Practical Issues Arising from the Introduction of the Euro

267 business days to go before January 1999

Issue No 6 *10 December 1997*

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"LET'S HAVE AN EMU UPDATE,
THAT SHOULD CURE THE INSOMNIA"

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Cartoons by Pugh on frontispiece and on page 81, reprinted by courtesy of The Times; cartoon by Basil Hone on page 49.

CHAPTER 1: INTRODUCTION

The Chancellor's statement on EMU

1 The Chancellor announced in Parliament on 27 October that the UK would exercise its opt-out from Stage 3 of EMU and would accordingly not be a participant on 1 January 1999. Summing up the Government's position, he said:

> *"we believe that, in principle, British membership of a successful single currency would be beneficial to Britain and to Europe; the key factor is whether the economic benefits of joining for business and industry are clear and unambiguous. If they are, there is no constitutional bar to British membership of EMU;*
>
> *applying the economic tests, it is not in this country's interest to join in the first wave of EMU starting on 1 January 1999 and, barring some fundamental and unforeseen change in economic circumstances, making a decision, this Parliament, to join is not realistic;*
>
> *but in order to give ourselves a genuine choice in the future, it is essential that the Government and business prepare intensively during this Parliament, so that Britain will be in a position to join a single currency, should we wish to, early in the next Parliament."*

2 Commenting on the practical preparations required, the Chancellor said:

> *"...if a single currency works and is successful, Britain should join it. We should therefore begin now to prepare ourselves so that, should we meet the economic tests, we can make a decision to join a successful single currency early in the next Parliament. At present, with no preparation, it is not a practical option. We must put ourselves in the position for Britain to exercise genuine choice.*
>
> *The questions of preparation are immense - practical questions for business, as well as for Government. Euro notes and coins will, for example, be circulating across Europe from 1 January 2002. Some companies, like Marks & Spencer, have already decided to prepare to accept euro in Britain. Others will want advice on what is best for them.*
>
> *Because both the Government and business must prepare intensively during the next years, we will:*
>
> *commence work on the detailed transition arrangements for the possible introduction of the euro in Britain, including the introduction of notes and coins, should we wish to enter;*
>
> *step-up the work on what business should do now to prepare for the introduction of the euro in 1999, whether we are 'in' or 'out'; and*
>
> *work with business on what Government must do to prepare for EMU, should we decide to join it in the next Parliament."*

3 The Chancellor announced that:

- He would establish a Standing Committee, including himself, the President of the Board of Trade, the Minister for Trade and Competitiveness in Europe, the Governor of the Bank of England, the President of the CBI, the President of the Association of British Chambers of Commerce and the General Secretary of the TUC, to oversee the preparations necessary for EMU.
- From early in 1998, a series of regional and sectoral conferences on preparations for Monetary Union would be held.
- The Prime Minister had decided to extend Lord Simon's Treasury responsibilities to include European Business Preparations in the Government, covering the long-term planning of the new Standing Committee.

4 The related work of the Business Advisory Group, which the Chancellor had established previously, in July this year, is described in Chapter 6.

Planned timetable for the introduction of the euro

5 Chart A provides a timetable of the main steps in the run-up to the start of EMU and the main stages in the so-called 'changeover scenario' thereafter.

