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The Birth of the Swap

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Abstract

In the 1970s, the dark ages of regulatory excess, globalization was impeded by tough restrictions imposed by governments on outflows from their capital markets. U.S. and U.K. companies got around some of these restrictions by devising parallel loan agreements whereby U.S. companies funded subsidiaries of U.K. companies in the United States and U.K. companies funded subsidiaries of U.S. companies in the United Kingdom. Thus, cross-border transfers were avoided. But these arrangements were complex and subject to legal haggling. In 1976, the swap emerged as a much simpler solution to the problem, and its popularity has grown ever since as more and more uses have been found for this predominant derivative.

In the 1970s, the dark ages of regulatory excess, both the United States and the United Kingdom attempted to guard their foreign-exchange reserves with tough restrictions on outflows from their capital markets. Around the same time, companies in both countries were becoming increasingly globalized and required funding for their international investments. Consequently, a back-scratching arrangement arose whereby a U.S. company with operations in the United Kingdom would provide dollars to a U.K. company's subsidiary in the United States. At the same time, the U.K. parent company 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.

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