

THE
FOREIGN EXCHANGE COMMITTEE

ANNUAL REPORT

1951

CONTENTS

	Page
Chairman's Report	3
Advisory Role of the Foreign Exchange Committee	4
Subcommittee Reports	5-13
Trading Practices Subcommittee	5-6
• Historical-Rate Rollovers	5
• Points	5
• Disputes Resolution Body	5
Risk Management Subcommittee	6
• Price Risk Management	6
Market Structure Subcommittee	7-9
• Model Agreement for Foreign Exchange Options	7
• Model Agreement for Spot and Forward Foreign Exchange	7
• Electronic Order-Matching Systems	8
Communications Subcommittee	10
• Committee Publications	10
• Seminars on Foreign Exchange Options Master Agreement and Price Risk Management	10
Membership Subcommittee	10-13
• Organizational Changes	10
• Formal Meetings of the Committee	11
• Subcommittee Assignments for 1991 and 1992	12
Selected Documents	15-55
(a) Paper on Price Risk Management	16
(b) Letter on Historical-Rate Rollovers (December 26, 1991)	23
(c) Letter on Brokers' Points (May 3, 1991)	25
(d) Guidelines for the Management of Foreign Exchange Trading Activities	26
(e) Document of Organization	34
(f) ICOM Master Agreement	36
(i) The Agreement	36
(ii) Guide to the Agreement	46
Index	56-58
Foreign Exchange Committee Members and Alternates in 1991 and 1992	59-60

CHAIRMAN'S REPORT

Nineteen ninety-one was a year of exceptional activity for the Foreign Exchange Committee. A new organizational structure allowed members to give their attention to a number of issues simultaneously. As a result, the Committee completed work on one long-standing project, prepared and circulated papers on new topics ranging from off-market trades to the management of price risk, and launched a number of other activities that carried over into 1992.

The organizational changes instituted at the beginning of 1991 were twofold. First, four new standing subcommittees were established, bringing the total to five: Trading Practices, Market Structure, Risk Management, Communications, and Membership. Committee members were asked to serve on these subcommittees according to their preferences and professional backgrounds. This new structure enhanced the work of the Committee by focusing individual members' efforts on specific projects of the Committee. The second organizational change was the creation of a staff position, the executive assistant, to be provided by the Federal Reserve Bank of New York. The executive assistant not only relieved Committee members and Federal Reserve officials of much of the work load that they had previously assumed but also provided important follow-through on Committee projects between meetings, thereby enhancing the Committee's ability to complete work in a timely fashion.

Reflecting the change in Committee structure, this document is organized as a series of subcommittee reports. Each topic is presented according to the subcommittee responsible for addressing that topic:

- The Trading Practices subcommittee outlined procedures appropriate in the extension of certain maturing foreign exchange contracts and composed a letter reiterating the Committee's opposition to the use of points in the foreign exchange market.
- The Risk Management subcommittee prepared a paper explaining new ways to assess market risk among different products.

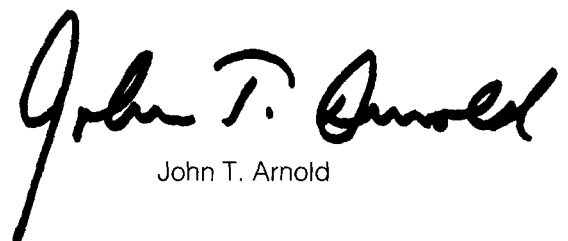
- The Market Structure subcommittee advised lawyers drafting model agreements for foreign exchange options and for spot and forward foreign exchange and sponsored a Committee discussion on proposed electronic trading systems.

- The Communications subcommittee considered ways to broaden publication of the Committee's work, including organizing seminars on Committee projects.

- The Membership subcommittee coordinated membership of the other subcommittees and considered organizational changes for the Committee.

