Your Guide to Foreign Exchange

Strategies for managing risk and making payments worldwide.
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Capitalizing on global opportunities

Studies indicate that 40% of the world’s small businesses are interested in doing business globally.

Companies seeking to reach new customers and find new sources for finished products or raw materials are increasingly exploring opportunities in established and emerging markets worldwide.

Despite lingering debt concerns in Europe and the U.S., these markets remain among the most active for global trade. In addition, the “BRICs” (Brazil, Russia, India and China) and countries as varied as Turkey, Indonesia and Singapore are showing signs of sustainable growth and shifting consumption patterns that bode well for companies in search of import and export opportunities.

What’s more, international commerce is no longer solely the domain of large multinational corporations with globally-recognized brands. As many as 40% of the world’s small businesses have an eye on establishing global operations over the next few years.

Forward-thinking companies understand that foreign exchange (FX) tools can play an indispensable role in making cross-border payments and managing risks that can arise with doing business internationally. The enclosed overview of FX tools may help your company consider ways to build, expand or deepen cross-border relationships.
Bringing the benefits of FX to your business

FX instruments are designed to help companies:

- Access the international monetary system
- Understand the global payments architecture
- Maximize profit while controlling risk

With the world’s economies and payment systems rapidly integrating, understanding how to transact across borders—and currencies—is becoming an increasingly critical part of a company’s international strategy. Companies that know how to use FX tools can gain a competitive advantage by managing international business risks, securely making and receiving cross-border payments and improving efficiency by increasing transaction speed.

Distinct business benefits can include:

- **Locking in exchange rates**
  Know the precise cost in your operating currency and protect against losses from exchange rate fluctuations.

- **Avoiding hidden expenses**
  Eliminate the hidden costs and market-fluctuation markups that can accompany foreign bills or invoices quoted in your operating currency.

- **Making timely and secure payments**
  International payments are sent to the designated foreign bank within two business days, and the local currency equivalent is deducted from your account on the day the request is made.
Integrating FX into our risk management approach

Transacting across borders introduces several types of risk that may be new to your business. Once you understand these risks, you can begin exploring ways to integrate FX instruments into your company’s risk management framework. Some of the risk categories that can arise from international payments can include:

- **Transactional (or cash flow) risk**, which applies to the profitability of operations, is the risk that revenues are worth less than expected or costs are higher than expected in your operating currency terms.

- **Economic (or competitive) risk** is the risk of lost business or decreased margins due to adverse pricing abroad in your operating currency. For example, a U.S.-based exporter with customers in Italy that prices goods in dollar terms may face risks when the dollar strengthens in comparison to the Euro, since this shift effectively raises the price to Italian customers in Euro terms.

- **Translational risk** applies to the operating currency value of your assets held abroad. As an example, a U.S. company with an overseas subsidiary can face unexpected swings in the book value of the subsidiary’s assets across reporting periods due to fluctuations in exchange rates.

Here are several tangible examples of how these broad risk categories can impact a company.

<table>
<thead>
<tr>
<th>Risks for importers:</th>
<th>Risks for exporters:</th>
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<tr>
<td>• The local bank may charge excess premiums to convert your operating currency into the local currency, and the vendor will receive less local currency at conversion.</td>
<td>• Customers may choose to buy from a competitor that prices goods in the local currency.</td>
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<tr>
<td>• If your operating currency depreciates against the local currency, payments in your operating currency will become more expensive.</td>
<td>• If your operating currency strengthens significantly against a customer's local currency, the customer may delay payment until the exchange rate becomes more favorable to them.</td>
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<tr>
<td>• International wires of your operating currency can take 3-5 business days to be received by the vendor, while payments sent in the local currency can be delivered same day in some cases.</td>
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Hedging risks with FX instruments

Understanding several types of standard FX instruments can help your company take steps to mitigate risks that may arise from international transactions.

**Spot Contract**

A basic exchange of currencies, where the spot rate is the current market price and where the settlement date is the second business day after the date the transaction was agreed upon. Your business can benefit from using a spot contract to lock in a price and secure timely payment.