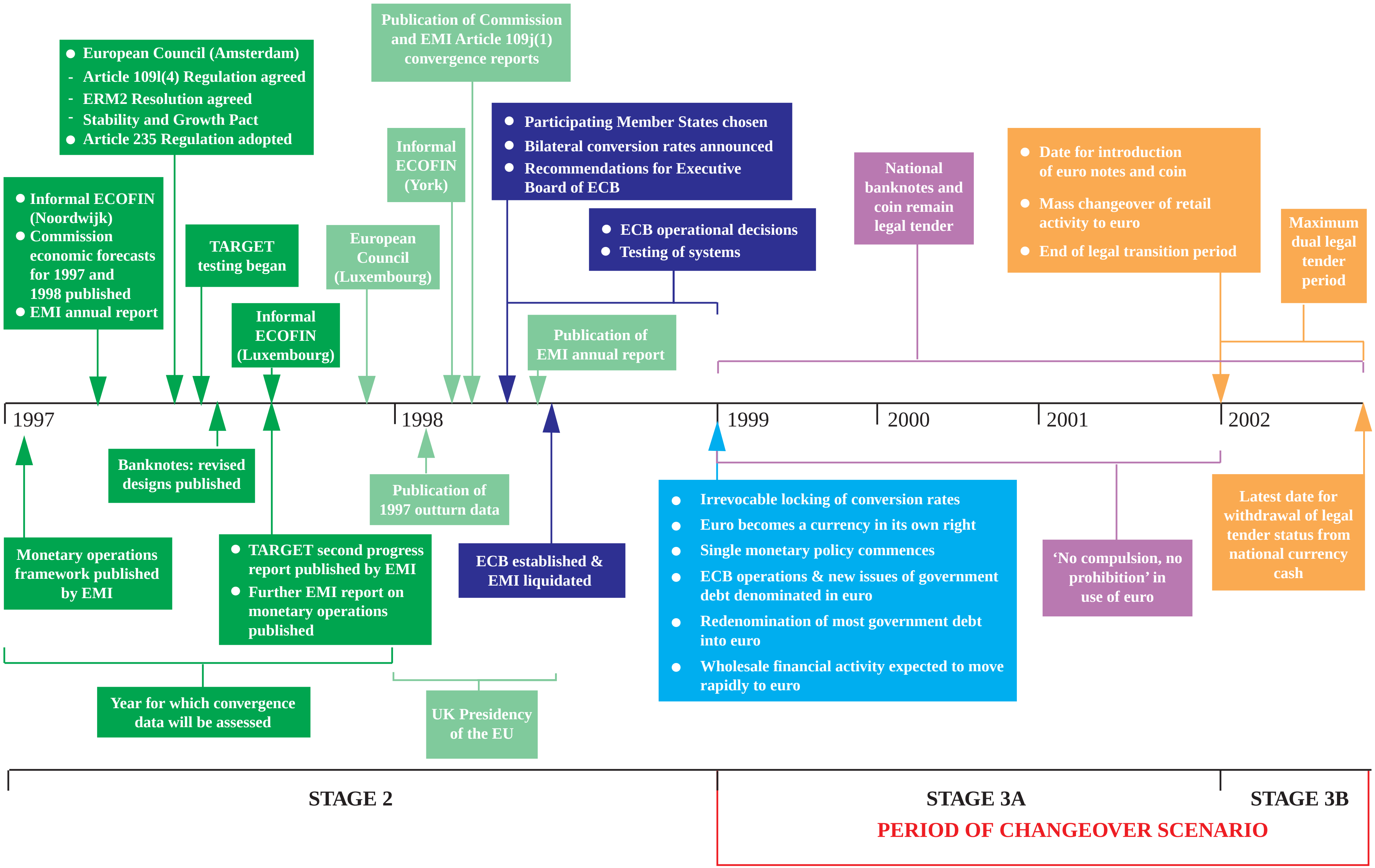
The UK Presidency of the EU

6 In January, the UK will assume the Presidency of the EU, for the first half of 1998. During the UK Presidency, a number of key decisions about EMU are due to be taken, on the indicative timetable set out below:

By 1 March	Submission of 1997 outturn data to the European Commission, and probable publication nationally.
20-22 March	Informal ECOFIN (York).
By end-March	Formal adoption of convergence reports by EMI Council and European Commission; both reports to be published the same day.
	Reports immediately submitted to the Council, European Parliament and National Parliaments.
	Commission submits recommendations to the Council on the abrogation of excessive deficits, and on which Member States fulfil the necessary conditions for the adoption of a single currency.
During April	Consideration of convergence reports by European Parliament and National Parliaments.
1-3 May	ECOFIN makes recommendations on which Member States should join EMU, by qualified majority on a recommendation from the Commission.

PLANNED TIMETABLE FOR THE INTRODUCTION OF THE EURO

CHART A



1-3 May (cont'd)	Decision of Heads of State or Government on participation in EMU, based on ECOFIN recommendations, taking into account the EMI and Commission reports and the European Parliament's opinion. ECOFIN meets again to adopt additional legislative measures, including determining and announcing the bilateral conversion rates for participating Member States at which the irrevocable locking will take place from 1 January 1999. Once the 'ins' are known, the Article 109l(4) Regulation on the legal framework for the introduction of the euro can be adopted; and nominations for membership of the ECB Executive Board can be made.
During May	European Parliament Committee confirmation hearings on Executive Board nominees.
1 June (possibly)	Informal establishment of ECB and ESCB.
15-16 June	European Council (Cardiff).
Early July	Latest time by when the ECB and ESCB must have been formally established.

What does being outside EMU mean?

7 The UK, by virtue of its Protocol in the Maastricht Treaty, has a different status from other Member States not participating in EMU from the outset (the UK will not be a 'Member State with a derogation'). The Government's decision initially to opt out of EMU means that:

- The UK will retain its powers in the field of monetary policy; so the Bank's Monetary Policy Committee will continue to set UK short-term interest rates to meet the inflation target set by the Government.
- The Bank of England will not participate in the monetary operations of the ESCB and will not transfer foreign reserve assets to the ECB.
- The UK will not be among those Member States able to appoint members, nor will any of its nationals be eligible to become a member, of the Executive Board of the ECB; nor will the Governor of the Bank of England be a member of the Governing Council of the ECB.
- The UK will retain the right to issue its own banknotes.
- The UK will not be subject to the full range of ECB legal acts (eg regulations).
- The Bank's independent status need not accord with the strict terms and interpretation of the Maastricht Treaty.

8 However, while the UK is 'out', it will be affected in other ways by the arrangements for Stage 3, as follows.

9 *Economic co-ordination.* Whether or not they participate in EMU, all Member States participate in ECOFIN, and they will all participate in the Economic and Financial Committee,

which will replace the Monetary Committee at the start of Stage 3. All Member States are already required, under Article 103(1), to regard their economic policies as a matter of common concern and to co-ordinate them within the Council. Under Article 102a, Member States are also required to conduct their economic policies with a view to the achievement of the objectives of the Community. In June 1997, the European Council asked ECOFIN to study how economic policy co-ordination could be improved. A progress report is due to be presented to the Luxembourg Summit this month.

10 *Stability and Growth Pact.* Strictly, the UK will have to continue to 'endeavour' to avoid an excessive public sector deficit, but will not be subject to sanctions and fines under the Stability and Growth Pact if it fails to do so. However, as the Chancellor made clear in his statement to Parliament, the Government is committed to ensuring that its fiscal rules, and its deficit reduction plan, continue to be consistent with the terms of the Stability and Growth Pact, thus underlining the Government's commitment to avoiding an excessive deficit and supporting greater economic co-ordination within ECOFIN. Under the Stability and Growth Pact, non-participating Member States are in any event required to prepare convergence programmes before 1 March 1999, update them annually, and make them public.