At the end of 1991, the Federal Reserve Bank of New York announced the retirement of Sam Y. Cross. As Executive Vice President in charge of the Foreign Exchange Function, Sam was closely associated with, and an enthusiastic advocate of, the Committee's work. In early December, the Committee invited all former members to a reception in his honor. Fifty-five members and former members returned from across North America and overseas — one from as far as Australia — to show their respect for Sam. But it was also clear that they had strong, continuing interest in the Committee's work. They had worked with Sam and other Fed officials to assure the integrity, efficiency and strength of the market and praised the Committee's expanding efforts in these areas, particularly during a year in which abuses were uncovered in other markets.

The former members' return was a reminder to current members, supporting financial institutions and Federal Reserve officials of the Committee's important contribution to the foreign exchange markets in the United States and abroad.



John T. Arnold

ADVISORY ROLE OF THE FOREIGN EXCHANGE COMMITTEE

A major objective of the Foreign Exchange Committee is to advise the Federal Reserve on issues related to the foreign exchange market. Members from commercial and investment banking institutions regularly comment at Committee meetings on their interpretation of recent exchange rate trends or their observations of trading conditions. Members from foreign exchange brokerage firms often comment on recent trends in the volume of transactions or on issues that reflect pressures on the bank-broker relationship. Such insights are particularly helpful in periods of increased market volatility, as occurred at the time of the Persian Gulf War in January 1991 and the attempted Soviet coup in August 1991.

In the context of these discussions, members evaluated the effectiveness of central bank intervention operations during the year. Many attributed the success of officials in placing a floor on the dollar's decline in February 1991 to the high degree of coordination among a number of central banks and to their readiness to shift intervention tactics as the situation warranted. Members also felt that the dollar's subsequent recovery had been effectively capped by coordinated intervention to sell dollars in July 1991.

From time to time, Committee members also give their views to the Federal Reserve on legislative developments affecting the foreign exchange market. In 1991 many members voiced concern over a possible amendment to the Treasury bank reform proposal requiring banks to move part of their foreign exchange activity into separately-capitalized securities affiliates. These members felt that this amendment could raise the cost of trading in foreign exchange for customers, reduce the international competitiveness of U.S. banks, and reduce liquidity in the U.S. foreign exchange market. Some members, however, felt that the amendment could help level the playing field in the U.S. foreign exchange market between banks and non-banks.

The issue of market liquidity was discussed by Committee members on several occasions, as it had been in 1990. Many members felt that 1991 saw a con-

tinued decline in liquidity, defined as the ability to execute a sizeable transaction at a given price without moving the price decisively. Members believed that the decline in liquidity had occurred in part because exchange markets were one-sided for sustained periods during 1991. This one-sidedness reflected both a growing reliance by an increasing number of large-scale market participants on similar technical trading models, as well as strong economic and financial trends that led market makers to take proprietary positions in the same direction. The Committee was divided, however, on whether the decline in liquidity could be linked to an increase in price volatility that occurred during the year, and whether liquidity had declined more in the brokered segment of the market or in direct dealings between market makers. A few members disputed whether there had in fact been a significant change in liquidity over the past few years.

Committee members also considered the potential effect of impending bank mergers on market liquidity. Some were concerned that market-making capacity in the foreign exchange market as a whole would diminish as large trading rooms were merged. Others pointed out, however, that market-making would not diminish significantly if the merged entity had a strong commitment and a large presence in the marketplace, and if the position-taking activity of other institutions continued to grow.

The Committee also provided advice to the Federal Reserve on the design of the April 1992 foreign exchange turnover survey. The turnover survey has evolved over the years in response to changes in the structure of the foreign exchange market. Many members felt that, given the increasing importance of cross-currency trades since the last survey in 1989, the 1992 survey should request greater detail about these trades. Some members recommended that in-house bank trades be included in the turnover figures. Another suggestion was to fold the "swap" and "forward" categories into a single grouping. Based on the Committee's advice, the Federal Reserve added more detailed reporting on trading of the key cross-currency pairs and included, for the first time, internal bank trades done on an arms-length basis.

SUBCOMMITTEE REPORTS

TRADING PRACTICES SUBCOMMITTEE

The Trading Practices subcommittee focuses on day-to-day trading behavior among market practitioners, making recommendations to help reduce risk and enhance the reputation of the foreign exchange market. During 1991 the Trading Practices subcommittee concentrated on two issues — historical-rate rollovers and brokers' points. The subcommittee also discussed the possibility of creating a body within the Foreign Exchange Committee to help resolve disputes in the foreign exchange market.

