THE

FOREIGN EXCHANGE COMMITTEE

ANNUAL REPORT

1985

CONTENTS

CHAIRMAN'S REPORT

The foreign exchange and international financial market's reputation of being an exciting place was easily maintained in 1985. The relatively stable short-term U S dollar interest rates through most of 1985 were not duplicated in the foreign exchange markets. One had to be impressed with the ability of the professional market to maintain availability of risk management services in such an environment Product innovation carried over into this year from the hectic pace of 1984, but 1985 dealt more with the rapid evolution of the marketplace for previously introduced products.

Market participants appeared to have coped well with the product changes, large volumes, and market volatility. Yet in such an environment it is important that potential problems be discussed The increased awareness that results from this attention is an important step in ensuring the smooth functioning of the marketplace. The Foreign Exchange Committee was very active in such discussion during 1985, as reflected in this report.

The Committee continued to give considerable attention to issues that promote the conscientious development of internal control by financial institutions on exposure to credit risks and market rates resulting from trading activities. Among the many topics discussed were the increasing use of foreign exchange contracts with more distant maturity dates, the growth of 24-hour and off-premise trading, and foreign exchange confirmation practices.

The Committee held follow-up discussions of the bilateral foreign exchange netting agreement it developed last year It also reviewed the effort of some banks in London on foreign exchange netting that will use a somewhat different approach. Foreign exchange contract netting involves many complex issues that will take both time and effort to resolve. Nevertheless, the largest trading banks continue to maintain their interest in these projects

The deliberations on new product evolution focused primarily on the appropriateness of standardizing terms and conditions on foreign exchange options, interest-rate swaps, and forward (interest) rate agreements. The product enhancements taking place in the decades old over-the-counter markets are running parallel to those recently introduced by organized exchanges for similar financial products. The merging of these two previously distinct markets and of these different trading practices and traditions is beginning to raise some complex new regulatory issues

An important strength of the Committee is its excellent balance in technical skills and U S. geographic representation. Its effectiveness this year was due to individual efforts of its members and the assistance of the Federal Reserve Bank of New York. I would like to express my gratitude and that of the Committee to the staff at the Federal Reserve Bank of New York for being especially supportive in 1985.

Ray Peters

Raymond R. Peters

COMMITTEE DELIBERATIONS ON MATTERS OF MARKET PRACTICE

The Committee's discussions during the past year focused on the requirements for a smoothly functioning foreign exchange market and the need to insure sound business practices in a variety of ways.

These discussions, especially in the first half of the year, occurred against the background of increasing strain in U.S. financial markets. A number of customers including several local governments and thrift institutions had incurred losses as a result of the failure of three U.S. government securities dealers, though they constituted only a very small part of that market. The question arose whether the foreign exchange markets were vulnerable to a similar type of disruption or accident.

Members of the Committee felt that the exchange market was generally robust for a number of reasons. The traditional foreign exchange instruments have been in widespread use for a long time and now should be sufficiently established to be understood by most market participants. Internal control systems have been continually strengthened as new technology becomes available. Moreover, the exchange markets have traditionally been regarded with a heightened sense of caution. These markets transcend national boundaries. Consequently, market participants assume that the monetary authorities, either singly or in combination, do not have as direct and as dominant a supervisory role in the exchange markets as they may have in any one domestic financial market.

Sources of Market Vulnerability

Nevertheless, Committee members identified two major areas of risk to the foreign exchange markets. The first involves credit exposure. There is a tendency for dealers at times to underestimate the credit exposure being built up as a result of their dealing activities. This tendency may become more pronounced with the development of new products and the construction of complicated, negotiated deals —many of which establish credit exposure in nontraditional ways. Moreover, the growing volume of long-dated forward transactions may be exposing banks to greater credit risks than is generally acknowledged by their internal control procedures.

The Committee noted that it has made several studies on varying aspects of credit exposure in recent years. It reaffirmed its commitment to continue to work in this area.

The second source of concern is the ever present risk of fraud. A number of members mentioned particular examples of trading irregularities that had come to light during the year. One bank reported that it had decided to tighten its confirmation procedures for transactions with nonbanks and customers. This procedure was adopted primarily to protect itself against the possibility that an unauthorized individual might attempt to effect a foreign exchange transaction, as well as to reduce the possibility that an authorized individual might attempt to exceed his authority.

The Committee concluded the most important approach to dealing with this problem is to stress the importance of controls. Conscientious compliance to internal controls gives institutions the best protection against fraudulent activities by individuals, either inside or outside the institution.

Apart from these general areas of concern, the Committee focused on several particular aspects of market practice.

Banks' Relations With Customers

A potential source of strain in the foreign exchange market became evident during the Committee's discussion of banks' recent experience in dealing with corporate customers. Members reported frequent requests for narrow spread quotations from corporate customers seeking to cover increasingly large commercial transactions. Members noted that this situation is frustrating for traders. They must cope with pressure from management to be profitable. At the same time, traders cannot expect reciprocity in making markets or getting quotations with narrow spreads from customers to cover their own needs. The Committee agreed that these circumstances require a high degree of integrity and respect in relationships between dealers and customers.

Long-Dated Forward Contracts

Another specific area of evident concern among the membership was long-dated forward foreign exchange contracts. Members uniformly agreed that the volume of forward transactions has increased and the maturities have lengthened in recent years. A number questioned whether current market practices concerning documentation requirements for these transactions are adequate. Long-dated forwards are entered into with counterparties with no documentation except the usual confirmation of the deal. Other forms of long-term credit extension, however, routinely require substantial documentation. One bank, noting the anomaly of this situation, attempted to require increased documentation for forwards but found counterparty acceptance difficult.

