April 2011

FACT SHEET: NOTICE OF PROPOSED DETERMINATION ON FOREIGN EXCHANGE SWAPS AND FORWARDS

The Dodd-Frank Act put in place a comprehensive set of reforms to help build stronger, safer, and more efficient financial markets. The Obama Administration fought hard for and strongly supports the Dodd-Frank Act's comprehensive reforms to the derivatives market, which will reduce risk, increase transparency, and provide accountability for market participants.

Recognizing that the unique characteristics and oversight of the FX swaps and forwards market already reflect many of Dodd-Frank's objectives for reform – including high levels of transparency, effective risk management, and financial stability – Congress provided the Secretary of the Treasury with the authority to determine whether central clearing and exchange trading requirements should apply to foreign exchange (FX) swaps and forwards.

The FX swaps and forwards market is markedly different from other derivatives markets. Existing procedures in the FX swaps and forwards market mitigate risk and help ensure stability. Central clearing requirements will strengthen the rest of the derivatives market, but could actually jeopardize practices in the FX swaps and forwards market that help limit risk and ensure that it functions effectively. This market plays such an important role in helping businesses manage their everyday funding and investment needs throughout the world that disruptions to its operations could have serious negative economic consequences.

Given these considerations, Treasury is today issuing a Notice of Proposed Determination providing that central clearing and exchange trading requirements would not apply to FX swaps and forwards.

This proposed determination is narrowly tailored. FX swaps and forwards will remain subject to Dodd-Frank's rigorous new trade reporting requirements and business conduct standards. Additionally, the Dodd-Frank Act makes it illegal to use these instruments to evade other derivatives reforms. Importantly, the proposed determination does not extend to other FX derivatives, such as FX options, currency swaps, and non-deliverable forwards. These other FX derivatives will be subject to clearing and exchange requirements.

The FX Swaps and Forwards Market Operates with High Levels of Transparency, and Dodd-Frank Will Further Increase Transparency

- ***Market Pricing Transparent and Readily Available.*** Unlike other derivatives, FX swaps and forwards already trade in a highly transparent, liquid, and efficient market. FX swaps and forwards are heavily traded on electronic platforms, and market pricing information is readily available from a number of sources.

- ***Additional Transparency through Dodd-Frank.*** Dodd-Frank's trade-reporting requirements for FX swap and forward transactions will further improve the information available to regulators and their ability to oversee this market and its participants.

A Number of Unique Factors Limit Risk in FX Swaps and Forwards Market

- ***Fixed Terms, Physical Exchange of Currency.*** In contrast to other derivatives, FX swaps and forwards always require both parties to physically exchange the full amount of currency on fixed terms that are set at the outset of the contract. Market participants know the full extent of their own payment obligations and their exposure to the other party to a trade throughout the life of the contract.

- ***Well-functioning Settlement Process.*** Because FX transactions involve the actual exchange of currency, settlement risk (the risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought), is the main source of risk in these transactions. The strong, internationally coordinated oversight of this market led to the establishment of a well-functioning settlement process that effectively addresses this risk. There is extensive use of payment systems that permit the transfer of one currency to take place only if the final transfer of the other currency also takes place.

- ***Shorter Duration Contracts.*** FX swaps and forwards are predominantly short-term transactions (68 percent of the market matures in one week or less and 98 percent in one year or less). Other derivatives have much longer average maturity terms, ranging from two to thirty years. Because of their short duration, FX swaps and forwards pose significantly less counterparty credit risk than other derivatives.

FX Swaps and Forwards Are Subject to a Strong, Comprehensive Oversight Framework That Dodd-Frank Further Strengthens

- ***Subject to Strong, Comprehensive Oversight for Three Decades.*** The FX swaps and forwards market and its key participants have been subject to strong, comprehensive, and internationally coordinated oversight by central banks for more than three decades. Prudential regulators impose capital and margin requirements and monitor the use of FX-related settlement arrangements and other measures to reduce counterparty credit risk. Through the Basel Committee on Banking Supervision and the Committee on Payments and Settlement Systems, central banks and prudential regulators continue to strengthen already robust risk management and settlement practices of FX market participants.

- ***Oversight of FX Swaps and Forwards Further Strengthened through Dodd-Frank.*** The Dodd-Frank Act provides the Commodity Futures Trading Commission (CFTC) and banking regulators with additional oversight of the participants in the FX Swaps and Forwards market. It subjects these participants to heightened business conduct standards. It also provides the CFTC with strong powers to prevent market participants from using FX swaps and forwards to evade requirements imposed on other derivatives.