Historical-Rate Rollovers

Historical-rate rollovers involve the extension of a forward foreign exchange contract by a dealer on behalf of his customer by applying the historical rate of a maturing contract to the spot end of a new contract. When the current market rate deviates from the spot rate of the maturing contract in a way that is adverse to the customer, the dealer is, in effect, providing credit to the customer by an amount equal to the difference between the original and marked-to-market values of the contract.

Articles appeared in the overseas press during 1991 discussing the practice of historical-rate rollovers. Reports indicated that the credit exposures created as a result of this practice were sizable. Several Committee members expressed concern that information on these exposures was limited and that the nature of these exposures was generally not well understood. Accordingly, the Committee asked the Trading Practices subcommittee to explore the subject of historical-rate rollovers, with particular attention to the risks associated with this practice.

Upon completing its review, subcommittee members concluded that the practice of providing historical-rate rollovers to customers deserved special attention because the dangers involved were often not fully appreciated by market participants. For example, dealers providing historical-rate rollovers might unwittingly become involved in aiding illegal or inappropriate activities. In addition, dealers and customers, not fully understanding the special nature of the transaction and the associated credit exposures, might fail to take adequate precautions. The subcommittee concluded that historical-rate rollovers were appropriate only if (a) customers have a

legitimate commercial justification for extending the contract, and (b) senior management at both the customer and dealer institution are fully aware of the transaction and the exposures involved.

The subcommittee drafted a letter reflecting these concerns and making suggestions on how prudently to handle requests for historical-rate rollovers. The letter was approved by the Committee in December 1991 and shortly thereafter was distributed to market participants throughout the United States (see pages 23-24). The Foreign Exchange Committee's Management Guidelines were subsequently amended to reflect procedures recommended in the Committee's letter (see pages 26-33).

Points

A second letter drafted by the Trading Practices subcommittee reiterated the Foreign Exchange Committee's opposition to the use of points in the brokered foreign exchange market. The Committee first voiced its concern about points in 1988. In 1989 the Committee published a letter stating its opposition to a points system of any kind. Informal surveys conducted during 1990 revealed that, despite success in reducing the use of points, situations involving points continued to occur. While the Committee was gratified by the progress made in the United States in reducing the frequency of points situations, members were concerned not to give the impression that the Committee was willing to condone the occasional use of points. The May 1991 letter therefore restated the Committee's dedication to the elimination of the use of points in the foreign exchange market (see page 25).

Disputes Resolution Body

The Trading Practices subcommittee also debated whether the Foreign Exchange Committee should establish a special panel to help settle trade disputes in the foreign exchange market. Some members questioned whether sufficient demand existed to warrant setting up such a panel, while others believed that the very existence of such a group might elicit excessive demand for its services. In the end, a consensus emerged that the subcommittee should not involve itself directly in the mediation or arbitration of individual disputes, but should seek to learn of and discuss disputes that raise legitimate

issues of market practice. Suggested issues for future subcommittee work included (a) guidelines for handling the initial discovery of a disputed contract, (b) guidelines for the taping of dealing and confirmation lines, (c) guidelines for exchanging settlement instructions, (d) guidelines for the trade confirmation process, and (e) guide-

lines for proper terminology and use of abbreviations on standard spot and swap transactions. The results of these discussions could be worked into the Committee's management guidelines or could come out as a set of special recommendations or principals for settling payments disputes.

RISK MANAGEMENT SUBCOMMITTEE

The goal of the Risk Management subcommittee is to foster understanding of risk management issues and facilitate improvements in the quality of risk management in foreign exchange and related international financial markets. During 1991 the Risk Management subcommittee prepared a paper outlining a "dollars-at-risk" approach for measuring and managing price risk in foreign exchange (printed on pages 16-22).

Price Risk Management

The Foreign Exchange Committee first addressed the price risk issue in 1988, arguing that, in designing risk management systems, institutions should concentrate on potential dollar losses rather than nominal positions. Many trading institutions have since recognized the merits of such a system. However, implementation of "dollars-at-risk" or comparable approaches for day-to-day risk management has generally been limited to a few large international banks.