11 *Participation in the ESCB.* The ESCB will comprise the ECB and the National Central Banks (NCBs) of all 15 EU Member States. Whilst the Governor of the Bank of England will not be a member of the Governing Council of the ECB, he will participate in its General Council, which will comprise the President and the Vice-President of the ECB and the Central Bank Governors of all Member States. The General Council will be informed about the activities of the Governing Council, including its decisions on monetary policy. It will contribute to the preparations for non-participants joining EMU; take over some functions of the EMI in relation to non-participants; and contribute to the work of the ESCB in other ways (eg statistical reporting).

12 *Exchange rate policy.* Under Article 109m of the Treaty, each Member State is required to treat its exchange rate policy as a matter of common interest. From the beginning of Stage 3, this Article will continue to apply to non-participating Member States, including the UK. The European Council in Amsterdam in June 1997 adopted a Resolution on ERM2. Membership of ERM2 will be voluntary, and the Government does not have any current plans to join ERM2.

London as the international financial centre for the euro

13 Given the Government's decision, it is relevant to ask whether the City will in some way be disadvantaged by the UK at least initially being outside the euro area. The Bank believes this to be unlikely. The City's fundamental strength is as a uniquely international, rather than simply a national or regional European, financial centre. Its position derives from the critical mass of markets and financial services in commercial and investment banking available in London; and the concentration of the strongest financial businesses from all around the world. There are more banks operating in the City which are incorporated abroad than there are domestic banks, and more than half the total deposit base of the UK banking system is denominated in foreign currencies, worth over £1 trillion. The box sets outs some facts on London's position as an international financial centre.

LONDON AS AN INTERNATIONAL FINANCIAL CENTRE

London ranks with New York and Tokyo as one of the world's top three financial centres, and is the leading financial centre in Europe. New York and Tokyo are more influenced by the size of their domestic economies, whereas London's success can be attributed to its international wholesale financial business. London leads the world in foreign exchange trading, cross-border bank lending, primary international bond syndication and secondary market trading, foreign equity trading and OTC derivatives business.

Financial services sector contribution to UK economy

The UK's finance, banking, insurance and financial auxiliary services account for 8% of UK GDP and 5% of total UK employment. The broader service sector, comprising financial, business and professional services, such as the accountancy, consultancy, computing and legal professions, contributes about 25% of total UK GDP and 17% of total employment. In 1996, the UK financial sector was the largest net contributor to the UK's balance of payments current account with net overseas earnings in excess of £22 billion.

UK's global position in international financial markets

Banking

London is home to more foreign bank branches, subsidiaries and representative offices than any other financial centre (565 as at February 1997), with two-thirds of these coming from non-EU countries.

BIS statistics confirm that the UK is the largest centre for cross-border bank lending, with $1,460 billion of assets outstanding at end-December 1996, representing a market share of almost 18%. Japan ranks as the second largest, accounting for 14% of total global cross-border bank lending and USA third (market share of 8%). The UK accounted for over 30% of such lending in European countries. More such business is done in the UK than in France and Germany combined (the second and third largest European centres for cross-border bank lending).

Foreign exchange

The latest BIS survey, conducted in April 1995, confirmed London as the world's leading centre for foreign exchange business, with average daily net turnover amounting to US$464 billion, representing 30% of global foreign exchange business. This was almost twice the business done in the second largest foreign exchange centre, New York (US$244 billion, representing a 16% share of global turnover). More than half of foreign exchange business in European countries is done in London. Average net daily turnover in London is six times greater than that in Frankfurt ($76 billion) and eight times that in Paris ($58 billion).

A larger share of foreign exchange business in US$, DM and FF takes place in London than in each currency's country of origin.

Approximately 79% of foreign exchange business in London is undertaken by foreign-owned institutions.

International bonds

London is the principal centre for the international bond markets. Bank of England estimates at end-1994 suggest that 60% of the primary international bond syndication and 75% of the secondary market trading is centred in London.

Equities

The London Stock Exchange (LSE) is the world's largest centre for the trading of foreign equities, accounting for approximately 60% of global turnover in 1996. With a market share of around 25%, New York is London's nearest competing market for foreign equity business. Some 90% of foreign equity turnover within Europe is intermediated by LSE member firms.

More foreign companies are listed on the LSE than on any other exchange (533 at end-1996). This compares to 416 foreign company listings on the North American based system NASDAQ (National Association of Securities Dealers Automated Quotation system), 187 on the French Bourse and 220 on the German exchanges.

Derivatives

The London International Financial Futures and Options Exchange (LIFFE) is the largest financial futures exchange in the world outside Chicago, and together with the other derivatives exchanges in London accounts for around 16% of global exchange-traded derivatives contract turnover. More than 162 million contracts were traded on LIFFE during 1996, which accounts for more than a third of contract turnover carried out on all European exchanges. During 1996, 67 million contracts were traded on the DTB in Germany and 68 million on France's MATIF.

In April 1995, the BIS carried out the first survey of global OTC derivatives activity. With a market share of 27%, London ranked as the world's leading centre for OTC business. New York, the second largest centre for the trading of OTC derivatives, recorded a market share of 20%. Paris and Frankfurt accounted for 8% and 5% of global OTC derivatives business respectively.

Insurance

1994 figures show that London is one of the world's largest centres for insurance business, accounting for 25% of world marine insurance business and 35% of aviation insurance business. UK premiums account for 6% of total world business (both life and non-life insurance), exceeded only by the USA, Japan and Germany.

