foreign exchange committee

FXC

COMMITTEE LETTER

November 29, 2010

The Foreign Exchange Committee (FXC)[1] welcomes the opportunity to submit this letter in response to the Treasury Department's Request for Comment on Determination of Foreign Exchange Swaps and Forwards.[2]

As the responses outlined below reflect, the FXC believes that changing market practice by mandating central clearing and trading through swap execution facilities will have the potential unintended consequence of increasing systemic risk and possibly driving the market to other jurisdictions.

I. Foreign Exchange Swaps and Forwards: Product Overview

In response to questions one through three (see appendix A for list of questions):

Foreign exchange swaps and forwards are qualitatively different from other asset classes of swaps in many very important ways. These differences make it particularly challenging to implement and maintain mandated central clearing for these products.

Product Overview

The foreign exchange market serves as part of the backbone of the global payments system and helps to underpin international commerce and global economic activity. Foreign exchange products facilitate cross-border trade and investment. Foreign exchange swaps and forwards, in particular, serve as critically important cross currency funding tools for a wide variety of economic participants. A **foreign exchange swap** is a contract under which two counterparties agree to exchange two currencies at a set rate and then to re-exchange those currencies at an agreed upon rate at a fixed date in the future. A **foreign exchange outright forward** is a contract to exchange two currencies at a future date at an agreed upon exchange rate.

Key Differences From Other Swaps Covered Under the Commodities Exchange Act (CEA):

- *Both foreign exchange swaps and outright forwards have fixed settlement values and are not derivative instruments.* That is, there is no payment uncertainty to manage—the terms of these transactions are fixed and agreed upon at the time of trade execution, and they do not change

[1] The Foreign Exchange Committee is an industry group that has been active since 1978. The Committee produces best practice recommendations for the foreign exchange industry addressing topics such as management of risk in operations and trading.
[2] This letter represents the views of the private sector members of the Foreign Exchange Committee, which include members of sell- and buy-side firms, but is not intended to represent the views of the Federal Reserve Bank of New York.

over the course of the contract based upon changes in other asset prices. The mark-to-market of the position may change based on movements in exchange rates, but the actual settlement amounts will not. In this sense, they are far more similar in nature to other products not covered under the CEA, such as repo transactions or other money market funding products. Finally, the obligations under these transactions are not dependent on future values of interest rates[3] or exchange rates. As such, they cannot be used to re-construct other types of swaps under the CEA that include variable interest rate components.[4]

- *Foreign exchange swaps and forwards involve the exchange of more than one currency*. Unlike other instruments covered under the CEA, these instruments are not simply denominated in U.S. dollars or another single currency.[5] This has particular implications for the potential effectiveness of a central clearing framework mandated by a single jurisdiction given the multi-jurisdictional nature of the product, which will be discussed in greater detail below.

- *Foreign exchange swaps and forwards require the ability to physically settle the transfer of multiple currencies for each transaction*. Unlike some other instruments covered under the CEA, these transactions require the ability to physically settle the exchange of multiple currencies. To date, no central clearing solution has proven viable for these products in light of the potential need for a central clearer to provide funding in significant size across a wide array of different currencies in the event of counterparty default. This challenge will be discussed in further detail below in the risk framework section of the response. In addition, due to the physical settlement requirement, these products are similar to commodity forward contracts, which are specifically excluded from the definition of "swap" so long as the transaction is "intended to be physically settled" by an exchange of the underlying asset.[6]

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[3] Though foreign exchange rates are certainly sensitive to changes in interest rates, the settlement values of FX swaps and forward transactions do not change in response to changes in interest rates as there is no variable interest rate component in these transactions.

[4] The only covered derivative replicable through FX forwards is a fixed to fixed cross currency swap. This product is a combination of two single currency interest rate swaps and a cross currency basis swap and is primarily used by end-user corporates in concert with bond issuance and does not include a variable interest rate component. This is not a product traded by dealers in the inter-dealer market. The notional volume traded of this product is de minimis compared with the overall swap and FX marketplace. Further, there is anti-avoidance language in the Dodd Frank Act, and the transparency of the FX market provided by the data warehouse will prevent users from using an exemption of FX swaps to avoid the requirements of the legislation.

