

CHAIRMAN'S REPORT

I take pleasure in submitting to the foreign exchange community the second Annual Report of the Foreign Exchange Committee. 1980 was a productive year for the Committee and one in which I believe that the Committee had the opportunity to make some meaningful contributions to the continued efficient functioning of the foreign exchange markets.

Summarized in the following pages is the work done by the Committee in a variety of ways and covering a broad spectrum of issues. Although it had not been anticipated that a major portion of the Committee's time would be occupied with the preparation of documents, in fact, for the second year in a row, a considerable amount of time and effort was so directed.

In particular, the Committee decided early in the year, following the release of the 1979 Guidelines for Foreign Exchange by the Federal Financial Institutions Examinations Council (FFIEC), that there remain significant management issues relating to the control and supervision of foreign exchange trading activities that had not been addressed in the available literature and that it was appropriate for the Committee to fill this gap.

This effort was brought to what we hope was a successful conclusion at the beginning of the current year, and that document, "Selected Issues Relating To The Management of Foreign Exchange Activity," was distributed in February 1981.

Technical Problems

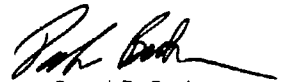
In addition, the Committee was active in dealing with the kinds of special technical problems that had been envisaged at the time of its creation.

In particular, the Committee worked with the Federal Reserve Bank of New York to help resolve settlement issues arising from the changed Memorial Day holiday in New York, and with the New York Clearing House and the Federal Reserve to deal with some of the complex questions arising from the proposed change in settlement procedures in the CHIPS system. The latter is an ongoing effort which undoubtedly will occupy the Committee during the course of 1981.

Several meetings of the Committee during 1980 were devoted to its more general role as a vehicle for communication between the market and the authorities. Productive meetings were held with Anthony Solomon, president of the Federal Reserve Bank of New York, and with Franz Scholl, head of the Foreign Department of the Deutsche Bundesbank.

At year-end, under the established procedures, the terms of a number of members expired, and during the course of the year there were other changes in membership as several members withdrew from service on the Committee following transfers in assignments within their institutions.

I would like to express my thanks to all of them, and to the other members and alternates, for their work and their dedication to achieving the objectives of the Committee over the course of its first two years.



David E. Bodner

COMMITTEE DELIBERATIONS ON MATTERS OF MARKET PRACTICE

The Foreign Exchange Committee again this year focused much of its attention on questions of market practice.

In considering how it might best provide guidance to the market here in the United States, the Committee felt its members were in a position to identify difficult management issues that have emerged in recent years, a number of which are not explicitly addressed in existing codes of good trading practices or guidelines for foreign exchange operations.

Moreover, after working in an advisory capacity with several of the regulatory agencies in the United States as they established guidelines for foreign exchange operations, the Committee concluded it would be desirable to have an additional document define good market practices in several areas.

Furthermore, the Committee again wanted to emphasize its concern about the need to reduce costly errors that arise from misunderstandings over, or lack of attention to, the particulars of transactions, this time by highlighting the need for adequate support staff

Special Management Attention

The Committee, consequently, devoted a major part of its attention this year to developing a paper directed to bank management pointing out issues that arise in foreign exchange trading operations that warrant policy direction or special management attention

This paper, entitled "Selected Issues Relating To The Management of Foreign Exchange Activity" (see page 8), discusses a number of traditionally troublesome areas such as conflict of interest, the trader-trader relationship, obligations of reciprocity, the trader-broker relationship, confidentiality, and the importance of support staff.

This paper also addresses several issues which have taken on greater importance as the foreign exchange market in this country has grown and become more fully integrated with markets overseas

In considering a statement about trading practices, members of the Committee felt it important, now that individual dealers have

access to sophisticated telecommunications systems almost everywhere in the world, that each institution establish an approach for handling reports of information which might be potentially sensitive or disruptive. Several committee members thought it appropriate to warn bank management about the now frequent practice of name switching, and to caution that a foreign exchange trader might unintentionally assume an undesirable credit risk when accepting a deal on which the name has been switched.

The Committee also felt the substantial increase in foreign exchange trading either off premises or outside normal business hours points up the need for a clear management policy to cover these practices. There was general agreement within the Committee that any institution wishing to deal under these circumstances should make arrangements to do so in advance, identifying the individuals who are designated to have dealing authority and limiting the number of such individuals to the more senior among the trading personnel.

Statement Of Management Issues

The Committee's paper on good market practices is different from the codes of behavior or guidelines for operations developed by other organizations or in other countries.