Related comments reflected members' skepticism that the credit exposure resulting from these transactions was accurately being assessed. One idea that emerged from this discussion was that long-dated forward transactions with each customer be revalued to market rates each month. If the customer has sustained a loss during the month on a transaction, then the implied increase in credit extended should be charged to that customer's credit line. There is, of course, a mutual risk involved in foreign exchange contracts so that if a customer has a profit on the transaction, the risk of nonperformance is shifted to the customer.

Twenty-four Hour Trading

Several issues the Committee discussed reflected recent growth in trading after normal hours on the East Coast. The development of interbank foreign exchange trading in New Zealand and Australia offered previously unavailable trading opportunities in the time interval between the New York close and the Asian opening. Since the removal of exchange controls and the introduction of floating exchange rates in both countries, trading in these centers has increased dramatically and has attracted international participation. At the same time, many U.S. based institutions, responding to increased exchange rate volatility, were anxious to find opportunities for adjusting their exchange rate exposures before waiting for business to open in major financial markets. As a result, several U.S. brokers began to offer foreign exchange services well after the New York close, and several U.S. trading institutions began to permit individual dealers to operate from home. Some institutions moved even further in the direction of extending trading hours. They increased trading on site outside normal business hours to permit a reduction of trading units worldwide.

A concern of several members was the adequacy of management control procedures being applied to off-hours trading, either at the office or at home. In this discussion a number of institutions described the control procedures they had introduced. Several banks indicated they limited at-home trading to senior staff. Other banks allowed only those deals which reduce exposures and are executed with their own foreign offices. One broker indicated it required written notification from senior management naming those individual bank traders authorized to deal after hours. The broker then assigns an identification number to each person authorized to deal at home. The bank dealer calling from home must identify himself with his assigned number before the broker does business with that person.

Transaction Date Questions

Questions had also arisen about the appropriate dealing date for transactions done after the New York close. The market convention is that dealers entering into transactions after the close of business must specify their desired value date, even for spot transactions, the party making the price can determine the value date for spot. When, however, transactions are done between two counterparties across the international date line, the spot value date is presumed to reflect the spot value prevailing in the financial center of the Asia-Pacific region.

Notwithstanding these conventions, misunderstandings have developed about value dates, particularly in brokered deals. The Committee learned that the international organization of foreign exchange traders, the Association Cambiste Internationale (ACI), recommended that, for international dealing, 5 p.m. New York time be considered as the end of dealing in the United States. This procedure does not prevent U.S. banks dealing with one another from negotiating a value date of their choosing. Nor does it preclude U.S. banks outside the eastern time zone from considering 5 p.m. local time as the end of the day for internal reports on end-of-day positions and regulatory reports.

To the extent that a variety of closing times are used, close-of-day positions of banks reporting to the Federal Reserve reflect positions at different times of the day. Some members expressed the view that priority should be given to making the end-of-day definition meaningful from the point of view of the individual bank's reporting system rather than imposing a common definition across all banks.

Management Guidelines

In view of the Committee's concerns with many aspects of market practice, a reexamination of its paper "Selected Issues Relating to the Management of Foreign Exchange Activity" *(see Annual Report 1983, pp. 12-14)* seemed appropriate. Committee members noted that a number of changes had occurred in the market since the guidelines were first formulated.

Also, some members expressed particular interest in reconsidering the issues surrounding trading for one's own account. The Committee had previously pointed to the potential conflicts of interest arising from individual financial transactions and had expressed the view that outright position taking should be prohibited. Members' concerns about this type of conflict of interest are in no way diminished. Nevertheless, competitive pressures on banks for personnel have led to some feeling that a rigid prohibition may no longer be feasible. Moreover, the proliferation of new products and the opportunities for creating a synthetic foreign exchange position through transactions in other markets have added to the complexities of this issue.

The Committee did not come to any conclusion on this matter. But it did establish a subcommittee to review its management guidelines paper.

Confirmation of Spot Transactions

Another issue considered by the Committee concerned the confirmation of spot foreign exchange transactions. It was noted that some institutions were reassessing the usefulness of exchanging confirmation letters for spot transactions. These letters often arrive after settlement, and the costs of supporting a trading operation could be significantly reduced if this procedure were eliminated.

Those members of the Committee that spoke to this subject uniformly endorsed the procedure of confirming spot transactions. Although in some cases banks may not take action to obtain missing confirmations once the transaction has been settled, the banks regard confirmation as the only clear-cut documentation of the deal.

BILATERAL NETTING OF FOREIGN EXCHANGE CONTRACTS

The Committee published, in early 1985, a draft netting agreement to serve as an example of how a procedure for netting outstanding foreign exchange contracts between two banks might be established in the U.S. interbank market.

As detailed in the 1984 *Annual Report*, the agreement was based on the premise that two bank counterparties would enter into a master agreement providing that future transactions between them be netted automatically. It was intended to limit banks' risk by reducing both payment and contract obligations resulting from their interbank foreign exchange trading, and to clarify a bank's legal position on its foreign exchange position in the event of a counterparty's insolvency.

The Committee's netting agreement was intended to serve as a model. As such it dealt only with the most general issues. It was clear from the start that, as two institutions actually attempted to establish a bilateral netting agreement, the provisions suggested by the Committee might have to be adjusted to suit the parties' needs.

Many Complex Issues

As individual banks started to negotiate netting agreements with their interbank counterparties, they came to realize that many complex issues needed to be resolved before a final agreement could be achieved. To some extent, the complexity of this process reflected the fact that it was the largest banks, and frequently those with a most complicated form of organization, that wished to pursue netting. Consequently, questions arose about which operating units should be involved and the extent to which deals should be consolidated among parts of one institution before being netted with the other.

In addition, questions arose about the scope of any bilateral netting agreement. For example, banks considered which currencies and which contract maturities it was feasible to include. They wondered also whether the model agreement, which had been designed to apply to individual pairs of currencies, could be varied to net multiple currencies.

