of this content only. The material is based upon information which we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such.

Foreign Exchange Hedging Policy Template

Statement of purpose

The purpose of this policy is to establish the objectives, policies, procedures, and practices for ABC Limited governing the management of foreign currency exposures. Foreign currency risk management covers the identification of currency exposures, risk measurement, and the actions employed to mitigate such risks. Currency risk mitigation entails cash flow management or utilising hedging instruments to protect against volatility of earnings or the GBP equivalent of cash flows associated with changes in foreign exchange rates.

It is the responsibility of the Board of Directors, *[Appropriate Committee]*, and senior management to establish an effective set of policies for the purpose of using derivatives (also referred to as “hedges”) consistent with the Company’s underlying strategy, commercial objectives, level of risk tolerance, and financial capacity and flexibility.

Scope

This policy applies to ABC Limited and its subsidiaries (hereinafter referred to as “the Company”).

Objectives

The objective of currency management is to reduce, to the extent possible, impacts due to fluctuations in foreign exchange rates on ABC Limited’s earnings or fair values of assets and liabilities, without exposing ABC Limited to additional undue risk. The Company will generally pursue currency risk mitigation strategies that result in the least amount of reported earnings volatility under Generally Accepted Accounting Principles (GAAP) while still meeting strategic economic objectives and maintaining adequate liquidity and flexibility. *[The primary objective of the cash flow hedging program is to reduce earnings risk over a 12-month period by 50-80%.][The primary objective of the balance sheet hedging program is to reduce variability in FX Gain/Loss by hedging 80% of monetary assets/liabilities.]*

Definitions

Authorised representatives

Company employees, officers, or directors *[who hold the position of chief financial officer/treasurer/assistant treasurer/insert others, as appropriate]*, who evaluate swaps and make swap trading decisions on behalf of the Company and whose education, experience, industry knowledge, and board approval demonstrate their capacity to carry out these responsibilities on behalf of the Company.

Cash flow hedge

A derivative that hedges exposure to variability in the cash flows of a recognised asset or liability or a forecasted transaction, for the risk being hedged.

Dealing mandates/Board resolution

A letter signed by the authorised signer which lists those who are authorised to enter into foreign exchange contracts. This also includes immediate verbal and written notification of the change in status of any employee authorised to conduct foreign exchange business.

Derivatives

Financial instruments whose value changes in response to the changes in underlying variables or assets (such as commodities, equities, bonds, interest rates, exchange rates, or indexes).

Currency Swap: the combination of a spot FX transaction with a forward contract in the opposite direction. For example, if a spot transaction was executed to buy EUR and sell GBP, then the forward contract must by definition be a sell EUR and buy GBP contract. The combination of the spot and forward transactions are executed simultaneously to create execution efficiency and to reduce risks of spot movements (currency swaps are generally “spot insensitive”). Currency swaps are generally used to manage bank account balances or alter the maturity of an existing contract.

FX Collar: A combination of an option purchased by the Company and an option sold by the Company. The premiums of these two options offset each other in such a way as to make the total contract costless to the Company. The purchased and sold options will typically share the same currency pair, the same exercise date, and the same settlement date. However, one option will be a Call option with its own unique strike whereas the other option will be a put option with its own unique strike. Typically, both options will be out-of-the-money at the inception of the contract.

FX Forward Contracts: A legal contract to buy one currency and sell another currency with predefined amounts, settlement date, and exchange rate. Forward and forward window contracts are used to lock in exchange rates (a forward rate) for a specific future date, or for a range of dates (a window). Forward contracts are often used as a tool to eliminate the impact of adverse currency movements and to protect profit margins. A forward rate is calculated by taking the spot rate and adding or subtracting forward points. Forward rates are determined by the interest rate differential between the countries of the two currencies which are being exchanged.

Purchased FX Options: A legal contract that confers the right but not the obligation for the option owner to buy one currency (call) and sell another currency (put) with a predefined amount, exercise date, settlement date, and exchange rate (option strike). ABC Limited prohibits selling an option to an institution unless it is part of an underlying structure that has been approved, or to unwind or offset an existing purchased option.

Foreign currency

ABC Limited is UK-based, therefore the term “foreign currency” refers to all currencies other than Pounds Sterling (GBP).

Functional currency

The currency of the primary economic environment in which a company or subsidiary operates.

