

## Risks by the foreign exchange on Forex

The Forex is essentially risk-bearing. By the evaluation of the grade of a possible risk accounted should be the following kinds of it: exchange rate risk, interest rate risk, and credit risk, country risk.

Exchange rate risk. Exchange rate risk is the effect of the continuous shift in the worldwide market supply and demand balance on an outstanding foreign exchange position. For the period it is outstanding, the position will be subject to all the price changes. The most popular measures to cut losses short and ride profitable positions that losses should be kept within manageable limits are the position limit and the loss limit. By the position limitation a maximum amount of a certain currency a trader is allowed to carry at any single time during the regular trading hours is to be established. The loss limit is a measure designed to avoid unsustainable losses made by traders by means of stop-loss levels setting.

Interest rate risk. Interest rate risk refers to the profit and loss generated by fluctuations in the forward spreads, along with forward amount mismatches and maturity gaps among transactions in the foreign exchange book. This risk is pertinent to currency swaps, forward outright, futures, and options (See below). To minimize interest rate risk, one sets limits on the total size of mismatches. A common approach is to separate the mismatches, based on their maturity dates, into up to six months and past six months. All the transactions are entered in computerized systems in order to calculate the positions for all the dates of the delivery, gains and losses. Continuous analysis of the interest rate environment is necessary to forecast any changes that may impact on the outstanding gaps.

Credit risk. Credit risk refers to the possibility that an outstanding currency position may not be repaid as agreed, due to a voluntary or involuntary action by a counter party. In these cases, trading occurs on regulated exchanges, such as the clearinghouse of Chicago. The following forms of credit risk are known:

1. Replacement risk occurs when counterparties of the failed bank find their books are subjected to the danger not to get refunds from the bank, where appropriate accounts became unbalanced.
2. Settlement risk occurs because of the time zones on different continents. Consequently, currencies may be traded at the different price at different times during the trading day. Australian and New Zealand dollars are credited first, then Japanese yen, followed by the European currencies and ending with the U.S. dollar. Therefore, payment may be made to a party that will declare insolvency (or be declared insolvent) immediately after, but prior to executing its own payments.

Therefore in assessing the credit risk, end users must consider not only the market value of their currency portfolios, but also the potential exposure of these portfolios. The potential exposure may be determined through probability analysis over the time to maturity of the outstanding position. The computerized systems currently available are very useful in implementing credit risk policies. Credit lines are easily monitored. In addition, the matching systems introduced in foreign exchange since April 1993 are used by traders for credit policy implementation as well. Traders input the total line of credit for a specific counterparty. During the trading session, the line of credit is automatically adjusted. If the line is fully used, the system will prevent the trader from further dealing with that counterparty. After maturity, the credit line reverts to its original level.

Dictatorship risk. Dictatorship (sovereign) risk refers to the government's interference in the Forex activity. Although theoretically present in all foreign exchange instruments, currency futures are, for all practical purposes, excepted from country risk, because the major currency futures markets are located in the USA. Hence, traders have to realize that kind of the risk and be in state to account possible administrative restrictions.

## About the Author

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