

**THE
FOREIGN EXCHANGE COMMITTEE**

ANNUAL REPORT

1982

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CHAIRMAN'S REPORT

In reviewing the extraordinary market conditions prevalent during 1982, one can fully appreciate the vision expressed in the 1979 study of the feasibility of establishing the Foreign Exchange Committee. The notable efforts of the Committee's early members, the previous chairman, and the Federal Reserve Bank of New York have indeed created a "forum for discussing matters of mutual concern in the foreign exchange and, when appropriate, offshore deposit markets"

The major developments in the markets during the last twelve months clearly demonstrated the usefulness of the "forum" In particular, the evolution of domestic and international credit concerns and the extreme fluctuations in major currencies have reinforced the need for all market participants to intensify their focus on the size and nature of the risks encountered in the international markets. Contrary to some forecasts, heightened uncertainty has acted to increase trading volume dramatically and, at the same time, help stimulate the development and relative role of the United States in the world foreign exchange markets.

Enhance Risk Awareness

A key function of the Committee, in the rapidly evolving environment of 1982, was to facilitate the exchange of information and to enhance awareness of potential risks and problems in foreign exchange and related markets.

Included among the topics of ongoing discussion at the regular meetings were: volatility of foreign exchange markets, the role of foreign exchange brokers, the influence of technical analysis, liquidity of the foreign exchange and eurocurrency deposit markets, the cause and effect of tiering in the deposit markets, and the implementation and development of U.S. International Banking Facilities

In addition, the Committee was fortunate this year to have as its guests Beryl W. Sprinkel, Under Secretary of the U.S. Treasury for

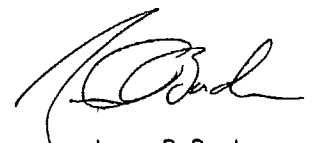
Monetary Affairs, and Takeshi Ohta, Director, Foreign Department, the Bank of Japan. Discussions with these gentlemen were extremely useful in broadening understanding

With the significant change in the U.S. foreign exchange markets, the Committee continued to review and assess current market practices. Early in the year, the 1980 paper on "Selected Issues Relating to the Management of Foreign Exchange Activity" was reissued (see page 11)

Focus on Name Substitution

In view of the rapid growth of brokered foreign exchange business in the United States during the second half of the year, the Committee focused on name substitution practices in the U.S. foreign exchange markets. A subcommittee was formed to review these practices and recommended a suitable course of action. After considerable discussion, both within the subcommittee and the Foreign Exchange Committee itself, it was decided that the subject was of sufficient importance to merit the issuance of a paper. The final document was approved at the December meeting. The purpose of the paper is to inform bank managements of practices that give rise to situations in which brokers may assume foreign exchange positions, or have the need to find banks to clear names for foreign exchange transactions.

In sum, I believe we can look at the Committee's efforts during 1982 with a high degree of satisfaction. Fortunately, the forum was in place. There is no doubt the effectiveness of such a forum is directly tied to the dedication of the participants, both in acting as an information conduit to the market place and in unselfishly applying themselves to the wide range of issues and problems brought before them. In this regard, I must express my thanks to Committee members and alternates for their contribution and support during the year and at the same time convey my optimism regarding the committee's effectiveness in the year ahead



James P. Borden

THE COMMITTEE'S DELIBERATIONS ON MATTERS OF MARKET PRACTICE

A major part of the Foreign Exchange Committee's work in 1982, as in previous years, was directed to questions of market practice.

Many challenging issues face the manager of a trading operation in today's environment.

These issues reflect, among other things, the stresses of the trading profession, the possibility of abuse or indiscretion in the handling of sensitive information, and the possibility of conflicts of interest.

Recirculation of Statement of Management Issues

In considering these troublesome areas, the Committee felt that its 1980 paper, "Selected Issues Relating to the Management of Foreign Exchange Activity," was still a timely and useful guide to management (see page 11). It was designed to identify and define the difficulties of several issues which arise in foreign exchange trading operations and which warrant policy direction or special management attention. As such, it was intended to assist management in developing internal guidelines which are appropriate to each institution, without recommending specific solutions.

Since that paper was circulated, a number of institutions have informed the Committee that the paper has indeed served as a useful basis for the discussion of the issues and the development of an internal code for dealers. The Committee felt that these issues should be reviewed routinely in light of changing economic circumstances, market evolution and personnel changes. Consequently, the Committee recommended the paper again be circulated to all market participants once during 1982, and at periodic intervals henceforth.

During the course of discussion of these broad management issues, some Committee members described ways in which their own internal guidelines, especially those pertaining to entertainment, are stricter than those which might be implied by the Committee's paper. For example, some banks keep a log indicating who and on what occasion any dealer in its trading room is entertained, some reciprocate entertainment offered by brokers, and some required that junior traders not accept entertainment unless they are accompanied by a more senior trader.

Name Substitution Practices

One area where the Committee chose to expand significantly upon its previous work was on the issue of name substitution practices in the foreign exchange market. These practices have developed because of the way transactions effected through brokers

are handled in this market. Specifically, the broker does not disclose the names of potential counterparties until agreement is reached on all other aspects of the transaction. When the names are exchanged, one party might find the other unacceptable because, for example, it already has a large number of transactions with that institution on its books.

In its "Selected Issues" paper, the Committee had already cautioned that a foreign exchange trader might unintentionally assume an undesirable credit risk when accepting a transaction on which the name has been switched. Even so, during the intervening two years, the number of "name" problems appearing in brokered transactions has increased substantially, at least for some market participants. Consequently, the Committee, in line with its on-going interest in market practices and developments, decided to study the various practices by which names are substituted to evaluate the need for these practices, document the procedures used, and elucidate concerns that might attend these practices.