From an operational point of view, too, netting posed some issues. Those bank officials responsible for handling contract processing were anxious that the netting of contracts be accomplished in an automated fashion, yet were concerned that their computer software systems — many of which had just recently been installed — might require substantial and costly modification. They saw considerable operational difficulties if netting arrangements with different counterparties required different operational procedures. Some also expressed the view that, if the trace of each individual deal were lost as a result of netting, the process of identifying payment failures and of resolving the attendant disputes would become more difficult.

The Foreign Exchange Committee discussed these operational issues in general with the Council of International Banking (CIB). During these discussions, members of the Committee indicated they expected netting to be introduced gradually enough to permit an orderly transition in the processing of foreign exchange transactions. They also acknowledged that not all banks would be interested in netting at this time because, for many, the costs of implementing new operating systems could not be justified by the benefits of netting.

CIB Operational Suggestions

Meanwhile the CIB canvassed its membership, soliciting views on some of the specific attributes an initial netting system might have. From this survey, the CIB drew the following observations:

- The choice of currencies involved in any particular netting agreement should be left to the institutions entering the agreement.
- To be included in the netting procedure, a transaction should be entered into at least two business days prior to the value date. Deals done for cash or for one-day value — as well as non-routine and option transactions — should be treated separately, with the entire amount of the contract being settled.
- Given current operating system capabilities, most banks would find it easier to involve single entities in netting rather than combinations of branches and subsidiaries. This observation does not preclude those institutions that have or that are developing a global real time network containing a centralized client data base from including branches or subsidiaries in a netting agreement if they so chose and their counterparties agreed.
- The confirmation process, if properly designed, should provide a sufficient historical record to pursue payment failures and resolve disputes. More specifically:
    - All deals under netting agreements should continue to be confirmed on the actual dealing date.
    - A netting verification process should occur, prior to noon eastern standard time one business day before the value date, to include the specifics of the netted amounts to be delivered and received the next day.
    - Preferably this netting verification process would be designed to fit a standard SWIFT format.

Ongoing Interest

Though the process of establishing netting agreements proved to be cumbersome, the largest foreign exchange trading banks continued to be interested in establishing such arrangements. A number of banks pursued their efforts to establish bilateral netting agreements with other institutions and prepared to incorporate netting into their operating, accounting, and reporting systems. At least one such agreement had been reached by year end.

London Netting Project

During 1985, some banks in London were working on developing an approach to netting for that market In several respects the London project was more ambitious than the Committee's effort of 1984

As with the approach taken by the Committee's netting agreement, the London foreign exchange netting project seeks to reduce risk in interbank dealing by fundamentally changing the legal contract representing each counterparty's obligation The London group envisages that any two parties wanting to net would enter into a foreign exchange netting and close-out agreement Such an agreement has already been written for intra-London dealing consistent with U K. law. A U S law firm examined that agreement from the point of view of U S law, finding that the London agreement would stand in the event of a bankruptcy in the United States of the parent of one of the counterparties

Also like the Committee's agreement, the London one provides for mandatory close-out in the event of liquidation of one of the counterparties The close-out amount is computed by converting the net payments due for each settlement date into a common currency and discounting those amounts to present value. Under some circumstances, optional close-out is also permitted

Comparisons of the Two Approaches

In two respects the London project seeks to go further than the approach suggested by the Committee's netting agreement. First, the netting of contracts is to be more comprehensive since it would not be limited, as is the case in the Committee's agreement, to transactions involving predetermined pairs of currencies. Second, the London project entails the development of a specially fitted microcomputer and the appropriate software to accomplish netting without a basic alteration of banks' existing operating systems This equipment is being designed to interface easily with a variety of operating systems and to communicate with equipment of its type at other banks

In the London proposal, netting would be accomplished between two banks as part of an electronic and automatic confirmation process. The details of a deal are exchanged by the two counterparties and compared to be sure that the contract details match in every respect Once the deal is confirmed and matched in this way, the obligation for that transaction is automatically replaced by an obligation to make or to receive one payment per currency dealt for each settlement date.

THE COMMITTEE'S RELATIONSHIPS WITH OTHER ORGANIZATIONS

On occasion some of the matters considered by the Committee fell within the purview of other groups. The operational aspects of bilateral foreign exchange netting, for example, were also of interest to the Council on International Banking (CIB) which draws its membership from 327 banks. A CIB subcommittee, established to study the operational implications of netting, had expressed some apprehension about the extensive systems modifications they anticipated netting would require.

The Committee responded to the Council's interest in this subject in two ways. A Committee member addressed a foreign exchange seminar sponsored by the CIB in March. In addition, to enable the Council's concerns to be aired, the Committee scheduled a special meeting with the Council's subcommittee. As a result of this meeting the Council canvassed its membership to get suggestions for implementing netting arrangements. *(see page 6.)*

Many of the issues considered by the Committee are also of interest to the FOREX USA Inc., the professional organization of foreign exchange traders in this country affiliated with the Association Cambiste Internationale (ACI). For that reason, the Committee has always had as an observer the President of FOREX USA who, in that capacity, is also a member of the ACI's Council. During 1985, one of the Committee's members was also elected to the ACI Council to serve in a newly created position of Regional Delegate of the Americas. Another Committee member addressed the Midwest Chapter of FOREX on April 12, covering, among other things, the role of the Committee and an overview of its activities. *(see page 13)*

COMMITTEE DELIBERATIONS ON THE EVOLUTION OF MARKETS FOR NEW PRODUCTS

Markets in new products emanating from the current phase of financial innovation continued to develop in 1985. There were two recurring themes in the Committee's discussions of this process. One was the nature of the regulatory structure for over-the-counter (OTC) markets. A second was the appropriateness of standardizing the terms and conditions for trading in these new products.

