

Comment Regarding Determination of Foreign Exchange Swaps and Forwards

In response to Notice and Request for Comments published by the Department of the Treasury regarding the Determination of Foreign Exchange Swaps and Forwards

Americans for Financial Reform and Jennifer Taub, Isenberg School of Management and SAFER, University of Massachusetts, Amherst

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Americans for Financial Reform (AFR) and other groups concerned about the derivatives markets appreciate this opportunity to respond to the Notice and Request for Comments published by the Department of the Treasury (Treasury) regarding the Determination of Foreign Exchange Swaps and Forwards. AFR is a coalition of over 250 national, state and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, religious and business groups along with economists and other experts.

Exemption of Foreign Exchange Swaps and Forwards is Not Justified

AFR urges the Secretary of the Treasury (the Secretary) not to exempt foreign exchange (FX) swaps¹ and forwards² from the definition of “swap” under the Commodity Exchange Act (the CEA) and thus from exchange trading and central clearing requirements. We concur with a comment made by Senator Maria Cantwell that, “The security of our economy depends on foreign exchange derivatives coming under the same transparency and oversight provisions as the rest of the vast derivatives market.”³ We believe that given the current state of information about the opaque \$4 trillion-per-day⁴ FX market, on balance any reasons to exempt them do not outweigh the risks.

AFR believes that an exemption of FX swaps and forwards would create a loophole that would be exploited to undermine the purposes of the new reform legislation. FX swaps and forwards can be used in the same ways as cross-currency interest rate swaps⁵ – both types can be used both for hedging and for highly leveraged speculation. Furthermore, experts conclude that there is “significantly” more counterparty risk associated with FX because notional amounts are exchanged.⁶ As this is the case, given that cross-currency interest rate swaps are subject to the CEA, it does not make sense to exempt FX swaps and forwards. Moreover, “FX swap markets were immune neither to the turmoil nor [the financial] crisis.”⁷ Indeed, after the Lehman bankruptcy and AIG bailout in September of 2008, there was a “virtual shut-down” of the FX swaps market. Only with U.S. government intervention through the opening by the Federal Reserve of massive and ultimately unlimited transatlantic swap lines with certain foreign central banks along with backing up the money markets were the dislocations in the FX swap markets resolved.⁸

Consequences of this Broad Exemption are Profound

The implications of granting an exemption for FX swaps and forwards would be significant. The Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)⁹ provides that those derivatives transactions that are characterized as swaps move out of the shadows and become subject to regulation by the Securities and Exchange Commission (the “SEC”) and/or the Commodity Futures Trading Commission (the “CFTC”). The derivatives language in Dodd-Frank was subject to substantial debate and negotiation throughout the legislative process, and, in general, the language mandating clearing and exchange trading got clearer and stronger over the course of that process. This mandate is a central feature of the new derivatives regulatory regime created by the legislation, and a key building block of its system for making the financial system more secure.

The purpose of the clearing requirement is to ensure that those trading in swaps post sufficient collateral or margin to back up their trades. This requirement is designed to avoid a situation such as occurred with AIG -- when its credit default swap counterparties began demanding billions of dollars in cash when the bets began to turn against AIG. Because AIG did not have the self-discipline to set-aside cash in the event the market turned, ultimately, the taxpayer had to commit approximately \$182 billion to rescue it from collapse. Moreover, the AIG situation also showed us that the private market could not work on its own as counterparties allowed risk to build up at AIG and these counterparties received approximately \$62 billion when AIG began to fail. The purpose of the exchange trading is transparency. The investing public and regulators benefit from transparency regarding the volume and pricing of transactions.