The increased frequency of name problems appears to reflect a number of developments. Foreign exchange trading volume has increased overall. More institutions have come into the market in the U.S. and abroad, not all of whom are readily identifiable or equally well known in the United States. In addition, the current environment fostered an increased concern about credit lines and a greater need to observe existing limits. As a result, there are now more occasions when a bank's internal limits do not permit it to accept the name on the other side of a transaction.

When the original counterparties are incompatible, transactions have been completed in one of two ways. The broker finds either a clearing bank to interpose between the original counterparties, or a substitute counterparty to complete the transaction.

The Committee concluded from its study that neither the frequency nor the magnitude of name problems significantly impair the U.S. foreign exchange market at present. The losses that have occurred have been borne by the brokers, and, although the loss on any individual transaction could be substantial, so far the losses have not been a matter of financial concern.

Inherent Risks Clear

However, risks inherent in these practices are clear. The Committee expressed grave concern about any practice that, in effect, forces the brokers into a role of principal to a foreign exchange transaction, or of managing a foreign exchange position. Strong sentiment was expressed that all institutions reappraise the risks they incur when encountering name-substitution situations.

Toward this end, the Committee felt it could make a significant contribution to the market by issuing a paper on name substitution practices that would focus management attention on the risk of these practices and suggest some approaches for dealing with name problem situations. The Committee recognized the problem is a most complex issue and individual institutions may have their own views about how best to handle name situations. Even within the Committee membership, there remain differences of view about the seriousness of name problems and the most efficacious way for dealing with them. However, the Committee believed the market as a whole would benefit from a thoughtful in-depth discussion of the issue as seen by the Committee. The Committee recognized its discussions of these points greatly enhanced individual Committee members' appreciation of the many facets of the issue and heightened their sensitivity to the implications for others in the market of the way their own institutions handled such problems. The Committee hopes

therefore other institutions which have not had the benefit of participating in these discussions will find such a paper helpful and enlightening

Bank-Broker Relationship

The Committee's discussion of name-substitution practices pointed up the sensitivities which can exist within the bank-broker relationship. The Committee concluded it was extremely important—not only to each individual institution but for the market as a whole—to have effective management of these relationships at an appropriately senior level. The committee believes foreign exchange managers should themselves maintain contacts with the brokerage firms these institutions employ to establish the ways they want their brokering relationships to be structured.

PROCEDURAL MATTERS OF THE FOREIGN EXCHANGE COMMITTEE

Formal meetings of the Committee were held on the first Friday of each alternate month. In addition, special informal meetings were called on February 26 and May 5 to permit guests to address the group.

exchange market policy (see page 14). Takeshi Ohta, director of the foreign department at the Bank of Japan, spoke about recent trends in Japan's foreign exchange market and official Japanese attitudes towards the continued internationalization of the yen (see page 15).

FORMAL MEETINGS OF THE COMMITTEE

Meetings in 1982	Schedule For 1983
February 5	February 4
April 2	April 8
June 4	June 10
August 6	August 5
October 1	October 14
December 3	December 2

During the course of the year, the Committee was honored to have two guests comment on issues of general interest to the market. Beryl W. Sprinkel, under secretary of the Treasury for monetary affairs, discussed the Reagan Administration's foreign

Name Substitution Subcommittee

A major effort of the Committee was to review name substitution practices in the foreign exchange markets in the United States. An ad hoc subcommittee was established for this purpose under the chairmanship of Heinz Riehl (Citibank), in which Philip D'Angelo (Noonan, Astley and Pearce), Thomas Devine (Manufacturers Hanover) and Christopher Pavlou (Barclays Bank International) participated. Recommendations arising from this review were prepared and a paper on this subject was circulated to market participants early in 1983. The Committee also requested the Federal Reserve Bank of New York to reissue its 1980 paper, "Selected Issues Relating to the Management of Foreign Exchange Trading Activity."

At the end of the year, the Committee had outstanding requests from various market participants to consider the following questions:

IBF: Is it desirable and/or feasible to devise a negotiable instrument for International Banking Facilities which would at the same time meet the

Federal Reserve's concerns about complicating monetary control by providing a mechanism for leakage of domestic deposit-type liabilities?

TAPE RECORDING: Is it appropriate to use recorded tapes of conversations to confirm trades in the foreign exchange and money markets and to resolve disputes concerning the terms of a transaction?

EXPOSURE: When calculating foreign exchange exposure to any particular counterparty, is it appropriate to net offsetting transactions which fall due on the same day?

To consider the IBF question, a subcommittee was established under the chairmanship of Rolf Sellge (Morgan Guaranty) and comprised of Yoshihiko Nagaya (Bank of Tokyo), Raymond Peters (Bank of America), and Bryan Walsh (Irving Trust). The other issues had not yet formally been placed on the Committee's agenda.

In all of its actions or suggestions, the Committee—in accordance with its charter—does not attempt to issue rules or regulations. Rather, it recognizes that the force of its recommendations is dependent on the persuasiveness of the suggestion, and on the Committee's ability to engender respect in the market for its views.

*THE COMMITTEE'S ADVISORY ROLE TO THE FEDERAL RESERVE BANK OF NEW YORK
AND OTHER OFFICIAL INSTITUTIONS*

During a year in which market conditions and market structure were changing rapidly, the Foreign Exchange Committee served as an important channel of communication from the market to the Federal Reserve. In addition, the Committee effectively served as a forum for discussion among representatives of various types of market participants. These discussions frequently focused on market conditions and led to an enhanced appreciation of some of the causes and implications of the strains that developed, especially during the second half of 1982.