**Forward Contract**

An exchange of currencies that is settled on a pre-agreed date at least three business days after the date of the deal. The forward rate for any two currencies is a function of their spot rate and the interest rate differential between them. However, the exchange rate is fixed at the outset and parties aren’t required to exchange money until the transaction takes place.

Forward contracts can be used to lock in the cost of goods to protect against potentially adverse exchange rate movements. A forward contract is very flexible and can be easily customized to meet specific needs.

**Forward Window Contract**

This type of instrument allows the holder to exercise a forward contract on demand, in whole or part, at any time during a pre-established time period. The exchange rate and the start and end dates of the contract are fixed at the outset of the transaction.

A forward window contract enables even more flexibility than a standard forward contract and can be useful when the date or size of the transaction isn’t known.
Currency Call Option

Developed to add another dimension of flexibility to forward transactions, a currency call option enables the buyer to purchase the right (but not the obligation) to buy a currency at a fixed price on a pre-agreed future date. The agreed-upon price is called the strike price.

In exchange for this right, the buyer generally pays a nonrefundable premium two days after the transaction date. The option premium is determined by the spot rate, forward rate (or interest rate differential), tenor, strike price and implied volatility.

Generally, the buyer exercises a call option at maturity if it’s “in the money,” which occurs when the strike price is higher than the spot price. A call option expires without value if it’s “out of the money,” meaning the spot price exceeds the strike price.

When purchasing a call option, the buyer should:

• Anticipate the maximum future cost of imported goods (the dollar amount at strike plus the premium paid up front), because the option ensures the buyer won’t pay above the strike price
• Take additional steps to protect operating margins from FX risk (this can be accomplished via put options)

Currency Put Option

Similar to a call option, the buyer of a put option acquires the right (but not the obligation) to sell a currency at a fixed price on an agreed upon future date at the strike price.

In exchange for this right, the buyer pays a nonrefundable premium to the bank.

The buyer is guaranteed a minimum dollar income on the currency sale and protection of dollar margin on the sold goods. There is also upside benefit if the specified currency appreciates during the life of the option.
Understanding payment types and channels

In addition to the standard FX hedging products listed above, many banks offer extensive services to help companies make and receive cross-border payments quickly and securely. Bank of America Merrill Lynch clients can access a range of solutions to simplify cross-border payments, including:

- **Multi-currency payment**
  A payment made in one currency that is funded in another, requiring an FX transaction.

- **Local currency payment**
  A payment in a currency other than your operating currency, such as a Canadian Dollar payment paid from a Canadian Dollar account.

- **Cross-border payment**
  A payment between sending and receiving banks located in different countries. Cross-border payments can be denominated in either your operating currency or local currency.

- **Cross-currency receivables**
  Transaction where a company receives payment from a foreign vendor denominated in local currency.
In addition, Bank of America Merrill Lynch offers its clients several channels for initiating FX transactions quickly and easily.

### FX Wire Transfers
Transfer funds to more than 190 countries with the Bank of America Merrill Lynch wire service, which follows the global 140-character standard and provides formatting requirements for each country.

Payments process in a straight-through manner and reach beneficiary accounts through our branches and correspondent banks, which deliver local currency through the target country’s clearing system. Most FX wire transactions settle in two days.

### Centrally-printed Drafts
Issue paper-based FX payment drafts in 39 currencies across 52 countries for quick, easy clearing.

Drafts are printed on tamper-resistant paper stock and delivered via courier to you or your beneficiary. Your company appears as the drawer of the draft, and the drawee is the local currency account held by Bank of America Merrill Lynch in the country of currency.

### Cross-border ACH
Initiate recurring, low-value cross-border payments securely and efficiently in 17 major currencies via our CashPro® Online portal or Bulk FX file channels.

Cross-border ACH is an efficient alternative to wires and checks that can help you simplify international payments process and make it easier to meet country-specific requirements.
Work with a leader in global foreign exchange

Let us put our global capabilities and expertise to work for you. Contact a Bank of America Merrill Lynch client manager to learn more.
Glossary of terms

**American style option:** An instrument that allows the investor to exercise the option at any time prior to the expiration date.