Margin risk

Margin risk represents the fundamental mismatch that the Company has between the currency of its revenues and currency of its expenses. Consequently, margin risk is driven most significantly by projected revenues and expenses rather than booked revenues and expenses. Margin risks typically manifest themselves in operating margin, as well as cash flows. Margin risk can arise due to transactional exposures and translational exposures.

Mark-to-market (MTM) hedge

A derivative that is not designated for hedge accounting treatment, which gets marked to market through P&L as changes in fair value occur. Balance sheet hedges to manage re-measurement risk typically fall in this category.

Re-measurement risk

Once revenues and expenses are booked but not yet paid, accounting rules require the Company to recalculate the value of these monetary assets and liabilities in functional currency terms. Re-measurement of these line items is booked in the other income/expense line item under FX gain/loss, and can contribute to volatility in net income.

Reporting currency

The currency in which the entity prepares its local statutory financial statements.

Transactional exposure

Trade-related exposures (or margin risk) that give rise to non-functional currency revenues and expenses, and settlement related exposures (or re-measurement risk) that give rise to non-functional currency receivables and/or payables.

Translational exposure

Translation of a foreign currency functional subsidiary’s income statement and translation of a foreign currency functional subsidiary’s balance sheet, both for the purpose of presenting consolidated financial statements at the parent level.

Strategy

ABC Limited is exposed to foreign currency rate fluctuations in the normal course of its business. A portion of our revenue, expense and capital activities are transacted in foreign currencies. Treasury will always look for natural hedges (opposite cash flows in the same currency – either at the same entity or across entities in the group) to net foreign exchange exposures. If remaining net foreign currency exposure is deemed to present material risk, then the use of hedging strategies under the parameters below will be pursued.

Foreign exchange risks can be broken down into two primary categories: 1) margin risk and 2) re-measurement risk. Within each of these categories, there are further distinctions to explore:

1. **Margin risk:** Margin risk is driven most significantly by projected revenues and expenses. Margin risks typically manifest themselves in operating margin, as well as cash flows. Margin risk can arise due to transactional exposures and translational exposures. *[ABC Limited may hedge up to 80% of its net foreign currency exposures, driving margin risk, for a tenor of up to 12 months.]*
2. **Re -measurement risk:** Once revenues and expenses are booked but not yet paid, accounting rules require the Company to recalculate the GBP value of these monetary assets and liabilities. Re-measurement of these line items is booked in the other income/expense line item under FX gain/loss, and can contribute significantly to volatility in net income. *[ABC Limited will target a hedge of 80% of net exposure in each foreign currency, with a tenor that aligns with the next reporting period.]*

Allowable hedge products

The Company may use a variety of commonly used derivative products that are considered plain vanilla derivatives and are instruments also used by peer companies to manage FX rate risk. The Company expressly prohibits the use of derivative instruments for speculative purposes. The Company will not use derivative financial instruments which can be characterised or defined as leveraged, or which cannot be easily valued for mark-to-market purposes. The use of historical rate rollovers on expiring forward contracts will also be avoided as these can disguise accrued gains or losses. Approved products, including appropriate customisation to match the underlying risk presented, include:

- FX Forward Contracts and Window Forwards
- Currency Swaps
- FX Options (purchased options or option strategies that result in premium paid or zero cost)

Hedging entities

Hedges will typically be executed at the same entity that holds the underlying exposure. However, hedge entity determination will factor in credit strength and accounting/tax treatment, as needed, to ensure that the appropriate entity within the Company organisational structure is utilised.

Cost considerations

Every effort will be made to execute hedging transactions as efficiently as possible. The following are some of the factors that

will be considered in evaluating the cost component of the hedging strategy against the level of risk mitigation provided:

- Upfront cost associated with option premiums (e.g., FX options)
- Market pricing, inclusive of credit, associated with swap products
- Credit considerations (use of available capacity, collateral posting requirements)
- Transaction sizing for maximum liquidity and pricing efficiency
- Bank relationship considerations

Controls and monitoring

Performance monitoring

The FX risk management program will be monitored on a quarterly basis to evaluate changes to the risk profile or strategy, effective risk mitigation, appropriate accounting treatment and regulatory compliance.

Policy and program review

This policy will be reviewed and approved by the [Appropriate Committee] on an annual basis at a minimum. Any significant changes to capital structure or to the hedging program may warrant a revision (and approval by the [Appropriate Committee]) prior to the next scheduled annual review.

