

Chapter 1 : Five steps to managing your foreign exchange risk - Trade Ready

Foreign exchange risk describes the risk that an investment's value may change due to changes in the value of two different currencies. It is also known as currency risk, FX risk and exchange.

Transaction risk[edit] A firm has transaction risk whenever it has contractual cash flows receivables and payables whose values are subject to unanticipated changes in exchange rates due to a contract being denominated in a foreign currency. To realize the domestic value of its foreign-denominated cash flows, the firm must exchange foreign currency for domestic currency. As firms negotiate contracts with set prices and delivery dates in the face of a volatile foreign exchange market with exchange rates constantly fluctuating, the firms face a risk of changes in the exchange rate between the foreign and domestic currency. It refers to the risk associated with the change in the exchange rate between the time an enterprise initiates a transaction and settles it. Applying public accounting rules causes firms with transnational risks to be impacted by a process known as "re-measurement". The current value of contractual cash flows are remeasured at each balance sheet.

Economic risk[edit] A firm has economic risk also known as forecast risk to the degree that its market value is influenced by unexpected exchange rate fluctuations. Economic risk can affect the present value of future cash flows. Any transaction that exposes the firm to foreign exchange risk also exposes the firm economically, but economic risks can be caused by other business activities and investments which may not be mere international transactions, such as future cash flows from fixed assets. A shift in exchange rates that influences the demand for a good in some country would also be an economic risk for a firm that sells that good. As all firms generally must prepare consolidated financial statements for reporting purposes, the consolidation process for multinationals entails translating foreign assets and liabilities or the financial statements of foreign subsidiaries from foreign to domestic currency.

Contingent risk[edit] A firm has contingent risk when bidding for foreign projects or negotiating other contracts or foreign direct investments. Such a risk arises from the potential of a firm to suddenly face a transnational or economic foreign exchange risk, contingent on the outcome of some contract or negotiation. For example, a firm could be waiting for a project bid to be accepted by a foreign business or government that if accepted would result in an immediate receivable. While waiting, the firm faces a contingent risk from the uncertainty as to whether or not that receivable will happen. A deviation from one or more of the three international parity conditions generally needs to occur for an exposure to foreign exchange risk. In foreign exchange, a relevant factor would be the rate of change of the spot exchange rate between currencies. Variance represents exchange rate risk by the spread of exchange rates, whereas standard deviation represents exchange rate risk by the amount exchange rates deviate, on average, from the mean exchange rate in a probability distribution. A higher standard deviation would signal a greater currency risk. Economists have criticized the accuracy of standard deviation as a risk indicator for its uniform treatment of deviations, be they positive or negative, and for automatically squaring deviation values. Alternatives such as average absolute deviation and semivariance have been advanced for measuring financial risk. Banks in Europe have been authorized by the Bank for International Settlements to employ VaR models of their own design in establishing capital requirements for given levels of market risk. Using the VaR model helps risk managers determine the amount that could be lost on an investment portfolio over a certain period of time with a given probability of changes in exchange rate See also: Foreign exchange hedge

Firms with exposure to foreign exchange risk may use a number of foreign exchange hedging strategies to reduce the exchange rate risk. Transaction exposure can be reduced either with the use of the money markets , foreign exchange derivatives such as forward contracts , futures contracts , options , and swaps , or with operational techniques such as currency invoicing, leading and lagging of receipts and payments, and exposure netting. For example, the United States Federal Accounting Standards Board specifies when and where to use certain methods such as the temporal method and current rate method. Firms can manage translation exposure by performing a balance sheet hedge. Since translation exposure arises from discrepancies between net assets and net liabilities on a balance sheet solely from exchange rate differences. Following this logic, a firm could acquire an appropriate amount of exposed assets or liabilities to balance any outstanding discrepancy. Foreign

exchange derivatives may also be used to hedge against translation exposure.

Chapter 2 : Giddy/Dufey: Managing Foreign Exchange Risk

Another solution to foreign exchange rate risk is the use of netting. Netting is the practice of maintaining an equal level of foreign receivables against foreign payables. The net position is zero and thus exchange rate risk is avoided.