Market Conditions

After mid-year, as market participants began to evaluate credit quality increasingly critically, the Committee frequently took note of the changes in spreads that occurred between rates on different types of instruments and among obligations issued by different types of institutions.

With respect to the euromarkets, the movement to quality was reflected in a tiering of interest rates in the deposit market, a

widening in the spread between eurodollar instruments and U.S. Treasury bills, and changes in the interest-rate relationship between eurodollar certificates of deposit and deposits. These developments were attributed to concern about credit lines, liquidity preferences, and increased reluctance, for reason of capital adequacy, to arbitrage between various markets.

With respect to the exchange markets, there were increasing comments about the difficulty of finding counterparties willing to make a market during the New York afternoon and the decline in participation by medium and small-sized banks. While volume of direct trades between banks was reported to have declined, transactions through brokers increased and then was sustained at near-record levels. These phenomena were attributed to heightened concern about credit risk, as well as to greater adherence to daily settlement limits. Banks not only chose to cut back on the overall volume of foreign exchange trading. They also were not confident that they could live up to the need to conduct a direct dealing relationship on a reciprocal basis. In response, they apparently channeled more of their business through the brokers' markets.

Premiums in Market for Federal Funds

These discussions of market conditions afforded an opportunity for several Committee members representing foreign banks to express their concern foreign banks have consistently had to pay a premium in the federal funds market—a problem which intensified at the end of the third quarter. These discussions apparently had a constructive influence. Later in the year, foreign banks diversified their funding approaches. Partly as a result, the spreads they had to pay over the year-end were reportedly smaller than late in September.

Broker Takeovers, Management Changes

The year also saw a number of takeovers or other management changes among foreign exchange brokers in the United States. In some cases, brokers were taken over by institutions which had no prior familiarity with the foreign exchange business. The development was attributed to the attraction of profit opportunities in foreign exchange that require a relatively small capital outlay. So far, the Committee feels the reduction of the number of brokers in the United States has not resulted in an important reduction in the amount or the quality of service being provided. However, it was noted there have been a number of takeovers in other countries as well, and a continuation of this trend might lead to a reduction of competition among brokers worldwide.

Some Committee members noted how difficult it has become to decipher the management structure of individual firms or of the resulting groups of firms. Some concern also was expressed about the potential for conflict of interest as various entities developed a beneficial interest in more than one aspect of trading in these markets.

Nonbank Exchange Market Participants

Again in 1982, Committee members commented on the exchange market activity of nonbanks. The change in accounting rules had, at

least for a time, slowed trading activity for a number of banks' corporate clients. Some of the decline was offset, however, by the need to hedge a growing volume of borrowings in foreign currencies.

Bank members noted they had yet to see a substantial interest among their corporate clients in dealing through brokers—with the exception of investment banks and commodity trading houses.

Foreign Exchange Turnover Study

The Committee recommended to the Federal Reserve Bank of New York that a new foreign exchange turnover study be undertaken promptly. Market volume appeared to have grown substantially since the last turnover study was conducted in 1980. The market structure appeared to have changed at the same time, and questions were constantly being raised about the extent and durability of these changes.

Thus, in recommending the survey, the Committee expressed the belief that results of the proposed survey would be helpful to market participants for their internal planning purposes, and the usefulness of the survey would far outweigh any burden incurred in complying with the reporting requirements.

The Committee also recommended an effort be made to encourage central banks in other important trading centers to conduct a similar survey at the same time. Although the Committee preferred to have a survey as early as practical, it recommended the timing of the survey be adjusted to accommodate participation by other central banks.

The Committee also had specific suggestions to make about changing the survey form. These changes were suggested in order to clarify the instructions, ease the reporting burden, and adjust the survey to take account of recent changes in market structure and practice.

RECOMMENDATIONS PREPARED IN 1982

Name Substitution Practices in the United States Foreign Exchange Market

Issued January 6, 1983

Several practices currently are used by foreign exchange brokers that entail the enlistment of a new counterparty in a transaction that cannot be consummated as originally structured. Mainly these situations arise because one or the other of the original two counterparties is unwilling to accept the other, but they also may occur when a broker receives multiple simultaneous responses to a bid or offer. The Foreign Exchange Committee, in line with its on-going interest in market practices and developments, decided to study these practices in order to identify their causes, to document market practices as they exist, and to elucidate the concerns that might attend these practices. The Committee concluded that, while neither the frequency nor the magnitude of so-called name practices significantly impair the U.S. foreign exchange market at this time, there are clear risks entailed by these practices. The Committee's discussion of this issue also highlighted several points of sensitivity that can exist within the bank-broker relationship and underscored the need for effective internal management of these relationships.

The primary objective of this report is to enumerate and define the risks associated with these name substitution practices. The report also includes practical suggestions that the Committee believes would help to avoid some of the situations that give rise to these practices. These suggestions are intended to increase the amount of information available to market participants regarding potential counterparties and to prompt more open bilateral discussions among banks and brokers.

Description of Practices

When the two original counterparties are incompatible, it is usually because of credit line considerations. Since the convention of the foreign exchange brokerage market is not to exchange names of counterparties until the transaction size and exchange rate have been agreed to, the details of a trade are fixed before either party can realize that a name problem may exist. When a trade is aborted, each institution knows the details of a trade that, but for the name problem, would have been consummated. Because such information is considered privileged in this market, many institutions believe that,

once they have shown their hand in this way, they should complete a trade with the same specifications promptly. Brokers respond to this desire in one of two ways: either they find a new counterparty (a clearing bank) to interpose between the other two, or—if one counterparty cannot or is unwilling to proceed with the original transaction—they find a substitute counterparty for the remaining bank. In the past, many market participants have argued that these practices facilitate the consummation of transactions and make it more difficult for a counterparty to back away from an unfavorable transaction.

