

**THE  
FOREIGN EXCHANGE COMMITTEE**

**ANNUAL REPORT**

**1983**

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## CONTENTS

	PAGE
<b>Chairman's Report</b>	<b>3</b>
<b>The Committee's Deliberations on Matters of Market Practice</b>	<b>4-5</b>
<b>Negotiable Certificates of Deposit for IBFs: A Feasibility Study</b>	<b>6-8</b>
<b>Procedural Matters of the Foreign Exchange Committee</b>	<b>6</b>
<b>Meetings of the Foreign Exchange Committee in 1982-1983</b>	<b>6</b>
<b>The Committee's Advisory Role to the Federal Reserve Bank of New York and Other Official Institutions</b>	<b>9</b>
<b>Recommendations Prepared in 1983</b>	<b>9</b>
<b>Taping of Telephone Conversations in Trading Rooms, Confirmation Areas: A Report</b>	<b>10</b>
<b>Selected Other Documents of the Committee</b>	<b>11-28</b>
(a) <b>Selected Issues Relating to the Management of Foreign Exchange Activity</b>	<b>12-14</b>
(b) <b>Papers Related to Netting of Foreign Exchange Contracts.</b>	<b>15-25</b>
<i>Credit Risks in the Foreign Exchange Contracts</i>	<i>15-16</i>
<i>Advantages from Netting Foreign Exchange Contracts</i>	<i>17-18</i>
<i>Netting Foreign Exchange Transactions in the Same Currency for the Same Value Date</i>	<i>19-23</i>
<i>Banks' Risk Management with Foreign Exchange Customers</i>	<i>24-27</i>
<i>Establishing a Clearing House for the Netting of Foreign Exchange Contracts</i>	<i>28</i>
<b>U.S. Foreign Exchange Market Turnover (A summary of a survey in April 1983 by the Federal Reserve Bank of New York)</b>	<b>30-38</b>
<b>Other Documents of The Committee</b>	<b>39-41</b>
(a) <b>Document of Organization</b>	<b>40</b>
(b) <b>Foreign Exchange Committee Members and Alternates</b>	<b>41</b>
<b>Cumulative Index to Previous Reports</b>	<b>43-45</b>

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## CHAIRMAN'S REPORT

The Foreign Exchange Committee enjoyed both an active and productive year during 1983. It performed an advisory role to the Federal Reserve Bank of New York. The Committee also acted as a forum for the discussion and the dissemination of information on new market developments and concerns.

The Committee directed considerable attention to the study of two specific subjects. The first, discussion of tape recording foreign exchange dealing and confirmations, culminated in the issuance of a recommendation urging bank management to consider installation of recording equipment. The second, discussion of the applicability of bilateral foreign exchange contract netting, generated sufficient interest to continue the study into 1984.

These two subjects are noteworthy not only for the attention the Committee gave to them during the year, but also as a result of the increasingly complex and technical nature of the foreign exchange market. As the foreign exchange market in the United States has matured, there has been a rapid rise in complexity and innovation. Market issues being brought before the Committee have consequently become more technical. Such issues have both proven to be a challenge to the membership and served to reaffirm the desirability of having a focal point for discussion and guidance on matters of importance to the market.

In my opinion, the Committee has risen to the challenge. Its membership is broadly based and possesses the professional knowledge needed to deal with the increasingly complex issues facing bank management in the foreign exchange and Eurodollar markets. It also has benefitted from the effectiveness and dedication of its members, both in the conduct of the Committee's business and in communicating the Committee's work to peers in the market place. Only with the active participation of all of its members could the Committee accomplish the work described on the following pages.

In submitting my final report, I would like formally to express my gratitude to the members and alternates who were responsible for the Committee's work of the past two years. In addition, I would like to thank the Federal Reserve Bank of New York for the assistance and support it has given the Committee since its inception, and particularly during my term as chairman.



James P. Borden

# THE COMMITTEE'S DELIBERATIONS ON MATTERS OF MARKET PRACTICE

Pursuing its role to provide guidance to the U.S. foreign exchange market, the Committee addressed several longstanding aspects of market practice and dealt with several new issues.

## Reaffirmation of Statement on Management Issues

Intensifying competitive pressures and market challenges of 1983 underscored to Committee members the need for effective management of foreign-exchange trading operations. The Committee believes the 1980 paper, "Selected Issues Relating to the Management of Foreign Exchange Activity" still is timely and useful (see page 12 )

In view of the high turnover among dealers, the Committee decided to reprint the document in the hope all institutions would review it and circulate it to trading and supervisory personnel

## Name Substitution Practices

As indicated in the 1982 Annual Report, the Committee circulated at the end of 1982 a paper on name substitution practices—those practices used by foreign exchange brokers to enlist a new counterparty in a transaction which cannot be consummated as originally structured.

The Committee urged all institutions to reappraise risks incurred when encountering name-substitution situations. Recent experience suggests the Committee's paper helped to define the circumstances which generate these situations and delineated the issues management should consider in dealing with them.

Name substitution still occurs, typically when an active foreign-exchange trading bank temporarily reaches its limit with one or several potential counterparties in the market. However, the earlier rapid proliferation of this practice apparently has slowed. The time brokers inadvertently hold positions has been reduced. And, reportedly, fewer institutions are permitting their names to be substituted as a regular practice for other institutions

## Tape Recording

Early in 1983, the Committee considered a request from market participants to evaluate whether banks should use recorded tapes of conversations to confirm trades in the foreign-exchange and money markets and to resolve disputes concerning the terms of a transaction. Many foreign-exchange trading areas and/or confirmation operations of the Committee members' institutions already had begun to record conversations. Their experience with taping was uniformly positive

Taping can facilitate speedy resolution of disputes concerning trades or delivery instructions by revealing the source of any misunderstanding or error. Improving procedures for resolving disputes benefits banks in three ways

- minimizes the number of occasions a bank would pay for mistakes of others or split losses because responsibility for an error cannot be determined,
- helps preserve institutional as well as personal relationships in the market by eliminating prolonged debate and uncertainty about a disputed transaction; and
- helps management determine if there are any regular patterns to the difficulties encountered in its own operation.

Relative to these advantages and the potential costs of time-consuming and lengthy disagreements, the cost of installing taping equipment is low

Many Committee members believed that, as other institutions gained experience with recording of conversations, they too would come to realize a taped record of a telephone conversation affords protection to both the bank and its counterparties in foreign exchange transactions. The members expected taping to be a convention in the U.S. market for foreign exchange before long.

Under these circumstances, the Committee felt it appropriate to suggest strongly that all institutions active in foreign exchange thoroughly evaluate the tape recording of telephone conversations in both foreign-exchange trading rooms and confirmation areas.

## Tape Safeguards

The Committee recognized, however, that the introduction of recording devices into trading operations raised several points of sensitivity for bank management. Bank staff may view taping as an invasion of privacy, or believe it lessens the confidentiality of conversations they have with other dealers and with customers. Management may be concerned that tapes of conversations might be used and disclosed in legal proceedings.

Consequently, the Committee also recommended access to tapes containing conversations be strictly limited to those personnel with supervisory responsibility. It also urged federal and state statutes and regulations concerning the recording of telephone conversations be followed and, whenever taping equipment is installed, counterparties be given due notice conversations will be taped. Further, it suggested tapes need not be retained longer than necessary to permit most disputes to surface

Committee members who already had installed tape recording equipment in their own institutions believed the Committee might be in a position to share with other market participants insights gleaned from their own experience. Consequently, the Committee's recommendation included specific observations on the types of equipment which might be considered, secure storage of tapes, and procedures for notifying counterparties that taping equipment had been installed. The Committee also took the unusual step of supplementing its recommendation with a report which goes into these issues in greater detail.

After the circulation of these papers, most of the Committee members from institutions which previously had not taped conversations reported their institutions were now installing recording devices. They found the Committee's recommendation helpful in their own internal discussions and appropriately reflected the benefits of taping.

During the Committee's discussion of this issue, the Federal Reserve Bank of New York also indicated it intended to install tape recording devices in its foreign-exchange trading and confirmation areas early in 1984.

### **Netting**

Another question which the Committee discussed at great length was whether it is appropriate to net offsetting transactions with a particular counterparty either for evaluating foreign-exchange exposure to that counterparty or for making payments.

Interest in "netting" increased as the volume of banks' outstanding foreign-exchange contracts grew absolutely and in relation to capital. Traditionally, banks include all their outstanding contracts with any given counterparty—even those which reflect offsetting transactions in the same currency and on the same value date—as part of their exposure to that counterparty subject to credit line limitation. In addition, banks typically pay the full amount of all outstanding contracts on the value date of the transaction.

As the volume of foreign-exchange business grew, pressure on existing credit limits intensified. Lines sufficient to meet counterparties' needs appeared increasingly to be disproportionate to bank size, raising questions whether banks are exposed to as much risk as traditional ratios imply. The volume of payments so increased as to heighten the possibility of misdirection of funds or other types of error at time of settlement. Under these circumstances, many institutions sought to examine possible approaches for netting offsetting transactions in order to evaluate credit risk, make payments or both.

The Committee started out discussing netting in the hope it might be able to determine whether a systematic netting procedure would be beneficial to the market. But as the Committee discussed the issue, it became clear that the subject encompassed a number of complex management and legal questions. The Committee decided to put together a program on various aspects of netting, drawing on its own membership to make presentations. The papers prepared for the program, which took place early in April, are printed beginning on page 15.

### **Legal Study Group Formed**

Following these presentations, many Committee members concluded that the legal aspects of the issue might prove to be stumbling blocks to any systematic netting procedure. It wanted guidance on issues such as: what happens in the event of bankruptcy of the counterparty, how would a systematic netting procedure be established for the interbank market, and can a netting procedure be enforceable if a counterparty is subject to laws of a different country?

The Committee accepted the offer of Ernest Patrikis, Deputy General Counsel of the Federal Reserve Bank of New York, to organize a study group of lawyers from institutions represented on the Committee to consider these questions. The study group is scheduled to report to the Committee early in 1984.

# NEGOTIABLE CERTIFICATES OF DEPOSIT FOR IBFs:

## *A Feasibility Study*

Late in 1982, as the Committee discussed trading conditions in the Euro and foreign-exchange markets, considerable concern was expressed about the apparent illiquidity in the deposit markets, particularly around the end of the third quarter. Members also expressed disappointment that banks had not found their international banking facilities (IBFs) nearly as effective as they had hoped in raising short-term funds.

Committee members thought there might be a possibility of improving liquidity in the banking system, as well as for banks' cus-

tomers, by broadening the IBF market through issuance of negotiable instruments, such as certificates of deposit (CDs). Any action to increase potential sources of funding for IBFs was expected to have a beneficial effect on the market generally and alleviate, at least in part, some of the funding pressures then being felt most especially by foreign agencies and branches.

Under Federal Reserve Regulations "D" and "Q," as adopted by the Board of Governors in June 1981, IBFs may issue time deposits or similar obligations which are transferable but nonnegotiable, and

### PROCEDURAL MATTERS OF THE FOREIGN EXCHANGE COMMITTEE

Formal meetings of the Committee generally were held the first Friday of alternate months.

The June meeting was cancelled as it conflicted with a number of other international meetings. The October meeting was changed to permit a special informal meeting October 6 to accommodate the schedule of a guest addressing the group.

The Committee was honored to have as a speaker in October Stephen H. Axilrod, Staff Director of the Board of Governors, Federal Reserve System, as well as Secretary and Staff Director of the Federal Open Market Committee. He described the process through which monetary policy is discussed, decided upon, and implemented, drawing on several episodes from his personal experience.

The Committee issued one recommendation and a supplemental report concerning the taping of telephone conversations in foreign exchange trading rooms and confirmation areas (see pages 9-10). It solicited papers from its members on a variety of issues concerning netting of foreign exchange contracts (see pages 15-28).

The Committee also received an informal report from a special subcommittee established to consider the feasibility of preparing a proposal for negotiable CDs for IBFs. The subcommittee was chaired by Rolf Sellge (Morgan Guaranty Trust Co.) and comprised Yoshihiko Nagaya (Bank of Tokyo Ltd.), Raymond Peters (Bank of America N.T. & S.A.), and Bryan Walsh (Irving Trust Co.).

At year-end, the Committee was continuing its discussions about the netting of foreign exchange contracts. A subcommittee of lawyers was established to assist the Committee in this effort under the leadership of Ernest Patrikis (Federal Reserve Bank of New York). Other members of the group are John Baerst (Barclays Bank Inter-

### FORMAL MEETINGS OF THE COMMITTEE

#### Meetings in 1983

February 4  
April 8  
August 5  
October 6  
December 2

#### Schedule for 1984

February 3  
April 6  
June 1  
August 3  
October 12  
December 7

national), Robert Hand (Bank of Tokyo Ltd.), Gordon Insley (Citibank N.A.), Kathleen Ludman (Federal Reserve Bank of New York), John Mahoney (Bank of America N.T. & S.A.), James Matthews (Bank of New York), Peter McLaughlin (Marine Midland Bank), Barbara Parry (Credit Lyonnais), and Frank Puleo (Milbank, Tweed, Hadley & McCloy.)

The 1984 agenda calls for the Committee to:

- evaluate restrictions on use of interest-rate futures contained in Banking Circular 79 of the Comptroller of the Currency;
- discuss foreign-exchange options and their use, and
- evaluate procedures for assessing credit risk on interest-rate swaps and forward interest-rate contracts.

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

which are subject to restrictions designed primarily to limit the circulation of these obligations to foreign entities identified as eligible to hold IBF deposits. When considering the appropriate characteristics of IBF liabilities, the Federal Reserve has been concerned that any negotiable instrument issued by an IBF soon might circulate freely in the United States, increasing the leakage of reservable deposits into IBF deposits.

The Committee recognized that any IBF proposal would have to address this concern. It believed, however, that by drawing on its members' expertise, the Committee would be in a position to determine whether an instrument might be designed that would meet the needs of IBFs and isolate domestic from international CDs for monetary control purposes.

In the end, the Committee concluded that it could not put forward a viable proposal. Nevertheless, discussion of this issue went into considerable depth within both the Committee and a four-member subcommittee established to study the issue.

**Reasons for IBF Issuance of NCDs**

The subcommittee identified two major reasons why banks might want their IBFs to be able to issue negotiable CDs (NCDs).

Banks could manage their asset-liability positions more flexibly without necessarily expanding the size of their total balance sheet. They would no longer have to rely so heavily on increasing the quantity of both interbank deposit assets and liabilities on their books to adjust maturity profiles to changing market conditions. Instead, they could adjust the maturity composition of a portfolio of NCDs through sales and purchases in such a way as to minimize the effect on balance sheet size. The increased focus on capital adequacy by regulatory authorities makes efficient use of the balance sheet increasingly important.

Banks could probably borrow at lower cost by issuing NCDs. A class of eligible IBF depositors—foreign pension funds, insurance companies, and some official institutions—do not currently use IBFs because of investment limitations requiring these depositors to hold negotiable instruments. The subcommittee anticipated that these investors might be interested in NCDs of IBFs. Also, an NCD of an IBF was thought to represent a unique instrument, providing greater liquidity to the investor than a fixed time deposit and yielding a Eurodollar-based rate but carrying a United States country risk.

**Attempts to Devise an Instrument**

The challenge was to devise an instrument which would be attractive to investors, be relatively simple to administer, invite the development of a viable secondary market, and meet the Federal Reserve's requirements. The subcommittee attempted to develop a proposal for an instrument in which all holders would be "eligible"

customers of IBFs and all issuers would be "eligible" institutions, as required by current regulations.

The subcommittee believed the easiest solution would be for the Federal Reserve to provide a book-entry system to assure the eligibility of all participants. A Reserve Bank would know the depository of the NCD and the depository could be required to ensure it held the NCD for an eligible IBF depositor.

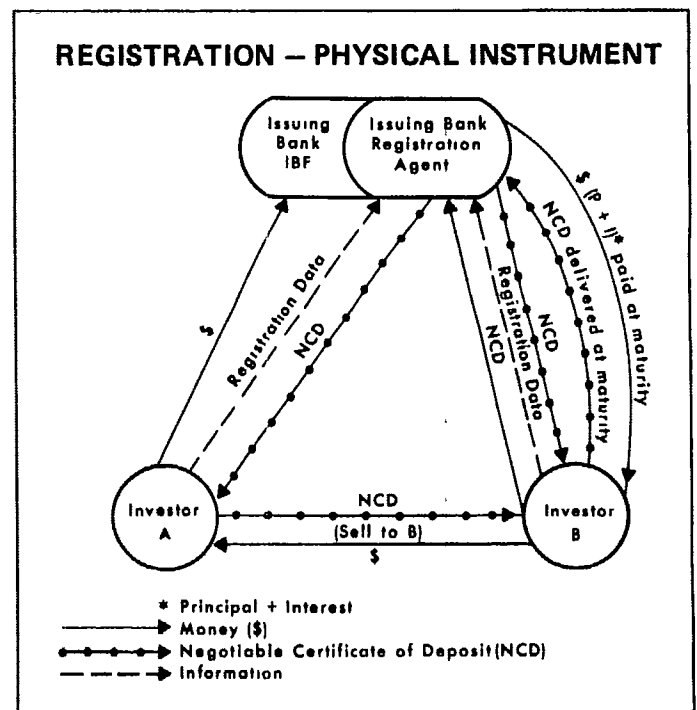
However, the New York Fed indicated that it would be premature for the Federal Reserve to consider developing a book-entry system for NCDs of IBFs at this time. The subcommittee, therefore, had to consider other alternatives.

