FXDS: The Benefits of Foreign Exchange Transactions That Settle Difference Only

Introduction

Throughout its twenty-year history, the Foreign Exchange Committee has served the foreign exchange community by providing channels of communication, offering ideas through issue papers and *best practice* recommendations and by encouraging measures and methods to improve the quality of risk management.

It is in pursuit of these goals that the Committee began a study about a year ago on the benefits and costs of a *broad-based* nondeliverable foreign exchange transaction that would involve key currencies and spot-value transactions. Admittedly, a general endorsement of this type of instrument was slow to develop.

However, over recent months, it has become increasingly clear to the Committee that nondeliverable foreign exchange transactions can be successfully introduced into the general trading environment. We base this conclusion, in part, on the successful startup of the more narrowly applied nondeliverable forward transaction (NDF) a few months ago.

This issue paper examines the increasing rationale for supporting foreign exchange transactions where only differences, rather than principal amounts, are settled (FXDS).

- The first section notes that the huge volume and growth of foreign exchange trading is necessitating the development and implementation of new means and methods to reduce settlement risk.
- The second section discusses the concept of nondeliverable foreign exchange transactions as vehicles for successfully eliminating settlement risk and improving efficiencies in the foreign exchange trading environment.
- The third section offers details on how an FXDS works.
- The final section outlines issues that the Foreign Exchange Committee identifies as important in the implementation of FXDS trading.

I. The Impact of Foreign Exchange Volume on Settlement Risk

An updated estimate of *average daily turnover* in the global foreign exchange markets will be available from the Bank for International Settlements (BIS) this fall. At that time, the BIS will release its triannual survey of foreign exchange markets based on April 1998 activity. The BIS survey measures total activity in spot, outright forward, and foreign exchange swap trades.

In early 1995, average daily turnover was estimated to be at $1.2 billion, double the $600 million estimated in the survey that was conducted in 1992. Recent anecdotal evidence and limited industry surveys suggest that volumes have continued to climb over the past three years.

The implications of this huge amount of trading, combined with the complex nature of foreign exchange activity in general, make settlement risk an important concern. Settlement risk occurs in every foreign exchange transaction, simply because of the mechanisms inherent in a routine trade. In any of these transactions, currency may need to be paid out by one party before the other currency is received.

II. How an FXDS Reduces Settlement Risk

At one time, foreign exchange market activity was closely tied to the volume of international trade. This relationship underscored the importance of physically exchanging the two currencies.

Today, some banks estimate that only a small portion of their foreign exchange transactions are related to actual foreign trade volume. Investment or position taking and hedging and/or speculative activity, where settlement of principal is not necessary, has become the primary business in the foreign exchange markets. Still, most foreign exchange transactions continue to involve the exchange of principal amounts.

When foreign exchange trading does not require an exchange of the underlying principal, then the trade could occur, and with more facility, without an exchange of such funds. Similar to the advent of the forward rate agreement (FRA), which replaced the deposit market as a means to manage interest rate risk, the FXDS can also be used as a means to scale back foreign exchange settlement risk.

Other benefits of the FXDS include lower transactions costs, a reduced role for credit limits, and enhanced liquidity. These benefits arise because only one currency--rather than two--needs to change hands. The exchanged amount is the difference between the original rate and an index rate. Furthermore, the amount transferred is a fraction of what would be delivered in a traditionally traded spot transaction. With no principal to exchange and no principal at risk, credit limits are less important and liquidity is enhanced.

III. How an FXDS Works

An FXDS transaction initially resembles a conventional cash deal. A trade is initiated, as in any traditional spot or forward deal, after counterparties set a price. However, the similarities end at the *time of indexing*. The *time of indexing* occurs (in most cases) the day before the value date. Both parties compare their original dealing rate, or price, with an index rate (in most cases, a market composite) to obtain a *difference*.

Only one payment in one currency--the difference between the original rate and the index rate applied to the nominal amount of the FXDS deal (or the profit, if there is any)--will be remitted. The point of indexing is a pivotal one for the FXDS. When the profit-loss ratio is determined, the exchange risk of the FXDS (or the exposure of the obligation to future shifts in the value of its component currencies) effectively ends.

In many respects, an FXDS can be viewed as a similar instrument to an NDF in that it is also priced to an index and settled without a principle. However, while the NDF involves emerging market currencies, small volume trades, and longer dated maturities, the FXDS is a vehicle for primary currencies as well as spot-value transactions.

IV. Important Issues Concerning the FXDS

A few uncertainties persist about the implementation of the FXDS including the following:

- The reliability of the published price index.
  The British Bankers Association and Reuters have begun to publish index rates for the FXDS. One index is from a panel of eight banks; another is from a group of five brokers. The mechanics of this rate setting has been agreed to by a group of banks in New York and London.

  However, the index is still experimental and reactions of market participants need to be evaluated. Also in question is the appropriate time of day that the index rates will be published and whether they will be available all days except for Christmas and New Year's Day.

- The need for a liquid tom/next market.
  It is believed that a tom/next FXDS market needs to develop to allow dealers the opportunity to extend the term of their original FXDS. Some participants believe that this issue will be resolved once the instrument begins to be traded and the community adapts current procedures to meet the changing needs of the market.

- Dealing room implications and mid- office/back-office issues.
  The issue of combining the cash and FXDS trading on one desk or using another arrangement is expected to be decided by individual firms. Individual firms may also determine how the FXDS is booked and managed within the dealing rooms.

  For the mid- and back-offices, a number of questions remain about whether there will be adequate time to permit banks to process currency transactions. Confirmations of an FXDS may need to indicate that the deal is a nondeliverable one.

V. Summary and Conclusion

Foreign exchange transactions have been growing rapidly. This growth has raised settlement risk among involved parties. The FXDS presents an opportunity for the community to almost eliminate settlement risk on selected transactions simply by doing away with the settlement of principal.

The FXDS may be perceived as an evolutionary product. Its settlement procedures will differ from current operations and will necessitate changes on the trading desk and in the back office. However, it is believed that the current uncertainties surrounding new trading and settlement operations will be sorted out once trading commences, as was the case when the nondeliverable forward (NDF) was introduced.

In accordance with the goal of reducing and eliminating settlement risk, it is important to view the FXDS as a compliment to, rather than a competitor with, other settlement risk-reducing alternatives such as multilateral and bilateral netting. In this way, effective control of settlement risk can be attained. Finally, an FXDS is an attractive instrument because it has the potential to eliminate settlement risk, improve efficiencies, enhance liquidity, and substantially lower credit risk.