By Electronic Delivery

February 25, 2011

The Honorable Timothy Geithner
Secretary of the Treasury
c/o Ms. Gabrielle Trabot
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: **New Information** on the Proposed Exemption of Foreign Exchange Swaps and Futures: Fed Data Show Collapse of Foreign Exchange Markets During Financial Crisis

Dear Secretary Geithner:

The recently released data by the Federal Reserve Bank ("Fed") prove that the foreign exchange markets were on the verge of collapse days after the financial crisis began in September of 2008. The new data also prove that only massive, emergency and unlimited Fed intervention in the foreign exchange markets prevented a collapse. The Fed's actions to save the foreign exchange markets were an essential part of its overall plan to stop the uncontrolled run on and prevent the failure of the entire shadow banking system. Thus, the data refute the claim that the foreign exchange markets performed well during the financial crisis and should be exempt from regulation.

The new data show that the foreign exchange markets in the fall of 2008 froze and were likely to collapse, just like the repurchase ("repo"), money market, commercial paper and the other parts of the shadow banking system. The same counterparty distrust that threatened those other markets also froze the foreign exchange markets and liquidity quickly evaporated. **As in those markets, the Fed had to bail out the foreign exchange markets with more than $2.9 trillion in October 2008 alone and with more than $5.4 trillion of foreign exchange swaps in the three months following the Lehman Brothers bankruptcy.**

Importantly, while these multi-trillion dollar amounts were massive, they actually dramatically understate the role of the Fed, which guaranteed the entire market when it removed all limits on the ability of foreign central banks to access the Fed for foreign exchange transactions in October 2008. Between the collapse of Lehman and mid-October,

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the Fed increased its intervention in the foreign exchange markets by more than 700 percent. Even that action was insufficient to stop the crisis as spreads continued to widen and liquidity continued to evaporate. The foreign exchange markets were spiraling toward imminent collapse, forcing the Fed to take even greater emergency action: in early October 2008, the Fed explicitly announced that it had removed all limits on its intervention, informing the markets that it would effectively guarantee the entire market.

Only after this wholesale Fed backstop for the entire foreign exchange market did the crisis begin to ebb and did the market begin to stabilize. Like the repo, commercial paper and other markets, the Fed's emergency intervention stopped the market's death spiral.

Moreover, the new data also reveal for the first time that the Fed's intervention was not primarily restricted to the spot cash market, but reached time periods ranging from overnight to more than 90 days. This proves that the Fed believed that it was necessary to backstop the entire market, both short- and long-dated. The intervention was not merely, as some have claimed, an accommodation of the spot foreign exchange transfers, but comprehensive support for the entire market.

There can be no dispute that this unprecedented, massive and emergency multi-trillion dollar intervention by the Fed was done solely to prevent the impending collapse of the foreign exchange markets.

Based on this new, incontrovertible information from the Fed, any exemption for foreign exchange swaps or forwards is clearly impermissible under the statutory requirements. Moreover, in light of the Fed's extraordinary emergency intervention required to prevent the foreign exchange markets from collapsing, it would be irresponsible to permit such markets to continue operating in the shadows without transparency or regulation, which is what an exemption would do. This part of the shadow banking system must also be brought into the light.

The Newly Released Fed Data Show That It Flooded the Foreign Exchange Markets with Cash to Prevent Collapse in the Fall of 2008

The newly released Fed data[1] reveal for the first time the scale of the Fed's intervention in the foreign exchange markets. The charts below, based on that data, clearly show that the Fed pumped massive amounts of dollars into the foreign exchange markets, which were on the verge of grinding to a halt.