[5] According to the 2010 BIS Triennial Survey, 85 percent of reported foreign exchange transactions include the U.S. dollar as one of the currencies. The share of total global turnover activity reported in the United States was 18 percent. (http://www.bis.org/publ/rpfx10.pdf)

[6] See CEA section 1a(47)(b)(ii).

II. Foreign Exchange Swaps and Forwards: Risk Management Framework

In response to questions four through seven (see appendix A for list of questions):

- Settlement Risk and Continuous Linked Settlement (CLS)

In foreign exchange swaps and forward transactions, the predominant risk is **settlement risk,** i.e., the risk that one party to a transaction transfers the agreed-upon funds to its counterpart while the other does not. This risk is mitigated to a very significant degree through the use of CLS.[7] CLS provides payment-versus-payment settlement services under which the settlement proceeds are transferred simultaneously and protects against loss of principal by ensuring that neither leg of the FX trade will settle unless both legs can be settled at the same time. CLS currently offers this service for seventeen currencies and across six transaction types including foreign exchange spot, swap and forward transactions. According to the 2010 Bank for International Settlement's (BIS) Triennial Survey, total turnover reported in CLS-eligible currency pairs was roughly $3.7 trillion, or ninety-three percent of overall turnover reported. CLS has plans to offer services for additional currencies in the future.

- Counterparty Credit Risk and Use of Credit Support Annexes (CSAs)

To a lesser extent, **counterparty credit risk**, i.e., the risk that a counterparty fails to meet a payment obligation, exists in these products as well. However, this risk is low relative to other products included in the CEA, given the short-term nature of the majority of foreign exchange swaps and forward transactions. According to the 2010 BIS Triennial Survey, sixty-eight percent of total foreign exchange swaps and forwards reported in the survey had an original term-to-maturity of less than one week. In fact, only one percent of total foreign exchange swaps and forwards reported had an original term-to-maturity of more than one year. This contrasts sharply with the maturity terms of other products covered under the CEA, e.g., interest rate swaps and credit default swaps whose terms to maturity generally concentrate between two to thirty years and five to ten years, respectively.

Despite this significant difference in maturity profiles, the foreign exchange market has nonetheless increasingly adopted use of master netting agreements and credit support annexes (CSAs) and other security agreements in order to further manage counterparty credit risk. Having master agreements in place that permit closeout netting in an event of default of one of the parties is one mechanism that can be used to more effectively mitigate credit risk. A CSA or other form of security agreement can also be negotiated as a supplement to master agreements. These agreements provide for the movement of collateral between parties during the term of outstanding transactions governed by the master netting agreement in order to reduce the net exposure that may result in the event of a trading counterparty's bankruptcy or other default under such agreement. Under a CSA, one or both parties agree to post collateral to secure counterparty credit exposure, typically on a mid-market, net basis. Under a CSA, failure to deliver required collateral also constitutes an event of default under the master netting

[7] CLS Bank International is an Edge Corporation regulated and supervised by the Federal Reserve. A more detailed discussion of CLS's structure is described later in this letter.

agreement. The ability of parties to implement effective collateral management programs benefits from the significant price transparency in the global foreign exchange market. There is a wide array of electronic trading systems by which to access pricing information on a real-time basis in this market. Additionally, a number of periodic fixing prices are also readily available for various currency pairs. For a more detailed discussion of credit risk management via master netting agreements and CSAs, please see Attachment A.

- Existing Risk Management Framework versus Central Clearing Framework

The use of CLS and CSAs creates a highly efficient framework for managing risk given the unique characteristics of foreign exchange swaps and forwards outlined in section I above. Nonetheless, there is room for further gains through increased use of both payment-versus-payment services, such as CLS, and adoption of CSAs in connection with master netting agreements. Please see the trade reporting response section below for further details on current levels of usage in these tools and the potential for further gains. Additionally, please see attachments A and B for further information on these topics.

