

**THE
FOREIGN EXCHANGE COMMITTEE**

ANNUAL REPORT

1993

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CHAIRMAN'S REPORT

Nineteen ninety-three was an exceptionally busy year for the Foreign Exchange Committee. The Committee completed important projects in each of the major areas of foreign exchange trading — trading practices, risk management and the legal and regulatory framework of the market. The Committee also presented two public seminars to increase public awareness and understanding of the Committee's work.

The 1993 Annual Report reflects the Committee's increased productivity. The Report discusses eight major Committee projects completed during the year: the paper *Measuring Pre-Settlement Credit Exposures With "Loan-Equivalent Risk,"* produced by the Risk Management subcommittee; Committee letters on the subjects of brokers' switches and confirmation practices, produced by the Trading Practices subcommittee; a Committee discussion on the future of the foreign exchange market and the Committee's formal comment on the netting and market risk proposals of the Basle Committee on Banking Supervision, both led by the Market Structure subcommittee; the International Foreign Exchange Master Agreement (IFEMA), completed by the Lawyers Group; and two public seminars, one on the pre-settlement risk paper and the other on IFEMA, organized and presented by the Committee's Communications subcommittee. Each of these projects is described in detail in the subcommittee sections that follow. Committee documents completed during the year are also re-printed herein.

Critical to the Committee's ability to make a meaningful contribution in so many areas was the full implementation in 1993 of two major organizational changes. In 1991, the Committee had implemented a structure of five standing subcommittees. During 1992, the Committee experimented with its membership structure by inviting members and alternates to the Committee's formal meetings. The former member/alternate structure and the formal/informal meeting distinction were eliminated at the end of 1992. This past year, 1993, was the first year that both of these important organizational changes were fully implemented. The full participation of all Committee

members at the subcommittee level as well as at all the Committee's monthly meetings greatly increased the energy and intellectual power that could be brought to bear on issues of concern.

Nineteen ninety-three also marked the end of an era at the Foreign Exchange Committee. Gretchen Greene, Senior Vice President at the Federal Reserve Bank of New York, announced that she would be moving from the Fed's foreign exchange area to head the newly-formed Economic Studies function in the Fed's Research Group. Gretchen had been a member of the Fed's Foreign Exchange Department since 1972 and had served as its senior officer since 1984. In that capacity, she was one of the principal founders of the Foreign Exchange Committee in 1978 and has been its guiding force ever since. More than anyone else, Gretchen Greene is responsible for what the Foreign Exchange Committee has become.

In November of this past year, the Committee invited all current and former members to a reception and dinner in Gretchen's honor. Seventy members, current and former, attended from across North America and overseas, some from as far away as Australia and Japan. This remarkable response is clear acknowledgement of the significance of Gretchen's contribution to the Committee and to the foreign exchange market, as well as the importance the Committee has achieved under her guidance. All of us at the Foreign Exchange Committee say thank you to Gretchen and wish her great success in her new responsibilities.



Lewis W. Teel

LEGAL INITIATIVES OF THE FOREIGN EXCHANGE COMMITTEE

To promote greater understanding of the laws and statutes that govern foreign exchange trading, and to enhance the integrity of the foreign exchange market by encouraging the adoption of sound trading practices, the Foreign Exchange Committee has in recent years sponsored projects to draft model agreements or evaluate the statutory underpinnings of the foreign exchange market in the United States:

- In early 1985 the Committee published a draft interbank netting agreement designed by a study group of lawyers representing institutions on the Committee.
- In 1986 an *ad hoc* Options Task Force established by the Committee reviewed U.S. law regarding over-the-counter (OTC) transactions in foreign currency options.
- During 1987 a Committee-sponsored Lawyers Group, comprised of legal representatives from various institutions active in the foreign exchange market in the United States, drafted an unpublished working paper, "U.S. Interbank Market Standard Terms and Conditions for Foreign Currency Options" (USICOM Terms).
- In April 1992 the Committee published the International Currency Options Market (ICOM) Master Agreement, which defines key terms and addresses formation, exercise, and settlement procedures for foreign exchange options as well as procedures for the event of default. The agreement was drafted by the Committee's Lawyers Group in conjunction with a similar group sponsored by the British Bankers' Association (BBA) and is applicable in both jurisdictions. The Committee held two public seminars on ICOM at the Federal Reserve Bank of New York in May of 1992. ICOM was also endorsed by the Executive Committee of the BBA in mid-1992. As of September 30, 1992, ICOM represents the customary market terms for trading in currency options in the London market, superseding the London Interbank Currency Options Master (LICOM) terms, which had been published by the BBA in August 1985. The ICOM Agreement and the Guide to the Agreement are printed on pages 36-55 of the Committee's 1991 Annual Report.