It is directed to management rather than to the dealers themselves. It identifies and defines the difficulties of each issue in order to assist management in developing internal guidelines that are appropriate to each institution without necessarily recommending specific solutions. In this way the Committee hoped to leave sufficient flexibility for each institution to fashion a policy response consistent with its own situation and management approach.

Nevertheless, the Committee fully intended that its effort be complementary to those of other organizations that had developed guidelines for the foreign exchange trading community.

The Committee expects, naturally, that bank managements will give due consideration to the Federal Financial Institutions Examinations Council's "Uniform Guideline on Internal Control For Foreign Exchange Activities In Commercial Banks" (see page 11).

The Committee also suggests that management encourage trading personnel to familiarize themselves with the "Recommendations for Dealers" under discussion during 1980 by the Association Cambiste Internationale. In addition, the codes of practice that have been recommended for markets abroad make a number of useful points. The Committee recognizes, however, that not all the arrangements in place overseas can be adopted in the United States since those arrangements often contain provisions which would conflict with the requirements of U.S. antitrust laws.

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

The Committee was again active in 1980 as a forum for exchange of information between the market and the Federal Reserve System and other U.S. and foreign official institutions

Committee members frequently offered their own views, and the views of the market more broadly, on exchange market developments and current choices of the policymaking authorities. The Committee paid particular attention throughout the year to the implications for the exchange markets of the Federal Reserve's new domestic open market procedures announced October 6, 1979 and the wide variation in dollar interest rates which followed the implementation of these new procedures

As in the past, the Committee offered its advice on several technical questions faced by the Federal Reserve and others.

Holiday Date Change in New York

The Committee held a special meeting in late March to discuss implications for the exchange and eurocurrency markets of a new state law passed in New York a few days earlier changing the date on which Memorial Day is observed.

Under the new law the holiday will be celebrated on the final Monday of May. Previously it was celebrated on May 30. The change was made effective in 1980, changing the previously scheduled May 30 holiday to May 26, and potentially disrupting settlement of the dollar side of the large number of eurocurrency and forward foreign exchange contracts which by late March were already on the books and due to mature May 26. The Committee discussed several alternative approaches to the problem.

It was apparent that it would be in the interests of the foreign exchange and eurodollar markets generally to deal with the change in holiday date in the most simple and practical fashion possible.

With respect to foreign exchange contracts, the Committee felt the simplest approach would be to extend settlement one business day to May 27 where possible, and to negotiate on an *ad hoc* basis where one of the two contracting parties was unable to accept such an extension. By this mechanism it would be possible, in most cases, to meet the usual foreign exchange contract requirement that foreign currency and dollar settlement occur on the same business day.

With respect to eurodollar contracts, the best solution seemed to be to extend maturity one business day to May 27, appealing to the standard language in most eurodollar transactions between banks and their nonbank customers providing for payment of interest for any additional time beyond maturity during which the liability is left outstanding. On the basis of these discussions, a letter was sent by the Federal Reserve to the Committee (see page 14) describing possible approaches to the problem, and that letter was distributed by the Committee to banks and brokers active in the markets. The markets generally followed these guidelines and very little disruption of settlements occurred.

Foreign Exchange Transactions Volume

Also in March, the Federal Reserve Bank of New York conducted an extensive *ad hoc* survey of transactions volume in the foreign exchange market.

Members of the Committee reviewed the survey in the proposal stage to provide guidance on its form, content, and respondent processing burden. During the reporting month the Committee discussed approaches being used to compile data and recommended the form in which it could be most usefully published.

After the results were published, the Committee discussed the findings with the Federal Reserve. Both bank and broker Committee members found the survey results useful in comparing the scale of their operations with the overall market, and in confirming their general impressions about the extremely rapid growth and changing structure of the market over the preceding three years. The Committee indicated that the survey could usefully be repeated at an appropriate time. (Copies of the survey are available from the Federal Reserve Bank of New York's public information department.)

CHIPS Settlement Conversion

In September, the New York Clearing House Association formally announced conversion on October 1, 1981 of CHIPS settlement from the current use of clearinghouse or next-day funds to a same-day settlement practice.

The Committee met with John F. Lee, Executive Vice President of the Clearing House, who described the background to the decision and detailed the plans to implement the change. The change will significantly reduce the delivery risk incurred by those receiving dollar payment which arises currently because delivery of good funds in dollars occurs one business day after payment of foreign currency abroad. In addition, the change will put settlement practices in New York on the same basis as that which already exists in all other exchange markets.