Market conventions with respect to traditional money market instruments evolved over time without any particular effort to impose standardization. But the new instruments were inherently more complex so there were many dimensions distinguishing one product from another. Also, maturities involved were, in many cases, longer than those for traditional money market instruments so credit risk considerations became an integral part of the new instruments.

Advantages and Disadvantages of Standardization

Under these circumstances, many market participants questioned whether a move toward standardization would be desirable. The proponents argued that standardization would reduce the scope for misunderstandings and errors, and foster greater liquidity in trading among dealers, thereby making it easier for the market professionals to manage positions arising from deals with their customers.

Others believed the appeal of the new products reflected in good measure the ability to customize terms and conditions to meet customers' needs. They argued that standardization would retard the growth of OTC markets, blur the distinctions between different institutions' products, and artificially eliminate opportunities for arbitrage

Efforts Underway

In any case, a variety of efforts were underway in the United States and the United Kingdom to provide some degree of standardization. The British Bankers' Association (BBA) took the earliest initiatives. It established working parties to collaborate with market participants in order to draft recommended terms and conditions for three types of instruments — interest-rate swaps, forward rate agreements and foreign exchange options. The result was that terms and conditions were prepared and endorsed by the London Foreign Exchange Committee as well as the Executive Committee of the BBA. Accordingly, since September 1985, it is assumed that, for London interbank transactions, BBA terms apply unless the parties agree otherwise.

In the United States, there was no one group that provided direction to the movement toward standardization. The International Swap Dealers' Association (ISDA) was at the forefront of efforts to achieve greater standardization in swap markets. As for foreign exchange options, the Committee's Options Task Force, established in 1984, was considering a variety of issues relating to market practice, including the question of standardization.

Foreign Exchange Options

Coming into 1985, market participants in the options market had expressed considerable interest in finding ways to standardize terms and conditions for options and otherwise to support the growth of interbank options trading. The Options Task Force established a subcommittee to study the question of standardization. The subcommittee found, however, that there was not sufficient cohesion of opinions about how specific terms might be standardized to provide the foundation for any recommendation for standardization

Later in the year, after the BBA had published its report on standard terms and conditions for interbank options trading in London, the Task Force's subcommittee reconsidered the issue. In particular, it studied the BBA terms with the view of determining whether these terms could appropriately apply to interbank trading in the United States. At the end of the year the subcommittee was proceeding on a proposal which the Foreign Exchange Committee circulated early in 1986 for public comment This proposal would suggest a few specific modifications to BBA terms for use in the United States.

In the meantime, participants in the options market had come to believe there was less need for an organized effort to support the options market. Trading in options had continued to develop, even without clear changes in the market's institutional or regulatory structure. But the pace at which banks' customers were increasing their demand for options may have slowed as exchange rate volatility declined during the year Moreover, the largest options dealers had come increasingly to look to the options markets on organized exchanges, rather than to the interbank market, as a mechanism for managing their own options positions For these participants, trading on the exchanges avoided a huge buildup in credit exposure. Also, as more institutions participated in the market for exchange traded options, the liquidity in that market increased.

Swaps and Forward Rate Agreements

Soon after the publication of the BBA terms for swaps and forward rate agreements, market participants asked whether the Committee could endorse the use of those terms for trading in the United States. As the Committee sought to respond to this request, it became apparent that two issues were involved. One issue, already discussed above, concerned the desirability of applying any set of standard terms and conditions. A separate issue was whether the Committee could endorse the BBA terms in particular as the basis for standardization in the United States. The Committee established a subcommittee from its membership to study these two issues.

ISDA and BBA Terms for Interest-Rate Swaps

The subcommittee on interest-rate swaps and forward rate agreements found that the existence of two different approaches to implementing standardization for swaps complicated its efforts of identifying a basis for standardization in the United States.

The BBA terms provide a set of standardized terms applicable, in its entirety, to interbank transactions unless variations from those terms are explicitly specified. BBA terms apply not only to swaps in a single currency, but also to cross currency interest-rate swaps and cross currency floating rate swaps. By contrast, the ISDA code, which applies only to single currency swaps, provides users with a menu of terms and provisions which may or may not be used in individual contracts. The question of whether the Committee wanted to endorse one of these two approaches was still under review at year-end.

Documentation Problems With Swaps

In the process of studying this matter, the subcommittee uncovered a market practice that aroused considerable concern. Apparently, it is not uncommon for traders to make commitments by phone on deals for which documentation and confirmation take months to finalize. The Committee noted that such a procedure could result in the counterparty claiming that there was no binding commitment and abrogating the original agreement, perhaps in order to take advantage, with the passage of time, of more favorable rates to conclude another swap.

The Committee has consistently recommended that confirmations be exchanged in a timely fashion. If confirmations are delayed because swap dealers are reluctant to accept the terms and conditions offered by other institutions, then Committee members believed the arguments in favor of standardization are more convincing.

Regulatory Issues

While the Committee's interest in standardization developed largely in response to requests from market participants, its interest in the regulatory environment for OTC markets was more internally generated.

As for foreign exchange options, the Options Task Force organized a subcommittee to prepare a background paper on the development of the OTC options market and its regulatory structure. The purpose of this paper was to provide a basis for interpreting the relevant legal statutes and judicial decisions that relate to this instrument. The paper was close to completion at year end.

Late in the year the Committee also discussed the scope of jurisdiction of the Commodity Futures Trading Commission (CFTC) as it applies to banks dealing in OTC foreign exchange futures. In October, the CFTC published an interpretation expressing its view that limits placed on the CFTC's regulatory authority by the Treasury Amendment of 1974 did not extend to trading in OTC futures involving certain non-institutional counterparties. The Commission also asserted its jurisdiction over the marketing of off-exchange futures products to the general public. The implication of the CFTC view is that off-exchange offers or sales to the general public of transactions involving foreign exchange futures are illegal. The CFTC also solicited comment from market participants concerning the nature of the participants and the types of transactions in the foreign exchange futures markets.