**Three Approaches Proposed**

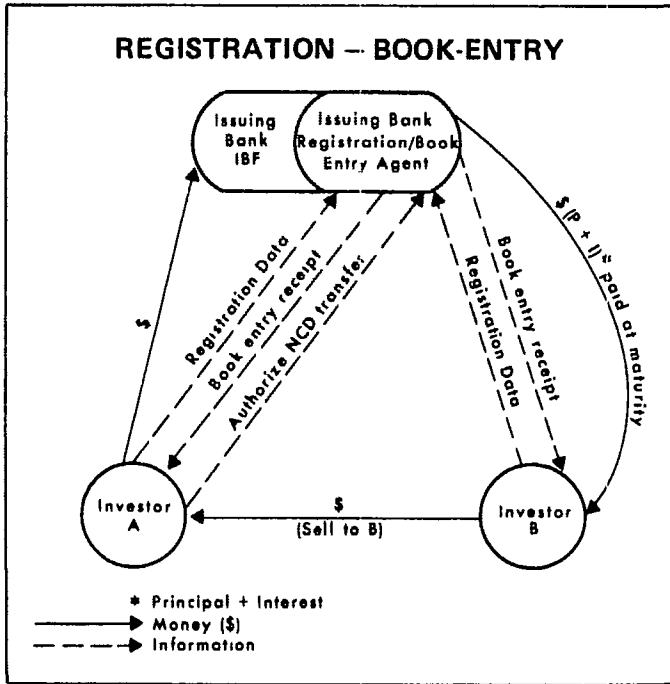
In its report to the Committee, the subcommittee proposed three possible approaches for structuring NCDs for IBFs.

The first two approaches established control over the eligibility of the investor by registration. The issuing bank would always know the name of the holder of the instrument and there would be no change in the domicile of the instrument.

In the first option, restrictions pertaining to the holding of the instrument would be an integral part of the physical security. If the certificate were resold, it would have to be re-registered with the original issuing bank.



In the second option, registration would be in book-entry form; the issuing bank would not deliver the instrument to the investor. If the investor sold the certificate, the investor would notify the issuing bank and request re-registration.

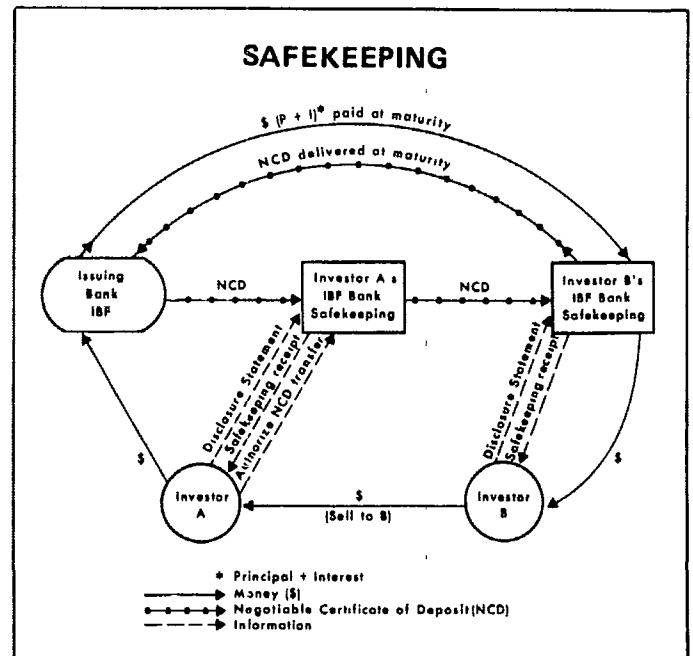


The third approach maintained control over the eligibility of the investor through the safekeeping of the security, rather than by way of registration at the issuing bank. The issuing bank would issue instruments, either in physical or book-entry form, and send them to a safekeeping unit. The safekeeping unit could be a bank or another institution, it might be centralized, as would be the case if a Federal Reserve Bank were to provide the service, or be decentralized as is suggested in the diagram in the adjacent column.

### Safekeeping Preferred

The subcommittee preferred the third option. It was the most likely to facilitate movement of the instrument among banks and provide the fewest problems for development of a secondary market. IBFs, foreign banks, and dealers in foreign locations would be able to operate in the market. Such an alternative also would be amenable to a future electronic environment.

Even with these advantages, the subcommittee doubted such an instrument would be readily accepted in the market. The characteristics required to enforce the Federal Reserve's rules for eligibility of issuers and holders rendered it complicated to understand, difficult to market, and unsuitable for a truly active secondary market.



Thus, the subcommittee concluded it would not be feasible to develop a negotiable instrument for IBFs which met all the criteria.

By the time the subcommittee had rendered its report, the need for a new instrument appeared less pressing. The market for CDs in the United States had entered a more subdued phase. U.S. banks were no longer bidding as aggressively for funds, partly because of the introduction of money market deposit accounts. Other factors continued to slow the development of IBFs. Consequently, the Committee concluded the time was not right to pursue this issue.



# THE COMMITTEE'S ADVISORY ROLE TO THE FEDERAL RESERVE BANK OF NEW YORK

## AND OTHER OFFICIAL INSTITUTIONS

The Committee again was active in 1983 as a forum for exchange of information among private market participants, the Federal Reserve, and other U.S. and foreign official institutions

### Foreign Exchange Turnover Survey

One of the Committee's major contributions during the year was to advise the New York Reserve Bank in connection with a survey of turnover volume in April 1983

The Committee in 1982 had recommended a survey be taken. It believed changes in market size and structure had been substantial since the previous survey of 1980, and a new survey would be helpful to market participants in their planning.

The Committee urged the Federal Reserve to encourage other central banks to conduct a similar exercise. The Committee also provided specific and technical suggestions to improve the survey form

The Committee also assisted the New York Federal Reserve Bank in evaluating market trends reflected in the survey. Members commented on the pace of growth in the U.S. market, noted the changing shares of currencies, and types of foreign exchange business, and made estimates of the size of the U.S. market relative to

others. Many of these comments were helpful in preparing the "Summary of Results" of the survey published by the New York Fed and reprinted starting on page 30

### Recent Growth in U.S. Foreign Exchange Market

Many members commented they believed the U.S. market in foreign exchange had become more active during the course of 1983.

A number of members reported the market had greater depth in the afternoon—a phenomenon attributed to increased corporate activity and a growing market on the West Coast

### Pressures on Dealers

Committee members noted there had been an unusually high level of turnover among senior dealers during the year.

They admitted that foreign exchange dealers are under increasing pressure to perform, and not all dealers respond to these pressures equally well. But overall compensation for experienced trading personnel is high, partly in recognition of the risks they are expected to assume.

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## RECOMMENDATIONS PREPARED IN 1983

### *Taping of Telephone Conversations In Foreign Exchange Trading Rooms And Confirmation Areas*

*(September 2, 1983)*

Taping dealer telephone conversations, as well as the conversations of personnel confirming transactions, has become a growing trend in foreign exchange operations. The Foreign Exchange Committee reviewed this practice and concluded taping of dealer conversations and those of confirmation personnel is generally desirable

**The Committee suggests banks active in foreign exchange thoroughly evaluate the tape recording of telephone conversations in foreign exchange trading rooms and confirmation areas.** Taping of all lines used for trading and confirmations will help resolve disputes readily and accurately with concomitant benefits accruing to the parties involved. Management may wish to provide untaped lines or install cut-out switches to give dealing personnel the opportunity to hold unrecorded conversations on sensitive topics. In addition, some banks may choose to provide personnel handling customers with untaped phone lines to be used in those cases where a customer has requested their conversations or transactions not be recorded

**Access to tapes containing conversations should be strictly limited to those personnel with supervisory responsibility for**

trading, customer dealing or confirmations. Tapes should be kept in secure storage for two weeks to a month—a time sufficient for most disputes to surface—and then recycled. With the provision of untaped lines and security procedures, bank management should find their dealers and corporate traders will have little resistance to taping as a general operating procedure.

Whenever taping equipment is installed, **banks should give counterparties due notice that henceforth conversations will be taped.** A single broadcast, by letter or telex, should be made to all existing counterparties stating that taping systems are being installed on dealing and confirmation lines to aid in the resolution of disputes. Subsequently, before trading is initiated with any new dealing partners, banks should also give written notice that conversations will be taped. Finally, management should ensure federal and state regulations on recording of telephone conversations are followed.

The factors the Committee considered in developing this recommendation are summarized in the report on page 10.

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# TAPING OF TELEPHONE CONVERSATIONS IN TRADING ROOMS, CONFIRMATION AREAS:

## A Report

(August 30, 1983)

This report identifies and summarizes the positive and negative aspects of taping and indicates several points of sensitivity management may wish to consider before installing recording equipment.

### Benefits of Taping

The dominant benefit from taping dealer conversations and those of confirmation areas is the speedy resolution of disputes concerning trades or delivery instructions. By listening to a recording, one can readily determine where any misunderstanding or error pertaining to a specific transaction may lie.

Improving procedures for resolving disputes by utilizing tape recordings benefits banks in several ways.

It reduces to a minimum the number of occasions a bank would pay for the mistakes of others, or have to split losses because responsibility for the error cannot be determined.

It helps preserve institutional as well as personal relationships in the market by eliminating prolonged debate and uncertainty about a disputed transaction.

Moreover, proper resolution of disputes will help management identify any systematic difficulties which may arise in its own operation.

The cost of installing taping equipment is low relative to the savings which are achieved if disagreements are resolved without time-consuming and costly procedures.

### Negative Aspects of Taping

On the negative side, some bank dealers believe taping is an invasion of privacy or can lessen confidentiality. These dealers may be less willing to share views with other market participants if they know their conversations are recorded; some topics may be considered too sensitive to be committed to tape.

Hence, dealers express concern others in turn may be reluctant to pass on the same amount or quality of information which would be available in the absence of tapes. Similarly, there is concern that some customers of bank dealers which often reveal intimate details of their foreign exchange exposure and timing of their transactions may be reluctant to discuss their affairs in detail knowing their conversations are taped.

Finally, management may be concerned tapes of conversations could be subpoenaed for use in legal proceedings.

### Dealing with Taping Concerns

There are several ways in which objections to different aspects of taping can be handled.

Trading rooms can be equipped with untaped lines—phones traders can use to make or receive calls where sensitive information might be exchanged—separate from the dealers' consoles. Dealers or corporate traders would have to make a specific effort to use these lines when wishing to exchange information; these untaped lines would not be used for trading.

Alternatively, some combinations of recording and phone equipment permit the installation of switches to stop a tape or block recording at individual work stations. Where individual cassette devices are used at single work stations, they may simply be turned off. Where wide band recording machines—those capable of tracking many lines or work stations on a single tape—are used, it is possible with some telephone equipment to install a switch which will block transmission from a work station to the wide band tape.

However, such an approach has the disadvantage that a dealer or corporate trader may neglect to re-engage a taping device. Only those systems where taping automatically resumes on the next call after being switched off, or where there is continuous taping, can ensure calls will not be missed.

Concerns by foreign exchange personnel that tapes may be used for purposes other than verifying information on a disputed trade can be readily addressed by management.

Statements reinforced by demonstration that tapes will not be used for trading purposes, performance evaluations, or displaying the operations of a trading room to outsiders are likely to allay these concerns significantly.

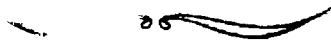
Secure storage of tapes, as well as restrictions on access to tapes to senior trading and confirmation personnel will further contribute to a sense that tapes are being used only for their stated purpose.

It is desirable to retain the tape for the period in which most errors will be discovered. Tapes can be recycled after the normal period in which transactions are consummated and confirmations are received. The longer a tape is stored, the more likely it could be used for an improper or undesirable purpose.

Retention of tapes for longer periods may be costly and provide few significant benefits.

**SELECTED OTHER DOCUMENTS  
OF  
THE COMMITTEE**

**ISSUES IN MANAGEMENT OF  
FOREIGN EXCHANGE ACTIVITY**



**NETTING OF  
FOREIGN EXCHANGE CONTRACTS**

## SELECTED ISSUES RELATING TO THE MANAGEMENT OF FOREIGN EXCHANGE ACTIVITY

(Reprint of 1980 Paper of the Foreign Exchange Committee)

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

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

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

### Conflict of Interest

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

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

The money and exchange markets are primarily telephone markets and ones in which close personal ties often develop between professionals. On the positive side, this facilitates the

smooth functioning of the market, on the other side, it opens the possibility that a trader could be tempted to assist a fellow practitioner at the expense of the employer. Consequently, the following two potential problem areas should be covered:

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

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

**of certain commercial transactions may justify the use of historical rates with customers, there should be no exceptions permitted in trades with other banks.**

### **The Trader - Trader Relationship**

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

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

### **The Trader - Broker Relationship**

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

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

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

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

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

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

### **Trading practices**

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

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

### **Confidentiality**

The issue of confidentiality deserves special consideration.

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

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

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

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

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

#### **Importance of Support Staff**

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

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

#### **Off-Premises Trading**

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

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

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

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

# CREDIT RISKS IN THE FOREIGN EXCHANGE BUSINESS

By Heinz Riehl

Credit risks in foreign exchange can be divided into two main categories—counter-party risk and clean risk at liquidation

Counter-party risk, also called the 20 percent risk, refers to the possibility a customer or trading partner fails *before* the maturity date of a foreign exchange contract. If there were to be an adverse movement in the exchange rate and the contract had to be replaced at the prevailing market rate, the bank could be exposed to a market risk. It is assumed the increased cost of replacing the contract would not exceed 20 percent of the value of

- Trading partner fails before maturity
- Adverse rate movement
- Replace contract at "then prevailing rate"
- Market risk (20%) up to 3 years
- Beyond 3 years add 5% per year

the contract, unless the currencies traded are likely to have exceptionally large fluctuations. Also, contracts with maturities longer than 3 years might be allocated an incremental risk-percentage, such as 5 percent per year (see chart 1)

Clean risk at liquidation, also known as the 100 percent risk, refers to the possibility the customer or trading partner fails on the maturity date. One party to the contract makes payments, but the other party fails—as in the case of the Herstatt Bank in Germany. Different time zones increase this risk, if, for instance, a European currency was sold and must be paid and U.S. dollars are to be received (see chart 2.) The bank does not get its anticipated payment and also may have to replace the original contract, exposing it to a maximum total loss of 120 percent

- Trading partner fails on maturity
- We pay, but do not receive payment
- Settlement risk (100%)
- Time zones

## Limiting Credit Risk

To recognize and limit these credit risks, banks establish standard exchange lines for each customer/bank. They set limits for the total contracts outstanding and sub-limits for clean risk at liquidation (see chart 3.) Application of that formula, and particularly the 20 percent on counter-party risk, leads to very large lines and theoretical credit exposures when applied to the most active trading partners (see chart 4)

- Standard Foreign Exchange Line
- Aggregate contracts outstanding (\$10MM)
  - Sublimit for clean risk (\$2MM)
  - Maximum loss
    - \$2MM (clean risk)
    - \$2MM (20% market risk on \$10MM)
    - \$4MM

A solution might be to re-evaluate the magnitude of the real risk to which the bank is exposed with each of its largest counterparties.

## Mark-to-market Calculation

One approach is to revalue to market rates all outstanding contracts with each of these counterparties. This alternative is particularly applicable if one deals actively with certain trading partners in a variety of currencies and on both sides of the market, i.e., as a buyer and a seller

- Traders cannot watch lines
- Lines cannot be eliminated or exceeded

- Jumbo lines to accommodate problem
- Formula approach indicates large risks

Under this approach the manager will periodically—weekly or monthly—mark to market or rebate every transaction outstanding with a given counterparty. Thus, the manager will simulate bankruptcy of a given counterparty and determine at which rate every contract could be replaced

A comparison of the actual rate on the existing contract with the rate at which the contract could be replaced will identify a positive or negative variance (see table 1)

An aggregation of all positive and negative variances on all contracts outstanding with a given counterparty will indicate the true market risk with that particular trading partner. In most cases it will be less than 20 percent of all the outstanding contracts with one party; it even could be positive

In the latter situation, it means the contracts could be replaced at more favorable rates, in which case there is no market risk. Under these circumstances, a net due to the trading partner in case of a bankruptcy could be offset against otherwise uncollectable receivables.

To implement the procedure, one could group outstanding exchange contracts with a given trading partner by calendar month, or even half month, and establish prevailing market rates for each currency and each period. If the amounts are very large in some cases, market rates should be adjusted to reflect likely movements in the market rate if such a large amount would have to be transacted.