At a subsequent meeting, the Committee reviewed the many issues for the exchange market associated with the changeover, deciding to focus on two or three questions where its contribution might be greatest. The Committee was primarily concerned with the pricing of contracts in the forward market, since there seemed to be little evidence that market participants had changed to same-day settlement as a pricing basis for new contracts written to mature after October 1, 1981. The Committee felt this issue would become pressing by late March 1981, when market participants would start pricing the heavily traded six-month forward contract to mature after the changeover.

To the extent that the market fails to take account of the changeover in its pricing decisions, potential settlement disruptions would be created. Committee members also expressed concern whether all market participants were adequately informed on the issues involved in the changeover, and whether they regard the change as certain to occur.

Subcommittee Advises Federal Reserve

The Committee decided to appoint a subcommittee to advise the Federal Reserve both on the technical implications of the change to same-day settlement and on the desirability of the Federal Reserve drafting a circular addressed to any potential areas of confusion.

By year-end, the subcommittee had been constituted, had met, and had expected to complete preparation of its advice early in 1981. On February 20, 1981, the Federal Reserve issued a circular on the subject (see page 17). Subsequently, the New York Clearing House Association issued a statement reiterating its commitment to the October 1 implementation of the change.

The Committee on several occasions discussed implications for the exchange markets of the October 6, 1979 change in Federal Reserve domestic open market procedures and the heightened volatility in dollar interest rates in 1980.

Many Committee members emphasized the great strains imposed on the exchange markets by the interest rate volatility, some

remarking that at least for the time being exchange rates seemed to be influenced less by economic fundamentals as a result.

In general, Committee members thought banks operating in the U.S. markets had coped well with the interest and exchange rate volatility, in part because of experience gained during the adjustment in the early 1970s from fixed to floating exchange rates. Some thought banks operating only in European markets were experiencing greater difficulty and had less understanding of the causes of variation in dollar interest rates.

Guidelines For Exchange Operations

Early in the year the Committee reviewed and prepared textual comments on draft guidelines prepared by the Federal Financial Institutions Examinations Council (FFIEC) for documentation, accounting, and auditing of foreign exchange operations.

The comments were prepared by an *ad hoc* subcommittee, reviewed by the full Committee, forwarded to and largely incorporated by the FFIEC in subsequent drafts of its standards. Discussion of the FFIEC standards led the Committee to consider the feasibility and desirability of drafting good business practice guidelines for the U.S. exchange market, discussed in greater detail on page 4.

In 1979, the Committee prepared comments on a proposal of the International Chamber of Commerce (ICC) for rules to be applied to foreign exchange contracts. The ICC group preparing the rules incorporated some Committee suggestions in subsequent drafts of the rules. During 1980 the ICC group focused on the question of how the rules should deal with the insolvency of one party prior to contract maturity.

By year-end, the ICC group had decided to relegate the insolvency question to an appendix apart from the draft rules, for fear that a solvent bank relying on the rules for insolvency in earlier drafts could find itself in conflict with national laws relating to bankruptcy.

During 1980 the Committee decided to postpone further consideration of the ICC rules until the insolvency question had been resolved.

PROCEDURAL MATTERS OF THE FOREIGN EXCHANGE COMMITTEE

In 1980, meetings of the Committee were usually held on the first Friday of each alternate month, except when the schedule conflicted with public holidays. In addition, a formal meeting was called on March 27, 1980 to discuss the problems presented by the change in the observance of the Memorial Day holiday in New York State

The Committee has tentatively decided to retain the "first Friday" schedule for 1981, recognizing that additional meetings may be called on an *ad hoc* basis if needed

During the course of the year, the Committee invited several guests to comment on issues of general interest to the market. Franz Scholl, head of Foreign Department at the Deutsche Bundesbank, discussed Germany's approach to foreign exchange market intervention. John F. Lee, executive vice president of the New York Clearing House Association, spoke about the prospective change in CHIPS settlement procedures and its possible ramifications for the foreign exchange market. Anthony M. Solomon, president of the Federal Reserve Bank of New York, met with the Committee to discuss informally a variety of items including the impact, if any, of

the Federal Reserve's new monetary policy operating procedures on foreign exchange trading and the approach of the U.S. authorities to foreign exchange market intervention

