



International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

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Impact of Treasury's OTC Derivatives Legislation on the Foreign Exchange Market

Since its development more than 2,000 years ago in the earliest trading centers, the foreign exchange market has become perhaps the largest and most liquid financial market in the world. Beginning at the inception of commerce among people of different societies and states, merchants, customers and, later, corporations and investors, have used the foreign exchange market as an essential means to facilitate trade and investment. This robust commercial activity has been vital to building and maintaining the dynamic global economy of our time. For much of this period, foreign exchange trading has been an integral part of the business activities of regulated commercial banks. As economic activity has become increasingly global in nature, the importance of the deep and liquid over-the-counter FX market has continued to grow. Notably, the FX market has withstood many market disruptions throughout its long history, from the rise and fall of governments to the more contemporary currency crises in the 1990's and the financial crisis of last year.

Participants in the FX market

Corporations participate in the foreign exchange market to:

- export goods abroad
- repatriate earnings from foreign operations
- effect payments to non-local suppliers and service providers
- invest in plant, equipment and businesses abroad
- hedge investment exposure and income.

Investors participate in the FX market to:

- repatriate earnings from abroad

- ensure adequate liquidity to meet obligations to pension owners, 401K owners and other investors
- settle the purchase of foreign assets, which allows foreign investors to readily purchase U.S. assets
- hedge the currency risk in foreign assets
- offset sovereign risk
- take currency views to manage portfolio risk and return.

Characteristics of the FX market

The FX market has historically been an over-the-counter market in which dealers have designed and offered a wide range of products to meet the currency and risk management needs of the market's participants. The global nature of the FX market and the many varied reasons for foreign exchange trades has created the need for customized products to effectively manage risks. As a result, the ability of FX dealers to tailor products to meet the specific needs of individual participants has become essential for these corporations and investors to most effectively manage their risks and most efficiently conduct their ongoing commercial business. The US Dollar is widely viewed as the world's premier reserve currency, with more than 80% of all FX trades estimated to involve the US Dollar. Accordingly, it is critical that any regulation of the foreign exchange market be carefully considered as the liquidity and efficiency of the market for the US Dollar significantly affects the global FX market. Furthermore, the large majority of OTC foreign exchange transactions executed today are short-dated (under one year in duration), resulting in relatively less credit risk than that of products whose average tenor is longer.

Current risk reduction practices in the FX market

The FX market has several important features that serve to substantially reduce risk to participants, including the availability of the Continuous Linked Settlement system, collateralized trading relationships and the use of automated operational processes and standardized documentation. The Foreign Exchange Committee¹ has discussed these features in detail in its recent paper, "Overview of the OTC Foreign Exchange Market: 2009". The most important of these features are the following:

Continuous Linked Settlement system (CLS). To reduce systemic risk, the FX industry created CLS Bank in 2002 at the behest of central banks around the world.

¹ A description of the Foreign Exchange Committee can be found on the FXC website at <http://www.newyorkfed.org/fxc>.

Settlement risk refers to the capital at risk from the time an institution meets its obligation under a contract (through its delivery of a currency) until the counterparty fulfills its side of the transaction by delivering the other currency that it is required to deliver under the transaction, which can occur many hours later in a different jurisdiction. CLS Bank significantly reduces settlement risk for FX payments through simultaneous settlement of both legs of an FX transaction. This eliminates any time lag between the deliveries of the two settlement currencies that gives rise to settlement risk. CLS currently settles 17 major currencies, with the addition of further currencies anticipated, and settles payments arising from a broad range of FX products, including spot, deliverable and non-deliverable forwards, swaps, and the exercise of options. Importantly, CLS continued to function without interruption throughout the financial crisis last year.

Collateralized trading. Although the short dated nature of most FX transactions results in less credit risk than that of many other products, participants actively use credit support agreements published by industry groups such as ISDA to further reduce credit risk.

Operational processes and standardized documents. The FX industry has moved significantly toward the automation of transaction processing, which substantially reduces the possibility of human error or delay that could prevent the accurate execution and confirmation of FX transactions. In addition, most participants in the FX market use standardized documentation developed by industry groups such as the Financial Markets Lawyers Group, ISDA and EMTA (a trade association for emerging markets).

Treasury legislative proposal

The administration's proposed legislation (the "Proposal") would sharply bifurcate the regulatory treatment of the foreign exchange market. Appropriately, it excludes physically settled spot and forward transactions from the definition of "swap". However, the Proposal does not exclude those foreign exchange transactions that are options or "cash settled" from being included as swaps and therefore makes them subject to the bill. This characterization would require that standardized swaps among swaps dealers and "major swaps participants" be traded on an exchange or registered alternative swap execution facility and cleared through a registered clearing organization. It also would impose capital requirements on all swaps covered by the bill, with those for non-cleared swaps set at a higher level, and would impose margin requirements on most non-cleared swaps.