Mobile Site Understanding Foreign Exchange Risk When you conduct business overseas, you will have to convert currencies involved at some prevailing exchange rate. Depreciation occurs when it takes more currency to purchase the currency of another country. Since most currencies are valued according to the marketplace, there are constant changes to exchange rates. This gives rise to exchange rate risk. There are several ways to reduce exchange rate risk. Two popular approaches are hedging and netting. Hedging is where you buy or sell a forward exchange contract to cover liabilities or receivables that are denominated in a foreign currency. Forward exchange contracts offset the gains or losses associated with foreign receivables or payables. A very popular form of hedging is the Interest Rate Swap. Interest rate swaps are arrangements whereby two companies located in different countries agree to exchange or swap debt-servicing obligations. This swap helps each company avoid the risks of changes in the foreign currency exchange rates. Due to the popularity of interest rate swaps, most major international banks offer interest rate swaps for organizations concerned about foreign exchange rate risks when making interest payments. The costs charged by banks for interest rate swaps is relatively low. Another solution to foreign exchange rate risk is the use of netting. Netting is the practice of maintaining an equal level of foreign receivables against foreign payables. The net position is zero and thus exchange rate risk is avoided. If you expect the currency to depreciate in value, then you should hold a net liability position since it will take fewer units of currency to pay the foreign currency debt. If you expect the currency to appreciate in value, then you would want to have a net receivable position to take advantage of the increased purchasing power of the foreign currency. There are other vehicles for dealing with exchange rate risk, such as option hedges and other types of derivatives. However, the costs and risks associated with these types of arrangements can be much higher than a simple approach such as the interest rate swap. If you have exchange rate exposure, then take a look at simple hedges and netting as ways of avoiding foreign exchange rate risk.

Chapter 3 : Foreign-Exchange Risk

Foreign exchange risk (also known as FX risk, exchange rate risk or currency risk) is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the company.

But there are risks involved in forex hedging itself. One long-term hedging technique includes two currency swaps: Understanding forex risk in the context of enterprise risk management enables finance chiefs to not fall into the trap of over-hedging their forex risks. Kristina Narvaez Some international transactions, for example, involve an uncertain amount of goods to be ordered, and therefore involve an uncertain transaction payment in a foreign currency. That can lead to excessive risk-financing costs. One way to avoid over-hedging is to hedge only the minimum known payment involved in the future transaction. Deploying a more comprehensive risk management mindset can help finance executives to more effectively analyze which currency hedges to use. Corporations typically protect themselves from foreign exchange rate volatility with forwards, which are contracts that lock in the exchange rate for the purchasing or sale of a currency at a future date. The upside of this hedging strategy is that it has no up-front premium. That could be especially damaging if, for instance, the organization had anticipated last year a weaker U. Taking the positive and negative aspects of forwards can help CFOs decide whether and how much their companies should be using them. To measure the impact of the exchange rate movements on a firm engaged in foreign currency transactions, the company must be able to identify three main types of exchange-rate risks: The cash-flow risk, including the effect of exchange rate moves on transactional account exposure related to receivables export contracts and payables import contracts, and repatriation of dividends. Once a firm has defined how the three types of exchange rate risk work within its own structure, it must measure its currency risk. Measuring currency risk may prove to be a hard task when dealing with translation and economic risks. For example, exposed assets and liabilities are translated at the current exchange rate while non-exposed assets and liabilities are translated at the historical exchange rate. Devaluation of foreign currencies can lead to increased competition in both overseas and domestic markets. Economic risk is the most crucial to hedge, and yet it is rarely addressed. One widely used method to measure these types of risks is the value-at-risk VaR model. VaR is used by companies to estimate the riskiness of their foreign exchange positions resulting from its business activities. These positions include the foreign exchange position taken by its treasury over a certain time period and under normal conditions. The VaR calculation depends on three factors: The holding period or length of time over which the foreign exchange position is planned to be held. The confidence level at which the estimate is planned to be made. The unit of currency to be used for the denomination of the VaR. To calculate the VaR there are three widely used methods: After identifying the types of exchange rate risks and measuring the associated risk exposure, corporate finance executives and financial risk managers need to decide whether to hedge or not to hedge these risks. These models represent a more integrated approach to hedging currency risk than buying a traditional forward contract to cover certain foreign exchange exposures. An efficient frontier model determines the most efficient hedging strategy that is the cheapest for the most risk hedged. Indeed, managing exchange rate risk exposure must involve the efforts of both the C-suite and the board.