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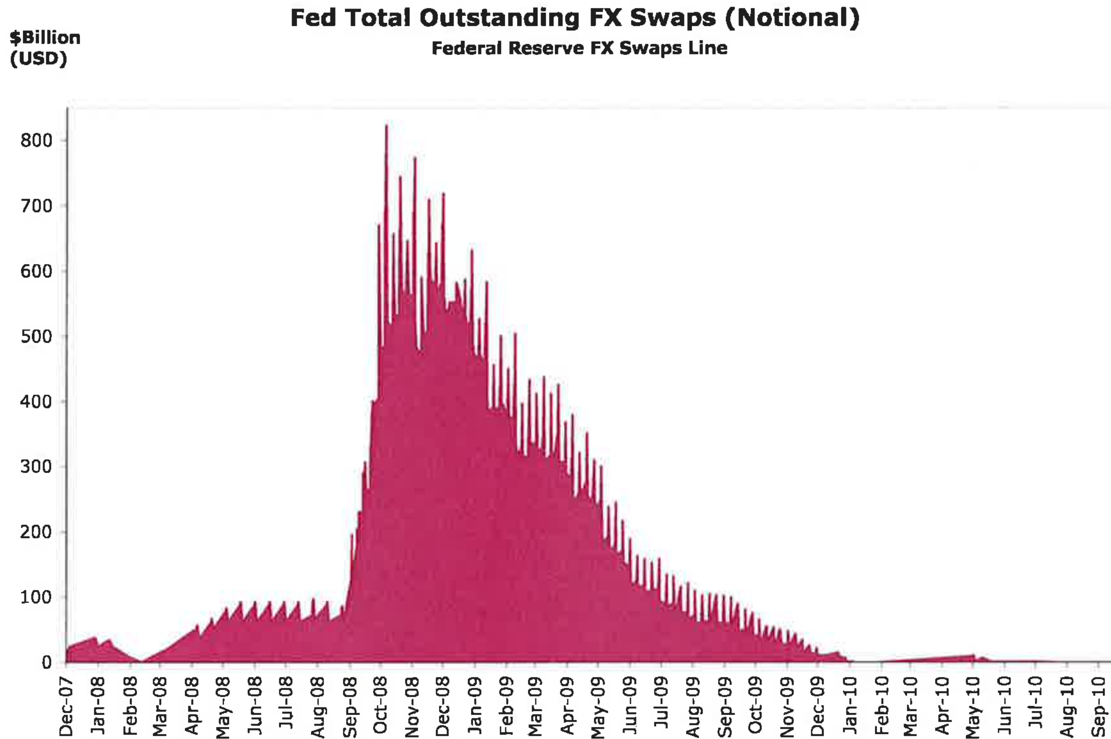
[1] http://www.federalreserve.gov/newsevents/reform_swaplines.htm. The new Fed data were only made public on December 1, 2010. Unfortunately, that was two days after the November 29 deadline for submissions to the Department of the Treasury regarding the possible exemption of foreign exchange swaps and futures from certain provisions of the Dodd-Frank Act.



[Source: Federal Reserve Bank]

As Graph 1, above, shows, after Lehman Brothers' collapse, the Fed was forced to inject huge quantities of liquidity into the FX market, with net exposure ranging from $500 billion to more than $800 billion at its highest point. This contrasts with the pre-Lehman environment, in which the stress created by March 2008 Bear Stearns' collapse required around $100 billion in Fed net exposure from March through August 2008. During the crisis period, therefore, the Fed was forced to expand its FX exposure by almost **700 percent**, a clear indication that the FX markets were in a state of near-collapse.[2]