Fund management

A survey by Technimetrics, the investment research company, ranked London as second only to Tokyo for the management of institutional equities. In 1996, more than $1,638 billion of institutional equities were managed in Tokyo, compared with $1,218 billion in London. Zurich ranked as the second largest European city with $423 billion equities under management. Edinburgh ranked as the world's fifteenth largest financial centre with institutional equity holdings of $132 billion, and sixth in Europe behind Paris, Geneva and Frankfurt.

14 The particular strengths that have contributed to this massive concentration of international business in London are many and various. They include: the English language; the convenient time zone; the ready availability in abundance of the relevant trading and other financial skills, as well as professional support services - in law, accountancy, tax, property, communications and so on. They include an effective technological infrastructure. They include an adaptive regulatory framework which has been remarkably successful in maintaining confidence in financial institutions and markets without stifling innovation and risk-taking. And they include London's history of openness in terms of welcoming foreign firms and, in turn, the external economies of scale that result from the concentration of financial firms in one location. This concentration leads to improved flows of information, greater liquidity and enhanced efficiency in organised markets, and helps to reduce costs.

15 None of these factors has anything to do with the question of which national currency is used either in the UK or in Continental Europe.

16 The main impact of the advent of the euro on financial activity is that it will encourage the development of broader, deeper and more liquid markets, in financial instruments of all kinds, where they are currently fragmented because they are denominated in the various individual national European currencies. The City of London thrives on liquid markets regardless of the currency - and it will thrive on the euro, even with the UK on the 'outside'.

17 Measured in these terms, the introduction of the euro represents an opportunity for London rather than a threat. There will be a vigorous 'Euro'-euro market in London, just as there is a vigorous market in Euro-DM, Euro-francs, Euro-$ and Euro-yen now. The location of financial activity does not depend on the local currency: it will continue to be carried on wherever it can most conveniently, efficiently and profitably be carried on. And the fact that foreign-owned institutions - from Continental Europe and from around the world - continue to build their presence in London, despite the doubts for some time whether the UK would participate in EMU at the outset, suggests that this perception is widely shared.

18 The rest of Europe should welcome the contribution that the City will make to the development of markets and other financial activity in the euro, because it is in its own interest too. International or intra-regional trade and investment activity is not, at the macroeconomic level, a zero-sum but a positive-sum game; and this is true of financial, just as much as of any other kind of economic, activity. If financial activity increases in the Continental financial centres, there will be increased activity also in London. And the converse is equally true. It is in this sense that the City is a major European, not simply a national, asset.

The Bank's role in the preparations for the euro

19 But London does not hold its pre-eminent position as of right. It continually has to earn it. As the Chancellor explained to Parliament, the financial services industry in the UK *"has the potential to thrive whether the UK is in or out of EMU, so long as it is properly prepared"*.

20 As we reported in our August edition, the Chancellor has confirmed the Bank's role in informing and co-ordinating preparations in the financial sector for the introduction of the euro. The Bank's role involves:

- Ensuring that the necessary UK infrastructure is developed to allow anyone who wishes to use the euro in wholesale payments and across the financial markets to do so from the first day of EMU: this means that our attention remains focused primarily on the wholesale financial sector.
- Helping the UK financial community in particular to prepare for the introduction of the euro by: explaining, as widely as possible, the relevant issues and how they are progressing; identifying areas for co-ordinated activity and cross-fertilisation; stimulating work, where necessary, within the private sector; and identifying and, where appropriate, filling gaps in the preparations.
- Promoting discussion between the European Monetary Institute (EMI) and NCBs with market participants across Europe about practical issues on which the market is seeking a degree of consistency and co-ordination, but on which no single authority has the sole power to take decisions.

21 The preparations are gathering pace and all of the major financial institutions operating in London which the Bank has consulted have confirmed their expectation that they will be ready for the introduction of the euro at the beginning of 1999.

22 The Bank will be holding a symposium on 20 January on ‘London as the international financial centre for the euro’. The theme of the symposium will be: ‘London will be ready’.

Particular points to note in this edition

23 This edition of *Practical Issues* follows a similar format to previous editions. The highlights in each area are summarised in bullet point form at the beginning of the Chapters.

Circulation and comments

24 We would welcome assistance in circulating our series of *Practical Issues* papers as widely as possible. Copies, including in bulk, may be obtained from the Bank’s Public Enquiries Group (tel no: 0171-601 4012; fax no: 0171-601 5460). They are also available on the Internet at (http://www.bankofengland.co.uk). The Bank is prepared to make available to institutions copies for them to supply to their overseas offices. It reserves the right to charge for supplies in bulk.

25 We continue to welcome comments on the practical preparations for the introduction of the euro, both in relation to the work which is already under way and any potential gaps. Comments, and requests for information or assistance, should be addressed to John Townend, Deputy Director, Bank of England, Threadneedle Street, London EC2R 8AH (tel no: 0171-601 4541, fax no: 0171-601 5637). We plan to publish our seventh edition in this series in the early spring.