In Dodd-Frank, Congress did not exempt FX swaps and FX forwards from regulation and oversight, indicating that Congress was not convinced an exemption was justified. The statute requires that the Secretary make a written determination regarding whether or not they should be exempted, and the statute does not set a deadline for that determination. Any hasty determination not based upon sufficient evidence and argument, and not fully open to public review before it is final, will lack credibility. It would be a sad irony if the exemption of this large, opaque, and highly leveraged and interconnected market from regulation were to be among the first significant ‘final rule’ decisions taken by the Administration to implement Dodd-Frank.

After Reviewing the Required Considerations, the Secretary Should Decide to Not Exempt FX Swaps and Forwards

Section 721 of Dodd-Frank permits the Secretary to make a written determination as to whether or not FX swaps and FX forwards should be regulated as swaps under the Commodity Exchange Act (the “CEA”). This authorization is qualified with the explicit requirement that the Secretary consider a specific list of criteria in making such a determination. We believe that a careful consideration of these criteria produce a strong argument that FX swaps and forwards should not be exempted from clearing and trading requirements. The relevant language from Dodd-Frank follows below in italics with our related commentary after each provision:

“(a) REQUIRED CONSIDERATIONS.—In determining whether to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term ‘swap’, the Secretary of the Treasury (referred to in this section as the ‘Secretary’) shall consider—

“(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”

We do not support the notion that requiring exchange trading and clearing of FX swaps and forwards would create systemic risk, lower transparency or threaten the financial stability of the United States. To the extent there is concern that central clearing organizations concentrate risk, the Financial Stability Oversight Council (the FSOC) has the ability to designate them for heightened prudential supervision. And, at a recent meeting, the FSOC voted to request comment on whether these clearinghouses should be deemed systemically important. The Secretary expressed the important view that, “This critical step will help enable the [FSOC] to place under heightened oversight all financial institutions, not just banks, that could pose a threat to our financial system.”¹⁰

To the contrary, we believe that failing to require these transactions to be cleared and traded on exchanges is essential to avoid systemic risk, increase transparency and avoid a threat to the financial stability of the United States. Notwithstanding industry claims, there was a crisis in the FX market shortly after the 2007 crisis began in the equity and fixed income markets.¹¹ This crisis was initially triggered by the unwinding of a large carry trade¹² in August of 2007.¹³ Moreover, volatility in the FX markets rose in the lead up to the government-backed rescue of Bear Stearns in March 2008. While this calmed temporarily, when Lehman filed for bankruptcy FX market volatility reached new heights and FX spreads widened dramatically, reflecting liquidity problems and counterparty risk concerns.¹⁴

Moreover, we question the contention that exchange trading and clearing of FX swaps and forwards will interfere with monetary policy. Central banks have demonstrated the ability to open swap lines in times of dislocation. In fact, the insufficient regulation of the FX market contributed to the crisis problems in the markets that required the Federal Reserve to offer unlimited dollar swaps to solve dollar shortages resulting from mismatches. This forcing was an interference with monetary policy. Had the FX markets been better regulated, the Federal Reserve might not have been forced to offer these huge swap lines to foreign central banks.

Because FX swaps are used to fund banks' foreign currency positions, problems include maturity mismatch (short-term funding and longer term investment in cross-border lending in general as well as carry trades) and rollover risk. As the recent report by the Committee on the Global Financial System/Markets Committee notes, spot markets need to function well in periods of stress or “central banks might have a role to play in facilitating orderly trading conditions.”¹⁵ As, indeed, they did.

Given the demonstrated necessity for central bank support to ensure market resilience and efficiency under stressful conditions, there is a need to know the extent to which carry trades exacerbated the conditions that required support and why. Given Congressional concern embedded

in Dodd-Frank about central bank backing for speculative activity, so large a channel for that activity should not continue to be conducted within an OTC market dominated by banks.

The CGFS paper makes another important point: “Information about off-balance sheet foreign exchange activities is vital for forming a complete picture (e.g. use of FX swaps, gross FX swap market value after netting, and forward sales of foreign currencies by exporters). These data are not available from the BIS banking statistics or other collections of international data.”¹⁶ This critical absence of transparency in the OTC market makes it impossible for authorities to see vulnerabilities at the systemic level.