- In August of 1992, the Committee submitted an *amicus curiae* ("friend of the court") brief in the case of Tauber v. Salomon Forex. The text of the brief is published in the Committee's 1992 Annual Report, pp. 31-39.

Model Agreement for Spot and Forward Foreign Exchange

Following the completion of the ICOM agreement, the Lawyer's Group began work in 1991 on a model master agreement for spot and forward foreign exchange. Work continued through the first few months of 1993 to clarify and refine certain aspects of the agreement. The Lawyers Group sought the Committee's guidance regarding several issues at the Committee's April meeting:

- Adequate assurances and credit-related events of default:
The Committee did not object to the inclusion of broader credit-related events of default (e.g., cross defaults, mergers, and guarantor defaults). The Committee decided that it would be acceptable to include a provision for a 15-day waiting period after the filing of an involuntary bankruptcy petition. The Committee also expressed strong support for an adequate assurances clause identical to that in the ICOM agreement.
- The appropriate discounting factor in close-outs:
The Committee expressed satisfaction with the use of a cost-of-funds valuation for determining interest payments to be added or discounted for the period between the value date and the close-out date.
- Exchange of confirmations:
The Committee felt strongly that best market practice required that confirmations be exchanged between principals in all transactions, even those that are brokered.
- Mitigation of losses and allocation of fault:
The Committee overwhelmingly endorsed requirements that Parties mitigate losses and that courts or other fact-finders allocate losses based on an assessment of comparative negligence.

The Agreement, termed the International Foreign Exchange Master Agreement (IFEMA) was completed and endorsed by the Foreign Exchange Committee in the spring of 1993. IFEMA provides a set of common contractual terms for spot and forward foreign exchange transactions and sets out procedures that will govern the methods of netting and close-out by which counterparties can liquidate their trading positions, including in the event of default by one counterparty. The procedures for netting contained in IFEMA are of particular importance given recent accounting rule changes associated with interpretation number 39 of FASB 105 that require banks to report unrealized gains and losses from their trading activities on their balance sheets. Like the ICOM Agreement, IFEMA was drafted by the Lawyers Group in conjunction with a similar group sponsored by the British Bankers' Association. IFEMA provides a basis upon which dealers operating in the United States and the United Kingdom can trade foreign currency with a wide range of dealing counterparties and customers on both

sides of the Atlantic without the need to negotiate costly specialized agreements. The Agreement is reprinted in this Report beginning on page 42.

To increase public awareness and understanding of IFEMA, the Committee held a seminar at the Federal Reserve Bank of New York on May 20 (the seminar is described in more detail on page 12). Copies of the Agreement, the accompanying Guide to the Agreement and an opinion of outside counsel were distributed at the seminar. Anecdotal reports suggest that many foreign exchange dealers have signed IFEMA with their dealing counterparties and customers. The IFEMA was also endorsed by the Executive Committee of the British Bankers' Association in the fall of 1993, and a Japanese version of IFEMA is expected in early 1994. Bound copies of the Agreement, the Guide and the other attending documents can be obtained by contacting the Committee's Executive Assistant.

TRADING PRACTICES SUBCOMMITTEE

The Trading Practices Subcommittee monitors issues raised by the trading behavior of market participants and makes policy and procedural recommendations to promote sound trading practices and enhance the integrity of the foreign exchange market. During 1993 the Trading Practices subcommittee focused on two important issues: name substitutions, or "brokers' switches," and confirmation and dispute resolution practices.

Brokers' Switches

In broker-arranged foreign exchange transactions, the names of the institutions placing bids or offers typically are not revealed until the transaction's size and exchange rate are agreed upon. The anonymity of potential counterparties is a matter of industry convention, as the very identity of the bidding or offering institution is information that could affect the terms of a transaction. From time to time, however, once the terms of such transactions are agreed upon and the identities of the institutions are revealed, one counterparty may be unacceptable to the other due to the limited availability of credit lines. In such situations, the counterparties generally agree to the substitution of a third counterparty, or "clearing institution," between them. The third institution clears the problem transaction by executing matching and offsetting trades with the original counterparties at the original price. Because it executes offsetting trades, the clearing bank does not assume price risk, but does bear the credit risk of both counterparties.

The Foreign Exchange Committee first analyzed the switches issue in 1982, at which time the Committee issued several recommendations on the practice (see the Committee's 1982 Annual Report, pages 8-10). In 1992, the Trading Practices subcommittee decided to re-examine the issue due to reports that switches had become increasingly difficult to arrange over the past few years as institutions became less willing to act as clearing banks. A short questionnaire distributed to dealing members of the Committee in April of 1992 confirmed that a significant minority of dealers, including several of the higher-volume dealers on the Committee, were reluc-

tant to act as clearing banks, citing the additional credit risk and the possibility for unethical behavior. Brokers stated that the difficulty in arranging switches could eventually diminish liquidity in the brokers' market.