Chapter 4 : Foreign Exchange Risk Management in Commercial Banks in Pakistan - Section 2

Foreign Exchange Risk Foreign Exchange Risk Foreign exchange (FX) is a risk factor that is often overlooked by small and medium-sized enterprises (SMEs) that wish to enter, grow, and succeed in the global marketplace.

There is also not any sufficient literature available on this specific topic. Different work has been done at different times regarding various topics included in the research objective of this study. An overview of the existing literature is given here. The importance of foreign exchange risk management can not be neglected for any firm or banking organization. Banks face foreign exchange risk management due to dealing in foreign currencies result of the operations in foreign countries or dealing with foreign exchange for their own account or for customers account. Foreign Currency Risk is an important source of risk for the banking industry and different studies have been done in different parts of the world. Different traditional types of foreign exchange risk i. Also different ways and strategies for managing foreign currency risk were analyzed along with advantages and disadvantages of each strategy and technique. Additionally, best practices widely spread were outlined along with data on financial derivatives and hedging practices by US firms. Sources of risks for banking sector have been investigated by many researchers in different economies. According to them during the period from to , share prices of banks responded with the appreciation of the Australian Dollar. According to them, banking industry as a whole do effective foreign exchange risk management and therefore, this type of risk is insignificant in pricing banking companies stocks. According to them, when banks had positive net position, depreciation of foreign currencies negatively affected the stock prices of banks before year and after banks stock returns responded positively with the depreciation of foreign currencies as banks had changed from positive to negative net open positions. Foreign Exchange Risk is also found out to be one of the major sources of risks in African Region. According to this study, all the major four banks in South Africa exhibit the foreign exchange risk and the Net Asset position in foreign currencies is a weak predictor of foreign exchange risk. Shamsuddin, mentioned that adoption of flexible exchange rate regime in along with financial system globalization have exposed Australian Banks to new risks along with new opportunities. According to him small banks are immune to changes in interest and exchange rate. Choosing the suitable hedging strategy is often a difficult task due to the difficulties involved in measuring precisely current risk exposure and deciding on the suitable degree of risk exposure that ought to be shielded. The need for foreign exchange risk management began to arise after the fall of the Bretton Woods system and at the end of the United States dollar peg to gold in Papaioannou M. It clearly shows the importance of the fact that firms give a significant attention to risk management issues and techniques. Contrariwise, international investors usually use their underlying assets and liabilities to manage foreign exchange risk. Since the currency exposure of international investor is majorly related to translation risks on assets and liabilities held in foreign currencies, they tend to consider foreign currencies as a separate asset class, totally separate from other assets, requiring a currency overlay mandate Allen, Page 17 Banks use Derivatives to manage foreign currency risk. There is much of literature which shows that foreign currency management tools significantly reduce foreign currency exposure. They did not find any significant relationship between derivative activities of banks and exposures. Hedging allows the commercial banks to manage foreign exchange risk but hedging itself poses additional risk to bank. Of Chartered Accountants of India is mentioned that currency derivatives like currency futures, currency forwards, currency swaps and currency options help in hedging foreign exchange risk of firms and other ways of hedging including off-setting positions against the underlying assets and money markets are themselves risky. Hedging and hedging right are two different things. If the hedging is not done properly in the right way, it itself can become a serious source of risk and have potential to pose a serious financial loss to the firm. Fluctuations in the foreign exchange rate force the changes in the portfolio returns as uncertain future exchange rates translate the returns on investments denominated in foreign currencies into US dollar returns. Foreign exchange risk can be managed if the diversification of portfolio is done across the assets in different currencies. Cash flows of a portfolio can be affected or changed by the usage of derivative securities. It entitles the buyer of Page 18 the option the flexibility of exercising settlement of that option or not. The article

focused on the dynamics of hedging foreign exchange risk with the usage currency options applications. Indeed, the foreign currency options are one of the best tools available for hedging foreign exchange exposures in different foreign exchange market conditions, like volatile market conditions, stagnant, bullish or bearish.