After 1978, when international brokering became widespread in the U.S. market, the frequency of these practices increased as the number of non-U.S. counterparties to brokered transactions grew dramatically. Some market participants have suggested to the Foreign Exchange Committee that the incidence may have increased still further more recently.

Associated Risks and Costs

The risk characteristics of the two methods of resolving name problems are different.

In the first case, when a third bank allows itself to be interposed between the original two banks and to act as a so-called "clearing bank", it does so out of a sense that it is contributing to the liquidity of the market. Both of the original two banks now have a credit exposure *vis-a-vis* the clearing bank which, as long as the clearing bank is in full knowledge of the trade and is operating in accordance with its normal procedures and limits, constitutes no different a risk than any other trade with that bank. The clearing bank, however, has tied up its credit lines with each of the other two parties. Consequently, its traders may have less flexibility in dealing with these institutions for a few days. (Usually these practices involve spot transactions, although occasional substitutions of names do occur in non-spot transactions.) Moreover, the two transactions entail the normal processing costs. They do not generate revenues, however, since both sides of the trade are executed at the exchange rate agreed to

by the original two counterparties. Some banks refuse to accept the name of a clearing bank and many banks refuse to act as a clearer in such transactions.

In the second case, one institution considers the transaction to have been executed but the counterparty cannot proceed with the deal and refuses to accept the name of a clearing bank. As a result, the broker effectively assumes a market risk until a substitute counterparty has been found because a replacement may not be found until after the exchange rate has changed from that agreed to originally. Often the broker offers to remit payment on any losses that result from market rate movements, while the replacement bank may realize a profit.

Sometimes when the loss accruing to a broker is substantial, a substitute bank agrees to defer settlement of a difference check for a specified period of time—perhaps up to the close of business. This is done as an accommodation to the broker to permit the broker, if the exchange rate should move back closer to the original rate, to find yet another counterparty willing to do an offsetting transaction with the substitute bank, thereby reducing the broker's loss. In these situations, the substitute bank ends up, in effect, playing the role of a clearing bank, but in the interim one side of the transaction has been left open for a time. Meanwhile, the broker has taken a view about possible exchange-rate movements during the time one side of the transaction has been left open.

Reasons for Possible Concern

Each institution which engages in these practices is exposing itself to the possibility of loss while at the same time forfeiting some of its control over the magnitude of potential losses. Difficulties or delays in finding a substitute or a clearing bank for a trade are factors that each manager should consider carefully before engaging in these practices.

At times one party refuses to accept a counterparty's name but insists that the broker find a replacement. The question has been raised whether the burden of finding an alternative counterparty is properly placed on the broker or, rather, whether the original trade should be canceled by both sides. Each bank should recognize that 1) any time its traders press the broker to find a substitute when it refuses to accept a counterparty to a trade, or 2) once the other counterparty has clearly canceled, or 3) each time a bank agrees to serve as a clearing bank without getting the names of the other two parties promptly, the broker is at risk to the extent that a substitute cannot be found before market rates change. Any loss incurred by the broker may be sufficiently sizable that the broker may be unable or unwilling to make good on the loss, even on a going-concern basis. In the event of bankruptcy proceedings, it is by no means certain the broker would be held liable for making payment to cover the loss. Therefore, the bank may be indirectly exposed to market risk in these transactions.

To the extent that brokers are held at risk in a transaction, their neutrality is impaired. Some brokers attempt to preserve their neutrality by following a strict policy of eliminating any uncompleted trade at the first possible opportunity regardless of rate. Nevertheless, there is likely to be a relationship between the frequency of the practice of name substitution and questions regarding the reputations of brokers.

Recommendations

The Committee expressed grave concern about any practice that, in effect, forces the brokers in a role as principal to a foreign exchange transaction or of managing a foreign exchange position. Foreign exchange brokering firms are often not capitalized to an extent appropriate to accept the risks of being put into those situations routinely. Moreover, the obligations which brokers are presumed to assume under some of these arrangements may not have a clear legal basis. Officers of banks with management responsibility for foreign exchange trading operations should be aware of these practices, determine if and under what circumstances dealers of their institutions should engage in these practices, and assure themselves that the institutions' policies or guidelines pertaining to these issues are being followed by all dealing personnel.

To the extent that such practices do continue in the foreign exchange market in the United States, for reasons of operational convenience and market efficiency, their frequency should be reduced to those situations that do not readily allow for alternative methods of resolution. A reduction in the frequency of name-related problems could be achieved if banks and brokers were to exchange more information with one another. The Committee believes some steps in this direction can be taken without creating ill will among institutions or divulging sensitive credit-related information.

A basic contribution that each bank and corporate user of brokers can make in this regard is to assure itself that its name is acceptable to enough of the participants in the brokers' market so that its actions do not contribute to name problems. By providing participants anonymity until a transaction price has been agreed to, a well-functioning brokers' market contributes to the depth and breadth of the market; but this method of doing business is practicable only if participants can be reasonably confident that virtually all counterparties met through brokers will meet certain minimum standards of creditworthiness. If there are some market participants perceived by most other participants as falling short of these standards, it is appropriate that potential counterparties be made aware of the possibly referable nature of any prices which such institutions show through a broker. Brokers cannot be expected to make credit judgments for banks. But they are in a position to know what addresses, if any, are consistently difficult to place and

have a responsibility of indicating to potential counterparties if a price they are currently showing is on behalf of such a name. Those institutions whose names are not sufficiently acceptable might consider whether it is appropriate or even in their long run interest to continue to use brokers to the same degree. Further, it would be constructive if banks were to advise potential counterparties, particularly those they consider referable, how they will be treated if met through a broker.

