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Foreign Exchange Risk: A General Perception

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Abstract

Exchange rate risk is a financial risk that changes the value of an investment due to exchange rate fluctuations. This represents the risk investors will face when losses are due to adverse movements in exchange rates and when it is necessary to close long positions or short positions in foreign currency.

INTRODUCTION

Exchange risks generally affect companies that export and / or import products, services, and supplies. It also affects international investors. For example, if a currency is fluctuating when the investment is sold and converted back to the original currency, or if the value of the investment increases or decreases, you must convert the money to another currency for the particular investment. (1-8)

Exchange rate risk

Exchange rate risk is the uncertainty of future calls with respect to other currencies. Currency risk represents the probability of loss due to exchange rate fluctuations. Currency risk is a risk arising from a change in currency valuation. This change may cause unexpected gains and losses when converting investment gains or dividends from foreign currencies to US dollars. Investors may use hedges and other techniques designed to cover all profits and losses related to currency to reduce foreign currency risk. (9)

For example, consider an investor based in the United States. Purchase a German stock for US $ 100. While this measure is being maintained, the euro exchange rate falls from 1.5 euros per US dollar to 1.3 euros. If an investor sells one week at 100 euros, you lose 13% after converting your earnings from euros to US dollars (10).

If the investor takes the position to sell the euro at the same time, the profit of the depreciation of the euro offset the loss of 13% conversion. In this article, learn how investors manage their exchange rates to protect their portfolio and increase risk-adjusted earnings.

Various types of exchange rate risk.

Exposure to the transaction

The Company is exposed to foreign currency risk if foreign currency receivables and accounts receivable are directly affected by exchange rates. Agreement between two companies that use different national currencies according to certain rules. This contract provides accurate prices and accurate delivery dates. However, this contract faces the risk that the exchange rate between the currencies will change before the service is delivered or before the transaction is resolved (9, 11).

Economic Exhibition

The Company faces currency risk due to economic risks known as expected risks when market prices are affected by unanticipated exchange rate fluctuations. The fluctuating exchange rate can affect the company's position, value and future cash flow compared to its competitors. These exchange rate fluctuations can have a positive impact on your business. For example, a US company with a Milk Supplier in New Zealand can cut costs if it wants to. The UU is strong against the New Zealand dollar. From this perspective, financial transactions can be strategically managed through financial transactions and subcontracting.

Exposure to translation

All companies generally prepare financial statements. This statement is for informational purposes only. Therefore, a multinational partner must convert significant numbers from one currency to another. This exchange rate poses a currency risk as exchange rates can change when converting national currency into other currencies. Although the exposure to translation does not affect the company's cash flow, the company's overall revenue may change. This affects the price of company stocks (12).

Accidental exposure

You may be involved in bidding for overseas projects, sign direct contracts with foreign companies, or be exposed to foreign direct investment. When companies negotiate with foreign companies, the exchange rate will continue to change before, during and after negotiations. For example, your company may be waiting for another foreign company to accept your proposal. The company is exposed to secondary exposure because the exchange rate may fluctuate to the atmosphere and the state of the local currency is not known otherwise when the proposal is finally accepted.

When investing in government bonds of the investor's country of origin and other bonds, the risk of exchange rate risk is low in the national currency.

Investors are exposed to currency risk if an investor pays a specified bond in a currency other than the country of origin. Interest and principal payments are made in foreign currency. When an investor receives a call, he enters the currency market and sells it to buy the local currency. The risk is that the currency risks less than what is expected to be devalued relative to the currency of the country of origin.

For example, buy a UU euro voucher for US investors. If interest payments are scheduled and the euro falls against the dollar, investors will receive less dollars than expected when trading in the currency market. In short, investors will receive fewer euros to buy dollars.

Exchange Rate Risk Measurement

If the foreign exchange market is efficient in terms of purchasing power, interest rates and international fishery effects, there is no need to protect itself against currency risk due to indifference to the decision of the company or investor. International investment In general, one or more deviations from the parity state are required to be exposed to currency risk.

Financial risk is more commonly measured in terms of variance or standard deviation of variables such as returns or exchange rates. For foreign currencies, the relevant factor is the exchange rate of the spot exchange rate between currencies. The variance represents the risk of the exchange rate against the limit of the exchange rate, and the standard deviation represents the exchange rate risk as compared to the average exchange rate average exchange rate deviation. The higher the standard deviation of the probability distribution, the higher the rate of change. Economists have criticized the accuracy of standard deviations as a risk indicator for positive or negative deviations and the uniform treatment of auto squares. To measure financial risk, alternatives such as absolute mean and variance have been proposed (13).