In discussing the CFTC's request for comments, Committee members recognized the need for a regulatory structure that insures consumer protection and sound banking practices. At the same time, some members noted that the comment letters being prepared in their institutions would point out the complexities involved in differentiating between futures and forward contracts. There was concern that, if the CFTC view prevails, some forward foreign exchange transactions that contain some of the characteristics of futures transactions presently taking place between banks and customers would then be prohibited.

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

During an eventful year in the foreign exchange markets, the Committee served as a channel of communication between the market and the Federal Reserve Committee discussions provided an opportunity for members representing various types of institutions to report their concerns about market conditions and to exchange views on developments as they occurred In light of the increased foreign exchange intervention that was occurring, considerable attention was focused on various aspects of central bank operations

The Role of Intervention

Committee discussions centered on the role of central bank intervention a number of times during the year The first time was in February when the dollar was near its high for the year Committee members expressed the view that large capital inflows provided evidence of a strong demand for dollars reflecting the strength of the U.S. economy, low U S. inflation, political stability and the safe haven role of the U.S. currency In these circumstances, members judged official commentary pointing to the unsustainability of high dollar exchange rates as having little influence on market psychology. The prevailing view in the Committee was that central bank intervention would be unable to reverse, but could serve to limit, the dollar's rise.

The role of intervention was reconsidered after the Group of Five (G-5) countries announced in September their desire for an orderly appreciation of non-dollar currencies Within the Committee, there was consensus that the G-5 announcement and subsequent central bank operations had been unexpected and well timed. The absence of upward pressure on U S interest rates, at a time when the U.S. Treasury postponed its normal financings pending congressional action to raise the debt ceiling, was cited as a factor reducing the demand for dollars immediately after the G-5 accord Members expressed the view, however, that the authorities would have to demonstrate their resolve to resist a renewed rise in the dollar whenever that might occur to insure the market's confidence in the effectiveness of intervention operations.

Dealing Relationships

The Federal Reserve Bank of New York took advantage of the forum provided by the Committee to review the technical aspects of its operating methods. The Federal Reserve indicated that, once a decision to intervene is made, it may approach the market indirectly or directly. In the former case, a bank is asked to serve as agent for the Federal Reserve, usually in the brokers' market Confidentiality is, of course, expected of any bank acting as agent for the Federal Reserve.

Establishment of a dealing relationship with the Reserve Bank is based on a mutuality of interest and does not reflect official endorsement of any particular institution The Reserve Bank accepts applications to the extent it can maintain its trading relationships fully. It not only seeks support for its intervention and customer business, but also considers the willingness of an applicant's personnel to exchange market information and opinion and weighs the extent to which the relationship is likely to help the authorities obtain market intelligence

Exchange Rate Volatility

Another recurring subject in Committee discussions was the volatility of exchange rates. Early in the year the short-run variability of dollar exchange rates was considered high by historical standards

Members attributed the increased volatility, at least in part, to changing patterns of participation by major market makers. They noted that several institutions had withdrawn substantially from interbank dealing, thereby reducing the depth of the market. Others limited the hours during which they dealt directly with other banks. Some members felt this curtailment reflected market makers' perception that they faced greater exposure to risk because of increased central bank activity.

Some members expressed concern about the lack of consistency in some institutions' participation in the market. A few even went so far as to suggest that standards for direct dealing by market makers be established as a means of encouraging greater, more consistent participation. On the whole, however, members were impressed by how well the markets continued to function under these circumstances.

U.S. Bank Participation in Eurodollar Market

Concern about the level of participation by U.S. banks in the Eurodollar market surfaced as members discussed the potential effects of a proposed extension of the Federal Deposit Insurance Corporation's premium base. Several proposals had been put forward which would impose insurance assessments on deposits at foreign branches and at International Banking Facilities, without extending formal insurance coverage to those deposits The proposed change was one of many to the Federal deposit insurance system under consideration.

Individual members expressed the view that the proposal's enactment would significantly increase U.S. banks' external cost of funds and adversely affect their competitive position in the Euromarkets These members expressed the view that any further reduction of U.S. bank participation would have an adverse effect on market liquidity. Others noted that the proposal, if implemented, would establish an incentive for banks to move business to subsidiaries that are exempt from the assessment. These members worried about the implications of such a shift since subsidiaries lack the credit standing of bank branches Members also cautioned that the assessment might incorrectly be perceived as a deposit guarantee

In addition to providing a forum for discussion, the Committee continued to serve in an advisory capacity to the Federal Reserve Bank of New York on a variety of technical issues

Foreign Exchange Turnover Survey

During the second half of the year, the Federal Reserve Bank of New York prepared for another in its series of surveys of foreign exchange turnover volume. A comparison of the results from its previous surveys had shown that market size and structure can change substantially over a period of three years. Questions had arisen about the nature and extent of such changes since the previous survey in 1983. Noting the usefulness of earlier surveys to market participants, the Committee welcomed the opportunity to provide its assistance once again in connection with a survey for 1986.

The Committee reviewed the survey form proposed by the Federal Reserve and provided technical suggestions to improve it During this review process, several interesting points emerged. Members doubted the usefulness of retaining "outright forwards" as a transaction category to be reported. The view was expressed that outright forwards had become an anachronism. Customers have become sufficiently sophisticated that they take advantage of the deeper markets in swaps rather than depend on outright forward transactions to meet their commercial requirements. Also, internal records of many institutions now treat a forward deal as two transactions, a spot and a swap. Members also questioned whether a breakdown of swap transactions with maturities greater than one year would be consistent across banks.