The Risk Management subcommittee therefore decided to focus not only on the concept of "dollars-at-risk" but, more importantly, on alternative means of implementing risk management systems based on this concept. Early in their discussions, subcommittee members compared the systems being used at their individual institutions and concluded that their approaches share many common features. Indeed, once subcommittee members agreed on a common terminology to conduct their deliberations, they realized that their individual systems use remarkably similar principles, assumptions, and in many cases parallel design fea-

tures. The paper prepared by the subcommittee emphasizes these similarities.

The differences that distinguish individual risk management systems generally reflect member institutions' distinct organizations or cultures. For example, some member institutions manage risks globally with centralized risk measurement and control, while others assign risk management to local units. In addition, some institutions have created strong links between position taking and accumulated gains or losses over a given period while others do not associate the two in any systematic way.

Other differences between risk management systems involve the techniques for estimating future price volatility, choosing an appropriate time horizon, selecting degrees of confidence and adjusting for correlations among different currencies or instruments. While members found that their approaches to these statistical issues were quite similar, the subcommittee felt that a discussion of them would be useful to highlight alternative ways institutions can design a "dollars-at-risk" system to meet their individual needs.

The members of the Risk Management subcommittee emphasized that no risk measurement system, "dollars-at-risk" or otherwise, can guarantee against large, unanticipated losses. While they saw "dollars-at-risk" as a helpful tool to predict the number of times losses would exceed specific levels, they remained cognizant that the size of those losses cannot be predicted. A well-constructed risk measurement system is an important element of, but not a substitute for, careful risk management.

MARKET STRUCTURE SUBCOMMITTEE

The Market Structure subcommittee considers developments that are likely to impact the functioning of the foreign exchange market over the long term. During 1991 the subcommittee focused on two projects: (i) advising in the development of master agreements for foreign currency options and for spot and forward foreign exchange, and (ii) monitoring the progress of private-sector initiatives to develop electronic order-matching, or brokering, systems for foreign exchange.

Model Agreement for Foreign Exchange Options

Since August 1990, a Lawyers Group, comprised of legal representatives from various institutions active in the foreign exchange market in the United States, had been working in cooperation with a similar group sponsored by the British Bankers' Association (BBA) on an agreement defining key terms and addressing formation, exercise, and settlement procedures for foreign exchange options as well as procedures for the event of default. This joint effort resulted in the "International Currency Options Market Master Agreement" (ICOM), which is intended to serve as a model foreign exchange options contract in the United States and the United Kingdom. The contract is intended for participants in the interbank market but can also be employed with customers. At various points in the drafting process, the Lawyers Group consulted with the Foreign Exchange Committee to ensure that the document would reflect good industry practice.

Most of the substantive work on this agreement was completed during 1990 (see the 1990 Foreign Exchange Committee Annual Report, page 7). The principal effort in 1991 was to have the draft reviewed by the relevant parties in the United States and the United Kingdom to ensure its effectiveness in the two jurisdictions. Toward that end, a draft of the ICOM agreement was submitted to counsel in the United States and the United Kingdom for opinions regarding enforceability. Counsel recommended several technical adjustments, which the Lawyers Group incorporated into the current draft. The ICOM agreement as amended was endorsed by the Foreign Exchange Committee in April 1992 and is now available for use in the United States. Use in the United Kingdom is contingent upon final approval from the Executive Committee of the British Bankers' Association. The ICOM agreement and

the user's guide to the agreement are published in this report on pages 36-55. Legal opinions from counsel in the United States and United Kingdom, and a memorandum outlining issues raised by the ICOM agreement under Japanese law, can be obtained by contacting the Committee's Executive Assistant.

Model Agreement for Spot and Forward Foreign Exchange

For some time, market participants have recognized the need to establish a model contract for spot and forward foreign exchange that would address issues such as netting, close-out, and the relative importance of taped trade conversations and confirmations in a disputed trade. A number of prominent trade disputes and increased recognition of netting by accounting and regulatory institutions during 1991 motivated the Lawyers Group to begin drafting a model agreement for spot and forward foreign exchange, termed the "International Foreign Exchange Netting and Close-Out Master Agreement." Work on this agreement should be completed by mid-1992.

