

CHAIRMAN'S LETTER

The Foreign Exchange Committee and the global community faced a number of complex challenges in 1999. The year opened with the debut of the euro, an event viewed with considerable caution by market participants despite the extensive preparations that preceded it. As the year unfolded, our Committee spent much of its time on force majeure issues. Responding to the foreign exchange disruptions in 1998, the Committee sought to provide new guidelines and standard documentation that would minimize uncertainty for participants in the event of foreign exchange crises.

The Committee's agenda also included efforts to address Y2K settlement concerns, recommend standard practices in the barrier options market, and clarify operational procedures for entities that only occasionally trade in the foreign exchange market. In all of its activities, from issuing best practice recommendations to providing a forum for the discussion of issues, the Committee sought to raise the level of knowledge among market participants and to encourage actions that would reduce global market uncertainty and its associated risks.

The year ended with a smooth transition to a new century for the foreign exchange community. The Committee was untiring in its efforts to make the market work better than in the past, even as the group confronted the uncertainties produced by Y2K. This dedication was apparent in the care taken by the Committee to coordinate its efforts with those of other international organizations so that the new century would begin without mishap.

As I reflect on our Committee's accomplishments in 1999, I am well aware that our success was the product of hard work, a continuing commitment to improving market efficiency, and the ready cooperation of other international associations. Our chief efforts for the year are reviewed briefly below.

PLANNING FOR Y2K

Of all the Committee's efforts in 1999, the Y2K project drew the greatest attention and was supported by the strongest cooperative efforts. The importance accorded this project no doubt reflected a global sense of urgency about preparing for the turn of the century. The

Committee's work on the project began in November 1998, when together with the Singapore Foreign Exchange Market Committee, it released a letter encouraging market participants to reduce settlement risk by limiting settlement activity in the first week of the year 2000. The Committee took further steps in 1999:

- It supported the efforts of the Financial Markets Lawyers Group (FMLG), the legal advisor to the Committee, to prepare *Y2K: Best Practices in the Foreign Exchange Market*. This paper offered guidelines for minimizing the uncertainty that could arise if foreign exchange contracts failed to settle when Y2K-related events affected clearing banks or central banks (see page 39). Before releasing the document in mid-October, the Committee sought broad industry support by sending it to organizations all over the world for review and endorsement.
- The Committee also sponsored a series of informal meetings among members to identify the principal Y2K issues confronting the market. At midyear, the Committee invited senior credit officers in the industry to participate in a roundtable discussion focusing on the potential for Y2K problems.

ADDITIONAL INITIATIVES TO REDUCE SETTLEMENT RISK

In 1999, the Committee pushed for further reduction in foreign exchange risk. In particular, it monitored two specific initiatives meant to reduce the level of settlement risk: the creation of CLS (Continuous Linked Settlements) Bank and the contract for differences (CFD).

- **CLS Services/CLS Bank**

The Committee recognizes that the introduction of CLS Bank is designed to reduce settlement risk but will also bring major changes to the way foreign exchange settles. When in operation, CLS Bank will settle payment instructions between members through the simultaneous debiting and crediting of funds. In 1999, the Committee monitored CLS' progress in setting up its new system and investigated the system's impact on the foreign exchange market. CLS officials briefed the Committee on their efforts at the February and December meetings.

- **CFDs**

The Committee followed developments relating to the CFD, a foreign exchange contract that reduces risk by settling without the exchange of principal. The trading of CFDs requires appropriate reference rates; the compilation and posting of these rates is targeted for midyear 2000. The Committee intends to continue monitoring developments with CFDs and will provide best practice recommendations as appropriate.

TRADING PROCEDURE ISSUES

Two Committee projects—one focusing on the issue of force majeure and the other on barrier options agreements—were aimed at reducing market uncertainty by resolving institutional differences in trading procedures.

- **Force Majeure**

A specialized subgroup of the FMLG undertook to clear up inconsistencies in international trading agreements that might encourage participants in the currency markets to take contradictory positions during times of crisis. Representatives of commercial and investment banks, the Emerging Markets Traders Association, and the International Swaps and Derivatives Association provided input. The project concluded with the recommendation of several new force majeure provisions for standard currency trading agreements (see page 57).