Several tests using this estimate of loss for each counterparty revealed failures would produce losses not exceeding two percent. The procedure has proven to be effective for active, two-directional trading partners.

**TABLE 1**  
**MARKET RISK ON FOREIGN EXCHANGE OUTSTANDINGS FOR BANK XYZ**

Based on Mark-to-Market Calculations

Currency Amount Outstanding	Bought/ Sold	Delivery Month	Contract Value		Market Value		Market Less Contract Value
			Contract Rate	Dollar Equivalent	Market Rate	Dollar Equivalent	Dollar Equivalent
DM 10,000,000	B	March	339 40/100	3,940,000	340.50	4,050,000	-110,000
SF 4,000,000	B	March	48 20	1,828,000	49 10	1,964,000	- 38,000
FF 20,000,000	B	May	16 80	3,300,000	16 20	3,240,000	+ 60,000
L 3,000,000	B	June	1 80	5,700,000	1 85	5,850,000	-150,000
Y 1,000,000,000	S	August	40	4,000,000	.41	4,100,000	+100,000
DM 7,000,000	S	October	41 10	2,877,000	41 70	2,919,000	+ 42,000
				21,745,000		22,123,000	- 94,000
			Formula Risk	\$4,349M			
			Actual Risk	\$4M			

The example shows that on a total of \$21,745,000 of exchange contracts outstanding, only \$94,000 would be lost, if that particular counterparty would fail and all contracts had to be replaced at prevailing market rates. That is a loss of only 23% and substantially less than the 20% assumed risk, which would suggest that risk is 20% of \$21,745,000 or \$4,349,000. Under this "mark-to-market" system, the total credit risk resulting from an exchange line will be the clean risk at liquidation plus the market risk as calculated above. Obviously, the size of the market risk fluctuates with change in the market rates.

**Other Solutions**

Other solutions might also be considered, but they have clear limitations (see chart 5). One could net the same currencies for the same maturity dates between two trading partners. The opportunity to net under these conditions would be infrequent, thus, this procedure would not effectively reduce the need for large lines. One could net the same currencies between two trading partners for different maturity dates. This procedure would permit more opportunities to net,

- Netting same currencies/same value dates rare occurrence, not effective
- Netting same currencies/diff value dates effective, but may lead to forced trading
- Marking to market or rebating  
Determine actual risk  
Book against clean risk line  
Effective for active, two-directional trading partners

but may also lead to forced trading.

Possible alternative approaches for reducing clean risk at liquidation also have their limitations (see chart 6). Reducing the limits covering transactions maturing on any given day would reduce the clean risk at liquidation but would also negatively impact trading activity. Netting transactions one business day before maturity could be effective, but is operationally complicated

- Reduce lines  
Impacts trading activity
- Netting one business day before maturity  
Effective, but operationally involved



# ADVANTAGES FROM NETTING FOREIGN EXCHANGE CONTRACTS

By Ray Peters

There are three different concepts associated with the thought of netting offsetting foreign exchange contracts

- **UNILATERAL RISK RE-EVALUATION** - A bank might interpret the effective credit risk for a counterparty, other than settlement risk, as the net mark-to-market value of all outstanding forward contracts.
- **MASTER CONTRACT** - Formalize the above approach under a master contract between actively trading counterparties. Individual transactions remain on the books, but the counterparties recognize each trade as a piece of the master contract.
- **EXTINGUISHMENT** - Counterparties agree to cancel or retire existing forward contracts on a date prior to maturity with only net funds payment

The following discussion uses as its definition for "netting" the extinguishment of contracts prior to maturity and the subsequent movement of net funds

The two general times when contracts can be netted are immediately prior to the contract's maturity, known as "cash settlement netting," and "forward netting," - the periodic netting of outstanding forward contracts as soon as possible after they are executed.

## Cash Settlement Netting

The advantages of cash settlement netting are reduced credit and liquidity risks, as well as reduced operating costs. Netting can greatly reduce credit risk due to the reduction of clean risk at liquidation caused by multi-time zone currency clearing. For U.S. clearing system members, netting can reduce the systematic risk caused by gaps from intra-day offsetting flows of funds.

Liquidity risks, such as those created by operational problems which affect one of two offsetting transactions, also can be reduced by netting. This applies to foreign currency flows as well.

Operational costs of foreign exchange trading can be reduced by netting contracts prior to the cash settlement date. The frequency of overdraft penalties on both U.S. and foreign currency clearing accounts, as well as the implicit cost of float, would be reduced. Also, payment costs and volume of transactions on both the U.S. and foreign payments systems could be reduced.

## Forward Netting

Forward netting—periodically netting offsetting contracts soon

after they are made—also reduces the costs, credit and liquidity management benefits associated with cash settlement netting. In addition, forward netting improves the management of credit risk by reducing the actual level of forward foreign exchange contracts subject to counterparty risk, improving a bank's measure of counterparty risk, and increasing the availability of credit lines for other transactions.

Additional advantages from forward netting include the improvement of the depth of foreign exchange markets as limits, which often restrict dealing, are freed.

Further, there would be a reduction in U.S. regulatory risks created by the change in regulators' attention to offbalance sheet items

## Key Issues

Although there are several advantages to both netting procedures, a number of key issues need to be addressed before such a procedure could be adopted. For example,

- How many currencies should be netted;
- How can the operational costs/benefits be evaluated;
- How should foreign branches be incorporated in a netting procedure, both from an operational point-of-view and in a way which resolves differences in taxes and other institutional aspects for the branches, and
- In the event of bankruptcy, would a lawyer sue to resurrect the cancelled contracts?

Forward netting produces some additional issues which can be especially complicated.

- At what frequency should contracts be netted, how far forward, and for what maturity date;
- For each currency, should contracts be netted for single or multiple days and then how should the time value of money be recognized,
- How should residual values be accounted for; and
- If cross-currency netting were included, what exchange rate should be used to revalue outstanding commitments, and how do the two parties agree to that rate?

## ADVANTAGES FROM NETTING FOREIGN EXCHANGE CONTRACTS

(Assumes Extinguishment of Contracts and Net Funds Movement)

### CASH SETTLEMENT

### FORWARD OUTSTANDING CONTRACTS

X ----->

#### Reduced Credit Risk

- *Reduced clean counterparty risk at liquidation caused by multicurrency clearing*
- *For U.S. clearing system members, reduce systematic risk caused by gaps from within day offsetting flows*

#### Reduced Costs

- *Reduced U.S. and foreign currency clearing account overdraft penalties and float caused by operational problems*
- *Reduced payment operational costs*
- *Reduced transactional volume pressure on payment systems*

#### Reduced Liquidity Risks

- *Operational problems which impact one side of offsetting transactions create liquidity management problems*

#### Improve Counterparty Risk Management

- *Reduce level of counterparty (foreign exchange contract) risk*
- *Improve the measurement of counterparty (foreign exchange) contract risk*
- *Increased availability for other credit lines*

#### Improve Depth of Foreign Exchange Markets

#### Reduce U.S. Regulatory Risks

- *Regulatory authorities giving increased attention to off-balance sheet items vs capital*

## NETTING FOREIGN EXCHANGE TRANSACTIONS IN THE SAME CURRENCY FOR THE SAME VALUE DATE

*By Kathleen W Ludman*

There are several possible ways to "net out" foreign exchange obligations of two U.S. commercial banks in the same two currencies maturing on the same value date. The method which appears most feasible would be a contract between two banks to net out their mutual obligations in two currencies for each value date. Practically, such a contract would require the computation of the net balance at some agreed upon time, either daily, weekly, monthly, or at the close of trading the day prior to the value date. Legally, such a contract would be unobjectionable. Earlier netting would reduce risk. Netting later would reduce risk associated with the "deliveries" of the currencies and result in a smaller number of transfers of funds over payments systems, such as the Clearing House Interbank Payments System.

Netting foreign exchange transactions becomes workable when two banks routinely trade in any two currencies. Transactions can vary widely in quantities traded and in terms. For a given value date, Bank "A" might be obligated to provide to Bank "B" Swiss francs for U.S. dollars on two spot contracts and one six-month contract and to provide dollars for Swiss francs on a three-month contract and two spot contracts. Bank "B," as counterparty to these agreements, would be obligated to reciprocate by delivering the other currency on each contract.<sup>1/</sup>

The reciprocal obligations might look like this.

	<u>date under- taken</u>	<u>value date</u>	<u>"A" obligation</u>	<u>"B" obligation</u>	<u>rate (SF/ \$US)</u>
Con. 1	3/30/83	4/1/83	103.78 SF	US \$50	2.0755
Con. 2	3/30/83	4/1/83	83.20 SF	US \$40	2.0800
Con. 3	9/30/82	4/1/83	203.65 SF	US \$100	2.0865
Con. 4	12/31/82	4/1/83	US \$80	118.56 SF	1.9780
Con. 5	3/30/83	4/1/83	US \$300	623.40 SF	2.0780
Con. 6	3/30/83	4/1/83	US \$30	62.43 SF	2.0810

The transactions present three constants, the identical parties, two currencies and value date.

Under present practice, each transaction, separately undertaken, is considered an independent contract. Each party is liable to deliver each quantity of currency promised. And the obligations on each contract are, in fact, separately performed.

The question is whether this process can be simplified by replacing each party's obligations for any value date by a single net obligation. In the example, the result of netting would be that Bank "A" would be

obligated to deliver only \$200 April 1, while Bank "B" would be obligated to deliver only 408.76 Swiss francs.

Such a change would possibly simplify procedure; it would assuredly lessen each party's risk. This is true because of the potential adverse consequences to banks of two sorts of occurrences, the first exemplified by the failure of the Herstatt Bank in West Germany in 1974, when U.S. banks suffered losses because of the time zone difference. Some U.S. banks had delivered currencies to Herstatt, which was closed by government regulators before it could reciprocate. If the U.S. banks had less exposure because their obligation was the net due Herstatt on the value date, they would have suffered a smaller loss. U.S. banks could have reaped a windfall if they had received first. Nevertheless, netting, by greatly limiting the possibility of either situation occurring, is a more equitable method of reducing exposure. It accomplishes this simply by reducing the number of payments, such as, the number of foreign exchange U.S. dollar payments through CHIPS.

Another worrisome situation, for which netting is only a partial remedy, can arise when a counterparty domestic bank fails. Under the Bankruptcy Code, which does not cover banks, the trustee in bankruptcy has the right to reject any executory contract on purely business grounds, which the trustee will do if the contract does not benefit the bankruptcy estate, rejection leaves the other party a breach of contract claim and an unsecured creditor status.<sup>2/</sup> Similarly, the Federal Deposit Insurance Corporation as potential receiver of a national bank once threatened to assert a right to disaffirm foreign exchange contracts which, because of rate movements or other factors, were not profitable for the closed national bank, although insisting on full performance of contracts on which the receiver expected to realize a profit.<sup>3/</sup> This is one of the reasons the New York Reserve Bank assumed the foreign exchange book of the Franklin National Bank.

### Disaffirming Executory Contracts

The right of a receiver of an insolvent national bank to disaffirm executory contracts is not set forth in the National Bank Act.<sup>4/</sup> While there are no judicial decisions dealing with foreign exchange contracts of insolvent national banks, the Federal Deposit Insurance Corporation takes the position that when, in its role as receiver, it rejects an executory contract, it expects the counterparty to submit a proof of claim for its damages. In normal course, the counterparty which proves its claim would be entitled to receive those damages in the same proportion as other unsecured creditors of the insolvent bank.<sup>5/</sup>

Netting only partially addresses this problem since the greatest risk in this situation is not of direct loss, as in the Herstatt situation, there is no risk of direct loss because, if the receiver does not disaffirm a contract, the receiver is obligated to perform the commitment. The greatest risk is rather of being forced to cover open positions at unprofitable exchange rates. This risk remains whether a bank is obligated to deliver its net commitment or the total currency it has promised. In fact, netting might lead to disaffirmance of the entire obligation, while some separate agreements might be performed if there is no netting agreement.<sup>6/</sup> There would also be loss incurred because the only transactions on which performance would be demanded would be those resulting in profit to the insolvent bank and loss to the counterparty.

In the hypothetical set of dollar-Swiss franc transactions, if Bank "B" went into receivership March 31, 1983, and the spot rate on April 1, 1983 was 2.0650 Swiss francs per dollar, its receiver would likely decide to honor contracts 1, 2, 3, and 4, each of which would yield the receivership some profit. Contracts 5, and 6, because of normal fluctuations in trading terms, would have given it no profit and thus be disaffirmed. As a result, Bank "B" would pay \$130 and receive 277.07 Swiss francs, representing an exchange rate of 2.1313 Swiss francs per dollar, as compared with 2.0438, the rate which netting would yield. The distortion of the effective exchange rate would result entirely from the receivership. The distortion would reap the receivership greater profit, but unfairly leave Bank "A" only an unsecured claim for breach of contracts 5 and 6; these obligations would now have to be covered at the current rate, representing a further loss.

Faced with the possibility of either of these situations, a prudent bank might prefer to limit its exposure, to be liable for its net obligation rather than fully liable on each separate transaction, and to reduce the number of required payments. The initial question, however, is how to structure the netting-out agreement, taking into consideration risk, cost, and efficiency. A further question is whether such an agreement would prove enforceable.

### **Structuring the Netting Agreement**

The draftsman of an agreement to net out foreign currency obligations has certain basic choices.

- Structure agreements between individual banks or among members of a clearinghouse organization;
- Provide for periodic netting or netting for each value date; or
- Provide for individual contracts for each netting or for a "master" contract incorporating all the separate transactions and providing for their netting.

These choices in various combinations yield several possible approaches

One approach would be to provide for separate netting agreements between two banks for each value date. Each contract would allow the replacement of the gross amounts of currency about to be due from each party with that party's net obligation. Since there is no obligation to deliver the currency until the value date, if the contracts were regularly drafted and signed after the finish of trading the previous day, the risk of exposure would be greatly lessened. The cost, however, seems substantial, in terms of cumbersome and needless procedure. Legally, such a contract would be an enforceable substituted contract or novation if it clearly provided that the prior obligations were discharged, as discussed later.

### **Variations on Netting Out Approaches**

A variation on the first approach would be to rely on periodic—for example, monthly—agreements of the same sort. However, the problem with this variation is such agreements would not cover commitments made for a period shorter than that between contracts. A monthly agreement netting out all prior agreements would not include those currency contracts agreed to during the following month for value dates before the next monthly contract; even a weekly agreement would not include those short-term contracts agreed to in the days immediately following the value date netting.<sup>7/</sup> The same weakness would flaw periodic variations of the following approaches as well and thus disqualifies all periodic variations from serious consideration.

The second approach would be to formulate a master contract between two banks. The master contract would provide for netting for each future value date the reciprocal obligations of the parties to deliver the two currencies. Because the obligation to deliver is not ripe before the value date, the netting operation could occur at the completion of trading on the day prior to each value date.

The risk of exposure would be substantially reduced by this approach. In addition, it would be relatively cost-free. Once the master agreement was put into place, ongoing net procedures would be implemented. Such a master contract would be enforceable if sufficiently definite and clearly drawn, as discussed later.

The third approach would be to set up a clearinghouse organization, analogous to those on the commodities futures trading exchanges. Such a clearinghouse would serve as a "middleman" for foreign exchange contracts, assuming the obligations and rights of each party, becoming the recipient of each obligation to deliver and the provider of each obligation to buy. The International Monetary Market operates by "cumulating," or netting, each member's position for each value date.<sup>8/</sup> Risk could be moved entirely to clearinghouse members if they would undertake to assure each contract would be performed as clearing members do on the commodities futures exchanges.<sup>9/</sup>

However, it would likely be extremely costly to interject such a mediating structure into foreign exchange transactions. Further, the commodities futures clearinghouse structure was developed in a market markedly different from the foreign exchange market, in which there are standardized contracts, few delivery dates, margin requirements, and minimal delivery expectations.<sup>10/</sup> These differences would suggest it cannot simply be assumed the development and use of the clearinghouse structure in futures markets makes it suitable for use in the foreign exchange market with its various transaction types and its normal expectation of delivery.

Considering the purpose of the proposed agreement along with the concomitant costs of each possibility, it appears the master contract idea best combines risk minimization and cost avoidance. While the parties' exposure would be limited to the net amounts due under this approach, their continuing agreement would not require an onerous daily procedure and would entail no substantial cost.

### **Enforceability of the Agreement**

A further question which must be considered with regard to each suggested type of agreement is whether it can be successfully challenged. To be usable such a contract must be unassailable. A contract which replaces the prior obligations to deliver on the separate contracts with the new obligation to pay the net amounts is enforceable if it clearly states the parties' intention to discharge the prior obligation.<sup>11/</sup>

Under New York law, an enforceable substituted contract or novation must involve a change of terms from the superseded agreements.<sup>12/</sup> This mutual change in terms constitutes the consideration which renders the contract enforceable.<sup>13/</sup> Mutual agreement to accept the net liability of the counterparty in place of its gross liability is such a change in terms.<sup>14/</sup> Moreover, under New York law, the requirement of consideration to support modification has been superseded by statute. Section 5-1103 of the New York General Obligations Law requires only that such contract, as modified, be in writing and signed by the party to be charged.