Subsequent Committee discussions of the issue raised additional concerns. For example, despite the Committee's 1982 recommendation that switches be executed within a few minutes, Committee discussions revealed that many switches continue to be arranged long after the initial discovery of counterparty incompatibility, occasionally up to several hours later. Because exchange rates continue to move between the time that a counterparty is rejected and the time that an acceptable clearing institution is identified, switched transactions will usually be executed at rates not currently quoted in the market, raising the risk of abuse associated with any off-market rate transaction (see the Committee's letter on historical-rate rollovers, 1991 Annual Report, pp. 23-24). In addition, because name substitutions as currently arranged are an accommodation between traders and brokers and are not normally reflected as switches in the records of the institutions involved, they are sometimes accomplished without the knowledge or approval of management.

With these concerns in mind, the Trading Practices subcommittee set out in early 1993 to draft a letter for the purpose of improving the practice of switching. The effort proved to be very challenging. Nevertheless, the letter was successfully completed and approved by the Foreign Exchange Committee in September 1993. The letter, reprinted in this Report beginning on page 23, outlines management principles and recommended procedures intended to enable trading room management to distinguish switches from other foreign exchange transactions, thereby bringing switches within management control and permitting more dealing institutions to support the liquidity of the foreign exchange market by occasionally providing the facility of name substitution to other firms with whom they have available credit lines.

Confirmation and Dispute Resolution Practices

In 1991, Committee members agreed that the foreign exchange market lacked a clear articulation of best market practice regarding the confirmation of trades and the resolution of trade disputes. With this in mind, the Trading Practices subcommittee also set out in early 1993 to draft a letter on confirmation practices in the hope that clearer guidelines would reduce the frequency of trade disputes and minimize the associated losses. The letter was completed and approved by the Foreign Exchange Committee in December of 1993.

The letter, reprinted in this Report beginning on page 25, outlines management principles and recommended procedures based on the understanding that all foreign exchange market participants have certain duties:

- to maintain an efficient and rigorous back office;

- to exchange same-day confirmations of all foreign exchange transactions to which they are a party;
- to make and store tapes of trades and phone confirmations;
- to respond to all reasonable requests for confirmation; and,
- to mitigate losses and resolve disputes.

In its letter the Committee also states that any losses arising from trade disputes should be allocated between the counterparties involved according to a standard of comparative negligence, the evaluation of which would encompass the parties' conduct in the original trade, the phone confirmation, the same-day written confirmation and the check-out process.

MARKET STRUCTURE SUBCOMMITTEE

The Market Structure subcommittee considers issues and developments that are likely to affect the structure and character of the foreign exchange market over the long term. During 1993, the subcommittee undertook two principal projects: leading a Committee discussion on the future of the foreign exchange market in the United States and co-drafting with the Risk Management subcommittee the Foreign Exchange Committee's formal comment on the market risk paper of the Basle Committee on Banking Supervision.

Committee Discussion on the Future of the U.S. Foreign Exchange Market

Over the past several years, the Foreign Exchange Committee has noted that rapidly expanding market turnover, increases in the number and types of participants, unprecedented price volatility and technological advances have accelerated the evolution of the market. In early 1993, the Committee decided to take stock of how the U.S. foreign exchange market has changed in recent years and to discuss where the market is heading. The Committee's Chairman asked the Market Structure subcommittee to lead the discussion, which took place at the Committee's May meeting. The subcommittee decided to structure the discussion around three principal topics: the legal and regulatory framework of the market, issues regarding the providers and users of market liquidity, and the likely impact of electronic brokerage systems.

During the discussion of the market's legal and regulatory framework, members expressed concern that the foreign exchange market may be facing greater oversight and perhaps even regulation following the events of September 1992. In response, a representative from the Federal Reserve offered four theoretical rationales for regulation: 1) to protect the small investor, 2) to ensure market activity does not undermine the policy goals of elected officials, 3) to ensure market activity does not represent a threat to the safety and soundness of the banking system, and 4) to ensure that financial institutions do not behave in a way that could undermine public confidence in the integrity of the financial system. Members agreed that only protecting the integrity of the financial system would be a good reason for increasing oversight.

The discussion of market liquidity began with the observation by one member that, while U.S. market daily turnover has increased from \$5 billion in 1977 to \$240 bil-

lion in 1992, there are fewer active market-making institutions. Most members nevertheless agreed that despite this trend, the foreign exchange market remains highly liquid. Members commented that the market's liquidity is due in large part to the fact that the market provides ample compensation in the form of information and revenue to market-makers. For this reason, members concluded that market liquidity is unlikely to become a problem. Members disagreed, however, regarding the likely impact on market liquidity of the forthcoming Basle capital requirements for foreign exchange trading.