In addition, foreign exchange managers should themselves maintain contacts with the brokerage firms their institutions employ in order to establish the ways they want their brokering relationships to be structured and to define the approach their institution will generally follow in handling specific name problems. Some banks provide their brokers with the names of institutions with which they are willing to deal, or alternatively, the names of institutions they will virtually always reject. With the help of this information brokers can reduce the frequency of name problems by not matching pre-specified pairs of institutions. Admittedly, this procedure places extra operational burdens on brokers. Nevertheless, since some banks have found this system helpful in reducing name problems, other banks might consider similar steps. Brokers should do their best to accommodate these approaches.

Managers of foreign exchange operations at banks can and should assess the extent to which and the ways in which their banks are used as clearing banks. In any case, no bank should allow its name to be used without its prior consent for each and every transaction. And each bank should establish the period of time it requires the broker to identify the names of both counterparties

U.S. brokers with links to affiliated brokers overseas can contribute by making greater efforts to ascertain whether a bid or offer price that is communicated to it by an overseas affiliate for dissemination here has been initiated by an institution that might be an unacceptable or unrecognized counterparty to many of the broker's U.S. clients. In this instance, the U.S. broker should indicate that the institution may either be

referable or unknown, even if the overseas brokers do not do so. Further, brokers should apprise their clients regarding the name recognition and credit line problems that each might face in executing transactions through a broker.

With respect to specific name problems in day-to-day market situations, the Committee recommends that managers with oversight responsibility for foreign exchange adopt, observe, and expect as market convention the following practices in connection with specific name problems:

If two institutions meet through a broker and one indicates that it cannot accept the name of the other for credit line reasons, i.e., either it has no line for the second institution or its line is full, the broker should explain to the second institution why the transaction has not been consummated and identify the other institution involved. Two considerations support this conclusion. First, most managers consider this information to be helpful since it clarifies the market standing of their institution. Second, market participants recognize credit lines are a necessary prudential constraint on market participants; their invocation in appropriate circumstances does not necessarily reflect poorly on either institution.

Regardless of whether a name problem arises for credit line or other reasons, each institution is left with two options: each can either cancel its bid or offer price with the broker or insist that the broker find a substitute. If it opts for the latter, it should allow the broker a reasonable period of time in which to find a new counterparty whose name is acceptable. A substitute should be found in no more than a few minutes and preferably within the same phone call. If an acceptable name cannot be provided in a reasonable time period, the institution should cancel its price.

SELECTED OTHER DOCUMENTS OF THE COMMITTEE

Selected Issues Relating to the Management of Foreign Exchange Activity

(Reprint of 1980 Paper of the Foreign Exchange Committee)

Managers of foreign exchange activity have available to them a wide variety of material concerning the nature of the basic risks inherent in the business. The most recent contribution to the literature was the publication of the "Guidelines on Internal Control for Foreign Exchange Activities in Commercial Banks" issued by the Federal Financial Institutions Examination Council. That document, which was designed to guide bank examiners, provides a very useful uniform frame-

work for establishing the internal controls and procedures necessary to manage and control exchange risk.

In the view of the Foreign Exchange Committee, however, there remain a number of market practices and potential areas of management concern that have not been explored adequately in the literature. This report is designed to satisfy that need and enhance managers' awareness and understanding of these issues.

Conflict of Interest

Most banks today recognize the need to establish a code of conduct for all their employees to protect both the bank and the employee from potential conflict of interest situations. Nevertheless, the role of the trader—in particular the unique ability independently to commit the bank to sizeable risk exposures—suggests that some further amplification of the general code of conduct is desirable for the trading function. With respect to a potential conflict of interest arising from an individual's own financial affairs, we suggest, that banks should have policy guidelines covering trading for one's own account.

TRADING FOR ONE'S OWN ACCOUNT: There is an obvious potential conflict of interest in this situation that should be discouraged. However, one may wish to distinguish between trading and investment. A trader might buy a foreign currency and invest the proceeds in a deposit or security denominated in that currency; a trader might sell a foreign currency forward to hedge an existing deposit or security transaction. Identifying investment as opposed to trading transactions is not always a simple matter, but a clear understanding between manager and trader of what the bank's policy is in this area will eliminate most potential confusion. Outright position taking by traders should be prohibited.

The money and exchange markets are primarily telephone markets and ones in which close personal ties often develop between professionals. On the positive side, this facilitates the smooth functioning of the market; on the other side, it opens the

possibility that a trader could be tempted to assist a fellow practitioner at the expense of the employer. Consequently, the following two potential problem areas should be covered.

GIFTS, ENTERTAINMENT: This subject ordinarily will be covered by the bank's general code of conduct, and management should recognize that social entertainment is a widely accepted practice among market participants. However, given the special connections among traders, and between traders and brokers in the distribution of the bank's business, management should be alert to the possible abuse of entertainment or gifts.

OFF MARKET RATES: Any use of "off market" rates raises serious questions of propriety and perhaps policy issues for the bank. This issue most often arises in connection with swap transactions where there can be a choice between using "current" or "historical" rates. Although the essence of a swap transaction is neither the spot, nor the forward rate *per se*, both of these rates utilized in the swap should be consistent with current market rates. Non-market rates can be employed to move income from one institution to another (perhaps over an income reporting date) or can impact upon the timing of reported taxable income. In any event, since use of historical rather than market rates can in effect result in a loan of funds between the parties, all such requests should be referred to management for policy and credit judgments. While the nature of certain commercial transactions may justify

the use of historical rates with customers, there should be no exceptions permitted in trades with other banks.