CHAPTER 2: ARRANGEMENTS FOR WHOLESALE EURO PAYMENTS AND SECURITIES SETTLEMENT

- CHAPS euro will be available to make euro wholesale payments within the UK, and cross-border to and from the UK, from the start of 1999.
- The ability of CHAPS to develop a robust, resilient and efficient euro RTGS system is demonstrated by the performance of the sterling RTGS system: this settles in real time the highest daily average value of transactions in the world outside the USA.
- The Bank's objective remains to make TARGET as a whole as efficient and attractive to users as possible.
- The terms of access to intraday credit from the ECB within TARGET remain undecided: the Bank continues to hope that a co-operative solution will prove possible.
- Whatever the outcome on intraday credit from the ECB, commercial banks operating from the UK will still be able to make and receive TARGET payments; this may involve scheduling payments or obtaining their own credit where needed. In addition, the Bank is continuing to explore the possibility of providing its own credit if necessary.
- Irrespective of the rules governing the payments systems, there will be active euro markets in the major international financial centres outside the euro area. Payment and settlement, as now, will take place by the most efficient, reliable and competitive routes. A variety of such routes will be available from London.

A CHAPS EURO

The development of CHAPS euro

1 Real-time gross settlement (RTGS) payments systems offer considerable advantages. In particular they are safer than net end-of-day payments arrangements, because they eliminate the exposures which banks build up in such systems between each other during the day. The Bank sees significant attractions in RTGS systems and wishes to promote their use for high-value transactions. The sterling RTGS system has been a great success, and the Bank welcomes CHAPS' decision to develop a similarly safe system for making wholesale euro payments, CHAPS euro.

2 The preparation of CHAPS euro, which has been described in previous editions, has gathered pace and remains on schedule. CHAPS euro will provide its member banks with a UK facility to make wholesale euro payments from the beginning of 1999; and they in turn will be able to provide a full euro wholesale payments service to their customers. Whereas a further degree of complexity had earlier been added to the preparations by the need to prepare for both UK 'in' and 'out' scenarios, the Government's decision not to participate in EMU in 1999 allows attention to focus in the immediate future exclusively on the UK 'out' scenario. It is now clear that CHAPS euro will operate alongside the sterling RTGS system, in parallel.

3 The technical specification of CHAPS euro was summarised in the August edition, and there have been no material changes. The CHAPS euro project has already moved to its implementation phase, with testing recently being initiated.

4 CHAPS euro will enable euro payments to be made both domestically between its members within the UK and between those members and members of other RTGS systems elsewhere in the EU through TARGET (which connects EU RTGS systems), thereby enabling participants to move funds throughout the EU in real time. CHAPS euro will be an attractive payments system for a number of reasons.

5 First, the CHAPS Company's ability to build, with the Bank, a highly efficient and resilient RTGS system is evident from its proven track record with the sterling RTGS system. This has now been functioning smoothly for over eighteen months. During this period it has been by far the highest volume RTGS payment facility anywhere in the EU, with peak daily volumes of some 135,000 payments worth around £225 billion. Only Fedwire in the USA currently processes more value in an RTGS structure anywhere in the world.

6 CHAPS euro is being built flexibly so that its capacity can increase with demand. The response times for euro payments between two UK domestic counterparties will be as rapid as in the current sterling system. Response times for cross-border payments within TARGET will necessarily depend on the performance of the other RTGS systems involved in receiving or sending the payments.

7 Second, whilst the pricing of cross-border payments within TARGET will be determined centrally by the ECB, within the range 1.5-3 euro, the pricing of payment transfers within national RTGS systems is for national decision, although the EMI has said that 'the price of domestic and cross-border transfers in euro should be broadly similar'. The pricing structure within CHAPS euro will aim to be competitive. Third, the Bank is working with CHAPS to ensure that the arrangements for providing collateral to the Bank to secure its euro exposures to individual banks will operate as smoothly as possible.

8 Fourth, in response to market demand, it is likely that CHAPS euro will be open on every day that TARGET is open, ie every week-day except Christmas Day and New Year's Day, even when it is a public holiday in the UK (see below); and for the full time each day normally allowed by TARGET (ie from 7.00 am to 6.00 pm Frankfurt time). In order to anticipate this, the opening hours for CHAPS sterling are being similarly extended next year.

9 And fifth, wider direct membership will be encouraged. Applications for direct membership from overseas banks on a remote basis will also be allowed although, given the number of banks already operating in London, this option is unlikely to be required by a significant number of banks. However a few of the Continental banks expressing an interest are doing so on this basis, since they can use the same system as they require to connect to the EBA Clearing, which is similarly based on S.W.I.F.T.'s FIN Copy product. The Bank will need to be satisfied in any such cases that, if it were to provide settlement accounts to banks on this basis, it would not itself be exposed to additional risk, including of a legal nature.

10 Around 20 international banks, in addition to the present 16 sterling settlement banks, have expressed interest in becoming members of CHAPS euro, with a number already making a firm

commitment to do so. As with CHAPS sterling, access to CHAPS euro will be on a two-tier basis, with settlement members and participants, but there are likely to be more direct participants in CHAPS euro than in CHAPS sterling. Membership of the CHAPS Company is available to banks wishing to operate in either or both currencies. In addition to the international players interested in becoming settlement members, it is expected that there will be some 300 participants with indirect access to the CHAPS euro system.

11 The CHAPS Company is encouraged that there is such a widespread demand for the euro service that it is developing; providing access over a standard banking interface allows banks to become direct members at a low cost, with minimal change to their systems. Decisions on the entry fee for CHAPS euro membership will be made shortly, but the level is expected to be only a fraction of the cost of joining the present CHAPS sterling system.

Access to intraday credit

12 There remains a question over the form in which intraday credit will be provided within CHAPS euro, which is dependent on decisions about TARGET yet to be taken. These are likely to have to await resolution by the ECB.