In its effort to keep participants in the foreign exchange market abreast of current market developments, the Committee circulated a letter it received from the Federal Reserve Bank of New York concerning the change in observance of the Memorial Day holiday in 1980. Early in 1981 it also circulated its paper on market practices entitled "Selected Issues Relating To The Management Of Foreign Exchange Trading Activity"

Apart from these documents, no recommendations were issued during the past year

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

FORMAL MEETINGS OF THE FOREIGN EXCHANGE COMMITTEE

1980	Schedule For 1981
January 11, 1980	February 6, 1981
March 7, 1980	April 8, 1981
March 27, 1980	June 12, 1981
May 2, 1980	August 7, 1981
June 27, 1980	October 2, 1981
September 26, 1980	December 4, 1981
December 6, 1980	

SELECTED OTHER DOCUMENTS

Selected Issues Relating To The Management Of Foreign Exchange Activity

(Document 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 Examinations Council. This 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 sizable 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. Nonmarket 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 brokering 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 counterparty 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 insure 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 discussions 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 24 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 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.

*Uniform Guideline on Internal Control for
Foreign Exchange Activities in Commercial Banks
(Document of the Federal Financial Institutions Examinations Council)*

(Issued June 13, 1980)

This guideline represents the current judgment of the three Federal bank regulatory agencies on minimum internal control for foreign exchange activities in commercial banks.

An internal control system is composed of administrative and accounting controls concerned with authorization and accounting for transactions and safeguarding of assets. This guideline focuses on (a) the establishment and documentation of policy; (b) internal accounting controls; and (c) audit documentation. It reinforces existing procedures and practices widely utilized by commercial banks in monitoring and controlling their foreign exchange activities and in providing timely and accurate reports to bank boards of directors, senior management, supervisory authorities, and other interested parties. It also applies to those foreign exchange activities undertaken to fund loans or other extensions of credit through the money markets.

Most commercial banks already have adequate systems and procedures for monitoring and controlling their foreign exchange activities that meet or exceed these guidelines. In establishing systems, a bank considers the flexibility needed by traders to protect the bank, its size and organizational structure, the volume of activity, and the costs associated with individual controls, as well as the differences in law and practice between trading markets. This guideline is a basis by which management, auditors, and supervisory authorities can evaluate a bank's internal control for foreign exchange activities. It should prove useful to bank management and supervisory authorities in promoting safety and soundness of individual banks and of the banking system as a whole.

Bank management is responsible for establishing an adequate audit function. The section on audit documentation below does not describe how audits should be conducted. Rather, that section is intended to facilitate identification and appraisal of the extent of internal and external audit work being performed.

This document is not intended to be all encompassing as to policies and procedures expected to be found in the most active market participants. It is essential that each bank's system of control be commensurate with the risks to which it is exposed. In certain situations, these minimum guidelines may specify greater internal control than is appropriate to a specific bank's activity. In such case, if the bank does not meet these minimum guidelines, the bank should stand ready to demonstrate that risks attendant to its activities are adequately

controlled. Such a bank should discuss its situation with its Federal supervisory authority.

Documentation Of Policy

Each bank engaged in foreign exchange trading should have written memoranda setting forth the goals and policies established for that activity by senior management. The memoranda should describe the scope of trading activity authorized, the lines and delegation of authority and responsibility, types of services offered, trading limits, reporting requirements, internal accounting controls, and other instructions to trading personnel at each office of the bank.

The bank's trading policy should include guidelines or required reports with respect to the following:

- (1) net overnight positions by currency, including U.S. dollars;
- (2) maturity distribution by currency of foreign currency assets, liabilities, and foreign exchange contracts;
- (3) outstanding contracts with individual customers and banks;
- (4) credit approval procedures for delivery or settlement risk either in the form of settlement limits or through other specified management controls, and
- (5) total value of outstanding contracts, spot and forward, to allow for review of the bank's general involvement in exchange markets or changes in trading patterns.

The policy should provide for reporting procedures adequate to inform management properly of trading activities and to facilitate detection of lack of compliance with policy directives. Each bank's head office should maintain current and complete records of exceptions to directives, policies, or controls pertaining to individual trading offices. Some very large banks have delegated substantial senior management review responsibility to major regional offices. Head office records referred to in this paragraph may be maintained at major regional offices where such records are accessible to examination personnel.

There should be periodic review and approval of established policies and controls. Consideration should be given to actual and projected trading, particularly of those offices where activity is not consistent with existing guidelines or limits

Whether a bank sets customer delivery limits or weighs delivery risk in determining individual customer limits for outstanding contracts, the bank should have documentary evidence that a customer's delivery exposure is being reviewed by responsible account and trading officials. Every bank should have the capability to readily report delivery exposure with customers and banks

The bank should, either in its overall code of conduct for employees or in its foreign exchange policy, set written standards covering.