### **Contract Theories**

To be distinguished is a statement of account, which simply substitutes the amount due and does not discharge the original obligation.<sup>15/</sup> It is essential to distinguish between payments for goods and delivery of foreign currency. The latter is delivery of a commodity and not payment for goods; an agreement to provide the smaller net amount is a change in the quantity term.

Also to be distinguished from a novation is an accord and satisfaction by which a party agrees to accept a different performance than originally agreed to but not to discharge the prior obligation until the new obligation is fully discharged.<sup>16/</sup> The draftsman must avoid confusion by clearly expressing the parties' intention that the new

contract effectively discharge the superseded prior obligations.

Under the Uniform Commercial Code, as adopted in New York, the pre-existing duty rule has been eliminated in Section 2-209(1) which states that "(a)n agreement modifying a contract within this Article needs no consideration to be binding." Therefore, the only pertinent requirement under Section 2-209 is the Statute of Frauds, if applicable, must be satisfied.<sup>17/</sup> Section 2-201, the Uniform Commercial Code Statute of Frauds, requires a writing signed by the party to be charged and containing a quantity term, as discussed later.<sup>18/</sup>

A master contract describing the obligations of both parties in net terms is quite unobjectionable. The promise of each party to hold the counterparty liable for only the net currency due is the bargained for valuable consideration which supports the master contract.

### **Quantity Term Must Be Definite**

The draftsman must be careful the quantity term is sufficiently definite. Courts have refused to enforce simple contracts and even requirements or output contracts on the ground the obligation is so indefinite the promise is illusory and, therefore, not good consideration.<sup>19/</sup> However, language clearly stating the obligation is to provide the net currency due on a given date should avoid any such problem.

Under the Uniform Commercial Code requirements of Section 2-201, a quantity term is expressly required. An agreement to deliver the net amount due would seem to satisfy the requirement.<sup>20/</sup> An agreement requiring delivery of a net amount is quite definite even though it cannot be determined until delivery is due.<sup>21/</sup>

Although the agreement being structured is not a requirements contract, since each transaction depends on immediate foreign exchange market factors and not a party's requirements, the situation is similar in that in each, precise quantity cannot be predicted until some time in the future and in each, the workability of the agreement depends on the good faith willingness of the parties to maintain an ongoing relationship. Thus, although the Section 2-306 requirements contract standard allowing "actual requirements as may occur in good faith" does not apply here, the same principle is nevertheless pertinent.

In addition, the Uniform Commercial Code frequently depends on commercial custom as a standard by which to gauge a party's performance or to interpret an agreement.<sup>22/</sup> While the agreement to net currency balances would be new, the manner in which the quantities of currency due are arrived at is clear according to well established trade practices.

The remaining possible method of netting foreign exchange liabilities is to form a clearinghouse organization. The necessary

agreements there would be among the organization members and the clearinghouse. Such agreements should not be exceptional.

#### **Bilateral Master Contract Most Workable**

To conclude, then, giving primary consideration to minimization of risk and cost avoidance, the type of agreement to net foreign exchange obligations which seems most workable is the bilateral master contract providing for the daily netting of mutual obligations in the same two currencies. Such an agreement would reduce risk by limiting exposure to the extent possible, but would require neither the interposition of a complex mediating body similar to a complex mediating body similar to a clearinghouse, nor the drafting of daily contracts

A precisely drawn master contract should prove enforceable under either New York contract law or the New York Uniform Commercial Code.<sup>23/</sup> Although the quantity due from each party cannot be made precise before the reckoning for each value date, the agreement should clearly incorporate accepted practices among currency traders. With that background, the quantity embodied in the concept of netting becomes clear and enforcement nonproblematical

In sum, the parties could find such an arrangement more beneficial than onerous. The more precise structure of the agreement would depend on such factors as the parties' desires to preserve their autonomy or to more closely regulate their commercial exchanges, accounting practices, and the parties' willingness to use modern technology in their relations with each other.<sup>24/</sup>

## FOOTNOTES

1/ Delivery of foreign currency does not ordinarily require the actual delivery of money; rather, it usually involves the transfer of bank balances

2/ Bankruptcy Code § 365, 11 U.S.C. § 365 (1978).

3/ F. Wille, *The FDIC and Franklin National Bank: A Report to the Congress and All FDIC Insured Banks* (Nov. 23, 1974) (presented before 81st Annual Convention of the Savings Banks of New York State).

4/ The Courts, however, have recognized such a right with respect to certain types of contingent contracts, such as leases. Moreover, courts appear to have been reluctant to allow damages against a receiver for exercising the right unless the contract was breached prior to the determination of insolvency. See *Federal Deposit Ins. Corp. v. Grella*, 553 F.2d 258 (2d Cir. 1977); *Argonaut Sav. & Loan Ass'n v. Federal Deposit Ins. Corp.*, 392 F.2d 195 (9th Cir. 1968), cert. denied, 393 U.S. 839 (1968); but cf. *First Empire Bank v. Federal Deposit Ins. Corp.* 572 F.2d 1361 (9th Cir. 1978), cert. denied, 439 U.S. 919. (FDIC not permitted to reject standby letters of credit of solvent institution simply because obligations contingent) *First Empire Bank*, however, applies to an obligation where one party has performed, exchange contracts may be different because substantial performance is yet required but not yet due from both parties.

5/ Ms. Ludman telephoned Senior FDIC Attorney, Carroll Shifflett, concerning FDIC practice concerning executory contracts. FDIC practice, as he described it, is consistent with practice under the Bankruptcy Act

6/ There remains the possibility, as discussed in notes 4-5, *supra* that the disaffirming party would assume liability for damages. However, parties attempting to assess risk on foreign exchange contracts should not rely on that possibility. Actual recovery from an insolvent estate probably would not be substantial

7/ Effective use of a periodic netting agreement would require a limitation of value dates

8/ *Consolidated Rules of the Chicago Mercantile Exchange and the International Monetary Market and the Index and Option Market Division Rule 3004* ('981).

9/ See generally 1 P. Johnson, *Commodities Regulation* 97-100. The clearinghouse members function primarily to confirm daily transactions and to make daily settlements under margin requirements as well as to guarantee all transactions

10/ M. Stigum, *The Money Market, Myth, Reality, and Practice* 372 (1978).

11/ Restatement (Second of Contracts) § 279, see *National Am. Corp. v. Federal Republic of Nigeria*, 448 F. Supp. 622, 642-44 (S.D.N.Y. 1978), *aff'd* 597 F.2d 314 (2d Cir. 1979), see generally E. Farnsworth, *Contracts* 284-85 (1982).

12/ Some confusion may result from New York terminology which, unlike that of the Restatements, includes substituted contracts in the general category of novations, in the Restatements, novations are substituted contracts involving a new party only and thus a subcategory of substituted contracts

13/ Farnsworth at 283-84.

14/ See *Moers v. Moers*, 229 N.Y. 294 (1920) (new reciprocal obligation legally sufficient to make substituted contract binding)

15/ Restatement (Second) of Contracts § 282; see generally Farnsworth at 287; but see Restatement § 422 (statement discharges original obligation)

16/ See *National Am. Corp. v. Federal Republic of Nigeria*, 448 F. Supp. at 643 (whether agreement an accord or a substituted contract depends upon the parties' intention), see generally Farnsworth at 285-85.

17/ Under N.Y. G.O.L. § 5-701, the Statute of Frauds is probably inapplicable unless the original obligations were within it, under this provision, an agreement need not be in writing unless "by its terms" it "is not to be performed within one year." See *Bankers Trust Co. of W. N.Y. v. Steenburn*, 95 Misc.2d 967, 409 N.Y.S.2d 51 (N.Y. Sup. Ct. 1978)

18/ Authority for the proposition that foreign exchange transactions fall within the scope of the U.C.C. Article 2 is *United Equities Co. v. First Nat'l City Bank*, 84 Misc.2d 441, 374 N.Y.S.2d 937 (N.Y. Sup. Ct. 1975), *rev'd*, 52 App. Div.2d 164, 383 N.Y.S.2d 6 (1976), *aff'd on opinion below*, 41 N.Y.2d 1385, 363 N.E.2d 1385, 395 N.Y.S.2d 640 (1977). These courts assume without discussion a forward contract for the purchase of yen constituted a "transaction in goods" and was thus governed by the U.C.C. Much earlier, however, New York Courts accepted the proposition that foreign exchange is treated as "a commodity bought and sold in the market." *Kerr S.S. Co., Inc. v. Chartered Bank of India, Austral and China*, 292 N.Y. 253, 21, 54 N.E.2d 813, 816, 48 N.Y.S.2d (1944)

19/ See *King v. Krischer Mfg. Co., Inc.*, 220 App. Div. 584, 222 N.Y.S. 66 (N.Y. App. 1927); *Tai Corp. v. Kals Systemet, Inc.*, 568 F.2d 145 (10th Cir. 1977) (decided under New York law), Farnsworth at 80.

20/ Under U.C.C. § 2-204, contract terms generally are sufficiently definite

21/ See *Bankers Trust Co. of W. N.Y. v. Steenburn*, 95 Misc.2d 967, 409 N.Y.S.2d 51 (N.Y. Sup. Ct. 1978), *Riegel Fiber Corp. v. Anderson Gin Co.* 512 F.2d 784 (5th Cir. 1975) ("all the acceptable cotton produced during the crop year 1973 on the following acreage, and none other" acceptable quantity term).

22/ U.C.C. § 1-205(4) and Official Comment 4; U.C.C. § 2-208(2); see generally J. White and R. Summers, *Uniform Commercial Code* 86, 101-02 (1980).

23/ The same would be true in other jurisdictions, of course, insofar as their contract law, both common law and statutory provisions, is essentially the same as that of New York

24/ One likely component of the agreement would be an arrangement under which the parties would confirm the net due each value date by an exchange of letters or telexes.

# BANK'S RISK MANAGEMENT WITH FOREIGN EXCHANGE CUSTOMERS

By Edward R. Dobbins

**B**anks today use netting procedures in connection with their foreign exchange trading activity primarily to identify, and more effectively control, the risks associated with those transactions.

It is important to consider the risks arising from these transactions and the methods which can be adopted to protect banks from them. The principal risks relate to the uncertainty of treatment of a netting arrangement under federal bankruptcy laws.

## Customer Agreements Urged

Thus, the best method to address the problem is for a bank to make an agreement with each customer establishing and defining certain "net" and "gross" limits for trading activity. The agreement also should define the types of contracts, such as "open" or "compensated," in which the parties will engage. Finally, the agreement should clearly specify how netting procedures apply to those transactions. This paper recommends the use of such an agreement.

Some definitions of terms in this paper might be helpful

- A "compensated contract" is an arrangement consisting of a purchase contract and sale contract. The terms of each contract should be for an equal amount of the same currency and should mature on the same value date. Compensated contracts should be settled by the bank or company, as applicable, in U S dollars of an amount equal to the net difference in the dollar value of the relevant currency at the exchange rate established in each contract.
- A "contract" is a formal agreement with the bank to purchase or sell a specified amount of a named currency at a firm rate for delivery and payment on a fixed date.
- The "exchange rate" is the price of one currency in relation to another currency at a given time.
- The "Gross Limit" means the maximum amount stated in U S dollars which the Bank will agree to buy or sell from the Company on an Open Contract basis.
- The "Net Limit" is the maximum limit of liability stated in U S dollars which the company may be obligated to pay the bank at any time after netting the value of compensated contracts.
- An "open contract" is a contract with the bank which is not offset by a corresponding contract with the bank maturing on the same value date.
- The "value date" is the date on which a foreign exchange transaction is settled by payment and delivery.

It also is important to emphasize this paper deals with bank-to-commercial customer contracts, rather than bank-to-bank arrangements. Since banks are exempt from the bankruptcy laws, the bankruptcy laws, the bankruptcy implications arising from breach of a foreign exchange contract or "fail" will differ. Accordingly, the methods chosen to manage the risks in these situations will no doubt vary.

## Current Practices

Occasionally, in connection with foreign exchange trading activities, banks liquidate certain compensated contracts prior to the relevant value date by netting the values of those contracts to determine settlement liability. In such case, the bank and its customer enter a liquidation contract evidencing their understanding to liquidate those contracts.

Such an arrangement is different from netting contracts on a regular and continuing basis as a means of managing exposure and customer trading limits. Under an agreement, a bank would establish a net limit for compensated contracts and gross limit for open contracts. The net limit would represent the maximum net dollar amount of exposure which the bank is willing to assume with respect to that customer on compensated contracts.

Alternatively, the gross limit represents the gross amount which the bank will assume on open contracts with that customer. Compensated contracts should be netted by the bank on a daily basis to determine the outstanding liability of the bank and its customer, and to verify the customer's liability on those contracts is within the net limit.

I understand current limits for compensated contracts and open contracts are calculated by banks on a gross basis rather than on a net basis. The present documentation evidencing these foreign exchange contractual transactions consists solely of advices confirming the terms of the contracts. These transactions are entered into with the customer generally on an unsecured basis. If the terms of these arrangements were evidenced by an agreement which contains, in addition to the provisions discussed, cross default, event of default and security provisions, a bank's position should be improved considerably. The improvement occurs because the agreement allows a bank greater control of the trading relationship and gives that bank a perfected security interest in property of the customer.



## Risks Due to Bankruptcy

The most serious risk a bank faces arises when its customer, due to bankruptcy, is unable to perform under the foreign exchange contract. In the event a customer becomes bankrupt, there are certain problems banks should be aware of, since the bank's ability to recover from the customer under the contracts may be reduced considerably

- A bankruptcy trustee could challenge the netting arrangement and attempt to collect on contracts on which the bank owed the customer, and reject those contracts on which the customer owed the bank
- The trustee probably would challenge as preferential transfers any payments or transfers of property occurring within ninety days of the bankruptcy
- The validity and enforceability of the bank's security interest in any collateral may be challenged by the trustee as a preferential transfer, and the bank's rights in that collateral lost.

Accordingly, a number of issues must be considered

### Rejection of Executory Contracts

The principal risk confronted by the bank arises under section 365 of the Bankruptcy Code, which permits a bankruptcy trustee, subject to the court's approval, to assume or reject any executory contract of the debtor. An executory contract is one which has not yet been completed or fully performed.

The foreign exchange contracts seem to constitute executory contracts and, as a consequence, a trustee may attempt to reject such contracts. Specifically, the trustee may claim to be entitled to reject that contract on which the bankrupt customer owes the bank, and enforce that contract on which the bank is obligated to pay the customers. In effect, the trustee could attempt to unbundle the contracts comprising a compensated contract arrangement.

If the bank bases its trading relationship with the customer in part upon the net limit established—because the bank considers this limit its real exposure to the customer—the bank may find it had improperly managed the risk if the trustee was successful in its rejection of the contracts.

Thus, the worst case situation would arise if the bank had to pay the trustee on one contract, and file a general unsecured creditor claim against that customer for the other contract.

Section 365 also provides that clauses automatically terminating the contract are invalidated by the Bankruptcy Act. The rejection of such contracts constitutes a breach of the contract as of the date immediately preceding the filing of the petition. Accordingly, such claims will be treated as pre-petition claims.

To attempt to defeat such a claim, the bank may argue the contracts making up a compensated contract are so inextricably identified or linked with each other that to separate them and treat each contract separately would frustrate the intention of the parties when they entered the arrangement.

Since the principal terms of each contract, except for the exchange rate, including currency, amount and value date, are identical, a court may be sufficiently persuaded by this argument to allow the netting of those obligations to determine the actual liability of the parties. In addition, if the agreement contained language reflecting this fact, a bankruptcy court may be sufficiently persuaded.

Under the proposed netting arrangement, therefore, unless the bank's argument is accepted, the claim for payment on the contract against the customer may result in an unsecured general creditor claim.

### Preferential Transfer

The Bankruptcy Code (§ 547) authorizes a trustee to invalidate even perfected security interests and to recover payments and other transfers of property to secured creditors and other third parties when made within ninety days, and in some cases, within the year of the filing of the petition.

The rule is intended to establish some arbitrary time prior to bankruptcy within which the debtor should be required to treat equally situated creditors equally. The debtor should not be permitted to pay one particularly favored creditor while failing to pay others.

For a trustee to establish a voidance preference, seven points must be proved

- There was a transfer,
- the transaction was of the debtor's property,
- the transfer was to or for the benefit of a creditor,
- the transfer was for or on account of an antecedent debt,
- the transfer was made while the debtor was insolvent;
- the transfer was within 90 days before the original filing of the petition,
- the transfer enables the creditor to receive more than would be received under a Chapter 7 liquidation.

Under this section all payments and transfers made within ninety days prior to the filing of the petition are vulnerable to attack.

