BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 18, 1977

CONFIDENTIAL (FR)
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TO: Reserve Bank Presidents

FROM: Arthur L. Broida ALB

Attached for your information is a recent memorandum to the Board of Governors from Peter Hooper entitled, "Procedures for Federal Reserve System Foreign Currency Operations," together with a transmittal by Mr. Reynolds.

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 11, 1977

To Board of Governors

Subject:

From John E. Reynolds

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This memo discusses the procedures followed by the foreign exchange trading desk in conducting foreign currency operations for the System Open Market Account and for foreign official correspondents of the Federal Reserve Bank of New York. It was prepared by Mr. Peter Hooper in response to a question raised concerning these procedures by Governor Coldwell when the Board approved the trading desk's request for a turnover survey of banks operating in the New York foreign exchange market.

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Peter Hooper
April 28, 1977

Procedures for Federal Reserve System Foreign Currency Operations.

I. Introduction and Summary

This paper is in response to a question by Governor Coldwell concerning why the Federal Reserve System does not undertake rounds of competitive bidding among banks in the U.S. foreign exchange market when it conducts its foreign currency operations. It also provides background information on the System's foreign exchange transaction procedures, in view of the survey of banks in the New York market which is being taken this month partly for the purpose of reviewing the current distribution of the System's transactions in the market.

There are two reasons why the System's foreign trading desk does not follow the domestic trading desk's normal procedure of conducting rounds of competitive bidding in its dealings with banks. One involves the objectives of the foreign trading desk's intervention activities, and the other involves the institutional structure of the U.S. foreign exchange market.

First, unlike the domestic desk, which acts on a sufficiently large scale to determine the Federal funds rate within a relatively narrow band, the foreign desk generally acts on as small a scale as possible to counter disorderly conditions in the foreign exchange market. It does not attempt to determine a specific rate level but rather views its role as a purely defensive one. In the foreign desk's judgment, the effectiveness of limited-scale intervention is enhanced in many situations if it is undertaken quietly, so as not to be detected by market participants. This strategy precludes undertaking competitive bidding among banks.

Second, the U.S. foreign exchange market is brokerage oriented: U.S. dealing banks do not contact each other directly, but deal through one of several foreign exchange brokers in New York. Competitive bidding is an on-going process in the brokers' market, so that rates quoted in that market are generally the most competitive rates available from U.S. banks. In view of the large number of banks that deal in the brokers' market (about 200) it would be less efficient to undertake competitive bidding directly with banks than to operate through brokers.

The System makes use of the brokerage system directly and indirectly, depending upon the types of transactions it is undertaking. Intervention sales of foreign currency are undertaken in the brokers' market through one of about 25 major dealing banks that act as the System's agents in that market. These transactions are made in the agent bank's name so that the System does not appear in the market. The System's other foreign exchange operations (a majority in recent years) are handled differently. These include transactions both for the System's own account and on behalf of its foreign correspondents. In executing these transactions the foreign desk does not deal directly in the brokers' market. Instead, it behaves as a customer in the market, contacting a small number of banks for each transaction, and seeking a competitive rate. It does utilize the brokerage system indirectly by seeking a rate that is consistent with rates currently quoted in the brokers' market.

The foreign desk generally makes only very limited use of competitive bidding to distribute its non-intervention transactions among dealing banks and to select banks to serve as its agents for intervention. This distribution and selection is spread among 25 to 30 major U.S. dealing banks out of the roughly 200 banks that operate in the brokers' market. From quarter to quarter, some banks may be significantly more active than others in business with the System, depending upon the foreign desk's needs for specific intervention transactions and upon its assessment of the quality of service rendered by each bank. Over longer periods of time (from year to year), however, the desk strives to distribute its total transactions among these major dealing banks so that each receives an amount roughly proportional to its share of total business in the market.

This distribution is currently based on a survey of banks' foreign exchange turnover taken in 1969, and upon qualitative information gathered in day to day contacts with the market. The survey being taken this month is designed, in part, to upgrade this information.

The remainder of this paper presents a more detailed description of the System's current foreign exchange transaction procedures. Section II discusses intervention procedures, Section III outlines procedures followed in other foreign currency operations, and Section IV covers the distribution of the System's transactions among banks in the U.S. market.

II. Intervention Procedures

The System's intervention transactions are conducted specifically to counter disorderly market conditions. During the past four years, these transactions have predominantly involved the selling of foreign currency, with total sales approaching $3-1/2 billion. There have been very few occasions when it has been determined that foreign currency purchases were warranted to counter disorderly market conditions.

The System processes these intervention transactions through the New York brokers' market, which puts it indirectly in contact with most of the U.S. banks that deal in foreign exchange. U.S. dealing banks seeking to make transactions do not call each other directly, but place their bids and offers through one of several brokers in New York. Brokers cannot undertake transactions in their own name, rather, they attempt to match bids and offers from dealing banks and receive a small, fixed commission on each transaction. Each broker maintains direct telephone lines to most of the major U.S. dealing banks. Bids and offers quoted in the brokers market reflect the most competitive rates available from U.S. banks.