**American term:** An alternative, less common currency quote method that expresses the dollar amount that can be exchanged for one unit of foreign currency.

**Appreciation:** A rise in the value of one currency in relation to another.

**Asset currency:** The currency in which the asset is held.

**At the money (ATM):** A currency option whose strike price is equal to or near the current market price of the underlying financial instrument.

**Base currency:** Foreign exchange is quoted as the number of units of one currency needed to buy or sell one unit of another currency. The currency whose value is set at 1.00 is the base currency. For example, in a British pound quote of 1.8300, the pound is the base currency (1.8300 USD per GBP). In a CHF quote of 1.2400, the dollar is the base currency (1.2400 CHF per USD).

**Call option:** An option contract that gives the holder the right, but not the obligation to buy the call currency at a specified price for a certain, fixed period of time.

**Central Bank:** The only institution with the right to issue banknotes and authority over monetary and credit policies for a particular currency zone. The central bank also controls the money supply, regulates domestic and foreign payment transactions and maintains internal and external monetary stability.

**Currency option:** A contract that gives the holder the right to buy or sell one currency against another at a specified price for a certain fixed period of time.

**Currency pair:** A method of establishing a currency’s relative value against another currency. All foreign exchange investments are listed in pairs.

**Discount:** The amount by which the forward rate is reduced relative to the spot rate.

**European style option:** A contract that allows the investor to exercise the option at expiration date only.

**Exchange rate:** The price of a foreign currency expressed in domestic currency. For example, $/CHF = 1.5 means that one US dollar costs 1.5 Swiss francs.

**Exercise price:** The price at which the option buyer can purchase (call option) or sell (put option) the underlying currency. Also called the strike price.

**Expiration date:** The last day that an option can be exercised.

**Forward rate:** The contracted rate for a forward trade, which equals the spot rate plus or minus forward points.

**Forward trades:** The exchange of a specified amount of one currency for another at a contracted rate, with a settlement date greater than two days from the deal date.

**FX swap:** A spot foreign exchange transaction simultaneously reversed by a forward contract. The difference in rates reflects interest rate differentials between the two currencies.
**Hedge:** The forward sale or purchase of a foreign currency to reduce the exchange risk exposure connected with assets or liabilities denominated in a foreign currency.

**Implied volatility:** The volatility implied by the market price of the option based on an option-pricing model.

**Interbank market:** The wholesale marketplace for currency exchange for professional dealers with reciprocal market-making agreements.

**Interbank rate of exchange:** The rate at which banks deal with one another in the market. It is usually a tighter market with narrower spreads than the market offered on commercial transactions.

**Maturity date:** The agreed-upon settlement date or delivery date for a forward contract.

**Option:** The contractually agreed upon right to buy (call) or sell (put) a specific amount of currency at a predetermined price on a future, or “forward,” date at a specified exchange rate. A premium is paid up front for an option.

- In-the-money call option — the market price is greater than the strike price
- In-the-money put option — the market price is less than the strike price
- Out-of-the-money call option — the market price is less than the strike price
- Out-of-the-money put option — the market price is greater than the strike price

**Premium:** Forward points corresponding to interest rate differentials that are added to the spot rate. Also, the price of an option that the option buyer pays to the option writer.

**Put option:** An option contract that gives the holder the right—but not the obligation—to sell the currency at a specified price for a fixed period of time.

**Reporting currency:** The currency in which a parent firm prepares its financial statements.

**Spot trades:** The exchange of a specified amount of one currency for another at a contracted rate with a settlement date of two business days following trade date.

**Spot rate:** Contracted rate of a spot trade.

**Strike price:** Rate at which the option holder has the right to purchase (call currency) or sell (put currency) upon exercise of the option contract.

**Tenor:** The term or life of a contract.

**Value date:** The date on which currency is exchanged or delivered, or on which a contract settles (also called settlement date).

**Volatility:** The standard deviation of the change in value of a financial instrument within a specific time horizon.
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