In analyzing this section, and its applicability to the instant transactions, it is important to keep in mind the section may relate to two aspects of the proposed netting arrangement.

First, it may apply to transactions within ninety days, such as payment occurring after netting. Second, it may apply to transfers to the bank of additional collateral. Thus, it is clear these transactions constitute "transfers of the debtors property" and "to or for the benefit of the creditor." It should be noted a transfer is deemed to occur in the case of the grant of a security interest at the time of perfection of that interest. Accordingly, in the instant case, if the customer delivers collateral to the bank, perfection will occur when the bank takes possession of the collateral.

The fourth requirement is the transfer must be for or on account of an "antecedent debt."

If the bank gives new value concurrent with the transfer in the form of money, the transfer is not deemed to be made on account of an antecedent debt. It is not clear how much time can pass between the time the debt is incurred and the time of the transfer without the debts being considered antecedent.

New value is defined as:

"money or money's worth in goods, services or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, but does not include an obligation substituted for an existing obligation . . ."

Under this definition it is not clear whether the obligation arising from a netting of contracts constitutes an obligation substituted for an existing obligation. The bank's obligations and customer's obligations on the contracts making up the compensated contract arrangement are discharged and the net liability determined. It is not clear how such an arrangement will be viewed by a bankruptcy court.

If the bank, due to its daily netting of contracts, determines the net limit has been exceeded and demands additional collateral, it is not clear whether this liability of the customer would be considered as new value.

Similarly, since the liability is caused by fluctuations in the value of the relevant currency, it is not clear whether collateral taken at that time would be deemed given for new value.

The sixth requirement also is relevant since transfer must occur within ninety days of the bankruptcy filing. It is important to note only the transfer must occur within ninety days, but the antecedent debt may have arisen earlier.

### **Secured Status of Bank in Bankruptcy**

If collateral is taken by the bank in these cases, it is assumed it will consist generally of government securities, certificates of deposit and cash balances in deposit accounts (collateral).

The bank will perfect its interest in the collateral by taking possession of the collateral. In a bankruptcy, the bank would be confronted with certain procedural matters affecting the collateral. I have discussed the foreseeable problems arising from the trustee's assertion of rights to avoid transfers as preferential, or to reject executory contracts. But there are certain problems associated with the protection of the bank's claim as a secured creditor during a bankruptcy proceeding.

If a petition in bankruptcy is filed, there is an automatic stay under § 362(a) which precludes not only the enforcement of any lien or judgment against the debtor or its property, but also the taking of "any act to obtain possession of property of the estate . . . (or to) collect, assess or recover" any pre-petition debt owed by the debtor (Code § 362(a)(3) and (6)). A bank as a creditor also would be prohibited from taking any steps to create, perfect or enforce liens or to effect setoffs (Code § 362(a)(4), (5) and (7)). A stay will be vacated only if the bank, as the principal in the suit, requests such relief. If the debtor is the subject of a reorganization proceeding rather than a liquidation, it may be difficult to obtain relief from the stay because the debtor has equity in the property and that property may be necessary for the reorganization.

Suffice it to say a bank, as a secured creditor, must look to the bankruptcy court for permission to carry out any act regarding the collateral. Code § 362(d)(1) provides that on request of a principal in the suit and after notice and hearing, the court shall terminate, annul, modify or condition the stay "for cause, including the lack of adequate protection of an interest in property of such party in interest." Sufficient "cause" for vacating the stay may be shown where there is a demonstrated need for relief, such as where the collateral is subject to widely fluctuating price changes.

In the areas of automatic stay, use, sale and lease of collateral and post petition financing, the Code provides for a concept of "adequate protection" of secured creditors. In effect, the court must take into account the interests of the secured creditor and not deprive that creditor of the benefit of the bargain in allowing the debtor to use the collateral or to obtain additional financing.

Section 361 of the Code specifies three methods of providing adequate protection for the interest of a secured creditor. The trustee will generally propose a protection method. If the creditor objects to the proposal, the court will determine the adequacy of the protection.

The concept of adequate protection is derived from the fifth amendment protection of property interests.

The policy grounds and reasoning for this section are based on the theory the secured creditors should not be deprived of the benefit of the bargain. The concept allows for alternative means of protecting the creditor. Suffice it to say, these methods are intended to provide

adequate protection of the value of a creditor's interest in the collateral by permitting the trustee to make periodic payments to the creditor, or to provide a replacement lien to protect against any decline in collateral value.

Finally, the court may protect the creditor by granting relief as will result in the realization by the creditor of the "indubitable equivalent" of the creditor's interest in the collateral. This last method is subject to interpretation by the courts

### **Benefits Of Agreements**

Therefore, it is advisable for banks to consider seriously the use of an agreement governing foreign exchange trading relationships with commercial customers. The use of such agreements should facilitate improved monitoring of this activity.

The agreement should provide to the bank considerably more protection than under present trading conditions. The use of event of default, cross, default, and security provisions may provide an early warning to a bank that serious problems have arisen or bankruptcy may be imminent. These provisions may permit a bank to adequately protect its interest by taking appropriate steps prior to the bankruptcy of its customer. Such protection is not available under the

present arrangement.

In this connection, it should be noted the terms of the agreement cannot insure protection absolutely. But it is clear that this protection language should increase considerably the likelihood of protection and assist in the avoidance of more dire problems

Of course a bank remains subject to the same risks arising from a customer bankruptcy as it does today. To the extent trading activity is increased due to the implementation of a netting formula, a bank may be incrementally at risk

The security taken by a bank should give the bank priority in that collateral, assuming it is given for new value concurrent with the transfer of the customer's property. Of course, any transfer which occurs within 90 days of the filing of a bankruptcy petition may be challenged by a trustee as a preference

It is not clear whether a trustee will permit netting and payments to take place rather than exercise its right to reject or enforce contracts with the bankrupt it considers favorable. However, if the bank and its customer have entered an agreement which specifically defines the netting procedure to be followed under the arrangement, the bank's position should be improved in a bankruptcy situation.

# ESTABLISHING A CLEARING HOUSE FOR THE NETTING OF FOREIGN EXCHANGE CONTRACTS

By Arthur H. Meehan

Recently, the board of directors of the Banker's Association for Foreign Trade approved surveying the U.S. voting membership on the subject of their interest in working towards a system, possibly a clearing house, for the netting of foreign exchange contracts.

The BAFT group has an interest in this issue from the following perspectives.

- The increased perception risks on transactions between banks are increasing, not remaining the same, or declining.
- Given the structure of global markets and the participant base in each of those markets, there are continuing problems of approvals, overlines, and sheer magnitudes of existing facilities. In short, dealing banks tend to have the same counterparties over a broad range of money centers.
- The assumption that the past governs the future is becoming increasingly uncomfortable for more people. The position of the FDIC on the issue of increased market acceptance of risk and the appropriateness of the current insurance premium is germane to this increasing discomfort level;
- The Banco Ambrosiano affair, which in the minds of some people is a continuation of a saga going back many years and including at least the Herstatt and the Israel British Bank affairs and others, points to the possibility that market participants misinterpret provisions of the Basle Agreement;
- Unforeseen ramifications emanating from the almost certain passage of the international lending reform act of 1983, currently under debate in the Congress,
- The discussions now going on in connection with the payments mechanism for the setting of caps for institutions in order to address the increasing concern over the sheer volume and size of the daily settlement, particularly involving C.H.I.P.S., and,
- The deep concern emanating from the involvement of the interbank market in current debt restructuring, particularly the Brazilian case.

Netting of foreign exchange contracts is not a new technique and has been used, admittedly sporadically, between a number of institutions over the years to reduce outstandings and to free availability under existing foreign exchange contract guidelines at those institutions. This technique has typically involved compensations extinguishing the contracts and settling the cash differential at some agreed upon discount. An extension of this concept to a broader market would have the effect of reducing the need for ever increasing foreign exchange contract limits for forward transactions as well as reducing the possibility of frequent overlines on such forward exchange facilities.

## Intent Of Netting

In addition, should the concept be applied to the spot market, there is a marked possibility for achieving a substantial reduction in the clean risk via the settlement process. It should be noted the netting concept is intended to limit risk, not to stimulate more trading volume which is a concept of some, including members of the BAFT Committee.

Perceived problems with this system surround the cost of its establishment; the legalities in various jurisdictions of extinguishing contracts under all scenarios, and the agreement not only as to the mechanism, but to the discount applied for the premature settlement on a cash basis of forward exchange contracts. It is believed the technology exists, but the stumbling blocks may prove to be costs, ownership of the system and sundry legalities.

A letter will be sent to the U.S. bank voting membership of BAFT shortly to determine the degree of support for this concept.

Should the support be strong, we will proceed to an operating mechanism to study the subject and to recommend an implementation process should agreement be achieved at the study/planning level. Should the membership prove disinterested in this issue, naturally it will die along with numerous other noble notions.

# **U.S. FOREIGN EXCHANGE MARKET TURNOVER**

**SUMMARY OF SURVEY**

**BY**

**NEW YORK FEDERAL RESERVE**

# U.S. FOREIGN EXCHANGE MARKET TURNOVER

*A Summary of a Survey In April 1983  
By the Federal Reserve Bank of New York*

**G**ross foreign currency transactions by 119 banking institutions in the United States foreign exchange market averaged \$33.5 billion for the business days in April, according to a survey by the Federal Reserve Bank of New York. Gross transactions arranged by 10 foreign exchange brokers averaged \$14.1 billion per day

The survey of banking institutions contains some duplication since banks reported transactions with each other. But transactions of banks either with nonbank institutions or with banks abroad were not double-counted. After correcting for double-counting in interbank transactions, average daily gross turnover was an estimated \$26 billion, an increase of about 44 percent over the March 1980 adjusted figure of \$18 billion

A total of 87 banking institutions participated in both the March 1980 and April 1983 surveys. Altogether these banks reported turnover of \$648.2 billion in April, a rise of about 34 percent from the \$484.0 billion reported in March 1980

The 119 banking institutions included in the April 1983 survey had gross turnover of \$702.5 billion in April, 43 percent more than the \$491.3 billion, or \$23.4 billion a day, reported by 90 banks in March 1980. The 32 additional banks participating in the April 1983 survey contributed \$54.3 billion, or about 7.5 percent, of total transactions

## **Special Conditions In April**

The 119 banking institutions surveyed included large money center and regional domestic commercial banks, Edge corporations, and U.S. branches and agencies of foreign banks. The New York Fed believes its survey of banks in the United States accounts for the great bulk of currency transactions in the United States by commercial banks.

In the United States, April 1983 and March 1980 each had 21 business days. However, several financial centers abroad were closed for the Good Friday and Easter Monday holidays in April 1983, probably reducing reported transactions even though the New York market was open on those days. Turnover in April 1983 also was reduced because European countries moved to daylight saving time in late March, about one month ahead of the United States. Thus, for most business days in April the time when European and U.S. foreign exchange markets were simultaneously open was reduced by one hour. Also, turnover in April 1983 may have been reduced because exchange market participants normally advance some transactions from April into March to adjust balance sheets before the quarter-end.

## **Broker Survey**

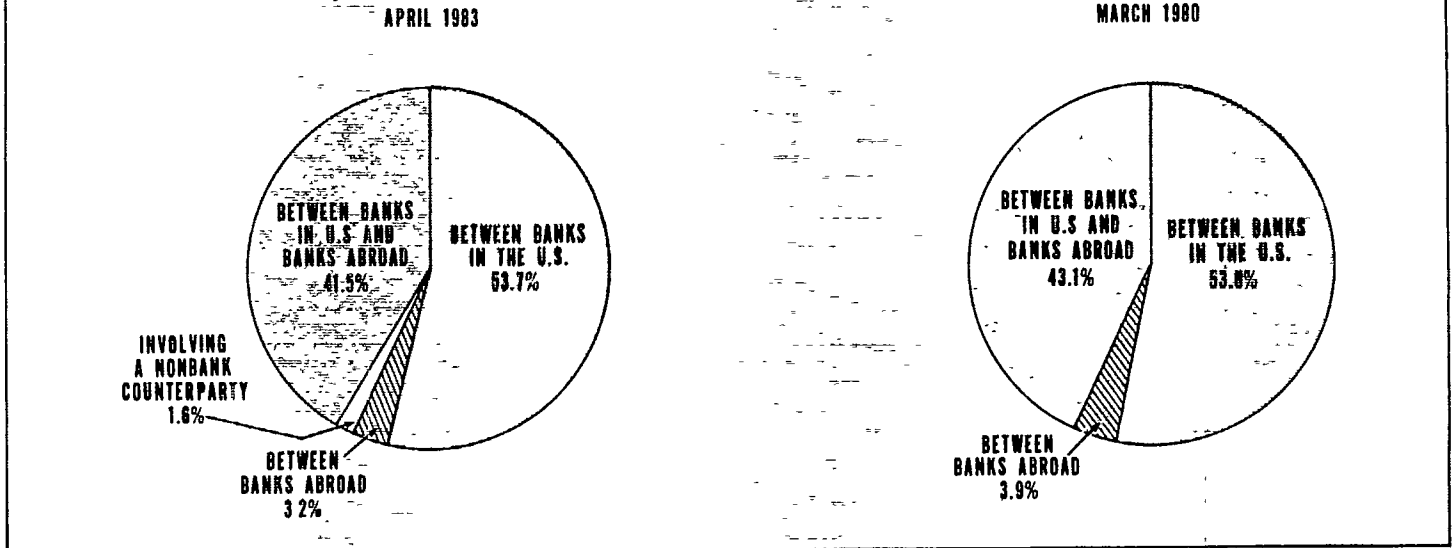
Foreign exchange brokers were surveyed separately. Unlike banks, the brokers surveyed do not trade currencies for their own accounts but, instead, act as intermediaries between market participants, mainly banks, wanting to buy or sell currencies. Because the brokers mostly act on behalf of the banks, a large portion of the turnover reported by brokers also was reported in the survey of banking institutions. Within the survey of brokers, there was no double-counting, since brokers do not deal with each other.

About \$225 billion, or 56 percent of interbank spot transactions reported by banks for April 1983, was done through brokers, compared with \$162 billion, or 54 percent in March 1980. Of all interbank transactions, including swap and forward contracts, reported by banks for April, about \$359 billion, or 59 percent, was done through brokers.

The 10 foreign exchange brokers had gross turnover of \$295.9 billion in April, up about 66 percent from the \$178 billion, or \$8.5 billion a day, reported by 11 brokers in March 1980. Nearly all brokers in the United States operating in the foreign exchange market were included in the two surveys.

The results of the survey of brokerage firms showed that 54 percent of the transactions reported by brokers were between two U.S. banks, 41.5 percent between a U.S. bank and a bank abroad, and 3 percent between two banks abroad, while 1.5 percent of the transactions involved a nonbank counterparty.

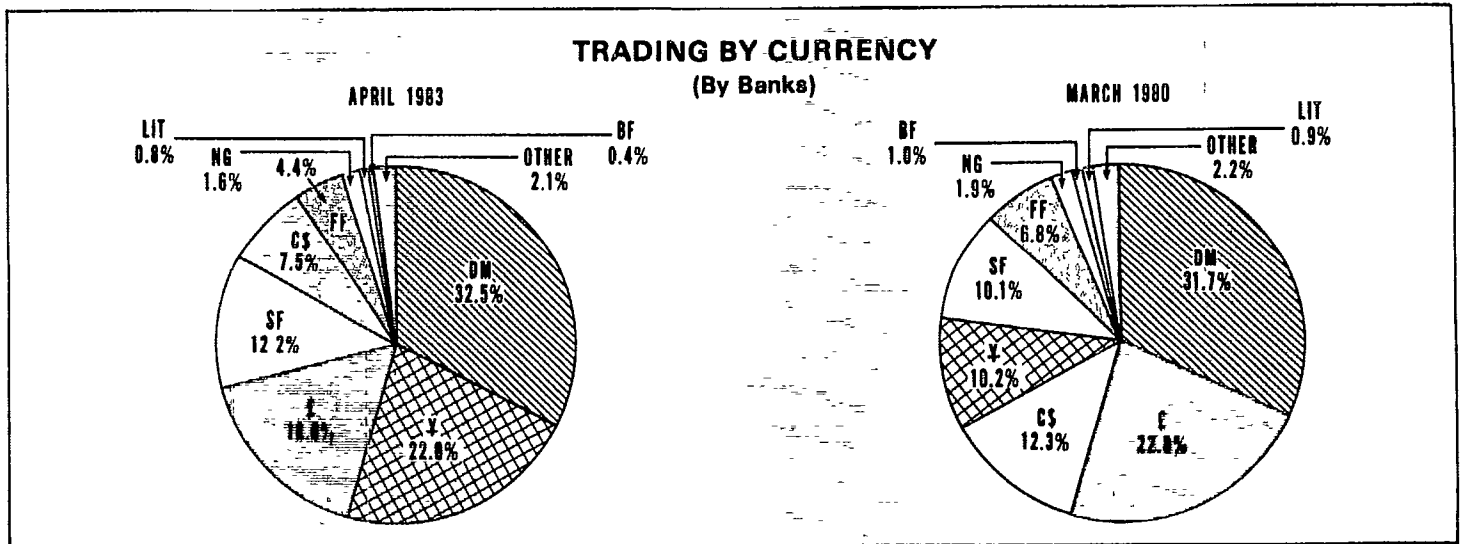
### TRADING BY TYPE OF COUNTERPARTY (By Brokers)



### Currency Mix

The latest survey showed the ranking of foreign currencies by transaction volume at banking institutions has changed considerably since 1980.