“(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 as amended by Dodd-F rank] for other classes of swaps”

FX swaps and forwards are not already subject to a materially comparable regulatory scheme if they are exempted from the definition of “swap.” At the heart of the new regulatory scheme are the central clearing and exchange trading requirements. The provisions that would remain, including antifraud, supervision by banking regulators, and the obligation to report transactions are not enough to deal with the credit risk and systemic risk problem associated with failure to post adequate margin. While some contend that most transactions between financial institutions involve the posting of margin, this data is not complete or transparent and the behavior is voluntary. The number of transactions does not reveal the risk. Consider that according to the Congressional Oversight Panel, AIG was brought down by only approximately 125 of 44,000 derivatives contracts.¹⁷

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

Participants in the foreign exchange markets may or may not be subject to sufficient supervision by banking regulators. For example hedge funds, active participants in the FX swaps and forwards markets are presently subject to little to no regulatory oversight. Even under Dodd-Frank, oversight is minimal and limited to the investment adviser of the hedge funds. In addition, it is still not clear which non-bank financial companies will be subject to supervision by the Federal Reserve. Moreover, even for those bank holding companies and nonbank financial companies that will come under the supervision of the Federal Reserve, the nature of the heightened prudential standards are not known. Thus it is not possible to know how adequate this supervision will be. Finally, the clearing and exchange trading requirements in the bill make it clear that Congress has not deemed Federal Reserve supervision of bank holding companies alone to be sufficient with regard to other similar swaps; we do not understand why it would be sufficient in this case.

“(4) the extent of adequate payment and settlement systems”

Certainly adequate payment and settlement systems are necessary, but they are not sufficient. The absence of these systems should create a red flag for the Secretary. However, the presence of these alone is not enough to argue for keeping these highly leveraged transactions in the

shadows. For FX spot transactions (that settle in around 2 days or less),¹⁸ the primary risk is settlement risk.¹⁹ But this is not the case with FX swaps and forwards. Both FX swaps and forwards contain a forward trade which is of three or more days' duration. Thus, there are other risks inherent in swaps and forwards beyond settlement risk.

Additional risks include counterparty credit risk, liquidity and market/price risk. Indeed, experts suggest that the counterparty risks associated with FX forwards are greater than those associated with currency rate swaps because principal is exchanged.²⁰ And, the empirical data shows: "after the onset of financial turmoil in the summer of 2007, CDS spread differences between European and US financial institutions were positively related to deviations from CIP observed in the FX swap market. The findings suggested that concern over the counterparty risk of European financial institutions was one of the important drivers of the deviation from covered interest parity in the FX swap markets."²¹

Counterparty credit risk is the risk that the other party could fail at some point during the life of the contract after amassing unrealized losses. Under this circumstance, the party that did not fail is unable to collect unrealized gains, since there were no collateral or "netting" agreements, or mark-to-market adjustments. This risk can be magnified to the extent that the defaulting party is more likely to be carrying losses than the non-defaulting party. These losses may, in fact, contribute to the probability of default.

Market or price risk is the risk associated with adverse fluctuations in the general market. The market risk in the FX market is that a shift in either interest or exchange rates will make the trade unprofitable and force the institution to liquidate its position - selling the investment currency (and depressing its value) to buy the funding currency (and increasing its value) to repay the loan. Because of the size of carry trade positions, these reversals in valuation have a huge impact on exchange rates for the two currencies involved and ripple effects for other currencies in bilateral contracts involving either of them. Private transactions cannot reduce market risks. However, as foreign currency futures and swaps are used to hedge against the price risk associated with current or future currency holdings, counterparty clearing models provide market participants with confidence that they have not simply swapped market risk for counterparty credit risk.