Regarding electronic brokerage, members agreed that while it is workable from a technological point of view, it is too early to tell whether electronic brokerage will ultimately prove to be a viable business alternative to traditional voice brokerage. Not surprisingly, members representing brokers were less optimistic about the prospects of electronic brokerage than members representing banks. The bankers noted cost reduction as the principle reason for their optimism. The brokers, however, pointed out that credit problems could not be handled as flexibly by electronic matching systems, and that the "human element," which becomes more important during periods of stress, would also be lost.

Committee Comment on the Basle Market Risk Proposal

In April 1993, the Basle Committee on Banking Supervision released for public comment papers outlining the proposed supervisory treatment of netting and market risk. Following the release of the papers, the Market Structure and Risk Management subcommittees were directed by the Chairman to co-draft a formal comment on the Basle papers to be submitted in the name of the Foreign Exchange Committee. At the first meeting of the two subcommittees, it was resolved that the Lawyers Group should be asked to draft the comment on the netting paper, while a smaller task force made up of Market Structure and Risk Management members would draft the comment on the foreign exchange section of the Basle market risk paper. Work on the comment began in August and the Committee's formal comment was submitted to the Secretary of the Federal Reserve's Board of Governors on December 22, 1993. The text of the Committee's comment is reprinted in this Report beginning on page 27.

RISK MANAGEMENT SUBCOMMITTEE

The Risk Management subcommittee fosters understanding of risk management issues and promotes improvements in the quality of risk management techniques in foreign exchange and related financial markets. During 1993, the work of the Risk Management subcommittee focused on two principal projects: completion of the paper *Measuring Pre-Settlement Credit Exposures With "Loan-Equivalent Risk"* and co-drafting with the Market Structure subcommittee the Foreign Exchange Committee's formal comment on the foreign exchange section of the Basle Committee's market risk paper.

Pre-Settlement Credit Risk

As early as 1983, the Foreign Exchange Committee published papers describing methods to measure and control pre-settlement credit risk — the possibility of counterparty default prior to the settlement of an outstanding foreign exchange contract which has positive value for the non-defaulting party. In its 1989 Annual Report, the Committee outlined the "loan-equivalent" approach for measuring pre-settlement credit risk, which separates pre-settlement risk into a current risk amount based on the marking-to-market of the outstanding contract, and a volatility-based potential future risk component. With this initial paper as a foundation, the Risk Management subcommittee began in 1992 an examination of the applications of the loan-equivalent method for measuring credit risk. The subcommittee structured its study around questions such as:

- What are the advantages and disadvantages of using loan-equivalent risk as opposed to more traditional measurements of credit risk?
- What alternative implementation techniques should be examined for loan-equivalent risk systems?
- Are loan-equivalent risk calculations useful for purposes other than estimating pre-settlement credit exposures from individual counterparties?
- What are the most effective methods to control pre-settlement credit exposures as measured by loan-equivalent risk?

An advanced draft of a paper outlining the subcommittee's findings was completed in late 1992. The subcommittee continued to revise the paper through the first few months of 1993. An important part of the revision process was the Committee's February meeting, which was devoted entirely to a presentation and discussion of the subcommittee's paper. The discussion was led by the subcommittee's co-Chairman and focused on five major aspects of the pre-settlement risk issue: (1) management of price correlation between contracts, (2) the value of credit risk "triggers," (3) the importance of centralized management of credit risk, (4) the "ownership" of credit risk within an institution, and (5) uses of the loan-equivalent risk method.

From this Committee discussion came some important insights that were subsequently incorporated into the final draft of the paper. For example, the loan-equivalent risk approach explicitly recognizes that pre-settlement credit exposures, unlike conventional loan exposures, can change over time without the addition or subtraction of new contracts as market prices fluctuate. It was also pointed out that because credit risk as measured by the loan-equivalent risk methodology is generally lower than gross nominal exposures, implementation of the technique would likely enable dealing institutions to transact a greater volume of business. Moreover, as credit risk triggers are approached, banks using the method can continue executing trades that reduce loan-equivalent risk, rather than discontinuing trading once limits based on gross nominal exposures are reached. It was also acknowledged that the loan-equivalent risk technique provides only an estimate of an institution's potential dollar exposure; the institution must separately estimate the probability of counterparty default.

The subcommittee's paper *Measuring Pre-Settlement Credit Exposures With "Loan-Equivalent Risk"* was finalized in the spring of 1993 and was printed in the Committee's 1992 Annual Report. A public seminar on the paper was held at the Federal Reserve Bank of New York on May 20, 1993. See page 12 for a more full discussion of the seminar.