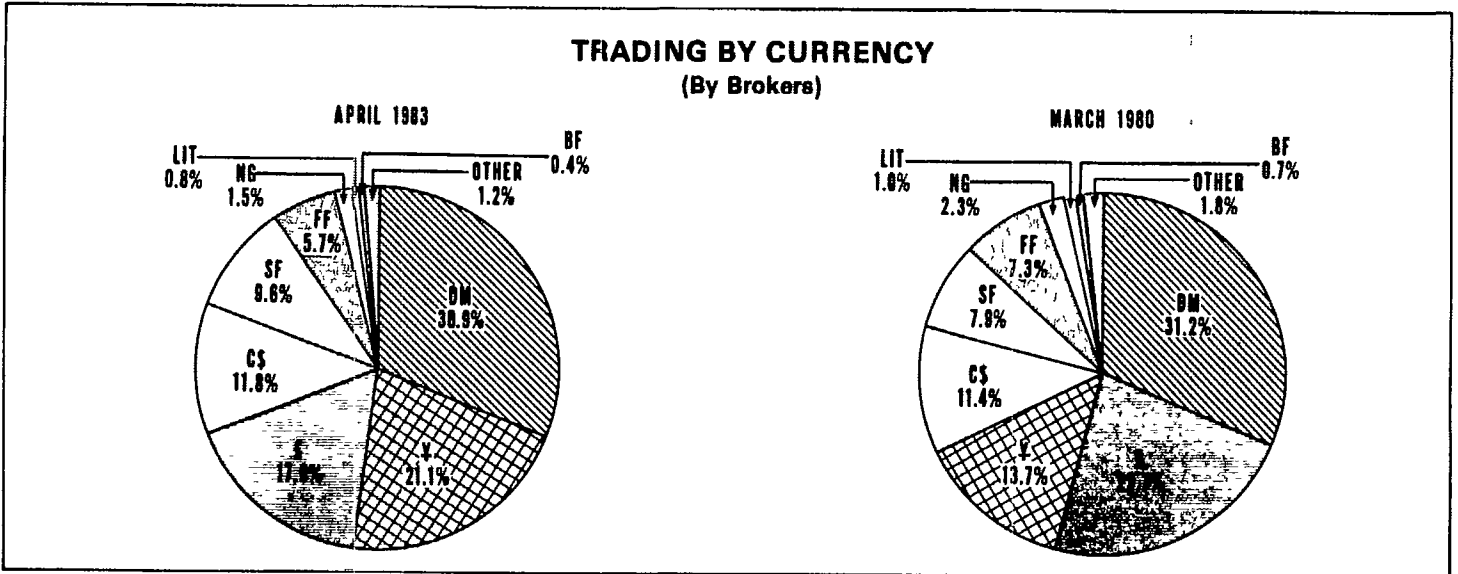
Trading in German marks continued to be the most active, accounting for 32.5 percent of the transactions by the banking institutions in spot, forward, swap, and futures contracts. In 1980, 31.7 percent of the activity was in marks.



However, the Japanese yen became the second most actively traded currency, accounting for 22.0 percent of gross turnover. In 1980, the Japanese yen was fourth, accounting for 10.2 percent of turnover. The British pound, which had been the second most actively traded currency in 1980 with a 22.8 percent share, dropped to third place with a 16.6 percent share of total turnover.

The Swiss franc moved into fourth place, accounting for 12.2 percent of activity, from fifth place in 1980 when it accounted for 10.1 percent. The Canadian dollar was fifth with a 7.5 percent share, down from third place in 1980 when its share was 12.3 percent.

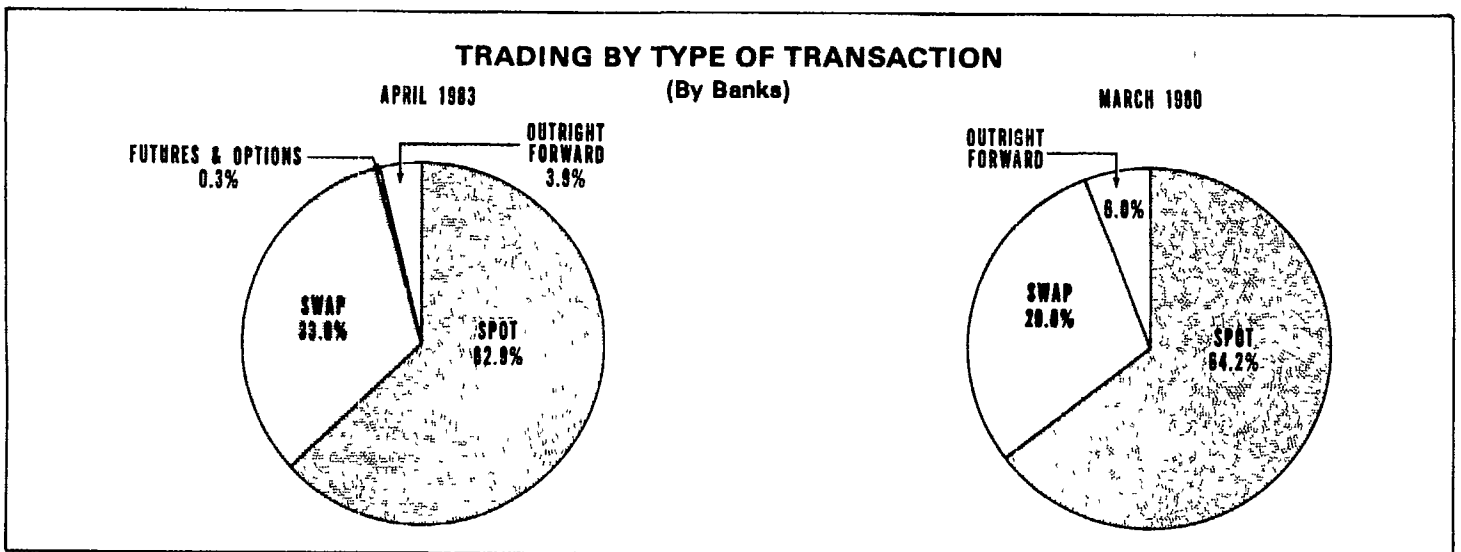
At brokerage firms the mark was also the most actively brokered currency, accounting for 30.9 percent of total turnover; the yen was second, accounting for 21.1 percent of total transactions; the British pound was third with 17 percent of transactions; the Canadian dollar was fourth with 11.8 percent, and the Swiss franc was fifth, at 9.6 percent.



For the first time the survey of banks included cross-currency transactions, in which a foreign currency is purchased or sold directly against another foreign currency rather than against the dollar. About 25 percent of the banks reported such transactions which amounted to a total of \$1.5 billion equivalent in April 1983.

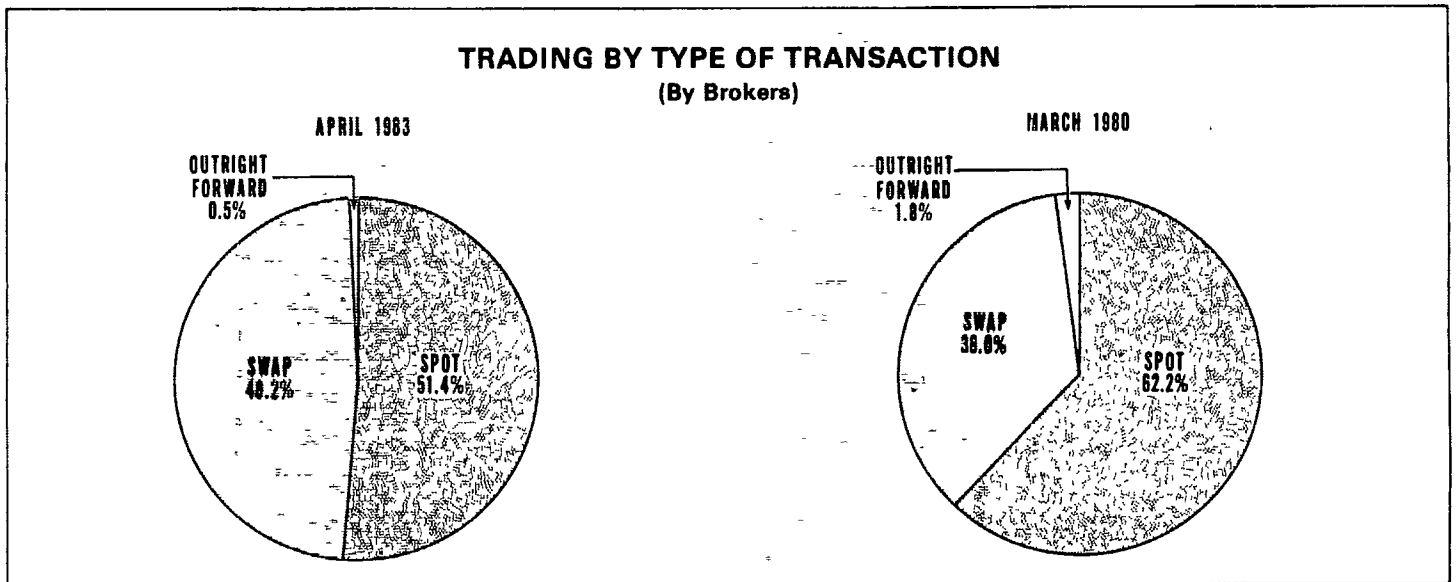
### Type of Transaction

During April about 63 percent of foreign exchange trading reported by 119 banks was in spot contracts, generally for delivery in two business days. Another 33 percent of total turnover was in swap contracts, in which a bank simultaneously buys (or sells) a currency for one maturity and sells (or buys) the equivalent amount for a later date.





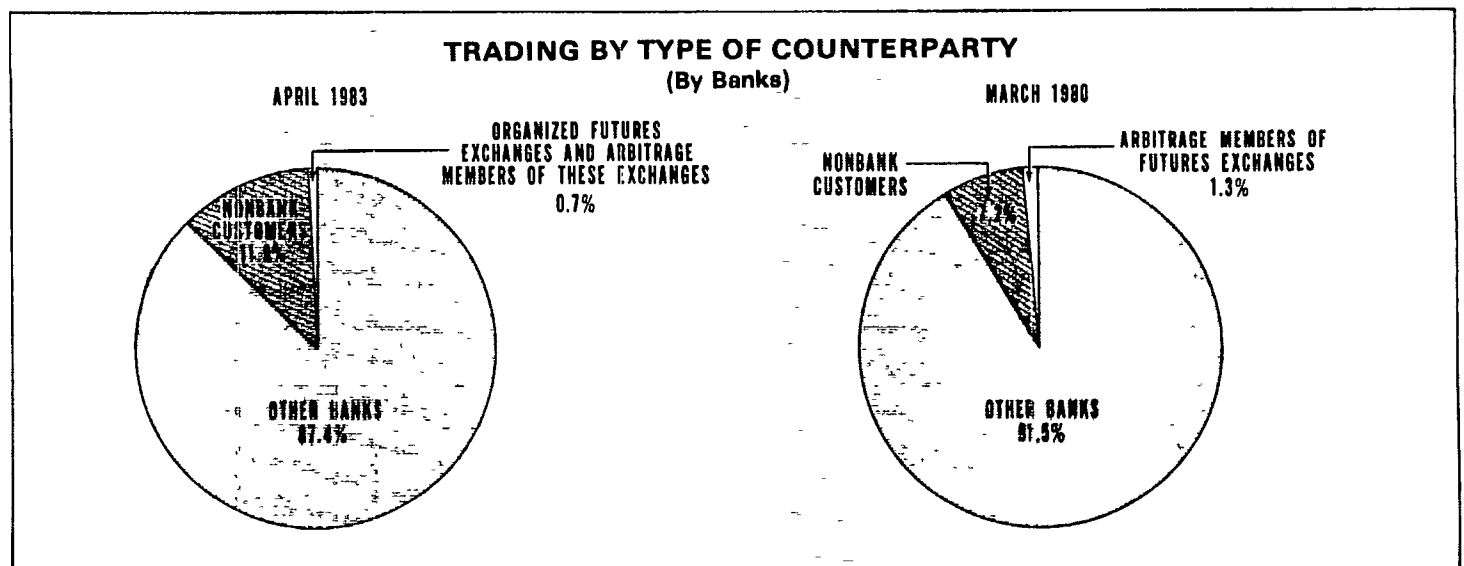
In addition, 4 percent of total transactions was in outright forward contracts in which currencies are purchased or sold for future delivery. In 1980, about 64 percent of trading was in spot contracts, 30 percent in swap contracts, and 6 percent in outright forward transactions.



One factor which may have contributed to the decline in the relative importance of forward transactions in April 1983 is a reduction by many U.S. corporations in the use of forward contracts to hedge balance sheet exposures. The decline in hedging activity is related to a change in accounting procedures for translating into dollars for consolidation purposes foreign currency items in the balance sheets of U.S. multinational corporations and their subsidiaries.

The new procedures, contained in Financial Accounting Standards Board Statement number 52, require that foreign exchange translation gains or losses be reflected in a separate component of stockholder's equity, rather than in current earnings as was true under the old statement, FASB 8. As a result, many companies have become less concerned than before about hedging balance sheet exposure. The increase in the share of swap transactions between the two surveys may be associated with the rise in exchange market activity in the yen, where swaps normally account for a larger proportion of total transactions than is true for other major foreign currencies.

Almost 12.5 percent of 1983 total volume reported by the 119 banking institutions was with nonbank customers, while the remaining 87.5 percent was reported to have occurred between banks. In 1980, 8.5 percent of total turnover occurred with nonbank customers. During the



interval between surveys a number of nonbank financial institutions have become more active in foreign exchange. In fact, transactions reported by banks with nonbank financial customers, including arbitrage members of currency futures exchanges, accounted for about 53 percent of total nonbank customer turnover in April 1983, up from about 33 percent in 1980. Thus transactions with nonbank nonfinancial customers as a proportion of total nonbank customer turnover declined to about 47 percent in April from 67 percent three years ago.

About 50 percent of April 1983 customer business took place in the spot market, 32 percent in swap contracts, and 18 percent in the forward market compared with about 36 percent, 21 percent, and 43 percent, respectively, in March 1980. In addition, nearly 4 percent of the trading reported with nonbanks was with arbitrage members of currency futures exchanges, down from 15 percent in 1980.

Arbitraging involves the simultaneous or nearly simultaneous buying and selling of currencies to take advantage of a price differential between the futures exchange and the interbank market. Arbitrage members are a small number of specialists authorized to do only such transactions. However, other exchange members can, and increasingly do, conduct these transactions as well. Thus, the reported decline may not represent an actual reduction in the relative importance of arbitrage activity between the two markets.

### **Futures, Options Transactions Reported**

For the first time banks were asked to report their foreign exchange futures and options transactions executed directly with the organized exchanges.

In a futures contract a bank buys or sells a standardized amount of foreign currency on an organized futures exchange for delivery on one of several standardized future dates. In a foreign exchange options contract a bank buys or sells on an organized options exchange the right—but not the obligation—to receive or deliver a standardized amount of foreign currency at a specified price on or before one of several standardized future dates.

Futures contracts accounted for 0.3 percent of overall foreign exchange turnover in April 1983. Although no options contracts with organized exchanges were reported, a number of banks themselves have written option contracts for their customers. Such transactions were not included in the survey.

### **Market Concentration**

The 10 most active banks accounted for 39.9 percent of transactions in April 1983, up slightly from 39.2 percent in March 1980. Thus foreign exchange activity became somewhat more concentrated even as the number of banks included in the survey increased.

Meanwhile, the share of turnover of foreign banks in the U.S. rose to 43.5 percent in April 1983 from 39 percent in March 1980. The rise coincided with an increase in the proportion of total respondents comprised of foreign banks to 50.4 percent from 46.7 percent three years ago.

The 1983 survey was conducted to determine structural changes in the market since the 1980 survey. A survey was also conducted in 1977.