Structuring a safe, effective central counterparty for foreign exchange products presents particular challenges. Indeed, diverting prioritization of resources away from increased use of existing tools, such as payment-versus-payment settlement services like CLS and CSAs, toward the implementation and maintenance of a new and untested framework has the potential to increase risk in this marketplace, with little benefit given the potential for increased usage of traditional risk mitigation tools.

Under a central clearing framework, the clearing institution is expected to guarantee the performance of transactions submitted for clearing by its members, which would include covering any related settlement risk associated with such cleared transactions. In the context of foreign exchange forward and swap transactions, this would require the central clearer not only to have a robust credit and risk management system in place to address the replacement risk of each cleared transaction but also to have the appropriate controls and procedures required to mitigate the related settlement risk. The management of settlement risk would be best addressed through the submission of payments through a settlement payment clearing system, such as CLS. However, if eligibility requirements do not permit the central clearing institution to be a direct clearing member of such payment clearing system, as is currently the case with CLS, then the central clearer would either need to clear their trades through an institution that is a direct settlement member or self-clear, thereby increasing risk for all parties involved and the system as a whole.

There is an important bridge between clearing and settlement of foreign exchange. In order to make use of a settlement system, the central clearer must first have the capacity to deliver the currencies to the payment clearing system. From a financial stability perspective, the capacity for the central clearer to meet its obligation to deliver multi-currency funding into the settlement mechanism is critically important. In practice for FX, this means having access to a global funding pool in significant size and scale in order to deliver multiple currencies into the settlement mechanism as required in an efficient and time sensitive manner. For example, in the event of a default of one or more of its members, the clearing institution could be faced with the need to draw down on funding lines to meet the multi-currency settlement obligations of its members. The central clearer would likely be relying on this very same pool of institutions to meet those needs, a pool which would include the defaulting members. It is very difficult to envision a scenario under which a central clearer could offer a credible guarantee of its transactions given the size and breadth of the foreign exchange market and the multitude of currencies involved without involving access to multiple central bank liquidity facilities. Without such a guarantee, the central clearing provider is simply relying upon a process analogous to the existing collateral management process, such as the use of CSAs in connection with master netting agreements. Indeed a central counterparty framework with exceptionally large credit lines to private financial institutions in multiple currencies would increase systemic risk by concentrating liquidity risk in the central counterparty and its credit providers.

For some discussion of how much foreign exchange activity is currently captured through CLS and through the use of CSAs, please see the section below on trade reporting.

III. Foreign Exchange Swaps and Forwards: Trade Reporting

In response to question eight (see appendix A for list of questions):

- The Foreign Exchange Committee, along with other central bank-sponsored foreign exchange industry groups, produces a report on turnover in the foreign exchange market on a regular basis. The FXC conducts its survey on a semi-annual basis. Given that foreign exchange swaps and forwards will be subject to trade reporting regardless of whether they are exempted or not, the availability of more data and at an increased frequency is very welcome.

- In 2008, the Bank for International Settlements Committee on Payments and Settlement Systems estimated that roughly fifty-five percent of the marketplace is captured in CLS. To determine a better gauge of this figure, we conducted a poll of the Foreign Exchange Committee member firms to determine what proportion of their activity during the month of September 2010 was being captured in CLS and to get greater insight into why the remainder was not being settled in CLS at present. We obtained responses from thirteen firms, representing a notional value of $98.5 trillion. The transactions were separated into those subject to settlement risk and those not subject to settlement risk. The individual responses were weighted by contribution to total notional in order to present a consolidated aggregate result. This aggregate result indicated that seventy-seven percent of notional value settled was not subject to settlement risk, either because it was conducted within CLS or was settled internally or externally without settlement risk.[8] Of the total transactions reported, twenty-three percent was subject to settlement risk. Nearly fifteen percent of the overall total, however, represented activity which could be eligible for CLS settlement. This suggests that further risk mitigation via increased use

[8] Internal transactions can be settled without settlement risk when they are between affiliates of the same corporate entity. External transactions may be settled without settlement risk when multiple offsetting transactions are netted down to single profit or loss expressed in one currency, or when the two counterparties have agreed to settle through a simultaneous delivery of payments.

of CLS is achievable. Please see Attachment C for a more detailed overview of these findings.