The Trader - Trader Relationship

With the growth of direct bank-to-bank trading in the North American market during the last two years, this topic has taken on new importance. Many banks are now dealing directly at a time when the market's rapid expansion has led to a situation in which a large number of young and relatively inexperienced traders have been given significant responsibility in representing the participating banks. This suggests the necessity of clearly defining a code of behavior in the trader-trader relationship.

RECIPROCITY: Management must be conscious of the obligations their bank assumes when it engages in direct dealing. Generally speaking, "Bank A" will be expected, upon request, to reciprocate in providing timely, competitive rate quotations for marketable amounts when it has received this service from "Bank B." Differences in the relative size of "Bank A" and "Bank B" and in their expertise or specialization in certain currencies will influence the determination of what is perceived by the two parties as an equitable reciprocity. A periodic analysis of trading activity by management will reveal any unusually large concentration of direct trading with another bank or banks. Any such concentration should be reviewed by management to assure that the level of activity is appropriate.

The Trader - Broker Relationship

The use of brokers is a long standing feature of the foreign exchange market. Relationships between brokers and traders are based on a variety of factors, including quality of service (speed, reliability, closeness of prices, size of deals) and personal interaction. In these circumstances traders are quite likely to favor a few brokers over others and such concentration is not inappropriate. However, inasmuch as it is possible for a trader to influence a broker's share of the bank's business, there is always the possibility that some brokers may attempt to ingratiate themselves with a trader or that a trader may make unreasonable demands upon some brokers.

Therefore, managers should be alert to subtle changes in patterns of brokers use and to possible undue concentration of business, especially if they perceive no significant difference in the quality of service from other brokers.

Bank management will find that their broking counterparts will welcome any questions or input concerning the nature or extent of entertainment provided to traders or any aspects of the relationships between their firms.

In the interest of preserving confidentiality of transactions, visits by traders to brokers' offices during the trading day should normally be pre-arranged. During such visits traders should not participate in the interbank market through utilizing the on-premises communications network.

Traders should not conclude a deal through a broker when the counter-party is not identified, for it opens the way to possible confusion, to potential abuses and to the possibility that the bank might be left with a credit risk that it did not wish to assume.

Brokers should take full responsibility for confirming all international transactions to the banks by Telex, or by any other means of written confirmation acceptable to the banking community. In addition, brokers have responsibility for passing instructions on all spot international transactions on the same day the trade is consummated.

Trading practices

At times when the markets are unsettled and prices are volatile, opportunities may arise for traders to engage in practices which may realize an immediate gain or avoid a loss, but which may be questionable in terms of the trader's reputation—as well as that of the bank—over the long run. The kinds of questionable practices are many, from sowing rumors to renegeing on deals.

Management should be alert to any pattern of complaints about a trader's behavior from sources outside the bank, such as by customers or other banks. Information available within the bank should be reviewed to detect if individual traders become frequently involved in disputes over trades or tend to accept deals at rates which were obvious misquotes, accidental or otherwise, by counterparts. Complaints about trading practices may be self-serving, however, and should be handled judiciously.

Confidentiality

The issue of confidentiality deserves special consideration

Participants in the market—commercial accounts and banks alike—are entitled to have their interest and activity known only by the other party to the transaction and the intermediary, if one exists

Bank management should ensure that traders are regularly reminded of this need for confidentiality.

In our 1979 Annual Report The Committee commented upon "the practice of having open two-way speakerphones between banks and brokers. A number of Committee members pointed to the benefits that speakerphones provided in transmitting bid-offer quotations quickly to many banks. At the same time, there was considerable concern about the need to maintain confidentiality of operations of banks, within their own trading rooms and with their customers." In the end the Committee concluded that "it believed continuously open speakerphones at either the banks' or brokers' end to be inappropriate and that both ends should, as a minimum, be controlled by the use of press-to-talk-buttons."

While discussion between the traders of "Bank A" and "Bank B" concerning the activity of "Bank C" is to be condemned, it is most appropriate for the management of "Bank A" to advise the management of "Bank C" of impressions of undue or unusual market activity by "Bank C's" traders

The trading room is a popular spot for visitors who enjoy the clamor and excitement that can readily result from an active market. Unfortunately names of participants can often be recognized by visitors. We suggest, therefore, that visits to trading rooms by outsiders be minimized and that every effort be made during such visits to preserve confidentiality

Importance of Support Staff

Management's attention with respect to a foreign exchange trading operation is usually directed to establishing trading policies, managing risk and developing trading personnel. Equally important both to the management and the shareholders of the bank and to those counterparties with it is an efficient "back office" or operating staff. Details of each trading transaction must be accurately recorded, payment instructions correctly exchanged and executed; timely information provided to management and traders, and the underlying results properly evaluated. Time consuming and costly reconciliation of disputed or improperly executed transactions mar the efficiency of the market and ultimately can impair the willingness of others to trade with the offending bank.

Accordingly, management must be aware of its responsibility to establish a support staff consistent with the scope of its trading desk's activity in the market. Conversely, traders must be instructed to confine trading levels to volumes that can be handled by the available support staff.

Off-Premises Trading

Foreign exchange trading today literally takes place continuously somewhere on the globe throughout each *twenty-four* hours of the trading day. This requires policy answers to several questions: Will management accept requests to trade from parties who are obviously trading outside of their normal market time? Will management permit their trading personnel to initiate trades after normal trading hours - from home or elsewhere? If so, how will they control the transaction? With respect to requests received from third parties, the major concern must be a determination of whether the trader calling from abroad after normal trading hours there is authorized by the bank to trade at that time. Use of Telex rather than telephone will at least confirm the physical presence of the trader in the trading room, although by itself this does not answer the basic question of authorization

When the request is initiated by a commercial customer communicating from one geographic trading center to another, presumably the arrangement will have been discussed in advance and a *modus operandi* arranged that will identify and protect all parties. Management should determine how detailed they want this procedure.