Settlement Risk

Following the completion of the pre-settlement credit risk project, the subcommittee had intended to take up the more difficult topic of settlement risk — the possibility of counterparty default during the settlement cycle. However, the subcommittee decided to postpone the project due to legal uncertainty surrounding the issue following an April 1992 decision of the Second Circuit Court of Appeals in the case of Refco F/X Associates, Inc. v. Koreag, Controle et Revision, S.A.

Refco is a New York-based dealer of commodities and foreign exchange. Koreag is a Swiss corporation that had been appointed liquidator of the estate of Mebco Bank, S.A., a Swiss bank that was placed into liquidation by the Swiss Banking Commission in April 1989. The case concerned Refco's attempt to reclaim \$6.9 million as well as an additional \$4.1 million in foreign currencies following Mebco's default during a late-April 1989 settlement cycle with Refco. Overturning a District Court decision, the Court of Appeals ruled, in part, that Refco had the right of reclamation against Mebco with respect to the

\$6.9 million transaction. The Court ruled in Koreag's favor regarding the \$4.1 million in foreign currencies.

The Court's decision has important implications for foreign exchange trading, and specifically the issue of settlement risk, as it amounts to the granting of preferential treatment to the counterparties to certain types of foreign exchange transactions during bankruptcy proceedings. The Subcommittee on Payments of the American Bar Association is currently preparing a paper regarding the Court's decision, in which the Subcommittee contends that the Court of Appeals was incorrect in recognizing foreign exchange transactions as "goods" under Article 2 of the Uniform Commercial Code. In its paper the Subcommittee argues that such transactions should be considered under Article 4A of the Code, which concerns wire transfers of bank credit and which does not include reclamation of delivered currencies. In light of this legal activity, the Risk Management subcommittee decided to postpone its settlement risk project until the legality of the issue is resolved.

COMMUNICATIONS SUBCOMMITTEE

The Communications subcommittee coordinates the dissemination of the Foreign Exchange Committee's work to market participants. Toward this end, during 1993 the subcommittee oversaw the distribution of two Committee letters, on brokers switches and confirmation practices, as well as the production and distribution of the Committee's 1992 Annual Report. Approximately 1,200 copies of each document were distributed during 1993. The subcommittee also planned and coordinated two public seminars.

Seminar on Committee Paper

On Thursday, May 20, 1993 the Communications subcommittee sponsored a public seminar on the Committee paper *Measuring Pre-Settlement Credit Exposures With "Loan-Equivalent Risk."* The paper is printed in the Committee's 1992 Annual Report. Members of the Foreign Exchange Committee's Risk Management subcommittee responsible for preparing the paper delivered the presentation (see page 10 for a more detailed discussion of pre-settlement credit risk and the loan-equivalent method). The seminar was held at the Federal Reserve Bank of New York.

The presentation phase of the seminar was divided into six sections: (1) an explanation of the loan-equivalent method, (2) the management of price correlation between contracts, (3) the value of credit risk "triggers," (4) the importance of centralized management of credit risk, (5) the "ownership" of credit risk within an institution, and (6) uses of the loan-equivalent risk method. The floor discussion that followed the presentation focused on the statistical assumptions associated with the method, the impact of price correlation on the measurement of loan-equivalent risk, and issues pertaining to the implementation of the method.

About 285 outside guests, mainly trading room man-

agers, risk managers and control officers attended the seminar. About 130 institutions were represented, including several foreign central banks. The seminar was also video taped. Copies of the paper or video cassettes of the seminar can be obtained by contacting the Committee's Executive Assistant.

Seminar on the IFEMA

On Thursday, September 9, 1993 the Communications subcommittee sponsored a public seminar on the International Foreign Exchange Master Agreement (IFEMA). The seminar was held at the Federal Reserve Bank of New York. Representatives from the two groups responsible for the drafting of the Agreement, the Committee's Lawyers Group and a similar group sponsored by the British Bankers' Association, delivered the presentation. Copies of IFEMA, the Guide to IFEMA, the London Terms and two opinions of outside counsel were distributed at the seminar.

The presentation phase of the seminar focused on the evolution of IFEMA and the rationale behind several of its key provisions. The floor discussion that followed addressed differences between novation and close-out netting, IFEMA's relation to other master agreements and plans to seek opinions of outside counsel in other jurisdictions. Representatives from the Federal Reserve Bank of New York, the Bank of England and the Bank of Japan also expressed support for IFEMA. Approximately 300 guests — foreign exchange traders, credit officers, back-office personnel and legal staff — representing about 130 institutions attended the seminar.

The Agreement, the accompanying Guide and the Sullivan & Cromwell opinion regarding the enforceability of IFEMA are reprinted in this Report beginning on page 42. Copies of any of these documents can be obtained by contacting the Committee's Executive Assistant.