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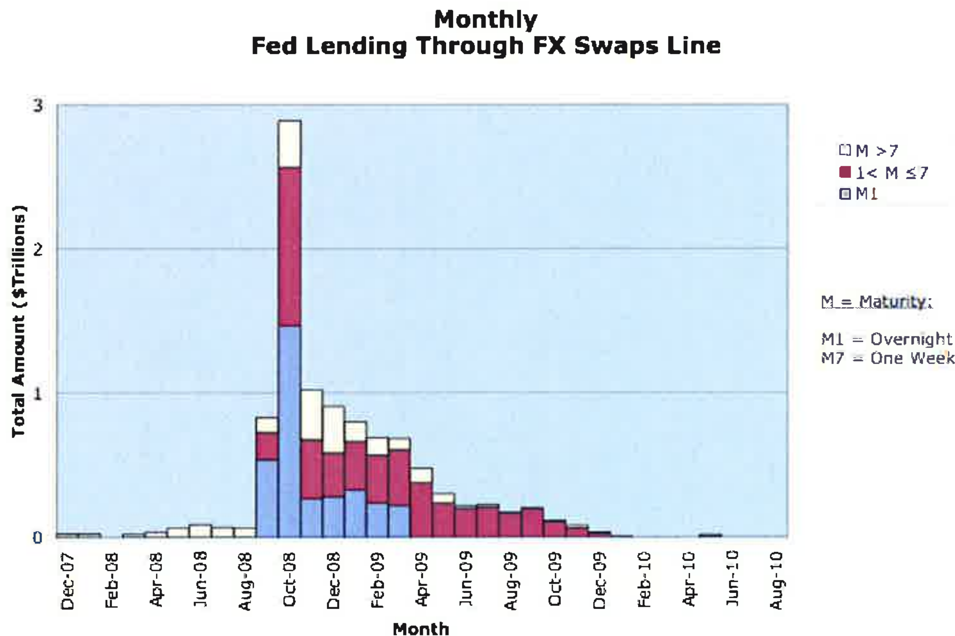
[2] The new Fed data allow for the calculation of two measures of the extent of its intervention in the FX markets via the FX liquidity swap line. The first is notional net exposure, a measure of the total notional value of the swaps outstanding on any given day. As the Fed opened more swaps during the FX liquidity crisis, its total net notional exposure increased by the notional value of the new swaps; when existing swaps expired, the Fed's net notional exposure decreased by the notional value of the expiring swaps. The second measure is total Fed lending. This captures total new Fed lending via the FX swaps line on a month-by-month basis, broken down by maturities. The net notional exposure measurement is useful because it takes into account both the trading of new swaps and the expiration of old swaps on a rolling basis, providing a daily snapshot of the Fed's notional exposure. The total lending measure is useful because it places an accurate number on the level of new funds made available through the swaps line during each separate month of the crisis.



[Source: Federal Reserve Bank]

The data on Graph 2, above, show that, just days after the multiple extraordinary events that culminated with the Lehman bankruptcy filing on September 15, 2008, the Fed dramatically increased its swap lines.[3]

We now know that this announcement triggered a series of very substantial, multi-hundreds of billions of dollars interventions by the Fed in the foreign exchange swap markets. In fact, between the collapse of Lehman and mid-October, the Fed increased its intervention in the foreign exchange markets several times over. While total lending through the swaps line in August 2008 before the crisis began was just $62 billion, **total new lending in October 2008 was $2.9 trillion, an increase of more than 4000% on the pre-crisis figure.** Thus, when we look at total lending rather than net notional exposure, we see an even clearer signal that the FX market was on the verge of collapse following Lehman's bankruptcy, had it not been for the intervention of the Fed.

But, even that massive intervention quickly proved inadequate to stop the crisis in the foreign exchange markets. The prospect of a wholesale collapse of these markets necessitated another dramatic move by the Fed in October 2008: it removed **all** existing limits on the amount of its swaps lines, thereby offering **unlimited** dollar funding at a wide

[3] http://www.federalreserve.gov/newsevents/press/monetary/20080918a.htm

range of maturities.[4] Thus, the Fed, acting on its belief that the foreign exchange markets were in crisis, concluded that only unlimited, emergency and wholesale backstopping might stop the coming collapse of the markets.

Counterparties in these operations will be able to borrow any amount they wish against the appropriate collateral in each jurisdiction. Accordingly, sizes of the reciprocal currency arrangements (swap lines) between the Federal Reserve and the BoE, the ECB, and the SNB "will be increased to accommodate **whatever quantity** of U.S. dollar funding is demanded. The Bank of Japan will be considering the introduction of similar measures."[5]

As a result, for a period of several months following Lehman's collapse, the Fed provided a rolling facility of unlimited foreign exchange swaps to backstop the markets. These swaps totaled $2.9 trillion in October 2008 alone and more than $5.4 trillion in the three months following the Lehman bankruptcy.[6] On several days, the total notional value of outstanding foreign exchange swaps provided by the Fed to bolster the market exceeded $700 billion.[7]

The Fed's maximum net notional daily exposure in the foreign exchange markets was greatest on October 22, 2008, when it reached $823.1 billion. [8]

The new swap-writing activity remained high until the spring of 2009, at which point it began to taper off. However, even after this initial "crisis period" ended, the Fed's rescue efforts in the foreign exchange markets continued well into late 2009 and early 2010, albeit at a reduced level.

