

Abstract

The client maintains a single currency ledger which does not capture the distinction between realised and unrealised exchange differences arising from non-functional currency transactions, resulting in an inability to manage FX rate risk. Avantage Reply was engaged to specify and report on the appropriate data capture systems and exposure management engine required to identify and quantify all FX transactional exposures. This report would form the basis for a functional specification used by IT to develop the appropriate systems and processes required to implement an effective FX risk management policy.



Review of foreign exchange risk management capability

THE CLIENT

The client is an established European Investment Bank.

THE CHALLENGE

The client maintains a single currency ledger. All non-functional currency transactions are translated at the rate prevailing on the trade date. The effect of variations in exchange rates is reflected daily through the profit and loss account. However, the distinction between realised and unrealised exchange differences is not captured and the open positions that give rise to continued FX exposure are not identified or quantified and therefore not managed.

The client recognised that even though gains and losses due to exchange rate movements were being accounted for in aggregate through P&L, it was unable to determine the extent (i.e. open positions) to which it was exposed to FX rate risk.

A substantial number of FX currency exposures were not being captured and therefore the initial requirement was to determine how to identify the exposures and quantify them correctly.

Furthermore it was not clear, once a process had been established for capturing and measuring the exposures, who should take responsibility for the management of the historic exposure and accountability for managing future FX transaction and translation risk.

APPROACH AND SOLUTION

The approach taken was to:

- Agree a methodology for inventory/position valuation (assumed first in first out basis);
- Review all position data to ensure comprehensiveness for valuation purposes (i.e., all relevant data captured to enable valuation to be undertaken), timeliness and accuracy;
- Define the data fields to be captured where absent;
- Define an algorithm for calculating potential exposures for all traded products; and
- Ensure the capture and accounting for corporate actions; and
- Provide policy recommendations for the management of FX transaction and translation risk.

RESULTS AND BENEFITS

All of the above was delivered in a report submitted to Treasury and IT which became the basis of a functional specification used by IT to develop the appropriate data capture systems and exposure measurement engine for identifying and quantifying all FX transactional exposures.

Agreement was achieved to the implementation of the FX risk management policy recommendations, once the historic exposures had been identified and measured following the completion and implementation of the systems applications (developed out of the report supplied by Avantage Reply) by IT.

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