The Committee considered whether March or April would be the more appropriate survey month There was concern about the effect of Easter holidays on March trading volume. Members noted that the Japanese fiscal year end might also distort data collected in March since it reduces Tokyo volume by as much as one-half. But the majority felt that the staggering across countries of the change to daylight saving time — a factor which affects almost every day of April — would pose an even greater problem for that month. In the end, March was chosen as the survey month.

The Committee recommended that non-bank financial institutions be included in the survey in light of their growing role in the foreign exchange markets. Partly as a result, several investment banks will be asked to participate in the 1986 survey. The Committee also suggested, as it had in previous years, that central banks in other important trading centers be encouraged to conduct a similar survey at the same time. In 1986 both the Bank of England and the Bank of Canada are planning to conduct surveys similar to that of the Federal Reserve Bank of New York. The Bank of Japan will also make an effort to provide some information on turnover in Tokyo.

Group of Thirty Survey

The Committee also provided technical support to the Federal Reserve Bank of New York which had a representative in a Group of Thirty Study Group on foreign exchange. That group designed questionnaires which were sent to commercial banks, investment banks, corporations and fund managers in connection with a Group of Thirty survey of exchange market participants. This survey sought market participants' impressions about the way exchange markets were adjusting to increased exchange rate volatility. The Committee helped the Federal Reserve's participant in this effort by discussing and evaluating issues concerning market practice that arose during the compilation of the survey results by Group of Thirty staff.

PROCEDURAL MATTERS OF THE FOREIGN EXCHANGE COMMITTEE

Formal meetings of the Committee continued to be held on the first Friday of alternate months in 1985.

The Committee also conducts meetings on an informal basis from time to time to permit guests to meet with the Committee One of these occasions was on June 28, when the Committee invited a subcommittee of the Council of International Banking, organized to study the implications of bilateral foreign exchange netting on bank operations

The Foreign Currency Option Task Force, established in 1984, followed its mandate to study and prepare recommendations for the Committee on foreign exchange options. The Task Force did not submit any final papers to the Committee during the year, though a number of the projects were near completion by year end The Task Force is chaired by S. Waite Rawls *(Chemical Bank)* and its members are Scott Dillman *(Bank of America)*, Bill Lipschutz *(Salomon Brothers)*, Varick Martin *(Merrill Lynch)*, Lisa Polsky *(Citibank)*, and Jay Pomeranze *(Bankers Trust)*. The Task Force is being assisted by a group of lawyers consisting of Franklin Feldman *(Strook, Strook, Levan)*, William David Harrington *(Brooklyn Law School)*, Ernest Patrikis *(Federal Reserve Bank of New York)*, and Thomas A. Russo *(Cadwalader, Wickersham and Taft)*.

As in the past, the Committee established subcommittees from among its members to work on specific projects One subcommittee was formed to review and update an earlier Committee paper on management guidelines. Its members were James P. Borden *(Chase Manhattan)*, Anthony Calvello *(Noonan, Astley and Pearce)*, Bruno Eberli *(Morgan Guaranty)*, Terry Joyce *(Toronto-Dominion)*, and Michael Snow *(Union Bank of Switzerland)* Later in the year, another subcommittee was established to recommend to the Committee how to proceed on a request to endorse standard terms and conditions for interbank transactions in forward rate agreements and interest-rate swaps Its members were Alan Chase *(National Westminster Bank)* and Heinz Riehl *(Citibank)*.

In accordance with its charter, the Committee does not attempt to write rules and regulations. It recognizes that the force of its recommendations rests solely on its ability to engender respect in the market for its views

FORMAL MEETINGS OF THE COMMITTEE

Meetings in 1985	Schedule for 1986
February 1	April 4
March 29	May 30
June 7	August 1
August 2	October 3
October 4	December 5
December 6	

SELECTED DOCUMENT:

THE LAST OF THE MOHICANS

(A speech to the Midwest Chapter of FOREX USA by Margaret L. Greene, SVP, NYFRB, in Denver on April 12, 1985)

It is hard to come to a city like Denver and not be entranced by the lore of the great American plains and the American West. As I was watching the miles slip below me this morning — comfortably seat-belted in that wonderful 20th century invention, a DC-10 — I couldn't help but recall some of the tradition and culture we associate with this part of the country. It is easy to forget that some of these traditions had roots back East as well In the rolling hills of my childhood hometown — now a well known "bedroom community" of metropolitan New York City — there lived an Indian tribe popularized by the early American author James Fenimore Cooper. In his book, *The Last of the Mohicans*, he describes a tribe that had achieved a particularly high level of culture and civilization. Yet, this tribe declined, and its culture disappeared, under the force of change beyond its control.

I now find myself peering over this lectern and looking at a room full of friends and colleagues in FOREX. On the one hand, it's a pleasure for me to be with you this evening and experience the warmth of the Midwest Chapter's hospitality. On the other hand, I have to confess to a gnawing question: Am I looking at the Last of the Mohicans?

The foreign exchange market in the U.S. has lived through a buoyant and exciting phase, especially during the past 10 years. Trading volume has grown rapidly, as tracked by the periodic turnover surveys of the FRBNY. I would conservatively guess that turnover today is running about seven times the level of 1975. New institutions are entering our market all of the time. Active foreign exchange trading operations are cropping up all over the country. We are aggressively pursuing every new technological advance in order to increase business, improve efficiency, and gain a competitive edge. We've broken through the barriers of national boundaries, of language, of cultural differences — and even of the international date line — to provide a liquid, global market 24 hours each day. We have financed a growing volume of world trade and accommodated an expansive growth of capital flows.