Significant Impacts of the Treasury Proposal

The Proposal would significantly affect foreign exchange trading activity that has functioned effectively for centuries as an OTC market. Several of the most important impacts on the FX market are discussed below.

Impact 1: The Proposal would increase the cost and difficulty of hedging FX positions and, as a result, lead to greater credit, settlement and market risk for companies and investors.

Requiring some FX products to be traded on exchanges and cleared in registered clearing organizations would lead to increased costs for these products as a result of clearing fees imposed on market participants. Furthermore, the split between cleared and OTC transactions may prevent parties from netting their positions across all FX transactions and cross-margining these products, which in turn could increase the credit risk that parties incur with respect to their counterparties on the non-cleared trades. It could also require parties to post more margin than they would otherwise do on a netted basis, further driving up the cost of managing foreign exchange risks.

This mandated split between cleared and OTC transactions would also make hedging and risk management more difficult for some market participants because they will not have the risk management systems to manage risk between cleared spot and deliverable forwards, on the one hand, and OTC options and non-deliverable forwards, on the other. In addition, requiring that options be exchange traded and cleared will make it harder to effectively manage option positions as options incorporate spot, rate and volatility components that would have to be hedged in entirely different markets. Hedging in different markets will tend to increase costs and introduce “basis risk” in that the transactions executed in different markets may not exactly hedge or offset each other.

We recognize that central clearing of transactions is intended to reduce credit risk. However, credit risk has not been a major factor in the FX market due to the short dated nature of the transactions and the extensive use of collateral to secure mark-to-market exposure. Depending on its implementation, the clearing requirement could have the unintended effect of substantially reducing the volume of trades in CLS, which will drive up its costs per transaction and make it less attractive for participants to settle their trades through it. As a result, the central clearing requirement will ultimately produce an increase in settlement risk, a much more significant factor in the FX market, as parties refrain from using CLS due to its higher costs.

As a result of all of these factors, when faced with these increased costs and hedging difficulties many companies and investors may not hedge their FX positions, leaving them exposed to the significant financial risk of adverse movements in international exchange rates. Furthermore, pushing a significant amount of foreign exchange trading into a handful of clearinghouses will substantially concentrate credit and operational risk to a degree not present in the over-the-counter markets. The ultimate result of the Proposal may be to increase, rather than decrease, risk in the large, global FX market.

Impact 2: The Proposal would discourage customization of FX transactions, which will further deter participants from effectively hedging their foreign exchange risks.

The exchange trading of options and non-deliverable forwards will necessitate a great deal of economic standardization in order to concentrate liquidity in specific contracts. This forced standardization will likely produce two results, neither of them desirable. First, it may lead market participants to attempt to manage their risks with the few exchange traded contracts that are available. As those contracts will not exactly match the participants' risk profiles, they will likely be left with unhedged risks. In addition, the higher capital charges for OTC transactions will discourage the development of customized transactions that are now characteristic of the OTC FX market by making them more expensive for dealers to offer. This may well encourage market participants to abandon hedging altogether as they will have difficulty obtaining products tailored to their particular portfolio and risks at an affordable price.

Importantly, corporations and investors already have the ability to choose FX trades executed on a futures exchange and cleared through their clearinghouses yet the large majority of foreign exchange transactions continue to be executed in the over-the-counter market. We believe market participants choose the OTC market due to the benefits it provides through customization and attractive pricing and that this choice highlights the fundamental limitations of the clearinghouse model.

Impact 3: By forcing non-deliverable transactions into exchanges and clearinghouses, the Proposal would disrupt the NDF and NDO market that is an important means of hedging risks in the emerging markets.

Non-deliverable forward FX transactions ("NDFs") are forward foreign exchange transactions that are settled on a net cash payment basis without a physical delivery of a notional amount of currency. Non-deliverable currency option contracts ("NDO's") are currency option transactions that likewise are settled with a net cash payment and not by physical delivery of a notional amount of currency. NDF's and NDO's generally settle in a "hard" currency, one of the world's major currencies such as US Dollars, euro or Japanese yen.

Transactions are generally structured as non-deliverable when the currency in question is not freely convertible or transferable or possibly so illiquid as to make delivery of the currency problematic.² Non-deliverable transactions are designed to be economically similar to deliverable ones and provide the same hedging benefit to users as deliverable FX trades.