Counterparty risk management

Approved counterparties to derivative transactions will be determined based on adhering to one or more of the following guidelines:

- Financial institutions with whom the Company either has a significant credit and/or cash management relationship

- Minimum long-term debt credit rating of “__” as rated by Standard and Poor’s or “__” as rated by Moody’s Investors Service
- Trading relationship documented under a mutually acceptable International Swaps and Derivatives Association (“ISDA”) Master Agreement (and associated Schedule), or market standard alternative such as a bilateral FX agreement

Controls

Companies should set internal controls and procedures that are appropriate for the roles and positions defined within the Company. Segregation of duties should be incorporated, particularly with respect to consecutive activities of recommending, approving, executing, and settling transactions. Sample language follows.

The chief financial officer, corporate treasurer, assistant treasurer and the FX treasury manager shall individually have the authority to enter into foreign exchange contracts in the Company name and on its behalf within the guidelines set forth in this policy. The corporate treasurer will authorize any other individuals to be able to enter into foreign exchange contracts in the Company’s name. Any exceptions to this policy must be approved, in writing, by the chief financial officer. A signed dealing mandate will be sent to all financial institutions.

This policy provides guidelines for the management of foreign exchange hedging. Under some circumstances, foreign exchange transactions that are appropriate for the Company and entirely within the spirit of this Foreign Exchange Policy as described in the Objectives section may not fall within the prescribed quantitative guidelines contained in this Foreign Exchange Policy. When the treasury manager determines that a foreign exchange transaction is in the best interest of the Company and is consistent with the objectives of this Foreign Exchange Policy, the transaction is permitted even though it is not consistent with the quantitative guidelines, subject to the following controls:

- Whenever a transaction is made that is an exception to the quantitative guidelines, the chief financial officer must approve the transaction in writing prior to execution.
- Exceptions will be reported to the chief executive officer and the Board of Directors in a monthly Foreign Exchange Report.
- If the policy is breached, the chief financial officer must be notified immediately. The chief financial officer is then responsible for notifying the Board of Directors of the breach of policy, either immediately or in the monthly Foreign Exchange Report.

Internal accounting controls

The treasury manager is responsible for recommending transactions, and the corporate treasurer is responsible for approving all hedging strategies. Only the chief financial officer, corporate treasurer, assistant treasurer, and the treasury manager shall have the authority to enter foreign exchange contracts that will provide foreign exchange coverage. The controller is responsible for implementing internal control procedures, accounting entries and ensuring that procedures are followed. Once the chief financial officer has approved a hedging strategy, the treasury manager is authorised to execute the contracts with an approved bank. The following procedures shall be followed:

- All transactions will be recorded immediately upon execution by the treasury manager. The aggregate amount of hedge contracts by currency should not deviate from the approved covering action.
- Immediately upon execution, the treasury manager (or appropriate finance staff member) will provide all details of each contract to the controller and send the bank a written contract confirmation listing the pertinent details of the contract: currency, amount, contract rate, value date and purpose of hedge. These contracts shall be cross-checked against the (internal) FX system of record. These confirmations will be used as the primary means of checking the accuracy of the confirmation issued by the banks.
- Bank confirmation of foreign exchange transactions will be sent directly to the Controller. The controller, or designated person, shall keep a log of incoming confirmations, filed by bank. If the confirmation has not been received within three working days after the execution date of the contract, the controller will personally contact the bank to verify that the trade is on the bank's records and request a confirmation in writing from the bank.
- The controller shall compare the bank's record of the transaction with the Company-originated confirmation. If the two records concur, the controller will sign the bank confirmation and return it to the appropriate bank (keep copies of the signed confirmation for the controller's and treasury manager's files). If there is a discrepancy, the controller will personally contact both the bank and the treasury manager to determine whose records are in error. The chief financial officer shall be notified of all discrepancy occurrences.

The *[Appropriate Committee of the]* Board of Directors delegates the following responsibilities to *[senior management/treasury/authorised representatives]*:

At the end of the month, the controller, or a designated person, shall review all incoming and outgoing cash transfers pertaining to foreign exchange. The controller shall ensure that the appropriate amounts were received/paid on the appropriate dates. Specifically, cash transfers related to FX contracts should be reconciled with the monthly FX Contract Summary at the end of each quarter for the entry supporting unrealised gains/losses on open FX contracts.