Once a decision to intervene has been made, the foreign desk contacts one of the major U.S. dealing banks and asks it to act as the System's agent in the market, usually for the duration of intervention operations during one working day. The agent bank provides the services of an experienced trader in the particular intervention currency, who undertakes transactions in the market at the System's request. These transactions are made in the agent bank's name, so that the System does not appear in the market as a party to a transaction.*/ Under this

*/ Once a transaction in the brokers' market has been consummated, each party to the transaction learns of the counter-party's identity in order to effect the necessary transfer of funds. When the System is dealing through an agent, the agent's name rather than the System's is given to the counter-party to effect this transfer.

arrangement the agent bank also absorbs any credit risk involved in dealing with other banks that operate through brokers.*/ In addition, the agent bank keeps the desk informed about conditions in the U.S. brokers' market, and, through its contacts with foreign banks, about market conditions abroad.

In serving as the System's agent for intervention, a bank agrees to respect the System's request for confidentiality and not to take advantage of its knowledge of the intervention by purchasing for its own account what the System has to offer.**/ In the view of the System's foreign trading desk, these requests have been respected with very few exceptions. The desk would most likely soon find out from other market sources if the agent were leaking information to the market, and the System could check the agent's records if it doubted its performance on the second condition. However, it would be difficult, if not impossible to tell if the agent had altered its dealings with other banks in light of its knowledge of the intervention.

*/ Credit risk refers to one of two possibilities: a) on spot transactions, one party to a transaction may fail to transfer funds after the other party has done so. (Several banks were inflicted with losses of this type when Herstatt abruptly went bankrupt), and b) on forward transactions one party may fail to deliver when the contract matures. (In this case there is a possiblity of gain as well as loss to the party holding the forward contract, depending upon which way the value of the currency it sold forward has moved during the life of the contract).

**/ On a few occasions, the System has sold directly to the agent bank at that bank's request. This has been the case only when the bank was clearly in need of the funds to cover its customer needs, so that it would not have to be seen, awkwardly, as both a buyer and a seller at the same time in the brokers' market.

The agent bank is paid a commission on the transactions it processes. The commission is small (equal to about .003 per cent of the value of the transactions), and, at times, agents have rendered their services for a whole day (providing information, etc.) without any transactions being made. In addition to the commission it receives, the agent bank may be able to use its knowledge of the System's intervention transactions to some advantage when other market participants are either unaware of or uncertain about these transactions.*/

It would be difficult to obtain objective evidence on the value of such "inside information" about System intervention in the foreign exchange market. The foreign desk believes that potential benefit to the agent bank is insignificant, for several reasons. First, System intervention is not aimed at setting specific exchange rate levels, but at slowing movements in rates. Second, intervention has been for the most part limited in scale, with a relatively small impact on rate movements. Even in the infrequent cases when the System intervenes on a larger scale and plays a more dominant role in the market (as the domestic trading desk normally does in the Federal funds market), the advantage to the agent would be small, it is argued, because other market participants could not help but be aware of both the presence of the System in the market and the magnitude of its intervention.**/ Finally, in a given intervention situation,

*/ An agent bank conducting intervention sales for the System may have reason to believe that a decline in the dollar's exchange rate will be halted within a short period of time. This knowledge might enable it to profit (or cut its losses) in dealing with other banks who are not aware of the System's specific intervention activities.

**/ In these cases, the System would be likely to intervene over several days or more, using different banks, so that the market would soon be aware of the System's presence.

the agent does not know ahead of time how actively the System is going to intervene, nor does it necessarily know what impact the intervention is going to have on the market.

The foreign desk prefers to operate through an agent rather than directly with brokers for several reasons. First, it believes that the benefit of the services rendered (including a continuous flow of information about market conditions,*/ assumption of credit risk, and reconciliation of clearing house funds with Federal funds**/) exceeds the relatively small direct cost in terms of the commission paid.

Second, by operating in the agent bank's name, the System can maintain the anonymity of its intervention activities. In recent years it has often been the judgment of the foreign desk that intervention transactions should be undertaken quietly, out of the view of market participants. The desk feels that this procedure allows for both greater control over and increased effectiveness of intervention operations. Both these considerations become more significant in view of the System's policy of limiting the volume of intervention as far as possible.

With regard to the issue of control, it is argued that intervention sales of foreign currency should be covert whenever there is a possibility that disorderly conditions will be worsened if market participants become aware of these sales. The reasoning goes as follows: if market participants believe that the System is intervening in limited amounts, they may try to take immediate advantage of the situation by increasing their purchases

*/ The desk feels that the quality and timeliness of information obtained from an agent is superior to information that could be obtained in less formal, routine day-to-day contacts with the market, i.e., when the System is not dealing directly with a bank.