A significant amount of the activity in the NDF and NDO markets takes place in the interbank market but investors such as asset managers and hedge funds and end-users such as corporations are also active users of this product. NDFs and NDOs are used by market

² A transaction in other currencies, namely those that are freely deliverable and transferable, could also be contractually arranged to settle on a non-deliverable basis if the parties desired in order to reduce settlement risk or facilitate a particular structure.

participants largely for hedging assets and liabilities in foreign currencies, often in connection with their commercial business activities or overseas investments. In that regard, large US corporations actively use NDFs and NDOs to hedge risks arising from their international business activities.

Importantly, NDFs and NDOs are net-settled transactions, meaning that a net payment by one party is paid to the other at the end of the transaction. This payment is far less than the notional amount of the transaction and thus the settlement risk associated with NDF and NDO transactions is considerably lower than for physically delivered transactions. In addition, since 2007 CLS Bank has included many NDF and NDO-traded currencies in its settlement system, further reducing settlement risk associated with this product.

The emerging markets can be volatile and companies and investors often find themselves with significant currency risks as result of their business activities and investments there. Discouraging use of these non-deliverable transactions by restricting them to a few exchange traded and cleared contracts will reduce the use of a highly effective hedging tool that can greatly mitigate the risk of global business and investment while largely avoiding the settlement risk that can be present in other types of transactions. In addition, there is at present no infrastructure for clearing non-deliverable FX transactions while the OTC market has CLS already available to mitigate settlement risk. As a result, imposing clearing requirements at this time would potentially cause a significant disruption to this essential market without a meaningful reduction of risk.

Impact 4: The Proposal would have an adverse effect on the functioning of the options market.

Currency options can take many different forms. There are "plain vanilla" options where one party (the "buyer") pays premium to the other (the "seller") in order to have the right at expiration or during a specified period to exercise the option into a spot foreign exchange transaction for a specified currency pair. There are also "structured" options, which have different features that allow the option holder to achieve different results, the most common of which are known as "barrier options" (i.e., knock-in and knock-out options) and "binary options" (i.e., one touch and no touch options). These structured options look at the spot exchange rate for a specified currency at expiration or during a specified period in order to establish whether the option is exercised or the option holder is entitled to a specified payment.

Given that currency options are traded globally and decisions regarding exercise are based on observations in the over-the-counter market, if these options were required to be cleared, it is likely that there would be a substantial decline in the liquidity of options as exercise would most likely be tied to hours that the clearinghouse is open. This is perhaps more problematic in the case of structured options where the observable event for purposes of determining the option payout is made by the barrier determination agent using well publicized rate sources or, in the case of less liquid currencies (for example, emerging

markets), currency trades observed in the over-the-counter market. In an attempt to standardize contracts, a clearinghouse may limit these observations to clearinghouse hours, specified markets and a restricted number of rate sources. These limitations would deny participants the effective connection to the global currency markets that they now achieve with OTC products.

Impact 5: Highly restrictive US regulation will tend to drive some FX business to offshore locations.

Due to its inherent international scope, the FX market operates in many financial centers throughout the world. Major FX dealers often maintain trading rooms in several of these centers and can readily shift personnel and trading activity between them. While large international banks often prefer to conduct FX activities in the stable business climate of the United States, regulations that restrict the products that they can offer their clients, mandate exchange trading and clearing and impose high capital and margin requirements may lead them to move a significant amount of their FX trading to offshore locations. This movement could lead to a loss of jobs and tax revenue in the US that now results from these profitable activities. In addition, it may lead to business being done in jurisdictions that lack the regulatory oversight of banks and other FX dealers now present in the United States, with an attendant risk to companies and investors that use these products as an important part of their business activities. Ultimately, the introduction of separate controls in each country in which FX is traded may lead to a balkanization of the foreign exchange market and attendant difficulty in managing FX risk in the global economy.

Conclusion

The global foreign exchange market has long functioned in a highly effective manner on an over-the-counter basis. It provides customized solutions for participants of all types who use it to prudently manage the risks of doing business in the international commercial and investment markets, giving it a particularly important role as trade and commerce become increasingly global. In order to further enhance the safety and reliability of the market, industry participants have developed risk management tools such as CLS, collateralized trading and standardized documentation that are now widely used throughout the world. The depth, liquidity, effectiveness and soundness of this vital global market is best supported by the current well developed industry practices known and understood by international regulators rather than the fundamental restrictions that would be imposed by the Treasury Proposal.