- A similar exercise was conducted to determine the recent evolution in the use of CSAs in recent years. Evidence suggested a sharp rise since 2007. Based on our survey, the average growth rate in CSAs covering foreign exchange products was roughly fifty-one percent since 2007. Further details on those findings is also available on Attachment C.

Given the scope for further gains in the use of payment-versus-payment settlement services and in the use of CSAs, we would encourage the development of a framework to track these figures on an ongoing basis and to ensure that further risk mitigation gains are indeed captured. The FXC will be evaluating its current survey processes to help facilitate this approach and to assist Treasury going forward.

IV. Foreign Exchange Swaps and Forwards: Effect of Mandatory U.S. Clearing on Foreign Exchange Market Liquidity and Operations of U.S. Firms

In response to question nine (see appendix A for list of questions):

- The U.S. dollar plays a unique role in global financial markets, and preserving the liquidity in the U.S. dollar and in the global foreign exchange market overall is of the utmost importance to support global economic and financial activity.

  - As cited earlier, the U.S. dollar is involved in eighty-five percent of the reported foreign exchange transactions according to the 2010 BIS Triennial Survey. Though the dollar itself is predominant in turnover, the United States is not the predominant trading center for such activity. According to the BIS Triennial Survey, only eighteen percent of global turnover was reported in the United States. The United Kingdom reported the largest percentage, roughly thirty-seven percent.

- It is generally expected that, if foreign exchange swaps and forward transactions were not exempted, the following negative outcomes could arise:

  - Impairment of corporations, banks, pension funds, mutual funds and others to manage risk as a result of the decreased use of foreign exchange swaps and forwards.

  - Diversion of foreign exchange activity to other jurisdictions when possible, as businesses will move to the lowest cost center thus having the opposite impact of the legislation’s objective of increasing transparency and lowering systemic risk.

- Consolidation of systemic credit and particularly liquidity risk around central clearing providers.

- Increase in risk in the marketplace in the event that the eligibility criteria for swap execution facilities (SEF) results in a reduction in the number and diversity of transaction execution channels.

- Reduction in the use of CLS in the event that the requirement to settle through a clearinghouse and to trade on a SEF causes volumes cleared through CLS to drop thus increasing the per ticket user costs of CLS[9].

These potential risks should be viewed against the questionable benefits of implementing a regime given the existing risk mitigation framework in place. Instead, the Committee suggests exempting FX swaps and forwards will allow the industry to focus on improving the existing risk mitigation framework to further increase the resilience and safety of transacting in the global foreign exchange market.

V. Other Reference Materials for Submission

Attached, please also find the following FXC publications which are relevant to the issues raised above:

Appendix A: Excerpt from Treasury's Notice and Request for Comment

Attachment A: Tools for Mitigating Credit Risk in Foreign Exchange Transactions
http://www.newyorkfed.org/fxc/2010/creditrisktools.pdf

Attachment B: November 2010 FXC Letter Announcing Best Practice Guidance on Payment-versus-Payment Settlement Services
http://www.newyorkfed.org/fxc/2010/pvpbestpractice.pdf

Attachment C: Survey Findings on Use of CLS and CSAs

Attachment D: Overview of the OTC Foreign Exchange Market: 2009
http://www.newyorkfed.org/fxc/news/2009/overview_nov_2009.pdf

The Committee appreciates the opportunity to share our perspective on this very important issue. Please feel free to contact Jeff Feig, Chair of the New York Foreign Exchange Committee to discuss these comments in greater detail.