MEMBERSHIP SUBCOMMITTEE

The Membership subcommittee advises the Federal Reserve Bank of New York regarding potential candidates for membership on the Foreign Exchange Committee. The subcommittee also makes recommendations regarding subcommittee assignments and considers organizational changes for the Committee. During 1993 the subcommittee recommended several changes to the Committee's structure, all of which were adopted by the full Committee.

Change in Membership Structure

In 1993 the Foreign Exchange Committee operated under a new membership structure under which all participants on the Committee are considered full members. The former member/alternate structure, under which the Committee had operated since its inception in 1978, had been suspended on an experimental basis in 1992. The suspension of the original arrangement was recommended by the Membership subcommittee, as the accelerated pace of the Committee's work and the formation of standing subcommittees had raised questions regarding the continued usefulness and appropriateness of a two-tiered structure. Alternates' attendance and participation at Committee's meetings over the course of 1992 subsequently indicated that a permanent change in the Committee's structure was warranted. Therefore, at the end of 1992, the Membership subcommittee recommended and the Committee approved that the member/alternate structure be eliminated, effective in 1993. The term of membership was changed to four years for all members and terms were to be staggered with approximately one quarter of the number of terms expiring each year. These changes were incorporated into the Committee's revised Document of Organization at year-end 1992.

Change in Subcommittee Structure

Following its meeting in early December 1993, the Membership subcommittee recommended that each member of the Foreign Exchange Committee be a member of one of the Committee's three principal subcommittees — Trading Practices, Market Structure and Risk Management. In making its recommendation, the subcommittee pointed out that, while the Communications and Membership subcommittees are vitally important, most of the Committee's substantive work is accomplished by the Trading Practices, Market Structure and Risk Management subcommittees. In order that all members of the Committee may have the opportunity to participate in the Committee's major projects, the subcommittee recommended that members serving on the Communications or Membership subcommittees should also be assigned to one of these three principal subcommittees. The Committee approved the subcommittee's recommendation, effective in 1994.

Following this recommendation, the subcommittee also proposed that the membership of the Communications subcommittee be comprised of co-Chairmen from each of the three principal subcommittees. It was thought that the leaders of the Committee's major projects would bring useful ideas to the task of publicizing the Committee's work.

The subcommittee also recommended that, while each of the standing subcommittees have designated members, any Committee member should feel free to participate in any Committee project. It was thought that this additional flexibility would complement the structure and coherence provided by the existence of standing subcommittees by ensuring that members who may have an interest or expertise in a particular Committee project are not prevented from making a contribution by the somewhat arbitrary subcommittee assignments. These recommendations were also adopted by the Committee, effective in 1994.

ADVISORY ROLE OF THE FOREIGN EXCHANGE COMMITTEE

A principal purpose of the Foreign Exchange Committee is to advise the Federal Reserve on issues related to the foreign exchange market. At the Committee's monthly meetings at the Federal Reserve Bank of New York, members from dealing institutions provide their assessment of recent exchange rate trends and trading conditions. Members from foreign exchange brokerage firms comment on recent trends in the volume of transactions and on issues pertaining to the bank-broker relationship. Such discussions are particularly useful during periods of increased market stress or heightened volatility, such as was experienced following the bombing of the World Trade Centers in February and during the turmoil in the Exchange Rate Mechanism of the European Monetary System in the late summer and early autumn of 1993.

Perhaps the most important project of 1993 pertaining to the Committee's advisory role to the Federal Reserve was its comment on the netting and market risk papers of the Basle Committee on Banking Supervision. The papers, which were released for public comment in April 1993, outlined the Basle Committee's proposal for the supervisory treatment of netting and market risk under the Basle Capital Accord. Understanding that once implemented the policies will have important implications for foreign exchange dealing banks and the market more generally, the members of the Foreign Exchange Committee decided to submit a comment. The Risk Management and Market Structure subcommittees were subsequently directed by the Chairman to co-draft the Committee's comment. At the first meeting of this group, it was resolved that the Lawyers Group should be asked to draft the comment on the netting paper, while a smaller task force made up of Risk Management and Market Structure members would draft the comment on the foreign exchange section of the market risk paper.

In its comment, the Foreign Exchange Committee endorsed the Basle Committee's proposal to amend the

1988 Accord to recognize the risk-reducing benefits of all methods of legally enforceable netting arrangements. It also supported the Basle Committee's effort to establish a framework for integrating into the Accord minimum prudential standards designed to protect banks against potential losses on traded instruments, including foreign exchange.