The Fed Intervention into the Foreign Exchange Markets Was Necessitated by the Precipitous Drop in Liquidity in the Foreign Exchange Markets

We now know, based on the newly released data, that the Fed's intervention in the foreign exchange market was massive and ongoing. Connecting that data to other market conditions reveals the extent of the crisis in the foreign exchange market.

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4 http://www.federalreserve.gov/newsevents/press/monetary/20081013a.htm.

5 Id. Emphasis added.

6 Total notional value of new swaps opened through Fed's central bank liquidity swaps line between the Fed's first use of the line after the Lehman Bankruptcy (Sept 18, 2008) and 3 months later (Dec 18, 2008).

7 Calculated from newly released Fed data as the total notional value of swaps opened (traded) by COB on a given date, minus the number matured by COB on that date.

8 Using the newly released data from the Fed, the maximum net exposure was calculated as the sum of all opened trades minus all closed trades as of the close of business. The Fed calculates its net exposure in the foreign exchange markets slightly differently. It uses the settlement date of the first leg of new trades rather than the date the trade was made, thereby lowering the number by netting. Thus, some data indicate that the high water mark was $586.1 billion. However, both figures are accurate.

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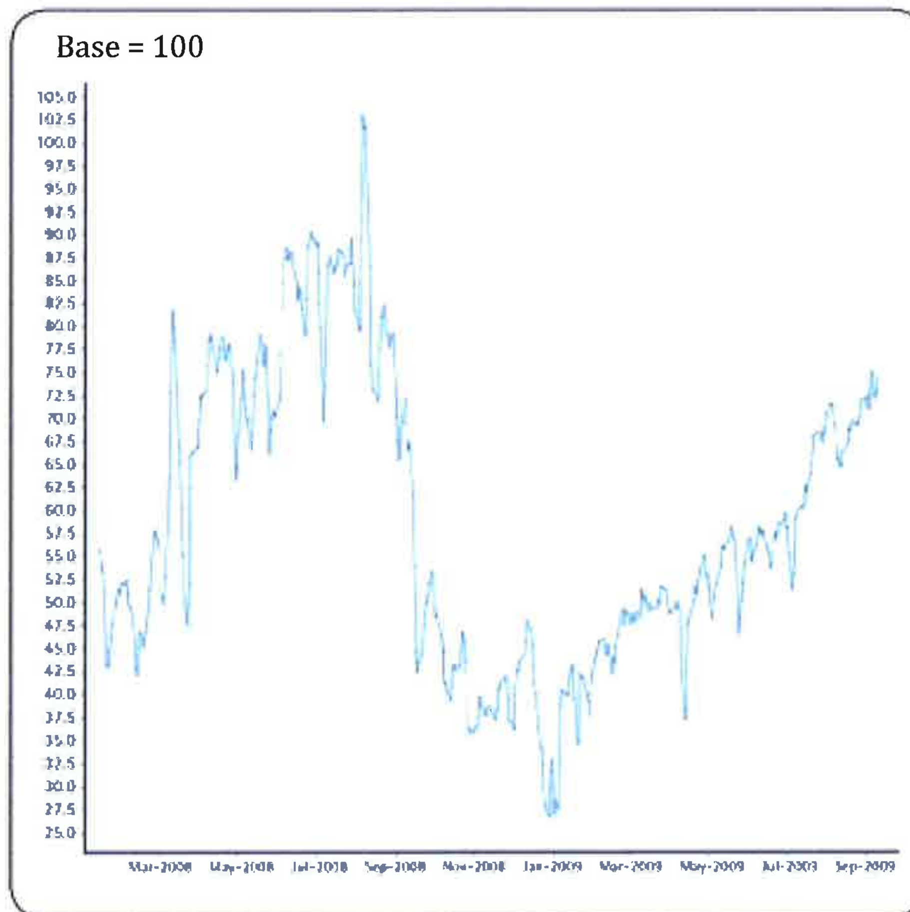
For example, Barclays published an Aggregate FX Spot Liquidity Index that clearly reveals the collapse of liquidity in the foreign exchange markets during this time period, as Graph 3, below, shows:

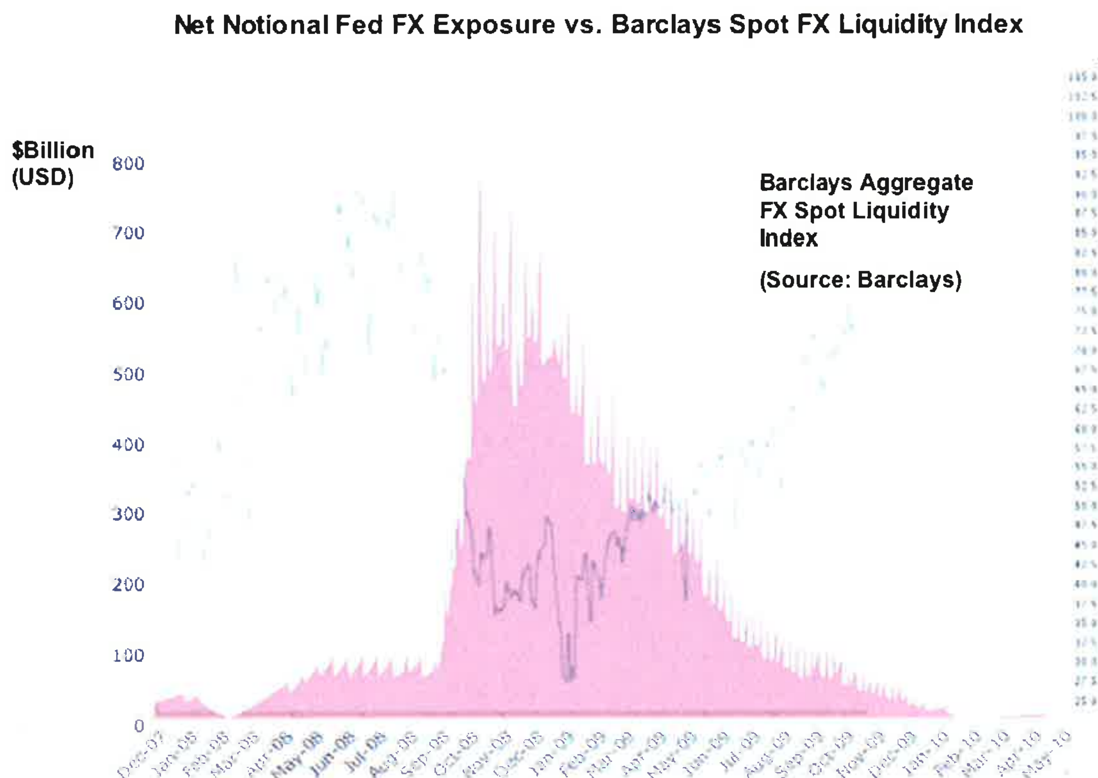


Aggregate FX Spot Liquidity Index
Source: Barclays Capital

Earlier in 2008, FX liquidity had struggled, to a degree, with the collapse of Bear Stearns prompting a drop in counterparty confidence. The Barclays FX Spot Liquidity Index had already hit a low of 42.5 in March 2008 after the fire sale of Bear Stearns to JP Morgan Chase. However, by the time of the Lehman collapse it had recovered to a healthy level of 102.5. The Lehman collapse then precipitated an unprecedented drop as the index tested new lows within days and did not bottom out at 27.5 until January 2009.[9]

[9] As is explained in I. Fender and J. Gyntelberg's, *Overview: global financial crisis spurs unprecedented policy actions,* Bank for International Settlements (Dec 2008), "A higher index reflects better liquidity conditions. The FX Liquidity Index is constructed using the notional amounts traded for a fixed set of FX spreads, aggregated using a weighting by currency pair." In other words, Barclays looks at the notional values of FX activity in various currency pairs, and compares them to a benchmark of "normal conditions" (=100).