Contact Information: 212-816-8022

[9] The cost of CLS has historically been a factor in keeping some financial institutions and counterparties from joining this settlement system. The current growth in use of CLS may be stymied if the user costs begin to rise. Any reduction in growth or use of CLS increases systemic risk in FX.

Members of the Foreign Exchange Committee represent the following firms:

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Appendix A: From the Federal Register

In making the determination whether to exempt foreign exchange swaps and/ or foreign exchange forwards,[7] the Secretary of the Treasury must consider the following factors:

(1) Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States;

(2) Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps;

(3) The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;

(4) The extent of adequate payment and settlement systems; and

(5) The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.[8]

The Treasury Department is soliciting comments on the above factors, and any relevant information that may bear on the regulation of foreign exchange swaps and foreign exchange forwards as ''swaps'' under the CEA, to assist in the Secretary's consideration of whether to issue a determination under section 1a(47) of the CEA. In addition, the Treasury Department is particularly interested in comments on the questions set forth below:

(1) Are foreign exchange swaps and/ or foreign exchange forwards qualitatively different from other classes of swaps in a way that makes them illsuited for regulation as ''swaps'' under the CEA? [9] Are there similarities between foreign exchange swaps and/or foreign exchange forwards and other products not defined as swaps under the CEA?

(2) Are there objective differences between swaps and foreign exchange swaps and/or foreign exchange forwards that warrant an exemption for either or both of these instruments? 10

(3) Are there objective differences between long-dated and short-dated foreign exchange forwards and swaps such that one class may be less suited to regulation as ''swaps'' under the CEA than the other? Is the same true for dealer to dealer transactions versus transactions where one counterparty is a non-dealer? Similarly, does one or more of the above-referenced, five statutory factors support the application of certain requirements set forth in the CEA, but not others (e.g., centralized clearing, but not exchange trading), to foreign exchange swaps and/or foreign exchange forwards?

(4) What are the primary risks in the foreign exchange swaps and forwards market,how significant are these risks, and how are these risks currently managed by market participants? Would centralized clearing and exchange trading address these risks? To what extent do current payment-versus payment settlement arrangements address settlement risk?

(5) To what extent is counterparty credit risk a significant concern in the foreign exchange swaps and forwards markets? If so, to what extent do current market practices (including netting and bilateral collateral support arrangements) mitigate these risks? What evidence, particularly during the period between 2007 and present, illustrate how current market practices have either addressed, or failed to respond, to these risks?

(6) Are there ways to mitigate the risks posed by the trading of foreign exchange swaps or foreign exchange forwards without subjecting these instruments to regulation under the CEA?

(7) Are there existing safeguards or systems that should be enhanced in order to protect against systemic or other risks in the foreign exchange swaps and forwards markets? What considerations are relevant to the application of Title VIII of the Dodd- Frank Act to the foreign exchange swaps and forwards markets, specifically to enhance supervision, strengthen risk management, and lower systemic risk?

(8) Given that the Dodd-Frank Act requires all foreign exchange swaps and forwards be reported to a swap data repository, what is the current standard or practice in the foreign exchange market for reporting trades?

(9) What would be the likely effects of mandatory U.S. clearing of foreign exchange swaps and/or forwards on foreign exchange market liquidity in the U.S. dollar? What would be the impact on the operations of U.S. end-users and U.S. dealers?

(10) What other factors should the Secretary of the Treasury consider in determining whether to exempt foreign exchange swaps and/or forwards pursuant to section 1a(47) of the CEA?

In addition, commenters are encouraged to submit supporting materials, including relevant transactional data, that would assist the Secretary's consideration of the issues relating to an exemption for foreign exchange swaps or foreign exchange forwards, or both, under section 1a(47) of the CEA.

Dated: October 19, 2010.
Mary J. Miller,
Assistant Secretary for Financial Markets.
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