13 We hope that TARGET will be highly efficient and quick, so that banks will choose to use it for high value payments. In our view this argues against unnecessarily restricting access to intraday credit for *any* user of the system (see box). However we recognise that some likely members of the euro area have concerns about access by ‘out’ NCBs to unlimited intraday credit from ‘in’ NCBs, and we are continuing to explore ways in which these can be met in order to allow ‘ins’ and ‘outs’ to be treated equally. The EMI has announced three possible techniques to deal with ‘spillover’ risk, as described in previous *Practical Issues*; and the technical specification of CHAPS euro is being designed to accommodate any of them.

A SUMMARY OF THE BANK’S VIEWS ON INTRADAY CREDIT IN TARGET

1 The Bank is an enthusiastic supporter of TARGET because it will be the safest cross-border system for euro payments, extending for the first time across national boundaries the systemic risk reduction benefits currently available in national RTGS systems through the elimination of inter-bank receiver risk. So it is an important part of the EU infrastructure for the next millennium, underpinning and supporting the Single Market.

2 But TARGET will be only one among a number of competing systems for making euro cross-border payments. All of the current arrangements, including using other group entities as correspondents or third-party correspondents, or remote access to overseas domestic clearing systems, will continue to be available; as will the euro successor to the EBA’s net end-of-day ECU clearing.

3 Against these other routes, TARGET will be safer but probably relatively expensive. Because RTGS systems make explicit the intraday credit which is implicit in net settlement systems, they run efficiently only if a supply of credit is readily available. But the collateral which banks are required to provide to secure this necessary intraday credit involves a

significant opportunity cost. Moreover RTGS systems are likely to have rather higher transactions costs because they have to be built to high standards of robustness and capacity to sustain their real-time capability.

4 Commercial banks individually tend to value highly the speed of RTGS systems, but intraday finality and the public good of minimising systemic risk are less valued by them than by central banks. So for some payments, some banks may choose CHIPS rather than Fedwire in the USA or EAF2 rather than EIL-ZV in Germany. In our experience, central banks have to work hard to persuade banks to use RTGS systems in preference to the alternative cheaper, but more risky, methods of payment.

5 TARGET will have to be promoted as a premium service but, as such, it must be at least as robust, reliable and efficient as its competitors (as well as competitively priced) to attract business. This means that payments must be able to flow freely throughout the entire system. Any restrictions on access to intraday credit by ‘out’ NCBs will have the effect of delaying payments, initially from ‘out’ banks to ‘in’ banks but ultimately for all participants - including within the euro area - because they represent ‘grit’ in the mechanism of RTGS. Any such restrictions would also have the effect of making ‘in’ banks bear a disproportionate share of the costs of obtaining intraday credit; and make less attractive the whole TARGET system, for ‘in’ as well as ‘out’ banks.

6 Nevertheless a number of countries in Europe have reservations about allowing EU countries outside the euro area access to TARGET, and specifically to intraday NCB credit, on the same terms as for countries within the euro area.

7 First, they wish, naturally, to protect the monetary policy of the euro area and to ensure that it is not disturbed by developments outside. This is a legitimate concern. The Bank believes that only if any intraday credit were to become extended into overnight credit could it affect the overnight or other short-term interest rates which are the fulcrum for monetary policy; and that effective mechanisms can, and should, be established to ensure that no such spillover would in practice occur outside the euro area.

8 Second, there is a concern that external euro activity might complicate the monetary policy of the euro area. Given free capital movements, however, it is inevitable that there will be a ‘Euro’ (ie offshore) euro market in the international financial centres outside the euro area, and this is most unlikely to be reduced by the imposition of restrictive regulations or controls. Lack of access to RTGS facilities for dollar, yen or Deutschemark payments currently, for example, does not deter their use now in the major international financial centres. Any restrictions on access by ‘out’ NCBs to intraday credit in TARGET might simply, at the margin, change the form, and the route, by which payments and the settlement of trades in the ‘out’ Member States would be made, away from TARGET to less safe routes. Nevertheless ‘out’ Member States might be able to help the euro area, for example, to monitor ‘Euro’-euro activity so that it could be taken into account by the ECB in setting the appropriate monetary policy for the euro area.

9 Third, there is an understandable desire to ensure that a level playing-field is established, so that banks within the euro area and banks outside compete fairly for euro business. The

Bank is sensitive to this concern. And fourth, there may be a worry that, if there were to be some kind of financial crisis, speculative flows could be exacerbated by euro activity in 'out' Member States. The ECB might reasonably look to 'out' NCBs for assistance in ensuring that the effectiveness of any policy response which it made was not capable of being undermined because of the structure of payments arrangements in 'out' financial centres.

10 The Bank hopes that it will prove possible to accommodate the euro area's concerns so that unlimited access to intraday credit may be granted for all users of TARGET. The Bank, for its part, will continue to work constructively towards this solution, so that an efficient TARGET system can be established to the benefit of the EU as a whole.

14 If access to intraday credit to 'out' NCBs were ultimately limited by the ECB, CHAPS euro would need to deploy one or more of the following techniques, all of which are technically feasible. Although ideally any RTGS system, or a linking of RTGS systems, should involve co-operative behaviour amongst banks, one inevitable consequence of differential treatment would be that more of the burden of accessing intraday liquidity would be passed to 'in' banks.