The prevalence of longer dated foreign currency forwards and swaps is increasing and these products are subject to counterparty credit risks concerns unless they are centrally cleared. According to data provided by the Bank for International Settlements ("BIS"), the percentage of OTC FX products with contract duration of 1 year or greater increased steadily between 2000 and 2009. In 2009 (per BIS data), 20% of OTC FX products had a maturity of 1-5 years and 18% had a maturity of greater than 5 years. The current market infrastructure in the foreign currency markets is sufficient for the risks associated with spot market trading, but it is insufficient in addressing the risks associated with the foreign currency forward or swaps markets.

Spot FX currency contracts are currently settled by CLS Bank International's ("CLS") multi-currency cash settlement platform. CLS does not operate on a counterparty clearing model. Instead, CLS settles transactions between major banks in a "payment vs. payment" ("PVP")

method. Payments from one party to the other go through CLS and payments are sent to both parties after both parties' payments are received. If one of the parties defaults, CLS has no role in diminishing the replacement risk the other side of the trade faces as a result of the default. CLS just returns the funds of the delivered currency to the party that did not default. Thus, the party that did not default takes on all of the market and replacement risk associated with the transaction. Some erroneously argue that the PVP method employed by CLS addresses the risk associated with foreign currency forwards or swaps, making counterparty clearing models unnecessary. The PVP model is designed only to address settlement risk. It is not designed to minimize other types of risks connected with foreign currency forwards or swaps.

In addition, currently, just over half of total interbank spot transactions use CLS, leaving a very large portion of the world's current foreign currency interbank trades outside CLS. CLS is available for spot transactions in only seventeen currencies. It cannot be used for the rest of the world's currencies. In May of 2008, BIS reported on efforts to address settlement risk: "significant success ... [in reducing settlement risk has been achieved] ... most visibly by the establishment and growth of CLS Bank ... at the same time, a notable share of FX transactions is settled in ways that still generate significant potential risk across the global financial system and so further action is needed." "The fact that \$1.2 trillion of FX obligations are still subject to settlement risk as a result of the use of traditional correspondent banking arrangements is partly due to the fact that some FX trades cannot be settled using existing PVP settlement services."

If the CLS PVP system is viewed as an adequate substitute for clearing and exchange trading, requirements not only will this significantly increase the risk of systemic failure through the lack of clearing credit and margin requirements, but it will rapidly create the incentive for a range of synthetic interest rate swaps to increasingly leverage these markets, and negate much of the purpose of Dodd-Frank. As a result of the volume and leverage in the markets, if Treasury exempts the FX market, the impacts on other markets and increase in potential for systemic risk will be profound.

"(5) the use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements".

We think there is strong evidence that this is a real and important danger. If one class of swaps is given special treatment, and those who engage in these transactions permitted to leverage excessively by not posting adequate margin to cover their trades, risk will concentrate even more greatly in this area. Gary Gensler explained that "The concern is that these broad exclusions could enable swap dealers and participants to structure swap transactions to come within these foreign exchange exclusions and thereby avoid regulation. . . .In short, these exceptions could swallow up the regulation that the Proposed OTC Act otherwise provides for currency and interest rate swaps."²² In addition, FX transactions can be used to mask debt.

For example, as Professor Michael Greenberger noted: "This kind of exclusion has proven highly problematical. Recently, we have discovered that Greece and Portugal, and possibly Italy and Japan (if not many others), have used, inter alia, foreign currency swaps sold by U.S. swaps dealers as a vehicle for masking short term sovereign debt in order to, inter alia, gain entrance to

the European Union in exchange of the case of Greece for paying swaps dealers hundreds of billions of dollars in Greek revenue streams extending to the year 2019.”²³ While these were currency swaps, in Greece,²⁴ FX swaps can be used for the same effect. As an expert has noted, “the participant receives a payment today that is repaid by the higher-than-market payments in the future. . . Such arrangements provide funding for the sovereign borrower at significantly higher cost than traditional debt. The true cost to the borrower and profit to the [swaps dealer] is also not known, because of the absence of any requirement for detailed disclosure.”²⁵

