19BAE710-FINANCIAL DERIVATIVES

A Currency Swap is a financial agreement between two parties to exchange a specified amount of one currency for an equivalent amount of another currency. These swaps are commonly used to manage currency risk, obtain better borrowing terms in different currencies, and facilitate international trade. Here's a brief overview of Currency Swaps:

1. **Definition:**
    - A Currency Swap is a financial arrangement in which two parties agree to exchange a certain amount of one currency for an equivalent amount of another currency, usually at the beginning and end of the swap period.
2. **Parties Involved:**
    - The two main parties in a currency swap are typically:
        - Counterparties: The entities entering into the swap agreement.
        - Swap Banks: Financial institutions that facilitate the swap by matching parties with opposite currency needs.
3. **Objective:**
    - Managing Currency Risk: Currency swaps are often used to hedge against currency risk, especially in situations where entities have cash flows or liabilities in different currencies.
    - Reducing Borrowing Costs: Entities may engage in currency swaps to obtain more favorable borrowing terms in a currency where they have a comparative advantage.
4. **Structure:**
    - In a typical currency swap:
        - Initial Exchange: The counterparties exchange principal amounts in different currencies at the beginning of the swap.
        - Interest Payments: Regular interest payments are exchanged in the agreed-upon currencies during the swap period.
        - Principal Exchange: At the end of the swap period, the parties exchange the principal amounts back.

5. **Notional Amount:**

   - The notional amount in a currency swap represents the principal amount used to calculate the interest payments. It is not actually exchanged but serves as the basis for cash flow calculations.

6. **Interest Rates:**

   - The interest rates used in currency swaps are typically fixed, floating, or a combination of both, depending on the agreement between the parties.

7. **Duration:**

   - Currency swaps can have varying durations, ranging from a few months to several years, depending on the needs and objectives of the counterparties.

8. **Types of Currency Swaps:**

   - Fixed-for-Fixed: Both sides pay a fixed interest rate in their respective currencies.
   - Fixed-for-Floating: One side pays a fixed rate, and the other pays a floating rate.
   - Floating-for-Floating: Both sides pay floating rates in their respective currencies.

9. **Benefits:**

   - Currency swaps offer flexibility and allow entities to match their cash flows and liabilities in different currencies more efficiently.
   - They can help lower borrowing costs by accessing more favorable interest rates in different markets.

10. **Counterparty Risk:**

    - As with any financial derivative, currency swaps carry counterparty risk. If one party defaults, the other may face financial losses.

11. **Regulatory Considerations:**

    - Currency swaps are subject to regulatory oversight, and regulatory changes may impact their structure and use.

Currency swaps are widely used by multinational corporations, financial institutions, and central banks to manage currency exposure and optimize their financing strategies across different markets. They play a vital role in facilitating international trade and investment by providing a mechanism to mitigate currency risk.