(i) Minimising the need for euro credit:

- 'Out' banks could queue their payments where - as in most cases - they were not time-critical, until payments from 'in' banks were received within the day; 'in' banks would have to wait before receiving these payments and thus more of the need for intraday credit in the system as a whole would fall on 'in' banks. In the extreme, if all payments were queued, 'out' banks could operate with no intraday liquidity at all, nor any significant euro credit balances, but this would slow down the TARGET system as a whole and increase the risk of gridlock, and of congestion at the end of the day, which would damage TARGET's efficiency and attractiveness throughout the EU.
- Equally 'out' banks could encourage 'in' banks to send their euro payments early in the day from the euro area to assist in meeting any expected net euro outflows.
- It will also be possible to minimise the need in an 'out' country for euro credit from 'in' NCBs by distinguishing domestic transactions from cross-border transactions with 'ins'. A way of doing so is being developed in CHAPS euro. Only cross-border transactions strictly require euro cash within the rest of the TARGET system to effect the payments: purely domestic transactions, between two local counterparties, can be effected across the local 'out' NCB's books without any need for euro liquidity which originated in the rest of the system.

(ii) Making the necessary euro liquidity available through alternative means, including the following:

- 'Out' commercial banks could themselves hold euro deposits within the euro area, which 'in' banks would be required to do if the ECB were to impose a minimum reserve requirement, and these could be drawn down intraday.
- 'Out' banks could mobilise their eligible collateral held within the euro area at the relevant local NCB at the start of the business day and have the resulting liquidity

remitted through TARGET to their account at the Bank of England for use in CHAPS euro.

- 'Out' commercial banks could borrow any necessary euro from banks within the euro area, intraday or at any longer maturity and through a number of possible routes and instruments.
- Or the Bank of England may provide the necessary liquidity, in whole or in part, from its own euro resources.

15 CHAPS euro is being designed to ensure that any of these options can technically be accommodated. The list is not meant to be exhaustive. The precise manner in which liquidity could be provided in CHAPS euro if it were not made available by 'in' NCBs, will continue to be analysed by the Bank and CHAPS but, as noted in the August edition, the ultimate outcome remains the subject of discussion and negotiation at the EMI/ECB. A definitive solution cannot therefore be announced until that process is complete, in 1998, even though this would be very late for planning and preparation. The Bank remains committed to ensure that UK-based banks will have the full range of payments options available to them. We will do all we can to ensure that CHAPS euro and TARGET are successful and become the system of choice for the majority of the highest value euro payments.

B TARGET

16 Whilst there has been no further progress on the intraday liquidity question since the August edition, discussions at the EMI on TARGET have continued, focusing on the myriad of detailed technical aspects necessary to progress the project. Many of these were covered in the EMI *Second Progress Report* on TARGET, published in September, and the accompanying technical documents on the *Interlinking Specification*, *Minimum Common Performance Features of RTGS Systems* and a *Data Dictionary*, all of which were revised versions of papers first published in August 1996. The EMI and NCBs have also made available a description of the proposed end-of-day procedures in TARGET, which are designed to ensure that the TARGET business day is completed in an orderly, timely and irrevocable manner.

The Second Progress Report

17 The *Second Progress Report* covers pricing policies, operating days and access to intraday liquidity. It confirmed that:

on *operating times:*

- The normal operating hours will be from 7.00 am to 6.00 pm European Central Bank (ie Frankfurt) time.
- In addition to Saturdays and Sundays, there will be two common holidays for TARGET, on Christmas Day and New Year's Day: on other business days TARGET will be open, although some national RTGS systems may close on local public holidays.

on *pricing policies:*

- There will be a common cross-border price for TARGET transfers, to be determined by the ECB within the range 1.5-3 euro, based on the principle of full cost recovery.

on *access to intraday liquidity:*

- Three possible mechanisms are being prepared to prevent intraday credit, if provided by euro area NCBs to non-euro area NCBs, from spilling over into overnight credit (see above). The final decisions will be made by the ECB.
- As reported in the August *Practical Issues*, the third mechanism, which relates to earlier cut-off times in 'out' countries, has been refined. It would not apply to the processing of payments by 'out' NCBs, but simply to their use of intraday euro credit: so beyond a liquidity deadline, in order to continue making euro payments, 'out' NCBs would have to be in positive euro balance with the euro area as a whole.

on *the role of the ECB*:

- It will provide end-of-day, and possibly other control, procedures for TARGET.
- It will provide settlement services to cross-border large-value net settlement systems including for the EBA (see below).
- It will process payments for its own account.
- And it will possibly maintain accounts for certain international customers.

and finally, to ensure that *TARGET is ready on time:*

- All NCBs will ensure their RTGS systems are ready by end-1997.
- Testing, which began in mid-1997, will continue through to mid-1998 when the simulation phase will start: all NCBs will be ready to take part by September 1998.
- And the technical specification of TARGET/Interlinking is in principle frozen until the start of Stage 3.

18 The *Second Progress Report* on TARGET, as expected, drew attention to the need for the timely implementation of TARGET and stated that to this end all NCBs must ensure that their euro RTGS systems were operating by the end of this year, to enable testing with the EMI's Test Centre, and also that all NCBs should be ready to participate in the simulation phase (due to start in July 1998) no later than 1 September 1998. The UK will be. However it is now clear that not quite all countries will have either their domestic RTGS systems or TARGET components ready for testing on schedule; and, more critically, there will be a few countries that will not be able to embark on the simulation phase until the final quarter of 1998. There will thus be very little time for full multilateral testing and, as noted in the last edition, there is simply no room for any further slippage. In this context, the Bank of England has continued to emphasise the importance of a detailed critical path plan. The EMI intends to adopt such a plan within the next month or so. It should be a crucial management tool for NCBs and the EMI.

19 Further policy decisions and technical information will be published by NCBs and the EMI as and when it seems helpful to the market. The Bank will continue to report on these developments in this *Practical Issues* series.