- (1) trading with entities affiliated with the bank or with members of the board of directors,
- (2) foreign exchange and deposit transactions with other employees;
- (3) personal business activities of the bank's dealers involving foreign exchange, and
- (4) personal business relationships with foreign exchange and money brokers with whom the bank deals

Management should ensure that these written policies are periodically reviewed with all dealers. The terms and conditions of any such transactions should not vary materially from similar transactions with nonrelated parties. The policy should cover any arrangements whereby a bank trading office holds positions or executes contracts either for the account of other offices of the bank or for the account of outside parties

Internal Accounting Controls

Each trading office should have available a written description of the organization and procedures used to account for and control both foreign exchange and those transactions involving foreign exchange to fund loans or other extensions of credit through the money markets. The organization and procedures should be adequate to give reasonable assurance that (a) reports on trading and funding activities are current and complete and (b) the possibility of misappropriation of funds or concealment of unauthorized transactions is minimized.

The following is a list of eleven internal controls that should be considered minimum for most systems. It is possible that a bank may address a risk area in a manner which is adequate although different from that listed below. In such case, the bank should stand ready to justify the omission

- (1) A chart of accounts and descriptions of the use of the accounts and the operation of the books of account
- (2) Segregation of duties between trading personnel and those performing trade-related accounting or disbursement functions

- (3) A procedure to allow reconstruction of the date and the approximate order or time trading personnel entered into individual contracts. Contract forms should be controlled and should bear a preparation date, if different from transaction date.
- (4) Clear descriptions of the types of interest arbitrage transactions (financial swaps/ treasury swaps/ internal contracts) in a bank's foreign exchange accounting system, together with descriptions of the accounting entries and bookkeeping methods for each type of interest arbitrage transaction
- (5) A procedure under which contract confirmations are sent and received by staff independent of the trading operation. Outgoing confirmations should include the following.
 - (a) date of transaction, date of preparation if different from transaction date, and date of value or maturity date,
 - (b) amounts of the currencies traded, accepted, or placed, and the applicable rate,
 - (c) name of counterparty, and
 - (d) liquidation instruction, if known, and reference number

Incoming confirmations should be verified by comparison with contracts. The bank should maintain a confirmation exception log or other record of every exception between an incoming confirmation and the bank's own records regardless of disposition. This exception record should be reviewed by a supervisor or official independent of the trading function. Some banks do not confirm spot contracts on the theory that the need for confirmation is quickly obviated by the settlement of such contracts. Any bank which omits such confirmation should be satisfied that alternate internal controls are sufficient.

- (6) A holdover register to record trades made but not posted to the bank's ledgers at the end of the day, the identification of such contracts as holdover items, and their inclusion in the trader or trading office day-end position reports to management.
- (7) A daily reconciliation of the dealers' position sheets with the bank trading positions as recorded in books and records of the bank.
- (8) Information on all overdraft charges and brokerage bills and on authorizations for such payments within the last 12 months; and retention of all foreign exchange Telex tapes or copies for at least 90 days.
- (9) Procedures for revaluing positions including independent verification of rates

- (10) Documentation of review and approval of limits and sublimits should evidence that consideration is given to actual and projected trading—particularly of offices where existing limits have consistently exceeded actual activity
- (11) Procedures to insure prompt identification and reporting of exceptions to limits and nondelivery upon settlement date

Audit Documentation

Federal bank examiners in reviewing foreign exchange activities increasingly rely on the work done by bank internal and external auditors. Adequate documentation of internal audit work and ready access to external auditors' reports will facilitate the judgment by bank examiners of the degree to which they may rely on internal controls and internal audits.

Significant exceptions disclosed in internal audits of foreign exchange activities should be reported in writing to the board of directors or a committee thereof. Such exceptions would include any significant uncorrected weakness in the system of internal accounting control, any significant unsatisfactory level of compliance with the existing internal control system, or any significant inadequacy in information supplied management regarding activity and positions.

Internal audit reports, workpapers, and files should be readily available for review by examination personnel at the bank's head office or elsewhere but need not be present at the site of every facility examined.