When trades are initiated either from the office after the support staff has left or from the trader's home, there is no way to record the trade and its impact upon the bank's position until the following business day. If the bank has a global network, it seems prudent to restrict such trading to intra-bank transactions with copies of the trade to be forwarded by the receiving location to the initiating location.

If management chooses to provide its trading room with flexibility to cope with the unexpected—the call either at midnight from abroad or from the trader's home—it should certainly restrict the authority to designated senior trading personnel.

*Excerpts from Remarks by Beryl W. Sprinkel
Under Secretary of the Treasury for Monetary Affairs
February 26, 1982*

A FREE-MARKET ECONOMIC POLICY: That is the essence of the Reagan Administration's economic policies: they are free-market policies. The premise of President Reagan's economic recovery program is the inherent superiority of private market activity as a guide to economic decisions and as an engine of growth. He has acted decisively to end needless government interference with private markets, to reduce the burden of government on the economy, and to provide a stable, non-inflationary policy environment.

FOREIGN EXCHANGE MARKET POLICY: Perhaps nowhere is this more obvious than in our approach to foreign exchange markets. Our policy is clear: we minimize intervention in foreign exchange markets, by restricting it to cases of serious disorder which disrupt the normal functioning of these markets.

We have two basic reasons for our policy. The first is that we do not believe any individual or government is capable of identifying what the correct level of an exchange rate should be. The second is that, historically, intervention to fix or manage exchange rates has been a failure. Greater exchange market stability is desirable, but it can only be achieved through better coordination of policies, that is, if all countries provide a better and more predictable policy environment.

Economists and exchange market analysts have plausible theories about the main factors determining exchange rates in the long run. My own belief is that purchasing power parity should hold over sufficiently long periods. But in the short run, many different factors influence exchange rates, not all of which are measurable or obvious.

Exchange markets are large and breathtakingly efficient. With their tremendous worldwide volume—sometimes estimated at \$40 billion to \$50 billion in total turnover per day—and the rapidity with which pertinent information becomes available to all market participants, it is difficult for any one market participant to gain any advantage over others. We can all read the news services and call our friends. How can you outguess a market like that? Most of us would admit that nobody can do so consistently. Experience has demonstrated repeatedly that governments can't.

In the short run, with everybody constantly digesting the most up-to-date information possible, what often ends up driving exchange rate movements is changing market expectations. While these are expectations about the future behavior of market fundamentals—like interest rate differentials, inflation rates, or balance of payments developments—they often bear no obvious relationship to what those fundamentals are doing right now. They may not even bear any relation to what the fundamentals will do in the future. After all, expectations can be wrong.

Thus it is that in recent years we have seen exchange rate movements apparently correlated with, and thus seemingly caused by, widely differing economic variables at differing points in time.

In 1980, when the biggest economic news . . . was the wild gyrations in U.S. money growth and interest rates, these seemed to drive exchange rate movements.

THE DOLLAR AND FOREIGN CONDITIONS: But since then exchange rate movements have been all over . . . with regard to particular economic variables. During most of 1981 the U.S. dollar was appreciating, in spite of contrary movements of international interest rate differentials. We sometimes inferred that pessimism over European economic performance was dominating—concern over European resolve to fight inflation, concern over some persistently large current account deficits, and concern over overly rapid money growth and budget deficits in many countries—but even this will always remain a conjecture. The Polish situation undoubtedly had a depressing impact on European currencies. And at times there seemed to be a kind of "Reagan euphoria" at work in favor of the dollar.

More recently, it would appear that the rebound in U.S. interest rates has driven up the dollar. But why has this factor only now begun to dominate again? Why not all those times last year when the interest rate differentials were moving against the United States?

MARKET INTERVENTION: Under these circumstances, perhaps it is fortunate that intervention in exchange markets has been so spectacularly unsuccessful. The major Western governments intervened frequently and massively during the late 1970s, but this did not prevent large and rapid exchange rate movements in the directions they were trying to avoid. Intervention in an effort to fix rates, or ranges for rates, does not prevent exchange rates from reaching the levels to which market forces were driving them. Even intervention to slow rate movements, by "leaning against the wind," presupposes much more knowledge of equilibrium rates (or, if you will, about the constancy of the wind's direction and strength) than governments ever really have at their disposal.

U.S. ECONOMIC RECOVERY: The U.S. current account surplus of the past few years is now being held down by the dollar's appreciation over the last two years. As the U.S. begins recovering from the current recession, that surplus will disappear.

Nevertheless, we expect that our strong non-inflationary economy will continue to be reflected in a strong dollar. So that aspect of foreign complaints is not going to go away. Disciplined U.S. economic policies will always tend to produce a relatively strong dollar.

Excerpts from Remarks by Takeshi Ohta
Director, Foreign Department, the Bank of Japan,
May 5, 1982

SIZE OF THE TOKYO FOREIGN EXCHANGE MARKET:

The total volume of foreign exchange transactions in the market amounted to \$75 billion per month in 1981. It was just \$8 billion per month in 1976. The size of the market has increased by almost ten times during those five years.

At the same time, the dollar interbank call money market has also grown. This market amounts to \$24 billion according to its outstanding loan balance.

These developments reflect continuous expansion of export and import business as well as sharp increases in capital transactions. In particular, foreign currency transactions between Japanese residents—that is dollar loans by Japanese resident banks to resident corporations and dollar deposits with Japanese resident banks by resident individuals or corporations—have greatly increased following introduction of Japan's new Exchange Control Law in December 1980. This has very much contributed to the development of the Tokyo market.