Reporting

The Treasury Department will prepare and the chief financial officer will review a monthly Foreign Exchange Report, containing the following information:

- The net transaction exposure of the Company by currency and recommendations of appropriate hedging actions
- Number of transactions (contracts purchased and sold) made during the month
- Summary of the current open foreign exchange contracts and explanation of the strategy behind the open positions
- Results of positions that have been closed during the month
- Violations or exceptions to the foreign exchange policy in the portfolio
- Status of any foreign exchange positions that might require management attention

The monthly Foreign Exchange Report will be distributed to the chief financial officer and assistant treasurer. Once per quarter, the report will go to the Board of Directors for review.

Roles and responsibilities

Responsibilities and qualifications

The roles for the members of the *[Appropriate Committee of the]* Board of Directors and senior management in relation to risk control of derivatives are described below.

The *[Appropriate Committee of the]* Board of Directors approves:

- The types of derivative contracts that may be used by the Company to hedge FX risk
- The use of any derivatives for purposes other than FX risk protection

Application of hedge accounting [optional]

If any derivatives will be designated for hedge accounting

- Identifying specific risks and hedging objectives
- Establishing trading limits and segregation of duties
- Executing the hedging transactions
- Reviewing memoranda necessary to document hedges for reporting purposes
- Monitoring the fair values of the derivatives in the hedging portfolio
- Monitoring the Company's potential FX risk exposure to ensure that it remains within limits approved by [the Company's Board of Directors, or Appropriate Committee]
- Reviewing the effectiveness of each hedge during the entire period of time the hedge contract is in effect
- Keeping the other members of the Company's executive committee informed as to all the above activities
- Determining on a trade-by-trade basis the use of the End-User Exception to mandatory clearing

Corporate treasury will:

- Report results of foreign exchange activity to the Treasury Manager at least quarterly, based on gain/loss thresholds
- Provide mark-to-market (MTM) information to the Treasury Manager and the accounting function monthly, within three days of the business month end
- Provide information on realised gains and losses to the FXC and the accounting function within three days of the business month end
- Run an MTM report of outstanding derivatives weekly. If any MTM report shows a change in unrealised losses of greater than [\$xxx], then this report will be sent to the FXC within one day of the MTM report being run
- Send all trade confirmations directly to the assistant treasurer from the financial institution of the foreign exchange contract
- Provide all contract-related information to the accounting function within three days of the business month's end

treatment, appropriate definitions and procedures should be included in policy. Hedge accounting treatment will require additional documentation and disclosures outside of this policy, which should be reviewed by auditors.

The Company has adopted IAS39, the accounting standard for financial instruments and hedge accounting. [Detailed procedures and controls supporting the application of hedge accounting are outlined in the attached Appendix _].

- *The Company records all derivatives on the balance sheet at the current mark-to-market value unless hedge accounting is applied.*
- *The Company will hedge exposures to the variability in the GBP equivalent of anticipated foreign exchange cash flows. These exposures arise from forecasted revenue and expenses that are denominated in non-GBP. For derivatives instruments that are designated as cash flow hedges, the after-tax gain or loss from the effective portion of the instrument is reported as a component of accumulated other comprehensive income (loss) in stockholders' equity, and is reclassified into earnings in the same period or periods in which the hedged item is recognised in earnings.*
- *The Company may hedge net investments in certain foreign subsidiaries whose functional currency is the local currency. For derivative instruments that are designated as net investment hedges, the Company records the effective portion of the gain or loss on the derivative instrument together with the changes in the hedged items in cumulative translation adjustment as a separate component of stockholders' equity.*

FX policy approved by:

Full Name: _____

Title: _____

Date: _____

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This sample foreign exchange policy has been prepared by SVB based on its employees' experiences and observations. The policies and provisions are suggested language that reflect those experiences and observations. This is intended as a guide to assist a company in drafting its own policies that reflect the needs, appropriate risks, appropriate foreign exchange activities, appropriate risk management strategies and reporting procedures as determined by the company's management, board of directors, advisors (including tax, accounting and legal advisors). Companies should have any policy, including any proposed foreign exchange policy (whether or not guided by this sample) reviewed by their advisors and consultants as well as their management and board of directors.

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