In addition to laying out criteria to be considered in making a determination of how to treat FX swaps, Dodd-Frank also specifies some of the questions that must be answered in the Secretary’s written determination. The relevant language from Dodd-Frank follows below in italics with our related commentary after each provision:

“(b) DETERMINATION.—If the Secretary makes a determination to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term ‘swap’, the Secretary shall submit to the appropriate committees of Congress a determination that contains—

“(1) an explanation regarding why foreign exchange swaps and foreign exchange forwards are qualitatively different from other classes of swaps in a way that would make the foreign exchange swaps and foreign exchange forwards ill-suited for regulation as swaps; and

FX swaps and forwards are well-suited for regulation as swaps. They are capable of being traded on exchanges and they present risks similar to other classes of swaps. While data concerning the extent to which they are used for speculation compared to legitimate hedging is not available, the one day jumps in exchange rates in August 2007 and October 1998 are indicative of the sizable impact of speculative carry trades - the primary channel for proprietary trading.

“(2) an identification of the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status.”

While types of swaps vary, these are distinctions without a true difference. They do not warrant an exempted status. In particular, cross-currency swaps do not differ significantly from FX swaps and forwards.

Given Pressing Deadlines for High Priority Matters to Protect Investors, Consumers and Taxpayers, Rushing to Exempt this \$4 Trillion-Per-Day Market is Not Justified

As a matter of process, given the significance of this determination, we recommend that the Secretary proceed with all possible deliberateness and transparency. There is no mandated timeline for this determination under Dodd-Frank, and we question the wisdom of rushing to effectuate this highly controversial exemption, particularly when there are many time-bound mandates under Dodd-Frank to meet for actions that will help to make markets safer and protect American investors, consumers and taxpayers.

Accordingly we encourage the Secretary to continue on the path of transparency and participation and request that prior to submitting a determination to Congress, the Department of the

Treasury first publish a proposed version of the written determination in the Federal Register and invite the public to review and comment on the data and arguments.

Conclusion

AFR urges the Treasury to proceed with caution. The consequences of such a blanket exemption may be profound. The risk of damage for exempting with haste far outweighs any inconvenience or cost that would be borne by market participants. History shows that sophisticated investors, on their own, cannot police the markets.²⁶

Notes

1 A foreign exchange swap is a transaction with two parts. For example, in the first part (the spot leg of the transaction), Party A gives 500,000 Euros to Party B in exchange for 450,000 Dollars at the current or a near date. As part of this swap transaction, the parties at the same time agree that at a future, far date they will swap back the currency, (the forward leg of the transaction). But based upon the deal, they might agree that at the future date, Party A should give back less than the 450,000 dollars. This might be the case if it happens that dollars earn less in interest than Euros do, so Party B would have better use of the Euros than Party A did of the dollars. See, The Learning Center: Foreign Exchange Swap Transactions, AIB, FXCenter USA, <http://www.fxcenterusa.com/us/learning/FX%20Swaps.pdf>

2 A foreign exchange forward is just the forward leg of the transaction described above.

3 Robert Schmidt and Silla Brush, Banks Seek Exemption from Dodd-F rank for Foreign-Exchange Swaps, BLOOMBERG, Nov. 24, 2010.

4 Katie Martin and Sarah M. Lynch, UPDATE: Bank Lobby Pushes US Treasury On Regulations Exemption For Forex , WALL ST. J. Nov. 18, 2010, 11:01 a.m.

5 With an interest rate or with a currency swap, instead of swapping principal, the parties swap periodic interest payments.

6 Naohiko Baba and Frank Packer, F rom turmoil to crisis: dislocations in the FX swap market before and after the failure of Lehman Brothers, BIS Working Papers, No. 285, July 2009, available at <http://www.bis.org/publ/work285.pdf?frames=0> , citing Duffie, D., Huang, M., 1996. Swap Rates and Credit Quality. 51 J. OF FINANCE 2 921-950.