Market Regulation

The foreign exchange market in this country has prospered in a relatively supportive regulatory environment. You may remember that in 1974 mismanagement of foreign exchange operations brought down two banks — Franklin National Bank in the U S. and Herstatt Bank in Germany. The authorities in many other countries with active foreign exchange markets responded to these events by imposing prudential limits or capital ratios on banks' foreign exchange positions. The Federal Reserve Bank of New York took the view that the best way to manage foreign exchange exposures is for management to have unambiguous responsibility for the exposures its institution assumes. We believed in the principle of self-regulation and directed our energies toward making a system of self-regulation effective. Consequently, after the Franklin episode, we worked with the FOREX and with the examiners of the Fed and of the Comptroller to do three things.

- to establish principles for the effective internal control of transactions,
- to establish and strengthen internal management information systems,
- and to improve the on-site examination process as it relates to foreign exchange operations of banks.

So far this system appears to have worked rather well. Few incidents have occurred in foreign exchange since the mid-70's. Those that did were manageable and readily contained. Our record looks pretty good. But, like the Mohicans, the foreign exchange market in this country may be subjected to forces of change beyond its direct control Because of developments in other major financial markets, we may have to defend the proposition that self-regulation is effective in preserving the integrity of the marketplace. A market as big and as important as ours cannot escape the scrutiny of the public or the Congress

Is Self-Regulation Effective?

On what basis can we conclude that the foreign exchange market should continue to operate on a self-regulatory basis? Let's look at the requirements for effective self-regulation:

1) An acknowledged set of principles and practices to which all participants adhere.

2) An unswerving regard to the ethics of the market.

3) Peer pressure that is supportive and that reinforces ethical and professional behavior.

4) A referee.

As individuals in this market, we each have the responsibility for providing the first three requirements. We do this by the way we manage our trading operations and train our dealers, by the way we treat our colleagues, and by the standards we apply explicitly and implicitly to all those with whom we come into contact.

What about the fourth requirement — the referee We have a bank regulatory system in this country that concerns itself with the safety and soundness of banking institutions. But what about areas of market practice.

For much of the period since foreign exchange trading resumed in this country after World War II, the FOREX in effect served as a referee in this respect. Through its executive board or the committee on market practice, the FOREX played an instrumental role in setting the institutional structure of this market, developing a sensitivity to good market practice, and providing a mechanism for arbitrating disputes But in the late 1970s questions began to arise whether the FOREX should or could continue as the appropriate or even most effective organization to serve this role.

Origin of the Foreign Exchange Committee

There was a perceived need to develop something that would be different from FOREX in several respects First, any new group should be *small* — small enough to conduct meaningful discussion of issues and make decisions when and if decisions might be appropriate. Second, membership should comprise *institutions*, not individuals. Individuals who might serve on any new group should be able to speak on behalf of their institutions and have the authority to commit his institution to decisions or recommendations the group might make. Third, membership, though limited, should be seen as *representative* of the interbank market in this country The specific points of view and interests of all market participants should be presented and given due consideration. Fourth, any new organization should have the support of, or be organized under the auspices of, a *monetary authority*

There was no intention to replace FOREX. On the contrary, the idea was to have any new organization be complementary to FOREX. Indeed, from the start, the president of FOREX was expected to serve as an *ex officio* member of any new organization

After participating in a two-year feasibility study with market participants to determine how such a group might be structured, the FRBNY agreed in 1979 to sponsor a new organization which we called the Foreign Exchange Committee. In agreeing to this undertaking, the FRBNY recognized it had no authority on its own, or through any group it might sponsor, to establish standards for the market or to enforce the recommendations of the new Foreign Exchange Committee It did, however, conclude that the market would benefit from having a mechanism for airing views about market practice and developments. We hoped that, over time, the Foreign Exchange Committee would develop sufficient stature in the marketplace to command respect for its views and recommendations. We also saw the Committee as a useful vehicle for maintaining communication between the market and the U.S. monetary authorities.

The Foreign Exchange Committee got off to a cautious start. Its original members understood their actions were establishing new precedents for this market. As a result, the Committee acted like a beginning skier on an expert slope. It knew that if it proceeded too timidly, it would never get down the hill. But if it proceeded too recklessly, it might jeopardize the entire enterprise.

During the early years, the Committee focused on relatively narrow, technical issues. Problems that touched on individual institutions' competitive positions were hard to deal with. But the Committee persisted in talking around these problems, exchanging views and discussing their individual experiences in the spirit of seeking a compromise solution. An important development during these early years was the completion of a paper, for circulation to all market participants, setting forth selective guidelines for managing a foreign exchange operation

Later on, the Committee became more active. It recognized that it could make a quick and clear-cut decision when the Committee was asked to recommend a convention to deal with an abrupt change in the observance of Memorial Day in New York State. This change, you may remember, affected the value date for outstanding six-month forward contracts. Some years later, the Committee found itself resolving a dispute between two large market participants. The resolution of this dispute found expression in a paper the Committee subsequently circulated on name substitution practices.

Expanded Committee Focus

During 1984, the Committee focused on credit risk in a variety of respects. That is because the Committee perceives the gravest risk facing the exchange market today to be the possibility that market participants may not fully appreciate the exposures being assumed and may not evaluate those exposures sufficiently critically.

Also last year, the Committee embarked on an enterprise that might begin to change the way the foreign exchange business is being conducted. It devised an example of how a bilateral netting arrangement might be achieved.

For 1985, the Committee undertook to review trading practices for the newly developing foreign exchange options market in order to consider whether there might be any recommendations that the Committee might wish to make to market participants with respect to trading practices in these instruments.

As you can see from this review of the Committee's work, it can play several roles It is willing to consider new ideas, to rethink existing practices and principles, and to discuss areas where disputes may arise.