- **Barrier Options**

A subgroup of the Committee circulated a questionnaire about current procedures pertaining to barrier options, received feedback from twenty-three institutions, and achieved consensus agreement on a number of market practices (see page 71). The subgroup has now turned its attention to composing standard confirmations with respect to the more commonly traded barrier options agreements.

PROVISION OF COMMENTS AND RECOMMENDATIONS

The Committee responded to a general request to the financial community by the Basel Committee on Banking Supervision for comments on its paper *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*. In a letter to the Basel Committee, the Committee strongly applauded the paper's intent and endorsed many of its recommendations, having made similar suggestions for many years (see page 89). However, the Committee was concerned that some of the recommendations in the paper might be too constraining and hence difficult for institutions to implement effectively. The Committee suggested that the Basel Committee might want to give financial institutions more latitude in their procedures for measuring settlement risk exposure, their use of netting, and their methods of managing fails and planning for contingencies.

In October, the Committee published a short paper with a long title, *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer*

Participants (see page 47). Authored by the Operations Managers Working Group of the Committee, the paper seeks to reduce market uncertainties by providing an easy operations-based reference guide outlining best practices for businesses that may not be frequent participants in the foreign exchange market.

WORK ON LEGISLATIVE AND REGULATORY ISSUES

Throughout the year, our Committee acted as an advocate for the foreign exchange market on issues related to regulatory oversight. Supported by the FMLG, the Committee wrote letters and provided information and comment to legislators and regulators. In March, the Committee submitted a written response to questions raised by the Senate and House Committees on Agriculture about the history of the legislative treatment of the over-the-counter foreign exchange market (see page 77).

In addition, as Chairman of the Committee, I appeared before the House Agricultural Subcommittee on Risk Management, Research, and Specialty Crops on May 20. The testimony I gave emphasized the importance of self-policing for the foreign exchange market (see page 33). The Committee also joined with a group of other industry associations to provide recommendations on the modernization of the Commodity Exchange Act (see page 27). Finally, the Committee responded to proposals of the Commodity Futures Trading Commission that would have a bearing on the foreign exchange market. A comment letter sent in May addressed the proposed rules concerning automated trading systems (see page 83).

COLLABORATION WITH OTHER INDUSTRY GROUPS

Increased proficiency with electronic communication enabled the Committee and other industry groups to collaborate more successfully in 1999. Project work became more efficient as organizations learned that they could tap the resources of other global groups as readily as their own. The dissemination of information also became easier, and the frequency of correspondence between industry groups increased. Many of our Committee's papers, including work on barrier options, force majeure, and Y2K, were distributed electronically for comment and approval of the global community. On-line communication also allowed the Committee to stay abreast of the risk-reducing efforts of other groups and to support those efforts.

Our Committee is proud of the close relationships it has developed with a number of international groups. It is also optimistic about increased global interaction and the benefits that our ties with other groups can bring to the entire financial community. Our relationship with the Singapore Committee in particular has proved fruitful.

On November 5, 1999, I was present when the two committees met in Singapore for their third annual joint session. The meeting started off with a discussion of the outlook for the global foreign exchange market and the Asian economies and moved on to an analysis of Y2K preparations in Singapore and Asia. The committees then turned their attention to the recent barrier options and force majeure projects and considered how these efforts would provide support to the operations of the foreign exchange market. The meeting ended with both groups looking forward to their fourth joint meeting, planned for New York on November 2, 2000.

LOOKING AHEAD: PLANS FOR THE YEAR 2000

In the upcoming year, several projects will be drawing the attention of the Committee. These include

- monitoring the activities of CLS Bank and studying its potential impact on the entire foreign exchange market;
- updating industry best practices to incorporate legal and market-related innovations of the last five years;
- following through on projects begun in 1999, particularly the effort to provide standard confirmations on barrier options; and
- helping the market make the necessary adjustments to an electronic world.

We recognize that many tasks—and perhaps some adventures—await us in 2000. The Committee will continue to disseminate information, provide best practice recommendations, and encourage further risk reduction to support the evolution of the foreign exchange market. We will also continue our active collaboration with other industry bodies. It is our belief that global teamwork, supported by effective communication, creates the best possible conditions for achieving an efficient and high-functioning foreign exchange market.

Paul Kimball