The internal auditor's files should contain evidence that the following steps have been taken:

- (1) The auditor has determined that the accounting system in use is adequately documented and that it conforms to bank policy.
- (2) The auditor has identified the internal controls incorporated in the accounting system and has determined whether they are sufficient to control risks related to the activity. The basis for decisions that it is not feasible or cost effective to control certain risks should be assessed by the auditor. Findings of insufficient controls should be set out in audit files. Files should indicate the specific controls, if any, recommended by regulatory guidelines but omitted from the system and should discuss the reasons for such omission.
- (3) The auditor has tested the internal controls to ascertain that they are, in fact, operative. Tests should include (a) tests of the accuracy of financial statements, reports to management, and reports to regulatory agencies and (b) tests of trading personnel compliance with bank policies and directives applying to foreign exchange.

It is essential that the internal auditor be alert to detect changed conditions which would affect the auditor's earlier determinations relating to the adequacy and effective operation of controls. Therefore, audit files should evidence the steps taken by the auditor to identify changed conditions. However, a comprehensive detailed evaluation of internal control is not necessary at every audit of foreign exchange activity.

Any external audit reports, management letters, engagement letters, and other descriptions of audit scope, procedures, or findings provided to a bank by its internal auditor should be readily available to examiners.

Griffith L. Garwood
Deputy Secretary
Board of Governors of the Federal
Reserve System

Hoyle L. Robinson
Executive Secretary
Federal Deposit Insurance Corporation

John G. Heimann
Comptroller of the Currency
Office of the Comptroller of the Currency

Scott E. Pardee's Letter Concerning Memorial Day

(Issued March 31, 1980)

Mr. David E. Bodner
Chairman
Foreign Exchange Committee
Room 1400
20 Pine Street
New York, New York 10015

Dear Dave

On Tuesday, March 25, Governor Carey signed a bill providing for a change in observance of Memorial Day from May 30 to the last Monday in May, effective this year. As a result, Memorial Day in New York will now conform with that in other states. Although this change will help eliminate confusion in the money markets in subsequent years, the change of holiday this year, just two months in advance, has raised some questions in the foreign exchange and Eurodollar markets. In both markets, there are contracts outstanding that require payments on Monday, May 26, now a bank holiday. In addition, the change in holiday effectively changes the value of clearing-house settlements on Friday, May 23, and Thursday, May 29, from those assumed at the time the transactions were priced.

On March 27, the Foreign Exchange Committee met to consider what problems might arise this year from the holiday change. We appreciated this opportunity to meet with the Committee and to hear from its members the approach that their banks thought would be most practical in responding to this situation.

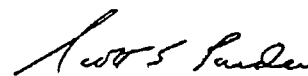
These discussions suggest to us that it would be in the interest of the foreign exchange and Eurodollar markets generally to deal with the change in holiday date in as simple and orderly a manner as possible. We suggest that market participants consider the following procedures which appear to us to be most practical under the circumstances.

Specifically:

- (1) For foreign exchange contracts, to attempt to roll over the value date one day from May 26 to May 27 for both sides of the transaction with compensation for use of currency an extra day. In cases where a one-day delay poses a problem for the buyer of currency, the two parties would have to decide between themselves whether the dollar payment should precede or follow settlement in currency by one business day, and whether compensation should be paid.
- (2) For Eurodollar transactions maturing on May 26, to roll over both sides for one more day, with interest to be paid for the use of the dollars the extra day.
- (3) For transactions maturing on May 23 and May 29, to proceed as originally contracted without adjustment.

It is understood that problems may arise on individual transactions which can be resolved only on the basis of bilateral negotiations between the two counterparties. Fortunately, there is some time remaining to the settlement date during which an accommodation can be achieved. In addition, May 26 is also a holiday in most of the major European financial centers, so the actual volume of transactions falling due on that day is probably much lighter than normal.

Sincerely yours,



Scott E. Pardee

Excerpts from Remarks Concerning CHIPS Conversion

By John F. Lee

(Executive Vice President, New York Clearing House)

At the SWIFT International Banking Operations Seminar

Copenhagen, Denmark, September 25-26, 1980

(updated February 1981)

Of the various means for transferring U.S. dollars among world banks, the most widely used today is the Clearing House Interbank Payments System (CHIPS).

Responsible for an estimated 90 percent of all international interbank dollar transfers, CHIPS is a computerized, telecommunications system that substantially eliminates checks in the movement of funds. It was devised by the New York Clearing House Association and became operational in 1970—probably making it the first use of “true electronic money” in the U.S. commercial banking system.