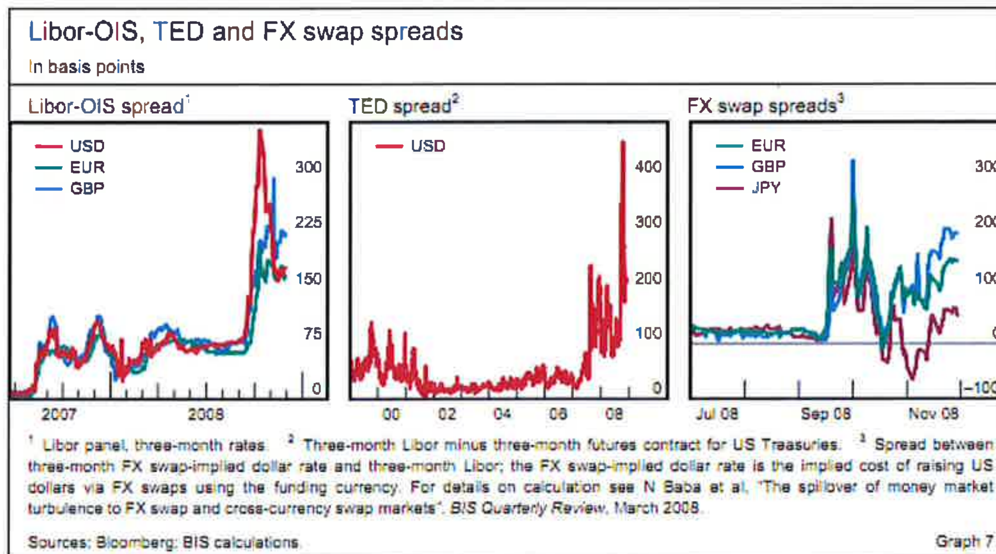
The new data show that the Fed's massive intervention coincided with this precipitous drop in FX liquidity, and was evidently triggered by it. The Fed's action provided essentially all the liquidity in the foreign exchange market and prevented its collapse. The next chart, Graph 4, below, overlays the net exposure of the Fed's foreign exchange swap lines, Graph 1, above, with Barclays Aggregate FX Spot Liquidity Index, Graph 3, above. This clearly shows that without Fed intervention, the foreign exchange market would have collapsed:



As is clear, the Fed's unprecedented action in the FX markets beginning in mid-September 2008 stopped the steep decline in FX liquidity, with the central bank amassing more than $800 billion in notional exposure in its efforts to stabilize the market. In October 2008, when the Fed announced it was lifting all limits on the FX swaps line, the rate of decline in FX spot liquidity slowed substantially and, with some setbacks and additional massive interventions, FX liquidity finally began to increase in January 2009.[10]

[10] Total new Fed lending through the FX swaps lines in January 2009 was $801billion.The peak net notional exposure during that month was $633.1billion on January 14, 2009, which was the high water mark for notional Fed exposure since October 2008 and coincided with a global low for spot FX of around 27.5. This implies that when the FX spot liquidity hit rock bottom the Fed was prompted to make one final massive intervention to reassure the markets once and for all. This intervention appears to have successfully triggered an upturn in FX spot liquidity, allowing the Fed to gradually roll off its net notional exposure from that point forward.