Chapter 5 : What is Foreign Exchange Risk

Foreign-exchange risk is the risk that an asset or investment denominated in a foreign currency will lose value as a result of unfavorable exchange rate fluctuations between the investment's foreign currency and the investment holder's domestic currency.

Thus, the value of noncontractual assets is not affected. The value of an inventory in a foreign subsidiary is determined not only by changes in the exchange rate, but also by a subsequent price change of the product--to the extent that the underlying cause of this price change is the exchange rate change. Thus, the dollar value of an inventory destined for export may increase when the currency of the destination country appreciates, provided its local currency prices do not decrease by the full percentage of the appreciation. Exhibit 4 provides a numerical illustration. The effect on the local currency price depends, in part, on competition in the market. The behavior of foreign and local competitors, in turn, depends on capacity utilization, market share objectives, likelihood of cost adjustments and a host of other factors. Of course, firms are not only interested in the value change or the behavior of cash flows of a single asset, but rather in the behavior of all cash flows. Again, price and cost adjustments need to be analyzed. For example, a firm that requires raw materials from abroad for production will usually find its stream of cash outlays going up when its local currency depreciates against foreign currencies. Yet the depreciation may cause foreign suppliers to lower prices in terms of foreign currencies for the purpose of maintaining market share. The firm planned to invoice its clients in ECU, the official currency unit of the European Community. The treasurer is considering sources of long term financing. In the past all long term finance has been provided by the parent company, but working capital required to pay local salaries and expenses has been financed in Dutch guilders. The treasurer is not sure whether the short term debt should be hedged, or what currency to issue long term debt in. Translation exposure has to do with the location of the assets, which in this case would be a totally misleading measure of the effect of exchange rate changes on the value of the unit. After all, the oil comes from Venezuela and is shipped to Germany: Both provide value added, but neither determine the currency of revenues. So financing should definitely not be done in Dutch guilders. Transactions exposure has to do with the currency of denomination of assets like accounts receivable or payable. This is because the currency of determination is the U. Economic exposure is tied to the currency of determination of revenues and costs. Clearly the currency of determination is influenced by the currency in which competitors denominate prices. In the example in the previous section, it does not matter whether, as a matter of business practice, the firm may contract, be invoiced in, and pay for each individual shipment in its own local currency. If foreign exporters do not provide price concessions, the cash outflow of the importer behaves just like a foreign currency cash flow; even though payments are made in local currency, they occur in greater amounts. As a result, the cash flow, even while denominated in local currency, is determined by the relative value of the foreign currency. The functional currency concept introduced in FAS 52 is similar to the "currency of determination" -- but not exactly. The currency of determination refers to revenue and operating expense flows, respectively; the functional currency concept pertains to an entity as a whole, and is, therefore, less precise. To complicate things further, the currency of recording, that is, the currency in which the accounting records are kept, is yet another matter. For example, any debt contracted by the firm in foreign currency will always be recorded in the currency of the country where the corporate entity is located. However, the value of its legal obligation is established in the currency in which the contract is denominated. An example of the importance of these distinctions may be found in Exhibit 5. It is possible, therefore, that a firm selling in export markets may record assets and liabilities in its local currency and invoice periodic shipments in a foreign currency and yet, if prices in the market are dominated by transactions in a third country, the cash flows received may behave as if they were in that third currency. This occurs because DM-prices for each consecutive shipment are adjusted to reflect world market prices which, in turn, tend to be determined in U. The significance of this distinction is that the currency of denomination is relatively readily subject to management discretion, through the choice of invoicing currency. Prices and cash flows, however, are determined by competitive conditions which are