Today, vastly expanded, and with a record of highly reliable and efficient operation, CHIPS serves 100 financial institutions through a network of 350 sending and receiving devices—ranging from intelligent terminals to large-scale computers—linked to its central computer in New York City. The system currently handles an average of \$164 billion each day, representing about 59,000 transactions. We have had larger days, of course. On November 28, 1980, we settled for \$289 billion, which represented about 111,000 transactions.

CHIPS was created to speed and simplify the processing of the continually increasing number of interbank payments in the New York City area. Initially, it served only international payments, and access to the system was limited to the banks belonging to the New York Clearing House Association. Our Association had been effecting daily exchanges and settlements by official checks among its members for more than one hundred years.

Domestic Transfers Incorporated

Within a short time, however, domestic transfers were brought onto the system and, with a growing number of financial institutions establishing physical bases in New York City, the Association opened participation to others—specifically, agencies and branches of foreign banks, Edge Act subsidiaries of domestic banks, and other commercial banks.

Two years ago, for various reasons, we began exploring the possibility of bringing CHIPS settlement into line with funds settlements in other cities and with other payments systems. Since its inception, the New York Clearing House had settled tomorrow

for transactions made today. Therefore, when we created electronic funds transfer capabilities, we simply continued the same procedure, even though the system had the capability to settle transactions on the same day they were sent.

In all other cities, and in all other settlement systems of which we are aware, settlement has been made traditionally on the day the transactions take place. We believed for a number of years that we should retain next-day availability—or Clearing House funds as they have come to be known. But on the advice of many—including our own banks, our central bank, and the central banks of some European countries—we have been working to bring CHIPS into conformity.

The moving force behind our decision to convert CHIPS to same-day availability of funds is the rapidly increasing risk in the system, exacerbated by continually increasing volume.

Two Categories Of Risk

Risk falls into two general categories—*intra-day* and *overnight* (or over weekend). Same-day settlement will completely eliminate the latter.

We recognize, however, that the change will also increase the former and that it will generate some other problems. Therefore, we have proceeded slowly and carefully in order that the anticipated rough spots can be smoothed in advance.

The following course was charted and followed since we set about to alter the settlement.

The first step was to institute some preliminary rule changes. They were developed last year and implemented on July 2, 1979. Essentially, they accomplished the following objectives:

First, they corrected a flaw in the emergency settlement procedure. (Originally Rule 12, now Rule 13).

Second, they provided the means for judging the financial responsibility of the participants.

Third, they provided for a new settlement mechanism employing the use of Federal wire transfers; and

Fourth, they moved the settlement hour forward from 1:00 p.m. (eastern time) to 10:00 a.m. (eastern time) on the day following the transactions.

We believed that these preliminary steps were a necessary foundation for the change in funds availability. Other preliminary steps have been taken since the rule changes were effected

We have formally petitioned the Federal Reserve to take action deemed essential in our plan to convert to same-day settlement. Such action was already under serious consideration within the Federal Reserve System, principally an extension of the Fedwire hours and a uniform nationwide cutoff for that system at 4:30 p.m., eastern time. We also need an additional hour on the Fedwire for bank-to-bank transfers, thereby allowing balancing of positions after customer transactions have been completed.

Request For New Settlement Mechanism

We have asked the New York Fed to negotiate with us a new settlement mechanism. There has been some discomfort with the mechanism devised and put into effect on July 2, 1979. By an exchange of Fedwire transfers among settling participants each morning at 10:00 a.m. (eastern time), the outstanding "net net" balances are debited and credited on the Federal Reserve's books.

It is the opinion of some that it would be awkward to use the present arrangement if and when the number of settling participants increases significantly.

Also, the Federal Reserve understands that the present arrangement moves some of the intra-day risk on the system from our banks to them for several hours during each day. From the 10:00 a.m. settlement time until the end of the Federal Reserve's computer run each night, it holds the risk of loss should any settling participant fail while it is overdrawn in its account at the Federal Reserve. In other words, if a bank has moved funds across the Fedwire without funds actually being in its account at the Federal Reserve and then it fails before the Federal Reserve's books balance, the Federal Reserve holds the risk of loss.

The proposal being negotiated would establish a special Clearing House account at the New York Fed into which all settling participants owing money would transfer funds by Fedwire. When all such wires are received, and the amounts balance, the Federal Reserve would then authorize the Clearing House to transfer out of the account by Fedwire to the settling participants which expect

money. By that means, Federal Reserve personnel would be able to assure themselves that all settling bank accounts contain sufficient funds at the time settlement is made.