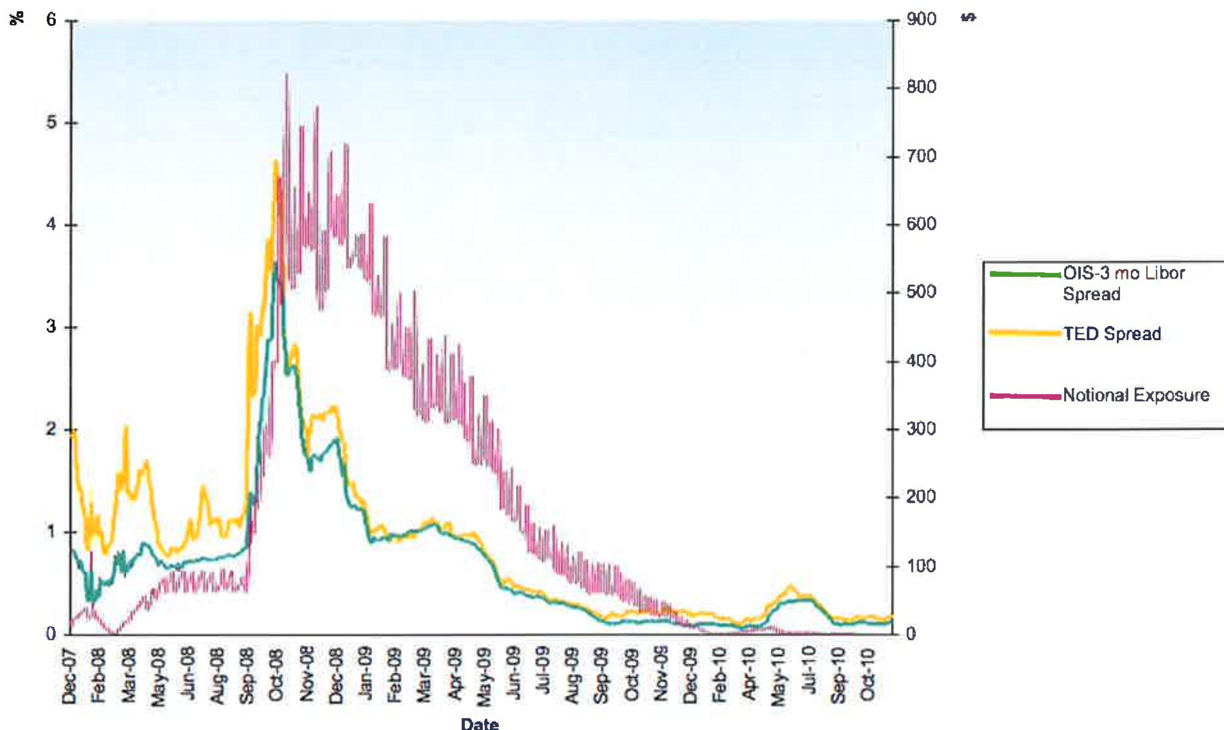
The tremendous stress in the FX markets was also revealed in the widening interest-rate spreads, which had to be another very troubling indicator to the Fed. As Graph 5, below, shows, spreads widened sharply immediately following Lehman's bankruptcy filing:



[Source: I. Fender and J. Gyntelberg, *Overview: global financial crisis spurs unprecedented policy actions,* Bank for International Settlements (Dec 2008)

The Libor-OIS spread jumped to a high of 364 basis points ("bps") on October 10, 2008. Its average over the previous year (even including the turmoil caused by the Bear Stearns collapse) had been only 69bps. The TED Spread, another important indicator of the health of the FX market, rocketed to a high of 464bps, also on October 10th. This represented a quadrupling from its average over the previous year of 114bps. FX Swap spreads, as reported by BIS, peaked slightly earlier, exceeding 300bps on October 1st. Before Lehman's failure, they had averaged around 20bps.

When these spreads are overlaid on the new Fed data in Graph 6, below, it is apparent why the Fed deemed such massive, emergency and wholesale intervention necessary. The foreign exchange markets were effectively frozen. It was only once the Fed provided unlimited liquidity that spreads narrowed and the market began to recover:



In October 2008, FX spreads all hit their peaks (Libor-OIS 364bps on October 10th 2008; TED Spread 464bps, also on October 10th; FX Swap spreads, reported by BIS, >300bps on October 1st).

In response, the Fed lifted the cap on their swaps line on October 13. The spreads started narrowing. The Fed quickly ramped up its net notional exposure, which reached its peak on October 22 at $823.1 billion. By end of October, TED was back down to 260bps and Libor-OIS to 240. By the end of November, they were down to 220bps and 180bps respectively.

Conclusion: The Fed Evidence Proves No Foreign Exchange Exemption Is Supportable

It simply cannot be denied that, but for the Fed intervention, the foreign exchange markets would have stopped functioning altogether and would almost certainly have collapsed in the fall of 2008 shortly after the failure of Lehman.