## GROWTH IN FOREIGN EXCHANGE TURNOVER AMONG U.S. BANKS

(March 1980 to April 1983)

CURRENCY	INSTITUTIONS REPRESENTED ON BOTH SURVEYS			ALL INSTITUTIONS REPRESENTED ON EACH SURVEY		
	MARCH 1980 (MILLIONS \$)	APRIL 1983 (MILLIONS \$)	CHANGE %	MARCH, 1980 (MILLIONS \$)	APRIL, 1983 (MILLIONS \$)	CHANGE %
GERMAN MARKS	154,784	213,045	+37.7	155,872	228,643	+48.7
BRITISH POUNDS	110,465	113,481	+2.7	112,084	116,995	+4.4
SWISS FRANCS	48,882	84,329	+73.2	49,889	85,994	+73.1
JAPANESE YEN	48,833	129,236	+164.8	50,086	154,894	+208.9
CANADIAN DOLLARS	58,754	51,085	-13.1	60,541	52,855	-13.0
FRENCH FRANCS	33,613	28,991	-13.8	33,636	30,830	-8.3
DUTCH GUILDERS	9,325	9,245	-0.9	9,325	11,194	+20.0
BELGIAN FRANCS	5,113	2,646	-48.2	5,113	2,801	-45.2
ITALIAN LIRA	4,203	5,012	+19.2	4,203	5,550	+32.0
ALL OTHER	10,201	12,523	+22.8	10,794	14,629	+35.5
TOTAL	483,953	648,195	+33.9	491,323	702,499	+43.0
SAMPLE SIZE	87	87	—	90	119	—

### LIST OF BANKING INSTITUTIONS AND BROKERS

(Participants In The April, 1983 Survey Of The U.S. Foreign Exchange Market)

(● Included in 1980 Survey)

#### BANKS

- Algemene Bank, New York
- American Express International, New York
- American National Bank and Trust, Chicago
- Amsterdam-Rotterdam Bank, New York
- Australia & New Zealand Bkg. Group Ltd, New York
- Banca Commerciale Italiana, Chicago
- Banca Commerciale Italiana, Los Angeles
- Banca Commerciale Italiana, New York
- Banco De La Nación Argentina, New York
- Banco Di Sicilia, New York
- Banco Do Brazil, New York Branch
- Bank Di Roma, Chicago
- Bank of America, San Francisco
- Bank of America, Los Angeles
- Bank of America International, Chicago
- Bank of America Intl., New York
- Bank of Ireland, New York
- Bank of Montreal, New York
- Bank of New England N.A.
- Bank of New York, New York
- Bank of Nova Scotia Agency, New York
- Bank of Toyko Ltd Agency, New York
- Bank of Toyko, San Francisco
- Bankers Trust Co., New York
- Bankers Trust International Pacific Corp., Los Angeles
- Banque De L Union Europeenne, New York
- Banque Francaise Du Commerce, New York
- Banque Indosuez, New York Branch
- Banque Nationale De Paris, New York
- Banque Paribas, New York Branch
- Barclays Bank International, New York
- Bayerische Hypotheken-Und Wechsel Bank, New York
- Bayerische Landesbank Girozentrale, New York
- Berliner Handels-Und Frankfurt, New York
- Brown Brothers Harriman, New York
- Caisse National De Credit Agricole, Chicago
- Canadian Imperial Bank Comm. Agency, New York
- Chase Manhattan Bank, New York
- Chemical Bank, New York
- Citibank International, Chicago
- Citibank International, San Francisco
- Citibank N.A., New York
- Commercial, Detroit
- Commerzbank AG, Chicago

#### BANKS

- Commerzbank AG, New York
- Continental Bank International, New York
- Continental Illinois Nat Bk and Trust Co., Chicago
- Credit Industriel Et Commercial, New York
- Credit Lyonnais, New York
- Credit Suisse, New York
- Crocker International Bank, New York
- Crocker National Bank, San Francisco
- Daiwa Bank Ltd, New York
- Deutsche Bank AG, New York
- Deutsche Genossenschafts, New York
- Dresdner Bank AG., New York
- European American Banking Co., New York
- The Fidelity Bank, Pennsylvania
- First National Bank of Chicago
- First Chicago Intl. Banking Corp., New York
- First Interstate Bank of California, Los Angeles
- First National Bank Minneapolis
- First National Bank of Atlanta
- First National Bank of Boston
- First Pennsylvania Bank, Philadelphia
- Fleet National Bank Providence Rhode Island
- French American Banking Corp., New York
- Fuji Bank Ltd, New York Agency
- Hansa Trust and Savings Bank, Chicago
- Hessische Landesbank Girozentrale, New York
- Industrial Bank of Japan Ltd, New York
- Interfirst Bank Dallas
- Irving Trust Co., New York
- Kredietbank NV, New York
- Loyds Bank International, New York
- Long Term Credit Bank of Japan, New York
- Manufacturers Hanover Trust Co., New York
- Manufacturers National Bank, Detroit
- Marine Midland Bank, N.A.
- Mellon Bank N.A., Pittsburgh
- Merrill Lynch International Bank Panama, New York
- Mitsubishi Bank Ltd, New York
- Mitsu Bank Ltd, New York
- Mitsu Trust and Banking Corp., New York
- Morgan Guaranty Trust Co., New York
- National Bank of Detroit
- National City Bank, Cleveland
- National Westminster, San Francisco

#### BANKS

- National Westminster Bank Ltd, New York
- Nippon Credit Bank, New York
- Nordic American Bank Corp., New York
- North Carolina National Bank, Charlotte
- Northern Trust Co., Chicago
- Northwestern National Bank of Minneapolis
- Rainier National Bank, Seattle
- Republic National Bank of Dallas
- Republic National Bank of New York
- Royal Bank of Canada Agency, New York
- Senwa Bank Ltd, New York
- J. Henry Schroder Bank and Trust Co., New York
- Seattle First National Bank
- Security Pacific International, New York
- Security Pacific National Bank, Los Angeles
- Shawmut Bank of Boston N.A.
- Societe Generale, New York
- Standard Chartered Bank Ltd, New York
- State Street Bank and Trust Co., Boston
- Sumitomo Bank Ltd, New York
- Swiss Bank Corp., New York
- Texas Commerce Bank N.A., Houston
- Tokai Bank Ltd, New York
- Toronto Dominion Bank, New York
- Union Bank of Bavaria, New York
- Union Bank of Switzerland, Chicago
- Union Bank of Switzerland, New York
- Wells Fargo Bank N.A., San Francisco
- Wells Fargo Bank International Corp., New York
- Westdeutsche Landesbank Girozentrale, New York
- Westpac Banking Corp., New York

#### BROKERS

- Bierbaum and Company, Inc., New York
- Debeussse and Company, Inc., New York
- Harlow Meyer Savage, New York
- Intercurrency Inc., San Francisco
- Lasser Marshall Inc., New York and San Francisco
- Mabon, Nugent, Godsell, and Co., New York
- Noonan, Astley, & Pearce Inc., New York & San Francisco
- R. P. Martin Inc., New York
- Tullet and Riley Inc., New York and Los Angeles
- Wallich and Matthes Inc., New York

# APRIL 1983 FOREIGN EXCHANGE TURNOVER SURVEY OF 119 BANKING INSTITUTIONS IN THE UNITED STATES

*Aggregate Results  
(In Millions of Dollars Equivalent)*

CATEGORIES OF TRANSACTIONS	GERMAN MARK	BRITISH POUND	SWISS FRANC	JAPANESE YEN	CANADIAN DOLLAR	FRENCH FRANC	DUTCH GUILDER	BELGIAN FRANC	ITALIAN LIRA	ALL OTHER	ALL CURRENCIES
<b>I OUTRIGHT SPOT TRANSACTIONS</b>											
<b>A INTERBANK</b>											
1 Direct with Banks in U S	33,984	13,683	13,289	20,674	3,373	2,827	1,885	160	718	3,817	93,790
2 Direct with Banks Abroad	29,137	13,861	11,101	11,282	6,878	3,387	1,650	473	688	3,139	81,143
3 Through Brokers	96,773	37,338	27,680	42,812	11,232	13,381	2,684	672	571	1,402	224,226
<b>B CUSTOMER</b>											
1 Non Financial Institutions	6,165	3,478	3,476	4,020	3,716	681	489	124	240	841	22,199
2 Financial Institutions	5,732	3,362	4,821	5,102	1,665	362	87	51	97	260	21,439
<b>II SWAP TRANSACTIONS</b>											
<b>A INTERBANK</b>											
1 Direct with Banks in U S	6,638	3,246	2,238	5,447	2,348	791	684	78	482	696	22,626
2 Direct with Banks Abroad	13,191	7,443	5,413	13,242	6,440	2,154	1,839	567	688	1,697	61,674
3 Through Brokers	36,732	21,600	10,704	38,192	12,085	6,059	1,677	448	1,485	1,230	130,209
4 Short-Dated Interbank Swaps (one week or less) Included in II A 1 through II A 3	33,540	16,914	11,241	32,286	11,298	5,492	2,063	521	1,766	1,674	116,796
<b>B CUSTOMER</b>											
1 Non Financial Institutions	1,939	2,559	1,611	1,849	1,065	487	116	50	144	288	10,108
2 Financial Institutions	3,366	3,184	2,692	5,236	2,443	273	40	22	48	195	17,499
<b>III OUTRIGHT FORWARD TRANSACTIONS</b>											
<b>A INTERBANK</b>											
1 Direct with Banks in U S	620	613	117	1,006	161	129	33	55	110	290	3,133
2 Direct with Banks Abroad	894	815	380	669	391	89	93	19	131	214	3,675
3 Through Brokers	690	1,162	239	1,816	202	78	2	68	40	131	4,618
<b>B CUSTOMER</b>											
1 Non-Financial Institutions	1,592	2,565	835	1,432	992	346	147	88	177	648	8,820
2 Financial Institutions	1,283	1,323	109	382	368	84	45	31	31	69	3,708
3 Arbitrage Members of Currency Futures Exchanges	280	418	631	1,293	595	22	3	—	—	12	3,254
<b>IV CURRENCY FUTURES AND OPTIONS</b>											
A FUTURES CONTRACTS	447	345	789	281	104	—	—	—	—	2	1,968
B OPTIONS CONTRACTS	—	—	—	—	—	—	—	—	—	—	—
<b>TOTAL OUTRIGHT SPOT</b>	<b>160,781</b>	<b>71,722</b>	<b>80,269</b>	<b>83,870</b>	<b>26,461</b>	<b>20,308</b>	<b>6,635</b>	<b>1,380</b>	<b>2,214</b>	<b>9,169</b>	<b>442,798</b>
<b>TOTAL SWAP</b>	<b>61,866</b>	<b>38,032</b>	<b>22,659</b>	<b>63,966</b>	<b>23,981</b>	<b>9,764</b>	<b>4,238</b>	<b>1,160</b>	<b>2,847</b>	<b>4,106</b>	<b>232,016</b>
<b>TOTAL OUTRIGHT FORWARD</b>	<b>5,649</b>	<b>6,895</b>	<b>2,281</b>	<b>6,577</b>	<b>2,709</b>	<b>788</b>	<b>323</b>	<b>261</b>	<b>489</b>	<b>1,362</b>	<b>27,205</b>
<b>TOTAL FUTURES AND OPTIONS</b>	<b>447</b>	<b>345</b>	<b>789</b>	<b>281</b>	<b>104</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>2</b>	<b>1,968</b>
<b>TOTAL INTERBANK</b>	<b>208,849</b>	<b>99,761</b>	<b>71,031</b>	<b>135,119</b>	<b>41,807</b>	<b>28,575</b>	<b>10,287</b>	<b>2,435</b>	<b>4,813</b>	<b>12,316</b>	<b>614,993</b>
<b>DIRECT WITH BANKS IN U S</b>	<b>41,242</b>	<b>17,542</b>	<b>16,644</b>	<b>27,126</b>	<b>5,882</b>	<b>3,447</b>	<b>2,482</b>	<b>291</b>	<b>1,310</b>	<b>4,503</b>	<b>119,449</b>
<b>DIRECT WITH BANKS ABROAD</b>	<b>43,222</b>	<b>22,119</b>	<b>16,864</b>	<b>26,173</b>	<b>12,406</b>	<b>5,610</b>	<b>3,582</b>	<b>1,069</b>	<b>1,407</b>	<b>5,050</b>	<b>136,492</b>
<b>THROUGH BROKERS</b>	<b>124,385</b>	<b>60,100</b>	<b>38,523</b>	<b>82,820</b>	<b>23,519</b>	<b>16,518</b>	<b>4,243</b>	<b>1,065</b>	<b>2,096</b>	<b>2,763</b>	<b>359,052</b>
<b>TOTAL CUSTOMER</b>	<b>19,347</b>	<b>16,889</b>	<b>14,174</b>	<b>19,294</b>	<b>10,744</b>	<b>2,265</b>	<b>907</b>	<b>366</b>	<b>737</b>	<b>2,311</b>	<b>87,024</b>
<b>CUSTOMER (EXCLUDING ARBITRAGE MEMBERS)</b>	<b>19,067</b>	<b>16,471</b>	<b>13,543</b>	<b>18,001</b>	<b>10,149</b>	<b>2,233</b>	<b>904</b>	<b>366</b>	<b>737</b>	<b>2,289</b>	<b>83,770</b>
<b>NON-FINANCIAL</b>	<b>6,686</b>	<b>6,602</b>	<b>5,921</b>	<b>7,301</b>	<b>5,773</b>	<b>1,514</b>	<b>732</b>	<b>262</b>	<b>661</b>	<b>1,775</b>	<b>41,127</b>
<b>FINANCIAL</b>	<b>10,381</b>	<b>7,869</b>	<b>7,622</b>	<b>10,700</b>	<b>4,376</b>	<b>719</b>	<b>172</b>	<b>104</b>	<b>176</b>	<b>524</b>	<b>42,643</b>
<b>TOTAL TRANSACTIONS WITH ARBITRAGE MEMBERS PLUS FUTURES &amp; OPTIONS</b>	<b>727</b>	<b>763</b>	<b>1,420</b>	<b>1,574</b>	<b>699</b>	<b>22</b>	<b>3</b>	<b>—</b>	<b>—</b>	<b>14</b>	<b>5,222</b>
<b>TOTAL TURNOVER</b>	<b>228,643</b>	<b>116,995</b>	<b>85,994</b>	<b>164,694</b>	<b>62,655</b>	<b>30,830</b>	<b>11,184</b>	<b>2,801</b>	<b>5,650</b>	<b>14,629</b>	<b>703,985</b>
<b>CROSS-CURRENCY TRANSACTIONS</b>											<b>1,486</b>
<b>ADJUSTED TOTAL TURNOVER</b>	<b>228,643</b>	<b>116,995</b>	<b>85,994</b>	<b>164,694</b>	<b>62,655</b>	<b>30,830</b>	<b>11,184</b>	<b>2,801</b>	<b>5,650</b>	<b>14,629</b>	<b>702,499</b>
<b>CURRENCY SHARE (PERCENT)</b>	<b>32.5</b>	<b>16.6</b>	<b>12.2</b>	<b>22.0</b>	<b>7.5</b>	<b>4.4</b>	<b>1.6</b>	<b>0.4</b>	<b>0.8</b>	<b>2.1</b>	<b>100.0</b>

**APRIL 1983 FOREIGN EXCHANGE TURNOVER SURVEY OF 87 BANKING INSTITUTIONS  
INCLUDED IN BOTH THE 1980 AND THE 1983 SURVEYS**