The Tokyo market consists of 134 Japanese banks, 71 foreign banks and 10 foreign exchange brokers. All the transactions are conducted through foreign exchange brokers. International broking is not allowed yet, although two foreign brokerage firms are already there. Interest in direct dealing and international broking is expected to emerge in the not-so-distant future.

The Tokyo market has a very unique—or civilized—practice. It is closed from noon to 1.30 p.m. for lunch—the only market where the lunch time recess is allowed.

INTERNATIONALIZATION OF THE YEN: Foreign official holdings of yen are estimated to have amounted to more than \$25 billion at the end of March 1982. Total foreign holdings of yen are just anybody's guess, but our "guesstimate" is more than \$70 billion at the end of 1981.

The use of yen in visible trade business—exports and imports—is still rather limited. Around one-third of Japanese exports is denominated and settled in yen. But the share of yen-denominated imports is only a small percentage of the total. The yen is used internationally as an investment currency rather than as a trade currency.

The authorities' policy stance towards internationalization of the yen is rather simple.

We neither encourage nor discourage it, but we accept this development as the inevitable course of evolution. We are not prepared to take any artificial step to promote its progress. Nor are we prepared to move towards establishing an artificial two-tiered market such as an off-shore market in Tokyo.

OUTLOOK FOR THE YEN: The yen was and is still considered weak. This does not reflect so much any particular weakness of the yen, but rather the dollar's overall strength. Against the German mark, the yen has been fairly stable at around 100 yen to a German mark. The major cause for the current weakness, unlike that in the past, is the large scale outflow of long-term capital—about \$10 billion in 1981 compared to the inflow of \$2 billion in 1980—induced by the unprecedented large interest rate differentials between the United States and Japan.

Sometimes Japan is accused of trying to keep the yen at an artificially low rate to promote exports. This is not true. The Bank of Japan has made short-term money market rates firmer than they would otherwise have been since late March 1982, demonstrating our determination not to allow already large interest rate differentials to widen.

At the same time, the Bank often intervened vigorously in the market to support the yen. We simply wish to have a stronger yen and are firmly determined to prevent the yen from further depreciating.

Document of Organization

CONCLUSION OF FEASIBILITY STUDY TO ESTABLISH FOREIGN EXCHANGE COMMITTEE (June 1978)

It was generally agreed that any new forum for discussing matters of mutual concern in the foreign exchange market (and where appropriate off-shore deposit markets) should be organized as an independent body under sponsorship of the Federal Reserve Bank of New York. Such a Committee should,

- 1 be representative of institutions participating in the market rather than individuals,
- 2 be composed of individuals with a broad knowledge of the foreign exchange markets and in a position to speak for their respective institutions,
- 3 have sufficient stature in the market to engender respect for its views, even though the Committee would have no enforcement authority;
- 4 be constituted in such a manner as to ensure at all times fair presentation and consideration of all points of view and interests in the market, and
- 5 notwithstanding the need for representation of all interests, be small enough to deal effectively with issues that come before this group

The objectives of the Committee would be

To provide a forum for discussing technical issues in the foreign exchange market, as well as the related international money markets

To serve as a channel of information between the market and the Federal Reserve and, possibly, other official institutions within the United States and abroad

It is understood that the Committee would seek to work closely with the FOREX Association of North America (FANA)

The Committee may consider the possibility of formulating recommendations for uniform terminology and technical standards for use in the foreign exchange market. It will not concern itself with the evaluation of individual market participants, nor will it attempt to set requirements, qualifications, or terms for participation in the market

The Committee

In response to the results of the study, the Federal Reserve Bank of New York agreed to sponsor the establishment of a Foreign Exchange Committee. It was agreed that:

- 1 The Committee should consist of no more than 14 members and an equal number of alternates. In addition, the President of FANA would be invited to participate.
- 2 Institutions participating in the Committee should be chosen in consideration of their participation in the exchange market here as well as of the size and general importance of the institution. Selection of participants should remain flexible to reflect changes as they occur in the foreign exchange market

3. Responsibility for choosing member institutions and alternates rests with the Federal Reserve Bank of New York. The Federal Reserve may solicit the advice of current Committee members

4. Initially, the terms of half of the members will be for two years and half for three. Thereafter, to provide for maximum participation in the Committee by institutions eligible for membership, the term of membership would be two years. It is envisaged that, at the expiration of each member's term, the alternate would succeed to full membership

The composition of the Committee should be as follows:

- 5-6 East Coast banks (possibly including one New York Edge Act corporation)
- 2-3 regional banks
- 2-3 foreign banks
- 1-2 brokers (preferably to represent both foreign exchange and Euro-depositors)

the president of the FOREX Association of North America

the Federal Reserve Bank of New York

Committee Procedures

At the outset, there would be a meeting of the Committee—with a specified agenda of items—at least every alternate month (January, March, May, July, September, November). The format of the discussion, however, would be informal

In the event that a member is unable to attend a meeting, his alternate may attend

Any recommendation the Committee wishes to make on items coming to its attention can be discussed and decided upon only at its meetings. Any such recommendation would be distributed not only to member institutions and their alternates, but to every senior officer in charge of the international money desks of every participating institution in the United States

The Committee may designate *ad hoc* working groups to focus on specific issues

Depending on the agenda of items to be discussed, the Committee may choose to invite other institutions to participate in its discussions and deliberations

Summaries of discussions at each meeting would be prepared and distributed to market participants generally by the Federal Reserve Bank of New York on behalf of the Committee.

Meetings of the Committee would be held at the Federal Reserve Bank of New York

In addition to the meetings provided for above, a meeting of the Committee may be requested at any time by two or more members

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(For terms beginning January, 1983)

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ALTERNATES

MEMBERS

ALTERNATES

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