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The Fed's recent data disclosure reveals that any claims that the foreign exchange markets worked well during the crisis are, at best, inaccurate. Just one example of such a claim is the National Association of Manufacturers' comment letter, which **quoted Treasury Department "talking points"**: "FX swap and FX forward markets performed well during the crisis."[11] Frankly, the prior arguments in support of the exemption require a fresh - and independent[12]- review because the premise underpinning them was a market that functions well at all times, including, specifically, during times of extreme stress. Given that the premise is now gone, much of those arguments are without support as well.[13]

If the enormous intervention by the Fed to prevent the collapse of the foreign exchange markets is considered as representing a well-functioning market, then, but only then, can anyone claim that those markets performed at all. Without such intervention, the foreign exchange markets would have collapsed, which would have brought down every major non-U.S. bank, which would have then brought down every major U.S. bank. If the foreign exchange market performed well (a conclusion attributed to the Treasury Department by the National Association of Manufacturers and stated as fact in numerous other comment letters), then so did the repo, money market and commercial paper markets. The conditions were parallel: in each case, the market would have failed completely were it not for massive Fed intervention.

The Fed's emergency actions in preventing the collapse of the foreign exchange markets were the same as it took to save the other parts of the shadow banking system. And, the same reasons that require regulation of other swaps and the other parts of the shadow banking system (which also pose an unreasonable risk to the entire financial system and economy) apply equally to the foreign exchange markets. The Fed's own emergency actions to save the foreign exchange markets during the crisis prove this.

Collapse of the foreign exchange markets would almost certainly have led to a global depression, which is why the Fed intervened without limits and made it clear that they would do whatever was necessary to ensure that they continued to function. Private bank transactions during this period were only possible because the participants knew that they could be rolled over into the Fed facility if necessary (which, incidentally, resulted in an enormous riskless windfall for the few U.S. banks with balance sheets healthy enough to transact foreign exchange business).

That unlimited guarantee by the Fed and the trillions of dollars it injected are what gave the appearance of the markets performing well during the crisis. Without those

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[11] Letter from National Association of Manufacturers to Secretary of Treasury Department dated November 29, 2010.

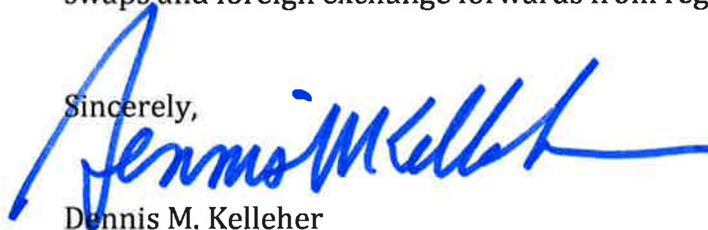
[12] Better Markets proposed such an independent verification process in its prior letter. See p. 11-12, Better Markets, Inc. Letter to U.S. Department of the Treasury dated November 29, 2010 Re: Notice of Request for Comments - Determination of Exemption for Foreign Exchange Swaps and Futures. Copy attached.

[13] Just one example was the November 15, 2010 comment letter from the so-called Global FX Division that cited as support studies from 1988, 1990, 1993, 1996, etc. Given the Fed data and the dramatic changes in the foreign exchange markets in the last two-plus decades, such "arguments" should be very carefully reviewed.

actions, the market would have collapsed, and that is why no exemption should be granted.[14]

We hope this presentation of the Fed's recently released data is helpful in connection with your ongoing consideration of whether or not to exempt foreign exchange swaps and foreign exchange forwards from regulation as swaps.[15]

Sincerely,



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[14] The new Fed data also provide substantial new support for Better Markets' original submission, which demonstrated that no exemption should be granted. See note 12 above. Copy attached.

[15] Of course, all of the recently reported allegations of misconduct regarding FX trading can only happen because there is no transparency in the market, which provides yet another and independent reason to deny the exemption. See "States Widen Currency-Trade Probes," Mollenkamp, Wei and Zuckerman, Wall Street Journal, February 3, 2011, "Suit Alleges Mellon Created Fake Trades, Overcharged," Mollenkamp, Wei and Zuckerman, Wall Street Journal, February 4, 2011, and "Suspicion of Forex Gouging Spreads," Zuckerman, Mollenkamp and Wei, Wall Street Journal, February 10, 2011.