A worthwhile value

Experts have adopted financial risk management techniques called value at risk (VaR) by development and regulatory authorities. VaR examines the end of revenue distribution due to currency fluctuations to emphasize results with the worst returns. European banks have been authorized to use the VaR model when establishing capital requirements for a certain level of market risk for international settlement banks. The var model allows a risk manager to determine the amount an investment portfolio can lose over a period of time based on the likelihood of exchange rate fluctuations.

How to manage the risk of change.

International investors offer several options related to exchange risk management, including the use of options such as currency futures, futures options and hedge funds. However, these instruments are often expensive and complex to use by individual investors. Currency denominated funds (ETFs) are a simple, flexible and flexible alternative to hedging foreign exchange risk.

There are several large financial institutions that provide a variety of foreign exchange funds. Two of the most popular suppliers are Currency Shares and Wisdom Tree. The company offers a variety of ETFs covering a variety of currencies around the world. This currency includes popular international investment destinations from Canada to emerging markets such as China and Brazil. (14)

Investors can offset the loss of conversion by buying put options in the ETF to benefit from the won appreciation. Another option is to purchase a unified currency hedge (ETF) to protect against currency risk. The UU assumes that the so-called smart beta funds offer the investment range options offered in the index to invest and provide the easiest option for investors.

Literary review

Bradford Cornell and Alan C. Shapiro (1983) described how to manage currency risk. Ian H. Dizziness and Gunter Dufey are different from the "economic risk management" in currency exchange risk management, in that his article is in many realistic situations, the economic effect of the random number is provided by means of various exposures Translated It is the currency of the location, Emphasize the distinction between currencies of business decisions. They argued that the international financial plan should follow a market-based approach.

Fok et al. (1997) found that coverage not only reduces the volatility of earnings but also increases the value of the company. They found that the scope not only reduced the opportunity of financial difficulties but also the cost of institutional debt and capital costs.

Chowdhry and Howe (1999) argue that firms should use financial instruments to manage exposures to short-term exposure and to long-term strategy (ie, operational risk avoidance) with long-term use.

Niklas Hagelin and (2002) Ben Guto pramborg investigated the effects of currency derivatives and foreign currency debt to reduce currency exposure. The results were positive.

(2008) Sathya Swaroop Debasish studied the case of exchange risk management for 501 non-banking Indian companies that identify the technology they use to cover their foreign exchange risk. Volatility and a decrease in cash flow were found to be the reason for coverage. The techniques used by Indian companies are leading contracts, swap and currency options. The perception of confusion in the use of derivatives, technology and management constraints and the fear of high costs has been found in the main reasons that do not use any management technology exchange rate risk. This article analyzes the various risk management techniques of exchange rates.

Jain, Yadav and Rastogi (2009) analyze and compare foreign exchange risk management strategies and strategies for interest rate risk management, with public companies, private companies and foreign companies operating in India. Not all risks are managed. The management of this company operating in India is of the view that the amount of collected exhibits does not require special treatment.

Compensation tools and technologies

1. **Term Contract** A term contract refers to a contract where a fixed amount of underlying assets is traded at a fixed price on a certain date in the future. In other words, a futures contract is an agreement that the other party agrees to exchange assets at a certain point in the future at the price agreed to today. These are the most commonly used exchange risk management tools. The Company may enter into forward contracts for foreign currency required for payment or foreign currency to be received in the future. There is no change in cash flow because the exchange rate is already fixed for future transactions. Therefore, any changes that occur between the contract date and the actual date of the transaction have no effect. This eliminates exposure to currency exchange. Future settlement dates are available at any time between the exact date or two consent dates.

2. **Currency futures** The currency futures contracts are traded on an organized exchange, including a standardization contract between the two parties that sells currency at fixed prices on a certain date in the future. Futures contracts are more flexible than contract terms because they are traded on an organized exchange. Currency depreciation can be hedged through futures trading and the value of money can be hedged through futures buying. Therefore, by buying and selling currency futures, you

can adjust the entry and exit of different currencies to eliminate exposure to exchange rates.