7 Baba and Packer.

8 Baba and Packer.

9 Public Law 111–203, 124 Stat. 1376 (2010).

10 Dave Lawder and Rachelle Younglai, Regulators to ramp up supervision of some clearinghouses , REUTERS, Nov. 23, 2010.

11 Michael Melvin and Mark P. Taylor, The Crisis in the Foreign Exchange Market , CESIFO Working Paper No. 2707, Category 7: Monetary Policy and International Finance, July 2009, available at https://www.cesifogroup.de/pls/guestci/download/CESifo%20Working%20Papers%202009/CESifo%20Working%20Papers%20July%202009/cesifo1_wp2707.pdf

12 To set up its position in a carry trade, an institution borrows in a low interest rate currency then sells that currency (the “funding currency”) in the spot market where it buys a higher-interest rate currency (the “investment currency”). The sale of the funding currency (the Japanese yen, for example) depresses its value while the purchase of the investment currency (the Australian dollar) raises its value and thus, profits accrue from both the interest rate differential and currency appreciation.

13 According to Melvin and Taylor, “The carry trade unwind occurring on August 16, 2007 . . . the one-day change in the JPY price of the AUD on August 16, 2007 was -7.7 percent, compare to the average daily change in that exchange rate for 2007 prior to August 15 of only 0.7 percent.”

14 Melvin and Taylor.

15 Committee on the Global Financial System/Markets Committee “The functioning and resilience of cross-border funding markets”, March 2010, BIS.

16 Id. at 11.

17 Congressional Oversight Panel, June Oversight Report: The AIG Rescue, Its Impact on markets, and the Government’s Exit Strategy, June 10, 2010, p. 8, (“COP AIG Report”), available at <http://cop.senate.gov/documents/cop-061010-report.pdf>

18 Federal Reserve Bank of N.Y., The Foreign Exchange and Interest Rate Derivatives Markets: Turnover in the United States, April, 2010, available at http://www.newyorkfed.org/markets/triennial/fx_survey.pdf

19 Using the example from the footnotes above, a spot transaction would be the first leg without a second one. Settlement risk, then would be Party A delivering the 500,000 euros, but Party B failing to deliver the 450,000 dollars.

20 Duffie and Huang.

21 Baba and Packer.

22 Analysis of Proposed Over-the-Counter Derivatives Markets Act of 2009, Commodity Futures Trading Commission, August 17, 2009 2, available at <http://tradeobservatory.org/library.cfm?refid=106665> (last visited Feb. 23, 2010).

23 Michael Greenberger, Out of the Black Hole: Regulatory Reform of the Over-the-Counter Derivatives Market, *Make Markets be Markets*, Roosevelt Institute, http://makemarketsbemarkets.org/modals/report_derivatives.php

24 Charles Forelle, Debt Deals Haunt Europe, WALL ST. J., Feb. 22, 2010, at A1; Kate Kelly, et al., The Woman Behind Greece’s Debt Deal, WALL ST. J., Feb. 22, 2010, at C1 (Goldman received \$300 million in fees for Greek deal); Michael Hirsh, Wall Street’s Euro Scams: Lobbyists are Quietly Working to Ensure Secret Derivatives Deals Behind Euros Stay Secret, NEWSWEEK, Feb. 16, 2010, available at <http://www.newsweek.com/id/233645>.

25 Satyajit Das, Stripping Away the Disguise of Derivatives, FINANCIAL TIMES, Feb. 17, 2010, available at <http://www.ft.com/cms/s/0/270fb2b6-1bcd-11df-b073-00144feab49a.html>.

26 See , Testimony of Dr. Alan Greenspan, Committee of Government Oversight and Reform October 23, 2008.