*Aggregate Results  
(In Millions of Dollars Equivalent)*

<b>CATEGORIES OF TRANSACTIONS</b>	<b>GERMAN MARK</b>	<b>BRITISH POUND</b>	<b>SWISS FRANC</b>	<b>JAPANESE YEN</b>	<b>CANADIAN DOLLAR</b>	<b>FRENCH FRANC</b>	<b>DUTCH GUILDER</b>	<b>BELGIAN FRANC</b>	<b>ITALIAN LIRA</b>	<b>ALL OTHER</b>	<b>ALL CURRENCIES</b>
<b>I OUTRIGHT SPOT TRANSACTIONS</b>											
<b>A INTERBANK</b>											
1 Direct with Banks in U S	31,997	13,330	13,089	19,948	3,198	2,431	1,443	148	530	2,171	88,283
2 Direct with Banks Abroad	27,552	13,600	10,922	10,478	6,497	3,076	1,492	450	560	2,492	77,019
3 Through Brokers	80,628	36,326	26,804	40,399	11,089	12,853	1,947	566	822	1,391	212,625
<b>B CUSTOMER</b>											
1 Non-Financial Institutions	4,840	3,448	3,441	3,808	3,654	631	466	123	238	823	21,470
2 Financial Institutions	5,409	3,323	4,786	5,047	1,657	348	87	81	97	280	20,965
<b>II SWAP TRANSACTIONS</b>											
<b>A INTERBANK</b>											
1 Direct with Banks in U S	6,125	3,004	2,101	4,966	2,107	708	350	76	425	671	20,530
2 Direct With Banks Abroad	12,300	6,966	5,244	9,363	5,116	2,040	1,594	530	685	1,694	46,532
3 Through Brokers	33,410	20,736	10,611	23,816	11,631	5,521	1,400	376	1,376	1,223	109,799
4 Short-Dated Interbank Swaps (one week or less) Included in II A.1 through II A.3	29,782	16,000	10,982	20,031	10,803	5,094	1,735	460	1,649	1,651	98,187
<b>B CUSTOMER</b>											
1 Non Financial Institutions	1,901	2,847	1,803	1,827	1,037	337	118	47	144	287	9,846
2 Financial Institutions	2,983	3,111	2,679	3,264	2,443	287	40	22	48	195	16,032
<b>III OUTRIGHT FORWARD TRANSACTIONS</b>											
<b>A INTERBANK</b>											
1 Direct with Banks in U S	614	608	111	985	153	107	28	55	63	253	2,977
2 Direct with Banks Abroad	877	797	341	639	372	97	90	19	87	209	3,528
3 Through Brokers	865	1,162	239	1,815	196	75	2	68	33	131	4,566
<b>B CUSTOMER</b>											
1 Non Financial Institutions	1,557	2,543	829	1,295	950	304	143	87	173	640	8,521
2 Financial Institutions	1,281	1,297	109	314	366	78	45	31	31	69	3,619
3 Arbitrage Members of Currency Futures Exchanges	280	418	631	1,293	595	22	3	—	—	12	3,264
<b>IV CURRENCY FUTURES AND OPTIONS</b>											
A FUTURES CONTRACTS	447	345	789	281	104	—	—	—	—	2	1,968
B OPTIONS CONTRACTS	—	—	—	—	—	—	—	—	—	—	—
TOTAL OUTRIGHT SPOT	150,426	69,927	59,042	79,678	26,998	19,439	5,435	1,336	1,947	7,137	420,362
TOTAL SWAP	56,698	36,364	22,238	42,936	22,334	8,671	3,499	1,050	2,678	4,070	200,738
TOTAL OUTRIGHT FORWARD	5,474	6,826	2,260	6,341	2,632	691	387	260	387	1,314	26,486
TOTAL FUTURES AND OPTIONS	447	345	789	281	104	—	—	—	—	2	1,968
TOTAL INTERBANK	194,367	98,429	69,462	112,109	40,359	27,006	8,346	2,285	4,281	10,235	564,879
DIRECT WITH BANKS IN U S	38,735	16,942	16,301	25,899	5,458	3,244	1,821	277	1,018	3,096	111,790
DIRECT WITH BANKS ABROAD	40,729	21,263	16,507	20,480	11,985	5,213	3,176	989	1,332	4,395	126,079
THROUGH BROKERS	114,903	58,224	37,654	65,730	22,916	18,549	3,349	1,009	1,931	2,746	327,010
TOTAL CUSTOMER	18,231	16,697	14,078	16,846	10,602	1,985	599	361	731	2,286	82,706
CUSTOMER (EXCLUDING ARBITRAGE MEMBERS)	17,981	16,269	13,447	15,553	10,007	1,963	596	361	731	2,274	79,462
NON-FINANCIAL	8,298	8,538	6,873	6,928	6,641	1,272	724	257	555	1,750	39,836
FINANCIAL	9,653	7,731	7,574	8,625	4,366	691	172	104	176	524	39,616
TOTAL TRANSACTIONS WITH ARBITRAGE MEMBERS PLUS FUTURES & OPTIONS	727	763	1,420	1,574	599	22	3	—	—	14	5,222
TOTAL TURNOVER	213,045	113,461	84,329	129,236	51,065	28,991	9,245	2,646	5,012	12,523	649,553
CROSS-CURRENCY TRANSACTIONS	—	—	—	—	—	—	—	—	—	—	1,368
ADJUSTED TOTAL TURNOVER	213,045	113,461	84,329	129,236	51,065	28,991	9,245	2,646	5,012	12,523	648,185
CURRENCY SHARE (PERCENT)	32.8	17.5	13.0	19.9	7.9	4.5	1.4	0.4	0.8	1.9	100.0

## APRIL 1983 TURNOVER SURVEY OF TEN FOREIGN EXCHANGE BROKERS

*Aggregate Results  
(In Millions of Dollars Equivalent)*

CATEGORIES OF TRANSACTIONS	GERMAN MARK	BRITISH POUND	SWISS FRANC	JAPANESE YEN	CANADIAN DOLLAR	FRENCH FRANC	DUTCH GUILDER	BELGIAN FRANC	ITALIAN LIRA	ALL OTHER	ALL CURRENCIES
<b>I OUTRIGHT SPOT TRANSACTIONS</b>											
A BETWEEN TWO BANKS IN U.S.	38,745	14,162	8,149	19,026	2,669	4,467	1,442	237	602	1,113	69,512
B BETWEEN TWO BANKS ABROAD	1,173	471	89	266	1,808	130	1	—	1	6	3,933
C BETWEEN A BANK IN U.S. AND A BANK ABROAD	19,945	8,994	6,003	7,722	6,184	4,736	1,054	232	324	694	66,898
D INVOLVING A NON-BANK COUNTERPARTY	438	360	1,230	603	125	3	—	—	—	3	2,762
<b>II SWAP TRANSACTIONS</b>											
A BETWEEN TWO BANKS IN U.S.	20,846	11,836	5,500	21,226	3,462	3,228	600	188	977	1,046	68,897
B BETWEEN TWO BANKS ABROAD	314	249	137	159	4,562	131	—	—	—	4	6,566
C BETWEEN A BANK IN U.S. AND A BANK ABROAD	11,926	11,935	6,979	12,744	15,666	4,149	1,388	578	503	533	66,301
D INVOLVING A NON-BANK COUNTERPARTY	24	540	264	582	482	—	14	—	—	—	1,856
E SHORT-DATED SWAPS (ONE WEEK OR LESS) INCLUDED IN II A THROUGH II D	19,363	12,776	8,948	19,729	15,898	5,528	392	528	1,020	1,152	85,424
<b>III OUTRIGHT FORWARD TRANSACTIONS</b>											
A BETWEEN TWO BANKS IN U.S.	188	122	—	131	—	18	—	—	—	9	478
B BETWEEN TWO BANKS ABROAD	—	34	—	—	70	—	—	—	—	—	104
C BETWEEN A BANK IN U.S. AND A BANK ABROAD	35	572	13	71	62	63	—	6	—	2	824
D INVOLVING A NON-BANK COUNTERPARTY	—	—	—	17	—	—	—	—	—	—	17
TOTAL OUTRIGHT SPOT	59,301	24,987	15,471	27,806	10,796	9,336	2,497	469	827	1,816	152,105
TOTAL SWAP	33,010	24,560	12,880	34,681	24,132	7,508	2,002	764	1,480	1,583	142,610
TOTAL OUTRIGHT FORWARD	233	728	13	219	132	81	—	6	—	11	1,423
TOTAL BETWEEN TWO BANKS IN U.S.	57,789	25,120	14,649	40,383	6,121	7,713	2,042	423	1,478	2,168	158,887
TOTAL BETWEEN TWO BANKS ABROAD	1,487	764	226	414	6,440	261	1	—	1	9	9,593
TOTAL BETWEEN A BANK IN U.S. AND A BANK ABROAD	31,806	22,501	11,985	20,537	21,922	6,948	2,442	816	827	1,229	123,023
TOTAL INVOLVING A NON BANK COUNTERPARTY	462	900	1,494	1,182	577	3	14	—	—	3	4,635
TOTAL TURNOVER CROSS CURRENCY TRANSACTIONS	91,544	50,275	28,364	62,516	35,060	16,925	4,499	1,239	2,307	3,409	296,138
ADJUSTED TOTAL TURNOVER	91,544	50,275	28,364	62,516	35,060	16,925	4,499	1,239	2,307	3,409	295,934
CURRENCY SHARE (PERCENT)	30.9	17.0	9.6	21.1	11.8	5.7	1.5	0.4	0.8	1.2	100.0

**OTHER DOCUMENTS OF  
THE COMMITTEE**

## Document of Organization

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

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

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

The objectives of the Committee would be

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

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

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

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

#### The Committee

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

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

3. Responsibility for choosing member institutions and alternates rests with the Federal Reserve Bank of New York. The Federal Reserve may solicit the advice of current Committee members.
4. Initially, the terms of half of the members will be for two years and half for three. Thereafter, to provide for maximum participation in the Committee by institutions eligible for membership, the term of membership would be two years. It is envisaged that, at the expiration of each member's term, the alternate would succeed to full membership.

The composition of the Committee should be as follows.

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

the president of the FOREX Association of North America

the Federal Reserve Bank of New York

#### Committee Procedures

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

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

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

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

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

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

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

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



# FOREIGN EXCHANGE COMMITTEE MEMBERS AND ALTERNATES

(January, 1984)

## MEMBERS

## ALTERNATES

### I. East Coast Banks

*Rolf G. Sellge*  
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*Horst Duseberg*  
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Senior Vice President  
Marine Midland Bank  
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*Peter J. Niosi*  
Senior Vice President  
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### II. Regional Banks

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*John Christopherson*  
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## MEMBERS

## ALTERNATES

### III. Foreign Banks

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### V. Forex Assn. of North America President (Observer)

*David Palmer*  
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### VI. Federal Reserve Bank of New York (ex officio)

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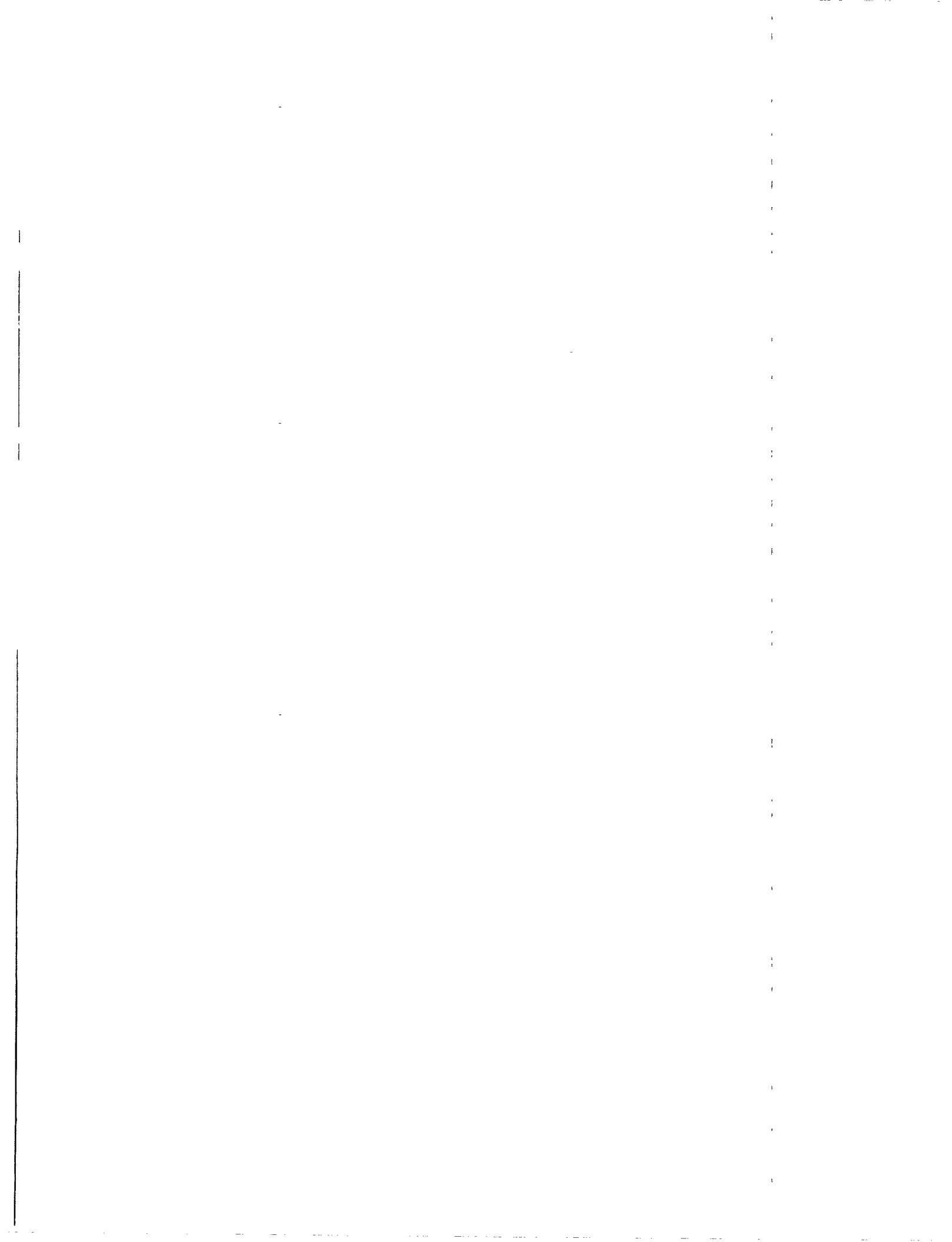
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**CUMULATIVE INDEX  
TO  
PREVIOUS REPORTS**

SUBJECT	ANNUAL REPORT	PAGE
Bank-Broker Relationship	1982	5
Bank-To-Broker Communication (Recommendation)	1979	7
Canadian Dollar-Quoting (Committee Deliberations)	1979	4
Chairman's Report	1979	3
—	1980	3
—	1981	3
—	1982	3
CHIPS Conversion to Same-Day Settlement	1980	5-6
—	1981	6
● Letter from David E. Bodner	1980	17
● Federal Reserve Bank of New York Circular	1980	17
● Excerpts from Remarks by John F. Lee	1980	15-16
Committee's Advisory Role	1979	5
—	1980	5-6
—	1981	4-5
—	1982	6-7
Committee's Relationships with Other Organizations	1979	6
Confidentiality	1979	4
—	1980	10
Conflict of Interest	1980	8-9
Confirmation of Foreign Exchange Transactions	1979	4
● Brokers Role In	1980	9
● Recommendation	1979	3, 7
● Responsibility for (Committee Deliberations)	1979	4
Document of Organization	1980	18
—	1981	8
—	1982	16
Exchange Market Intervention—Excerpts from Remarks by Under Secretary of the Treasury Beryl W. Sprinkel	1982	5, 14
Feasibility Study to Establish Foreign Exchange Committee and Document of Organization	1979	8-9
Federal Financial Institutions Examination Council (See Minimum Standards)	1979	5
—	1980	4, 11-13
Financial Futures Markets, Comments On	1981	5
Foreign Exchange Contract Standards—Comments On	1979	5
—	1980	4, 6, 8-13
—	1981	5
Foreign Exchange Contracts-Proposed Rules of International Chamber of Commerce	1979	5
—	1980	6
—	1981	5
Foreign Exchange Operations, Guidelines For	1980	3, 6, 8-13
● Audit Documentation (FFIEC)	1980	13
● Documentation of Policy (FFIEC)	1980	11-12
● Internal Accounting Controls (FFIEC)	1980	12-13
Foreign Exchange Transactions volume	1980	5
—	1981	4-5
Foreign Exchange Turnover Survey	1982	7
Formation of Committee	1979	3, 9
IBFs, Comments On	1981	4
—	1982	5-6
Interest Rate-Exchange Rate Volatility	1980	6
—	1981	4-5
International Chamber of Commerce-Proposal-Foreign Exchange Contracts	1979	5
—	1979	5
—	1981	5

SUBJECT	ANNUAL REPORT	PAGE
Insolvency	1980	6
Management Issues, Statement of (Committee Deliberations and Recommendations)	1980	4, 8-10
Management of Foreign Exchange Activity and Management Issues, Selected Issues Relating to	1982	4, 11-13
Meeting Dates (1978-1979)	1979	6
— (1980-1981)	1980	7
— (1981-1982)		
— (1982-1983)	1982	5
Membership (Participation changes)	1981	7
— (December 1979)	1979	11
— (December 1980)	1980	19
— (December 1981)	1981	9
— (December 1982)	1982	17
Memorial Day Observance in New York—Committee's Advisory Role	1980	5
● Letter from Scott Pardee	1980	14
Name Substitution Practices		
—	1982	3, 4-5
● Recommendation	1982	8-10
Name-Switching	1980	4, 9
Non-Bank Participants In Exchange Market, Comment On	1981	5
Off-Market Rates	1980	8
Off-Premises Trading	1980	4, 10
Ohta, Takeshi		
— Excerpts from Remarks	1982	15
Performance of the Exchange Markets, Comments On	1980	6
—	1980	7
—	1981	4
Recommendations For Dealers (Association Cambiste Internationale)	1980	4
Same-Day Settlement (See CHIPS Conversion)	1980	5-6
—	1981	6
Selected Issues Relating to the Management of Foreign Exchange Activity	1980	4, 8-10
—	1982	4, 11-13
Speakerphones	1979	4, 7
Sprinkel, Beryl W.		
— Excerpts from Remarks	1982	14
Support Staff, Importance of	1980	10
Tape Recording	1982	6
Trader-Broker Relationship	1980	9
Trading Practices	1980	9
Trader-Trader Relationship	1980	9
Two-Way Speakerphones (Committee Deliberations and Recommendation)	1979	4, 7
Uniform Guideline on Internal Control For Foreign Exchange Activities in Commercial Banks (FFIEC)	1980	11-13
Yen in International Markets		
— Excerpts from Remarks by Takeshi Ohta, Director of the Bank of Japan	1982	15

**NOTES**