3. **Currency Options** A currency option is a contract that grants the holder the right to buy or sell a certain amount of money at a specific price for a period of time. The currency option gives the contract owner the right to purchase or sell, but is not obligated. The contract owner may or may not use the option at the exchange rate. He / she can choose to sell or buy the currency or expire the option. The option creator receives a price that gives this option. The price you pay is called a premium. The fixed price at which the owner can sell or buy the currency is called the exercise price or exercise price. The option to grant a buyer the right to purchase is called the purchase option, and the option to give the holder a sale right is called a put option. Call options offer potential benefits. For example, an Indian company needs to buy capital goods from the United States. UU After three months, in US $, the company must buy a currency option. There are two possibilities. First, the spot exchange rate will be lower than the exercise price and the company will be able to buy US $ at the current exchange rate because it is less costly. Second, if the dollar appreciates, the exchange rate would not be desirable. The spot exchange rate will be higher than the exercise price and the company can use the rights and purchase US $ at the exercise price. So in both cases, the company will pay less to buy dollars to pay for the product. (15)

4. **Currency Swap** A currency swap involves an agreement between the two parties to exchange a series of cash flows into a series of cash flows in a different currency at agreed intervals during the agreed period. This is to convert the debt into a currency and convert it into another currency. Its purpose is to collect funds denominated in other currencies. The party holding the currency exchanges the currency with another currency held by the other party. Each party pays interest on the currency exchanged at regular intervals during the loan period. After expiration or termination, each party exchanges the won in two currencies.

5. **External Debt** External debt is an effective way to avoid foreign exchange risk. This is supported by the international Fisher effect relationship. For example, a company is expected to receive a fixed amount of euro in the future. If the national currency appreciates against the euro, the company is likely to experience losses. To cover this, the company can borrow in euros for the same period and convert foreign currencies into local currencies at spot rates. And if the company receives the euro, you can make a loan in euros. As a result, the company can completely eliminate call exposure.

6. **Cross Compensation:** Cross Compensation means taking opposite positions in a currency with a positive correlation. Can be used when the scope of certain foreign currencies is not possible. Cross-coverage is an important technology that can be used in the enterprise because the effect remains the same even if coverage is in a different currency.

7. **Currency diversification** Currency diversification means investing in securities denominated in different currencies. Diversification reduces risk even if the currency is not correlated. Provide global exposure to the company, minimize foreign exchange exposure and take advantage of exchange rate imbalances.

Deciding whether to cover

Creating hedge funds against foreign exchange risk can be very expensive. By definition, investors must offset one dollar to fully cover each unit of foreign currency. Some of these costs can be reduced by using stock options instead of stocks, but they are expensive for individual investors with low investments. Therefore, investors should first check whether insurance is required. Here are some common questions to ask before applying:

- Is insurance coverage a proportionate amount of total investment? In other words, is cost more important than currency reduction?
- How long does foreign security take? In the short term, money is relatively volatile, so the cost of hedging currency risk may not achieve marginal benefits.
- Do you think there is a significant risk that the currency will decrease? In a stable economy, currencies tend to trade with relatively low volatility, so insurance is unnecessary.

Steps to protect against currency risk with ETF:

1. Check the ETF. Look at ETFs for foreign currency investments through currency sharing, wisdom trees, and other ETF providers. If several are available, the investor must find the ETF with the lowest cost and commission.

2. Determine the address. Insurance is always the opposite of foreign investment. Therefore, if an investor buys a long-term stock in Canada, the short-term ETF must be Canadian dollars. On the other hand, if there is not enough investment in Chinese stocks, it should become China ETF.

3. Calculate the amount. Investors can partially or wholly cover foreign investment to prepare for foreign exchange risk. To fully cover, the investor must buy the same amount as the ETF currency. Or you can purchase the same amount of options in dollars.

4. Manage your transactions. Once the exchange is made, the investor must closely control the situation during the exchange. If the currency is stable, it may be convenient to sell some of the insurance, but unstable situations can guarantee greater protection.

Conclusion

Exposure management for foreign exchange management that can be ignored by governments around the world, including emerging economies like India, is so important. A company that did not pay proper attention paid a fine. Commercial companies should be active in foreign exchange risk management. Companies should consider establishing a robust risk management system and developing an insurance coverage strategy that adapts to specific characteristics and exposure. In India, regulations have been steadily eased to increase the business and liquidity of the currency derivatives market, but expiration agreements of less than one year were mainly used. Delivery and option contracts are the most common method. At first, only a specific bank could negotiate in the market, but now it is possible to enter into an option contract. Indian companies actively hedge currency risk through foreign currency and currency swaps and various types of options. The introduction of foreign exchange futures and options contracts traded on the stock exchange by RBI will enhance the ability of companies to effectively manage their currency exposure. To complete all aspects of risk management across the company, you need to develop extensive interaction models. Because business and industry are the most conservative and prudent strategies, we have come to the conclusion that the underlying case strategy must always cover actual exposure without exception. Governments should take appropriate measures to establish appropriate policies and accelerate the development of the foreign exchange market. The company must use innovative tools to update the Forex Risk Management (FERM) process and reduce call exposure.

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