Foreign Exchange Services

KeyBank Non-Deliverable Forward Solutions

• Do you import product from China?
• Are you finding that you continuously have to pay more for the same amount of product?
• Will increasing Yuan strength add pressure to your margins?
• Do you think that it’s impossible to protect yourself from further Yuan appreciation?

If you answered yes to any of the above, you should know about KeyBank Non-Deliverable Forward (NDF) solutions.

The NDF solution in action
An American Corporation imports product from China and pays its supplier in US Dollars. Standard terms state that payment is due 90 days from the date of invoice. The Chinese supplier states that it will pass along a 15% price increase due to concerns about further strength in the Chinese Yuan.

Question:
Is there a more cost-effective way for the American customer to structure the transaction; an alternative that would minimize the price increase while protecting both supplier and customer from further Yuan appreciation?

Answer:
Yes – set pricing in Yuan and utilize a non-deliverable forward.
How non-deliverable forward contracts (NDFs) work

A Non-Deliverable Forward (NDF) provides a hedging mechanism for non-convertible currencies, such as the Chinese Yuan. Non-convertible currencies are currencies that do not have forward capabilities or are restricted to certain types of transactions. The NDF is an offshore method of hedging an onshore exposure.

NDF’s are legally binding contracts that require cash settlement instead of physical delivery of currencies. At maturity, the difference between the contract rate and the prevailing spot rate is settled in a convertible currency. THERE IS NO EXCHANGE OF PRINCIPLE. It is important to emphasize, when doing an NDF, the one side of the transaction will also need to enter into a separate spot conversion in order to take physical delivery of the currency at the time of the NDF’s maturity. It is equally important to note that the spot transaction rate will most likely differ from the official central bank fixing rate that the NDF contract was settled against because the fixing rate is set during that central bank’s time zone. This does create an exposure for the corporation.

While a NDF is not a perfect hedge it offers the corporation a benchmark to work against. The following are the specific advantages and disadvantages of an NDF contract.

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<th>NDF Advantages</th>
<th>NDF Disadvantages</th>
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<td>• No sovereign/convertibility risk.</td>
<td>• Corporation is “locked” into a contract.</td>
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<td>• No local balance sheet impact – no onshore balance sheet/tax consequences.</td>
<td>• Limited liquidity in this specialized product.</td>
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<td>• No dependence on local markets, except for fixing.</td>
<td>• Not a perfect hedge against exposure.</td>
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<td>• Unlike spot markets, corporations can usually deal on both sides of the market.</td>
<td>• Market sentiment priced into hedge pricing.</td>
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<td>• Limited liquidity dictates minimum size requirements (usually $250,000 per transactions) for pricing.</td>
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A more detailed look at the example

• Counterparties both agree to 90-day terms and Chinese Yuan amount CNY 10 million.
• Today is March 5, 2008.

The NDF Contract:
Spot rate = 7.1075
Fwd Equivalent = -.1951
Contract Rate = 7.1075 -.1951 = 6.9124
Settlement Date = June 3, 2008, 5 PM Hong Kong time.
Central bank fixing posted on Reuters page SAEC.
Value Date = June 5, 2008.

Client and supplier should now fix the USD amount owed for product due in 90 days, based on the NDF rate (6.9124).
By the Numbers:  
Example of Cash Flows at Maturity

**Scenario 1:** Hedge is out of the money  
Chinese Central Bank fixing = 7.0100

- Contract Value = CNY 10 million/6.9124. = $1,446,675.54
- Official Fix = CNY 10 million/7.0100 =-$1,426,533.52
- American Corporation Pays to Bank = $ 20,142.02

American Corporation also remits to Chinese Supplier Net Amount, $1,446,675.54 less $20,142.02 OR $1,426,533.52  
(Note this is equal to the USD value of the original CNY 10 million at the fix.)

Chinese supplier then takes USD $1,426,533.52 and converts to Yuan, or can continue to hold net USD. Once again, the objective of protecting the hedge rate 6.9124 is accomplished.

**Scenario 2:** Hedge is in the money  
Chinese Central Bank fixing = 6.6800

- Contract Value = CNY 10 million/6.9124. = $1,446,675.54
- Official Fix = CNY 10 million/6.6800 =-$1,497,005.99
- American Corporation Received from Bank = $ 50,330.45

American Corporation also remits to Chinese Supplier Net Amount, $1,446,675.54 plus $50,330.45 OR $1,497,005.99  
(Note: this is equal to the USD value of the original CNY 10 million at the fix.)

Chinese supplier then takes USD $1,497,005.99 and converts to CNY, or can continue to hold net USD amount. Either way the objective of protecting the hedge rate 6.9124 is accomplished.

Regardless of the scenario, if Yuan are ultimately needed, one side of the transaction still needs to do a separate spot deal that will allow physical delivery of the currency. The resulting exposure involved with this transaction may be minimized by doing the spot component of the deal around the time that the contract fixes.

NDF’s are legally binding contracts. However, should the counterpart need to unwind the deal, there are ways to offset an NDF purchase. Should the corporation need to get out of the deal, they would need to sell the offsetting contract. Should the corporation need to change the date, the same action would occur but they would then purchase a new contract for the correct date. AT NO TIME ARE NDF’s CANCELED. Remember, the market for this specialized product is highly illiquid. Deals are much easier to transact during the morning. Prices may change quickly and dramatically.