**/ The brokers' market deals exclusively in clearing house funds, whereas the System deals in Federal funds.

of foreign currencies while the System is offering them, in order to make a profit when the System is forced, under pressure, to withdraw from the market. And, if the System does withdraw under pressure after a limited amount of intervention, general knowledge of that withdrawal could further increase the market pressure.

Finally, on the issue of effectiveness, one tactic frequently employed by the trading desk has been to use one or more small transactions to create the impression of relatively stable private demand and supply around a given exchange rate level. The reasoning behind this tactic is that in some situations market participants may be more responsive to the stabilization of market conditions if they believe the stabilization is due to private transactions than they would be if they knew it was due to official intervention.

III. Procedures for Non-Intervention Transactions.

The System conducts two types of foreign exchange operations in the market besides intervention. The first involves purchases of foreign currency for its own account to repay outstanding swap debts and to add to balances for future use in intervention sales. These foreign currency purchases have totalled less than $3-1/2 billion during the past four years.*/ The second type involves transactions undertaken on behalf of the System's foreign correspondents (foreign central banks and other international organizations that hold accounts at the New York Federal Reserve Bank). Correspondent transactions have totalled $10 billion since early 1973.

*/ The System's foreign currency purchases in the market have totalled less than its intervention sales because foreign currency has from time to time been acquired by purchasing directly from foreign central banks and other correspondents outside the market.

In executing these transactions, the System deals directly with U.S. banks. It prefers to deal directly with banks rather than through brokers partly because some of its correspondent transactions, at least, are in odd amounts (which are not handled in the brokers' market), and partly to avoid being put in the position of having to single out banks in the brokers' market that it believes to be poor credit risks.

The procedure followed is to contact two or three banks and obtain quotes for a particular transaction. Normally the best rate quoted is taken. But if none of the rates quoted are consistent with the desk's knowledge of what is being quoted in the brokers' market, other banks may be called until the desk is satisfied that it has obtained a rate aporoximating the best rate available in the market at that time for the given transaction. In most cases only a very few banks are contacted directly in connection with a given transaction. However, the foreign desk is in contact daily with many of the major dealing banks on an informal basis, and it can learn through these contacts what rates are being quoted in the brokers market (generally the most competitive rates available) at any point in time.

IV. Distribution of the System's Transactions.

Intervention transactions are distributed by the market pricing mechanism through the brokerage system, among the roughly 200 dealing banks that operate in that market. However, the distribution of the System's other transactions, and the selection of banks to serve as agents for intervention, is based primarily on non-price criteria. Non-intervention transactions are made with the 30 banks on the foreign desk's telephone board.*/ Selection of agents for intervention is limited to the 25 banks on the telephone board that are U.S.-owned.**/ The distribution of transactions among these banks may vary considerably from quarter to quarter, depending upon several short-term considerations.

First, in choosing agents for intervention, the System normally limits its selection to one of a small number of banks that meet the needs of a specific intervention strategy in a particular currency. When the desk wishes to operate quietly, the selection is limited to banks which are known to be major market dealers in the intervention currency so that transactions made on the System's behalf will not raise the suspicion of other market participants. When the desk wishes to "announce" its intervention activities to the market, it may select a smaller bank that is not known to deal actively in the intervention currency.

Second, both the selection of agents and the distribution of business done directly with banks is affected by the desk's assessment of the quality of service rendered by individual banks. Those banks that provide sub-standard service may be excluded from the System's business for a period of time, while those that provide superior service may be rewarded with additional business.

*/ The trading desk maintains direct telephone lines with 30 major dealing banks out of the 200 banks that deal in the brokers' market. On occasion, the desk has dealt with a small number of banks not on the telephone board.

**/ Several of the foreign-owned, U.S.-resident banks that operate in the brokers' market are included on the telephone board. While these banks are not involved in intervention activities, the System does deal directly with them in its other transactions. The System does not deal at all with foreign-resident banks.

Over longer periods of time (year to year) the desk tries to achieve a distribution of the System's total transactions among the banks on the telephone board such that each bank's share is roughly proportional to its foreign exchange trading volume. The banks' trading volumes have been estimated on the basis of a survey made in 1969, on the basis of judgmental impressions formed in day-to-day contact with the market, and on the basis of information requested by the System from dealing banks that have recently asked to deal directly with the desk.

There have been relatively few complaints by banks about the distribution of the System's business, though the current distribution is not generally known in the market. Morgan Guaranty has complained on several occasions, apparently because it felt that its share of the System's intervention transactions has not reflected its importance in the market. The System's records show Morgan's share of the System's total transactions has been at or near the top of the list, roughly in proportion to the foreign desk's estimate of Morgan's share of business in the market.

A survey of the volume of foreign exchange turnover of banks in the New York market is being taken during the month of April. The results of this survey will be used, in part, by the foreign desk to update the current distribution of its transactions among these banks.