Same Day Value

The Clearing House Committee decided on September 26, 1980 that CHIPS will move from next-day value funds to same-day value funds on October 1, 1981. The action was taken on recommendation of our Special CHIPS Committee and after careful assessment of the requirements of the 100 present participants on the system. Since the announcement of the date selected, it has been widely publicized and discussed with the news media.

Considerable work remains to be done during the remaining lead time provided. Fortunately, the Federal Reserve System took action to extend the Fedwire. New hours will take effect on May 1, 1981. We therefore expect the Federal Reserve to be operating its wire later by the time our scheduled cutover date arrives.

Systems readiness—both at the Clearing House and in the computer centers of our participants—is a paramount concern. A number of essential hardware and software improvements have been completed at the CHIPS center. A determined effort is being made to persuade and motivate our participants to put their own systems in order. This means that they must acquire sufficient reserve capacity to avoid breakdowns. We have announced a graduated curtailment of day-end extensions. Participants are on notice that a decreasing number of extensions will be granted beyond an announced time for cutoff. That cutoff time, then, will be gradually advanced until we reach a firm 4:30 p.m. (eastern time) ending each day.

The exercise in bringing New York interbank payments toward same-day availability has been a long and difficult one. Many talents and much banking expertise have been marshalled to accomplish the task. We are very grateful for the assistance and support which we have received.

Letter from David E. Bodner

*(Distributed by the Committee to the Foreign Exchange Community
with the Federal Reserve Circular on Chips Conversion)*

The Federal Reserve Bank of New York has just issued a circular concerning the prospective changeover by the New York Clearing House Association of CHIPS settlement to a same-day basis on October 1, 1981. Since this change in settlement procedures may well have an important impact on the pricing of foreign exchange contracts falling due after that date, the Foreign Exchange Committee felt that this circular should be brought to the attention of all institutions participating in the interbank market for foreign exchange in this country.

The Committee cannot, of course, recommend specific actions that each institution should take in response to this change in settlement procedures. You might be interested to know, however, that in my bank we intend to append this circular to a letter addressed to all of our correspondents, reminding them of the prospective change and indicating we intend to settle all contracts maturing from October 1, 1981 on a same-day basis unless otherwise specified explicitly.

Federal Reserve Circular on Chips Conversion

*New Settlement Procedures for Transactions Cleared
Through the Clearing House Interbank Payments System*

(Circular Number 9021, February 20, 1981)

(To All Commercial Banks, Edge and Agreement Corporations and U.S. Branches and Agencies of Foreign Banks in the Second Federal Reserve District, and Others Concerned)

The New York Clearing House Association has announced plans to put into effect on October 1, 1981 a change in the settlement procedures for transactions cleared through its Clearing House Interbank Payments System (CHIPS). Transactions cleared through CHIPS after September 30, 1981 are to be settled in immediately available funds (same-day settlement) rather than the present system of payment in "Clearing House funds" (next-day settlement)

Since the vast majority of foreign exchange and Eurodollar transactions calling for payment of U.S. dollars in New York are handled through CHIPS, questions have been raised about the potential impact of this change on the foreign exchange market, and particularly on the method of settlement of foreign exchange and Eurodollar deposit contracts (both those already entered into and those that may be entered into in the future) calling for payment in New York on or after October 1, 1981.

Such contracts have normally been based on the assumption that settlement is to be made in the traditional manner, i.e., in "Clearing House funds". Thus, if market participants generally do not have an understanding of the change in CHIPS settlement terms, the proposed change could give rise to confusion and even temporary disruption in the foreign exchange market. We understand that a number of market participants have informed their correspondents

of the proposed change and have arranged for confirmations of new transactions providing for payment in New York after September 30, 1981 to state that settlement will be in immediately available funds, with suitable adjustments if for any reason payment is made on a next-day basis after that date. We understand also that many outstanding contracts maturing after that date are now being amended to include similar provisions, or that general notifications to that effect are being sent to correspondents.

In our view, such approaches to the resolution of this problem are entirely appropriate; indeed, some such resolution appears essential to implementation of the proposed change in CHIPS settlement terms, which we support, without undue disruption in financial and foreign exchange markets. We understand that most market participants, because they are both buyers and sellers of foreign exchange—and borrowers and lenders of Eurodollars—in roughly equal amounts, would not be significantly affected by the general adoption of arrangements such as those described above, and we assume that adjustments would be negotiated in individual cases where appropriate.

*Anthony M. Solomon,
President*