The Committee's comment on the netting paper sought clarification of several important issues. For example, the Committee requested that the Basle Committee provide more specific guidelines as to what would constitute the important standard of a "well-founded legal basis." The Committee stated that the basic principles for reduced capital treatment should apply to all netting circumstances, i.e. multiproduct, multibranch and multilateral. The Committee also recommended that the Basle Committee clarify that netted underlying notionals are the appropriate basis for the calculation of the add-on.

As for the foreign exchange section of the market risk paper, the Foreign Exchange Committee made two principal comments: (1) that the proposed capital treatment of foreign exchange trading is unduly burdensome; and (2) that the Basle Committee's aim to achieve "approximate equivalence" between the shorthand and simulation methods is misguided. The Committee argued that the addition of a 3 percent scaling factor to capital levels determined by the more sophisticated simulation method is inappropriate if banks are to be encouraged to continue developing and enhancing their own risk management systems. The Committee also argued that the exclusion of Tier 3 capital from foreign exchange risk is inconsistent with the Basle Committee's policy objective of consistent treatment across instrument classes.

The Committee's comment was submitted to the Secretary of the Federal Reserve's Board of Governors on December 22, 1993. The full text of the comment is reprinted in this Report beginning on page 27.

FAREWELL ADDRESS TO THE FOREIGN EXCHANGE COMMITTEE

November 4, 1993

Margaret L. Greene
Senior Vice President, Federal Reserve Bank of New York

Jim, Members of the Foreign Exchange Committee past and present:

Though, as a seasoned Committee member and a co-conspirator to previous ceremonial dinners, I find this evening to be much more of a challenge than I had expected. The challenge is to find the appropriate words to convey my deep appreciation for the opportunity to see so many friends, to hear so many kind words and to feel such a strong expression of friendship from colleagues in the market place. This evening has touched me very deeply in ways that words seem inadequate to express. But let me try: Thank you from the bottom of my heart.

Now that you are finished with your testimonials, I feel compelled to set the record straight. Yes, I did try to provide some leadership to the Committee during its first 15 years. But its successes are not mine. They are the work of us all. There are so many of you around the room who are responsible for the record we applaud here tonight. Your contributions were various. There are:

1. Those of you who contributed by helping to establish the Committee and the framework in which it would operate.
2. Those who, by virtue of your experience or knowledge of the Federal Reserve, were able, at crucial points in the Committee's development, to help forge a venture that would serve jointly the interests of the Federal Reserve and the market place.
3. Those who gave generously of your time to take on positions of leadership.
4. Those who had the courage to bring to the Committee issues — sometimes very difficult issues — that deserved the Committee's attention and review.
5. Those who had the statesmanship to take back to their own institutions insights they gleaned from their participation in the Committee, even if doing so meant asking your institution to reconsider its approach to an issue that affected market practice or the integrity of the market place.

6. Those who offered ideas and thereby helped to establish the Committee as a source of evolving views about how to conceive of and to manage a trading operation in foreign exchange and related instruments.

In truth it is the whole Committee, not an individual, that we are celebrating here tonight.

As for my role in the Committee, there were three principles I tried to adhere to. I will share them with you now, in the hopes that you may find them useful as you take the Committee forward.

The first was to seek a broad base of participation in the Committee's work. I felt it important always to be attracting new members to the Committee, while retaining enough experience to maintain continuity. I felt it important to maintain a sense of balance among the various types of institutions represented on the Committee as well as for the personal attributes that individual members brought to the table. And I felt it necessary, while trying to ensure diversity, to retain enough cohesion to permit the Committee to build a consensus on issues.

This was not such an easy task. It required aggressive searches for new members from institutions all over the country. It also required a certain amount of good luck to maintain continuity and balance in the face of job turnover. And, of course, it required some real thought about how to make the Committee structure responsive to the changing structure of the foreign exchange trading community in this country.

Nevertheless, when you look at the diversity of the institutions represented here tonight, and the number of individuals who have served so far on the Committee, I think the record shows that we made a credible attempt at keeping the Committee accessible to a variety of inter-bank market participants.

The second was to establish and maintain a public identity for the Committee. The discussions that took place prior to the establishment of the Committee had brought to light the need to have a public record of the

Committee's deliberations. It also was apparent that the principal way the Committee would be able to exert influence was through the power of persuasion and example.

It was with these considerations in mind that I embarked, in December of 1979, to draft an Annual Report for the first year of the Committee's work. Though there were other things on my mind (some of you may remember that the exchange markets were rather turbulent at that time), and though the finished document was pale by comparison to what was to follow, it was a start. The practice of publishing and disseminating an Annual Report was established to the benefit of both the Committee and the financial community.

Since then, the Committee has prospered under the discipline of having to account for itself at the end of every year. And the document has become well respected as a unique and up-to-date source of information about the foreign exchange markets that is used by both foreign exchange market practitioners and academics.