In order that the Foreign Exchange Committee can properly serve the foreign exchange trading community, those of us closely associated with it have clear responsibilities. We must keep the Committee relevant, responsive to the market's changing needs, and accessible to market participants But you, too, can help the Committee be an effective force. You can bring issues of concern to the Committee's attention And you can give serious and thoughtful attention to its recommendations and reports

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 insure 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 woud 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

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 FOREX 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 USA, Inc

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

CUMULATIVE INDEX TO PREVIOUS REPORTS

CUMULATIVE INDEX TO PREVIOUS REPORTS

CUMULATIVE INDEX TO PREVIOUS REPORTS

FOREIGN EXCHANGE COMMITTEE MEMBERS AND ALTERNATES

(JANUARY 1986)

MEMBERS	ALTERNATES
I. East Coast Banks	
Heinz Riehl *Senior Vice President* *Citibank, N.A.* *399 Park Avenue* *New York, NY 10043* *(212) 559-0864*	*John Arnold* *Vice President* *Morgan Guaranty Trust Co* *23 Wall Street* *New York, NY 10015* *(212) 483-2912*
James P Borden *Senior Vice President* *The Chase Manhattan Bank* *One Chase Manhattan Plaza* *New York NY 10081* *(212) 552-7543*	*Jay Pomeranze* *Senior Vice President* *Bankers Trust Company* *One Bankers Trust Plaza* *New York, NY 10015* *(212) 775-3375*
S Waite Rawls III *Senior Vice President* *Chemical Bank* *277 Park Avenue* *New York NY 10072* *(212) 310-5233*	*Horst Duseberg* *Executive Vice President* *European-American Bank and Trust Co* *77 Water Street* *New York, NY 10015* *(212) 437-4561*
Christine Patton *Senior Vice President* *Manufacturers Hanover Trust* *270 Park Avenue* *New York, NY 10017* *(212) 286-7707*	*Ron Levy* *Senior Vice President* *Marine Midland Bank* *140 Broadway* *New York, NY 10015* *(212) 440-5718*
Kenneth G Hartwell *First Vice President* *Bank of Boston* *100 Federal Street* *Boston, MA 02101* *(617) 434-7120*	*Raimund Sargent* *Senior Vice President* *Fleet National Bank* *111 Westminster St* *Providence, RI 02903* *(212) 431-7900*
II Other Reserve City and Regional Banks	
David Harvey *Senior Vice President* *Head, Foreign Exchange Group* *First National Bank of Chicago* *One First National Plaza* *Chicago, IL 60670* *(312) 732-5369*	*Barry L. Kaufman* *Vice President and Manager,* *Foreign Exchange* *Northern Trust Company* *50 South LaSalle Street, B-12* *Chicago, IL 60675* *(312) 630-6204*
Kemp Mitchel *Senior Vice President* *Security Pacific National Bank* *300 South Grand Avenue, 19th Floor* *Los Angeles, CA 90009* *(213) 229-1381*	*Raymond R Peters* *Senior Vice President* *Bank of America, N.T & S A* *Flow of Funds Management No 3170* *555 California St, 11th Floor* *San Francisco, CA 94137* *(415) 953-9574*
William Rappolt *Executive Vice President* *Manufacturers & Traders Bank* *One M and T Plaza* *Buffalo NY 14240* *(716) 842-5553*	*Matthew Plawchan* *First Vice President* *Comerica Bank* *211 West Fort Street* *Detroit, MI 48226* *(313) 222-5266*
III. Foreign Banks	
Gerhard Stejskal *Vice President and Treasurer* *Deutsche Bank* *9 West 57th Street* *New York, NY 10019* *(212) 940-8040*	*Michael Snow* *Senior Vice President* *Union Bank of Switzerland* *299 Park Avenue* *New York, NY 10171* *(212) 715-3100*
Eishi Wakabayashi *Deputy General Manager* *The Bank of Tokyo, Ltd* *New York Agency* *100 Broadway* *New York, NY 10005* *(212) 766-3432*	*Douglas Grainger* *Manager* *The Royal Bank of Canada* *76 William Street, 9th Floor* *New York, NY 10005* *(212) 806-3376*
Alan Chase *Treasurer and Executive Vice President* *National Westminster Bank PLC* *175 Water Street, 20th Floor* *New York, NY 10038* *(212) 602-1000*	*Jean-Philippe Frignet* *First Vice President and Treasurer* *Banque Indo-Suez* *1230 Sixth Avenue* *New York, NY 10020* *(212) 408-5820*
IV. Brokers	
Stephen E Moore *Senior Executive Vice President* *Lasser Marshall, Inc.* *76 William Street* *New York, NY 10005* *(212) 943-0923*	*Anthony Calvello* *President,* *Noonan, Astley and Pearce, Inc* *Wall Street Plaza* *New York, NY 10005* *(212) 483-8297*
Richard M MaGee *Managing Director* *Tullett and Tokyo Forex, Inc* *80 Pine Street* *New York, NY 10005* *(212) 208-2006*	*Mr David Satchell* *President* *Harlow Meyer Savage, Inc* *1 World Trade Center, Suite 3111* *New York, NY 10048* *(212) 938-6210*
V. FOREX USA, Inc. (observer)	
David Palmer *Senior Vice President and Treasurer* *First American Bank of New York* *350 Park Avenue* *New York, NY 10022* *(212) 759-9898 ext 752*	
VI. Federal Reserve Bank of New York (ex officio)	
Sam Y Cross *Executive Vice President* *Federal Reserve Bank of New York* *33 Liberty Street* *New York, NY 10045* *(212) 791-6180*	
Margaret L. Greene *Senior Vice President* *Federal Reserve Bank of New York* *33 Liberty Street* *New York NY 10045* *(212) 791-5688*	