beyond the immediate control of the firm. Yet an additional dimension of exchange risk involves the element of time. In the very short run, virtually all local currency prices for real goods and services although not necessarily for financial assets remain unchanged after an unexpected exchange rate change. However, over a longer period of time, prices and costs move inversely to spot rate changes; the tendency is for Purchasing Power Parity and the Law of One Price to hold. In reality, this price adjustment process takes place over a great variety of time patterns. These patterns depend not only on the products involved, but also on market structure, the nature of competition, general business conditions, government policies such as price controls, and a number of other factors. Considerable work has been done on the phenomenon of "pass-through" of price changes caused by unexpected exchange rate changes. And yet, because all the factors that determine the extent and speed of pass-through are very firm-specific and can be analyzed only on a case-by-case basis at the level of the operating entity of the firm or strategic business unit, generalizations remain difficult to make. Exhibit 6 summarizes the firm-specific effects of exchange rate changes on operating cash flows. Sometimes, at least one of these reactions is possible within a relatively short time; at other times the firm is "locked-in" through contractual or strategic commitments extending considerably into the future. Indeed, those firms which are free to react instantaneously and fully to adverse unexpected rate changes are not subject to exchange risk. Thus, companies engaged purely in domestic transactions but who have dominant foreign competitors may feel the effect of exchange rate changes in their cash flows as much or even more than some firms that are actively engaged in exports, imports, or foreign direct investment. From this analytical framework, some practical implications emerge for the assessment of economic exposure. First of all, the firm must project its cost and revenue streams over a planning horizon that represents the period of time during which the firm is "locked-in," or constrained from reacting to unexpected exchange rate changes. It must then assess the impact of a deviation of the actual exchange rate from the rate used in the projection of costs and revenues. Estimation of planning horizon as determined by reaction period. Determination of expected future spot rate. Estimation of expected revenue and cost streams, given the expected spot rate. Estimation of effect on revenue and expense streams for unexpected exchange rate changes. Choice of appropriate currency for debt denomination. Estimation of necessary amount of foreign currency debt. Determination of average interest period of debt. Selection between direct or indirect debt denomination. Decision on trade-off between arbitrage gains vs. Decision about "residual" risk: Subsequently, the effects on the various cash flows of the firm must be netted over product lines and markets to account for diversification effects where gains and losses could cancel out, wholly or in part. The remaining net loss or gain is the subject of economic exposure management. For a multiunit, multiproduct, multinational corporation the net exposure may not be very large at all because of the many offsetting effects. How quickly can the firm adjust prices to offset the impact of an unexpected exchange rate change on profit margins? How quickly can the firm change sources for inputs and markets for outputs? To what extent do volume changes, associated with unexpected exchange rate changes, have an impact on the value of assets? Normally, the executives within business firms who can supply the best estimates on these issues tend to be those directly involved with purchasing, marketing, and production. Finance managers who focus exclusively on credit and foreign exchange markets may easily miss the essence of corporate foreign exchange risk. When operating cash inflows and contractual outflows from liabilities are affected by exchange rate changes, the general principle of prudent exchange risk management is: This can be achieved by maneuvering assets, liabilities or both. When should operations -- the asset side -- be used? We have demonstrated that exchange rate changes can have tremendous effects on operating cash flows. Does it not therefore make sense to adjust operations to hedge against these effects? Many companies, such as Japanese auto producers, are now seeking flexibility in production location, in part to be able to respond to large and persistent exchange rate changes that make production much cheaper in one location than another. Among the operating policies are the shifting of markets for output, sources of supply, product-lines, and production facilities as a defensive reaction to adverse exchange rate changes. Put differently, deviations from purchasing power parity provide profit opportunities for the operations-flexible firm. This philosophy is epitomized in the following quotation. It has often been joked at Philips that in order to take advantage of currency movements, it would be a good idea to put our factories aboard a supertanker, which could put down

anchor wherever exchange rates enable the company to function most efficiently. In the present currency markets, an aeroplane would be more in line with the requirements of the present era. It is obvious that such measures will be very costly, especially if undertaken over a short span of time. Hence operating policies which have been designed to reduce or eliminate exposure will only be undertaken as a last resort, when less expensive options have been exhausted. Exhibit 7 provides a summary of the steps involved in managing economic exposure. Whether and how these steps should be implemented depends first, on the extent to which the firm wishes to rely on currency forecasting to make hedging decisions, and second, on the range of hedging tools available and their suitability to the task. These issues are addressed in the next two sections.