More recently, the Committee has branched out even further in its efforts to reach the financial community with its series of seminars. I hope that you will continue with these programs.

Third, I believed the Committee, since it involved both the Federal Reserve and market participants, could play a useful role in exerting some form of self-regulation in the foreign exchange market in this country. Indeed, it is a source of satisfaction and pride for me that during the 15 years that the Committee was under my watch, together we avoided a major problem in the foreign exchange market that drew attention and reproach from the broader community.

It is not that foreign exchange is immune to such occurrences. The foreign exchange market had its share of notoriety during the 1970's.

It is not that the prevailing conditions during the period 1979 - 1993 made problems unlikely. Quite the reverse. This was a period of rapid growth of transaction volumes, huge increase in the number of participants, unprecedented price volatility, and almost frenzied pace of innovation — developments that normally put strain on a market's existing institutions and give rise to accidents or abuse. There was ample evidence that such problems occurred in other markets that were experiencing the same type of conditions.

It was not that self-restraint and prudence were particularly popular attributes at the time. They were not.

This was a period in which regulatory policy in the United States was moving away from the micromanagement approach of the past. As appropriate as the process of deregulation was, it was often popularly confused with the idea that there should be no restraint at all. In the Foreign Exchange Committee, however, we were able to keep alive a premise that the key market participants have a responsibility to the market as whole, as well as to their own institutions. We were able to establish the notion that, even though it would not be appropriate for the authorities to be at the wheel of every car on the highway, travel would be much safer and more efficient if there were commonly understood and observed rules of the road.

As you go forward, give consideration to how the Committee can continue the foreign exchange market's relatively good record. The task ahead is getting harder, not easier. The foreign exchange market has grown to the point that it now attracts the attention of and touches the lives of residents of the United States in a way it never used to before. Its growth has generated profitable business opportunities for your institutions. But those benefits have an associated cost — namely, the loss of privacy that comes from obscurity. Given the visibility of your business today, you will have many judges. Most of them will decide what they think is fair or unfair, just or unjust, without knowing much about, nor caring much about, the peculiarities of the foreign exchange business and the practices you think are appropriate to provide for an efficient and liquid market. The standard you apply to market practices must be expanded to ensure that your business survives the scrutiny of public opinion in the broadest sense.

As for myself, I leave the Committee not because of retirement but because of reassignment to bigger and broader responsibilities elsewhere within the Federal Reserve. In this way, the occasion that gives rise to this dinner is different from those of previous testimonial affairs. It means that I will still be professionally active in a position requiring a constant awareness of market developments of all types.

As many of you know, I have been asked to assist in building an enlarged research operation, formed by putting in one organizational unit virtually all of the research-type activities of the Bank, and to reorient that operation to make it more responsive to the needs of the Federal Reserve. In particular, I now have the responsibility for all of the economic studies covering the U. S. economy as well as the economies of the other countries of the world. This is a move that Mr. McDonough had

been thinking about even before he took on his present position and, together with the other changes to research, represents a cornerstone of his effort to streamline the Bank's organization. I bring to the research area at the Fed at least two important perspectives as a result of my many years in foreign exchange.

The first is a global orientation. For most of my career I have been thinking about and analyzing the interrelationships among economies — through the foreign exchange market, trade and capital flows. I hope this perspective will complement the approach more traditionally used by economists in this country, who tend to focus on the inner workings of a national economy and then, perhaps if they think it appropriate, adjust their thinking to take account of relevant developments outside the country they are analyzing.

The second is a respect for the information embodied in market price action. We have scores of professionals pouring over statistics of every conceivable kind. This is important work. Certainly, you and every one else have reason to expect that the Federal Open Market Committee has available to it, when formulating and implementing monetary policy, all of the useful information that can be extracted from extant data. But what can easily be overlooked — perhaps because fewer people are trained to analyze this kind of data — is the informa-

tion coming from markets. Markets are about the only source of current information and, together with surveys of attitudes, one of the most reliable indications of current assessments of future prospects. Just remember, for example, how many failed to take adequate notice of the warning signals coming from the foreign exchange and junk bond markets during the third quarter of 1987, before the stock market crashed.

I have valued the professional relationships I have had with each of you over the years and greatly enjoyed and benefitted from the discipline the market has imposed on me during the past 20-odd years. You never allowed me to get lazy; the dynamics of markets force a pace of "analytic adjustment" that can be very demanding at times. In order to keep in shape for my new endeavors I will need to be continually exposed to that same discipline. Therefore, I am not going to say "good-bye" tonight. Although I will no longer be meeting with you in the context of the Foreign Exchange Committee, I believe that there will be many opportunities for continued contact. At least from my side, I would welcome that. And, in any case, I was brought up to believe:

Once a dealer, always a dealer.

Thank you very much.