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Global Financial Crisis

The Birth of the Swap

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Abstract

In the 1970s, the dark ages of regulatory excess, globalization was impeded by tough
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would provide sterling to the U.S. company's subsidiary in the United Kingdom.

This parallel loan arrangement required at least two sets of agreements and was extremely susceptible to legal wrangling. In February 1976, discussions of a parallel loan transaction between two U.K. pension funds, on the one side, and U.S.-based Monsanto Company, on the other, gave rise to a eureka moment: Rather than by lending currencies to and fro, the desired result might be obtained by a direct exchange of equivalent amounts of two currencies and—in 10 years, say—a subsequent re-exchange of equivalent amounts of the same currencies, adjusted by the time value of cash. The first swap was completed a few months later, in August 1976.

Although many of the exchange controls that had fostered the emergence of swaps were relaxed or eliminated, currency swaps continued to grow in popularity as the marketplace recognized their many uses beyond facilitating access to foreign-currency markets. For instance, currency swaps often reduced borrowing costs for users by enabling them to take advantage of lower rates for domestic borrowers in foreign countries. They also provided a powerful risk management tool by allowing for the hedging of foreign-exchange risk and the customization of asset and liability flows to suit companies' financing and other needs.

Relate