Many students have learned about the balance of trade and how the more a country exports, the more demand there is for its currency, and so the stronger is its exchange rate. In practice, the story is a lot more complex. Research in the foreign exchange markets has come a long way since the days when international trade was thought to be the dominant factor determining the level of the exchange rate. Monetary variables, capital flows, rational expectations and portfolio balance are all now understood to factor into the determination of currencies in a floating exchange rate system. Many models have been developed to explain and to forecast exchange rates. No model has yet proved to be the definitive one, perhaps because the structure of the world's economies and financial markets are undergoing such rapid evolution. Corporations nevertheless avidly seek ways to predict currencies, in order to decide when and when not to hedge. The models they use are typically one or more of the following kinds: Academic students of international finance, in contrast, find strong empirical support for the role of arbitrage in global financial markets, and for the view that exchange rates exhibit behavior that is characteristic of other speculative asset markets. Exchange rates react quickly to news. Rates are far more volatile than changes in underlying economic variables; they are moved by changing expectations, and hence are difficult to forecast. In a broad sense they are "efficient," but tests of efficiency face inherent obstacles in testing the precise nature of this efficiency directly. The central "efficient market" model is the unbiased forward rate theory introduced earlier. It says that the forward rate equals the expected future level of the spot rate. Because the forward rate is a contractual price, it offers opportunities for speculative profits for those who correctly assess the future spot price relative to the current forward rate.

Chapter 6 : What CFOs Should Know About Foreign Exchange Risks

The risk that the exchange rate on a foreign currency will move against the position held by an investor such that the value of the investment is reduced.

SME exporters prefer to sell in U.S. From the viewpoint of a U.S. Obviously, this exposure can be avoided by insisting on selling only in U.S. However, such an approach may result in losing export opportunities to competitors who are willing to accommodate their foreign buyers by selling in their local currencies. This approach could also result in the non-payment by a foreign buyer who may find it impossible to meet U.S. Selling in foreign currencies, if FX risk is successfully managed or hedged, can be a viable option for U.S. Key Points - Most foreign buyers generally prefer to trade in their local currencies to avoid FX risk exposure. SME exporters who choose to trade in foreign currencies can minimize FX exposure by using one of the widely-used FX risk management techniques available. The following sections list FX risk management techniques considered suitable for new-to-export U.S. The FX instruments mentioned below are available in all major currencies and are offered by numerous commercial banks. The current spot market rate will then determine the U.S. For example, the U.S. The risk is further reduced if those peso-denominated export and import transactions are conducted on a regular basis. FX Forward Hedges The most direct method of hedging FX risk is a forward contract, which enables the exporter to sell a set amount of foreign currency at a pre-agreed exchange rate with a delivery date from three days to one year into the future. Such a forward contract will ensure that the U.S. However, if the German buyer fails to pay on time, the U.S. Accordingly, when using forward contracts to hedge FX risk, U.S. Under an FX option, the exporter or the option holder acquires the right, but not the obligation, to deliver an agreed amount of foreign currency to the FX trader in exchange for dollars at a specified rate on or before the expiration date of the option. If the value of the foreign currency goes down, the exporter is protected from loss. On the other hand, if the value of the foreign currency goes up significantly, the exporter simply lets it expire and sells the foreign currency on the spot market for more dollars than originally expected; although the premium would be forfeited. While FX options hedges provide a high degree of flexibility, they can be significantly more costly than FX forward contracts. Prepared by the International Trade Administration. With its network of offices across the United States and in more than 75 countries, the International Trade Administration of the U.S. Department of Commerce utilizes its global presence and international marketing expertise to help U.S. Locate the trade specialist in the U.S.

Chapter 7 : Foreign-Exchange Risk Definition & Example | InvestingAnswers

What CFOs Should Know About Foreign Exchange Risks. Understanding foreign exchange risk in the context of enterprise risk management enables finance chiefs to avoid overhedging their forex risks.

Chapter 8 : What does Foreign exchange risk mean?

Interest rates are critical, because when a country's rate rises, in many cases, so does its currency, said Shahab Jalinoos, managing director of foreign-exchange strategy at UBS.

Chapter 9 : What is foreign exchange risk? definition and meaning - blog.quintoapp.com

The Management of Foreign Exchange Risk by Ian H. Giddy and Gunter Dufey New York University and University of Michigan. 1 OVERVIEW.. 1 (a) Goals of the chapter. Exchange risk is the effect that unanticipated exchange rate changes have on the value of the firm.