The Lawyers Group conferred with members of the Committee, particularly the Market Structure subcommittee, to determine good industry practice for netting, close-out, and trade confirmation. One issue that arose in this connection was the proper roles of taped telephone and written confirmations as evidence of a foreign exchange transaction. Most members felt that a tape of the conversation between two traders should be the first and most important piece of evidence on the terms of a foreign exchange deal. Although other pieces of evidence, including a tape of the conversation between two confirmation clerks or a written confirmation, could also be considered, most institutions do not confer on back office clerks the authority to enter into or change the terms of a transaction. In the event of a discrepancy between a trader's deal, as verified by a tape, or a trader's recollection of a deal in the absence of a tape, and a confirmation, the confirmation does not necessarily define the terms of the transaction.

At the same time, many members felt that institutions should be held responsible for accurate and timely confirmation of trades. An institution that, for example, con-

firms an incorrectly-specified trade bears some responsibility if losses mount after the confirmation error is made. Members described instances in which a trader error at one institution was incorrectly confirmed by another institution, thereby compounding by several times the magnitude of the original error. After a lengthy discussion, the Committee concluded that the agreement could be drafted so as to accommodate these two positions. First, the agreement could state that a contract is formed in the conversation between two traders and that the best evidence of this contract is the tape of that conversation. At the same time, the agreement could specify the duty of both parties to confirm all trades in a timely manner. In a section governing mitigation of damages, the agreement could indicate that any breach of this duty or error in the confirmation process should be brought to bear in determining damages.

Electronic Order-Matching Systems

For several years a number of private-sector entities have been working to develop electronic order-matching systems for foreign exchange. These systems are designed to improve the speed and efficiency of inter-bank foreign exchange trading and reduce transaction costs. At the same time, designers are seeking to preserve the essential features of the current "live" brokers' market, including appropriate credit standards for participation and the "blind brokerage" system in which counterparty names are revealed only after the trade has been agreed upon.

To keep the Foreign Exchange Committee up to date on these developments, the Market Structure subcommittee organized presentations to the Committee in November 1991 by the three groups developing electronic order-matching systems: Electronic Broking Services (EBS), MINEX Corporation, and Reuters plc. An overview of the three systems under development by these groups is presented in the accompanying table. Following the presentations, Committee members discussed the possible effects of these systems on the function and structure of the foreign exchange market.

Members were generally of the view that electronic brokering had the greatest potential in high-volume, rou-

tine products such as spot foreign exchange, where sufficient market participation was available to ensure the required level of market liquidity. In the market for such products, the advent of electronic trading would lower transaction costs and bring more players into the market, and thereby lead to an even sharper increase in trading turnover.

Committee members were less certain about the implications of electronic deal-matching on exchange rate volatility. Several members expressed the opinion that broader participation, lower cost arbitrage, and increased investment flows would likely offset other factors contributing to illiquidity and volatility in the exchange market. Other members, however, expressed concern that electronic brokerage could facilitate the use of program trading strategies in which participants can receive the same signals and try to move in the same direction all at one time. This would result in larger swings, and greater volatility, as the market adjusts to a new equilibrium level.

Meanwhile, members considered the possibility that extensive use of electronic order-matching systems might lead to significant changes in the structure of the spot foreign exchange market. In the first instance, some spot market business might be drawn away from live brokers. However, brokers might end up with more rather than less business if overall turnover increased. Products requiring a high degree of customization or lacking a high level of liquidity would probably continue to be traded either directly between counterparties or through live brokers.

At a later stage, the impact of electronic dealing might be greater on dealers than on brokers, especially if customers are given direct access to these systems. In this case, electronic order-matching services might make it easier for corporate and institutional users of foreign exchange products to bypass dealers altogether. There would, however, always be a need for professional dealers since most end-users of foreign exchange would continue to require the informational and transactional services provided by dealers. In this scenario, banks that offered value added services — such as complex products, strategies and quality analysis — would prosper.