Other issues

20 Discussion has continued on a number of other open TARGET issues. Legal documentation for TARGET is currently being drafted and an ECB Guideline to cover the main Interlinking rules will be finalised by early next year. The main issues still being debated are the provisions on payment finality, including the precise nature of the situations where a liquidator would be able to unwind payments already entered into the system (it is clearly important that such situations are restricted as far as possible, while allowing unwinding in obvious cases such as fraud, criminal activity or error). Other elements still under discussion are enforcement issues (eg who can enforce performance by an NCB of its obligations, and how), the associated issue of what standard of care is required from an NCB in the performance of its obligations, and what is the effect of *force majeure* events putting that performance outside its control. Provisions on the law governing a TARGET payment also remain to be clarified.

21 Meanwhile a proposal for the TARGET service level which NCBs will offer their RTGS members is also almost finalised: it will cover main aspects of the proposed service level in a normal business day (eg operating time, availability of the system, capacity, security, irrevocability and finality) and in abnormal circumstances (including a delayed closing time procedure), and it will also outline briefly the responsibilities of RTGS participants themselves. Discussion is either proceeding or has still to start on contingency procedures: eg what can be done if a Member State is not yet ready to connect to TARGET (one possible solution would be the use of correspondent arrangements between NCBs). A high-level strategy for multilateral testing has been agreed, but the details of this as well as the simulation and migration of strategy have still to be worked out.

22 Other open issues include procedures for the daily management of TARGET (eg the role of each NCB's settlement managers and how they will communicate with each other in case of problems), and business arrangements for handling and returning unapplied payments.

Relationship between TARGET and securities settlement systems

23 Discussions are currently under way on the extent to which the operating hours and days of securities settlement systems need to be co-ordinated with those of TARGET. This is particularly relevant in the context of the cross-border use of collateral under the Correspondent Central Banking Model (CCBM) agreed by NCBs as the principal means whereby banks will be able to mobilise collateral held in another Member State (and described in detail in the April edition of *Practical Issues*). In particular, on operating hours, there is a debate on whether Member States' central securities depositories will need to be open before the start of TARGET so that counterparties can deliver foreign securities using the CCBM in time for credit to be available at the start of the TARGET day: and on operating days, there is a concern that, if some markets are closed on days when other markets are open, securities held in those closed markets will not be available under the CCBM for use against intraday credit in a Member State whose TARGET components are open. In both cases the Bank's view is that, provided counterparties are aware of the operating hours of foreign markets, and the days on which these markets will be closed (so they can ensure that securities are predelivered or that adequate securities are available in markets which are open), there should be no problem.

C EBA

24 The Euro Banking Association (EBA), formerly the ECU Banking Association, published in October literature describing its net euro clearing system[1]. The EBA views its proposed same-day value system as complementary to TARGET, providing volume clearing facilities for all 15 EU Member States through over 60 major banks operating in Europe, and initially focusing particularly on cross-border euro business.

25 The system features include, for risk management purposes, commercial intraday binding limits, debit caps and credit caps to control individual banks' exposures during the day before net settlement takes place. The EBA members have agreed that a collateral cash pool of €1 billion will be maintained. It would enable the EBA to inject the necessary liquidity into the system to complete settlement at the end of the day in the event that a participant failed to meet its obligation due to insolvency or an inability to borrow sufficient funds in the market. The EBA will have to demonstrate, *inter alia*, that this mechanism will operate effectively in Stage 3 in order for the clearing to achieve the necessary compliance with the Lamfalussy standards. Discussions are continuing between the EMI and the EBA on where this cash pool should be held, and under what terms.

26 The EBA clearing is based on an innovative legal structure, the 'Single Obligation Structure', which seeks to establish that the clearing between members occurs continuously as messages are exchanged between them, with the eventual single obligation being settled at the end of the day. In legal terms, the end-of-day payment is intended to be settlement of the final obligation due between each member and all other members, as calculated at the end of the clearing day, with the EBA acting as a settlement agent. In economic terms, the final single obligation is equivalent to the net amount due that day to or from a member to all other members. It is clearly essential that the legal basis, and in particular the concept of the single obligation, must be robust in all relevant jurisdictions. EU NCBs are obliged to come to a view on this question as part of the process of assessing the compliance of the EBA arrangements with the Lamfalussy standards. The Bank of England has been involved in constructive discussions with the EBA about the robustness of this approach under English law prior to implementation of the Settlement Finality Directive currently under discussion in the EU. It will be important to ensure that the EBA is covered by this proposed legislation.

27 The EBA currently operates an ECU clearing which settles across accounts held at the Bank for International Settlements. After prolonged discussion at the EMI, the Council agreed in September to adopt the centralised single settlement account model for the euro clearing, under which the ECB will hold a central settlement account for the EBA through which the vast majority, and possibly all, EBA banks are expected to settle. The Council also agreed to allow those NCBs which wish to do so to open an EBA account in their own books through which their local EBA banks can settle. Discussions are continuing in the EMI and with the EBA on the details of the settlement process. The aim is to ensure that this compromise *a la carte* solution operates in an entirely non-discriminatory way, so that any NCBs which opt for the decentralised arrangement will not be allowed to operate their local EBA settlement account independently of the overall EBA settlement. On this basis the Bank, after taking soundings of the UK EBA banks, can see no tangible advantage, but some added complication, from adopting a decentralised local sub-clearing; and is therefore minded to adopt only the single settlement

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1 Copies may be obtained from EBA, 4, Rue de Galliera, F-75116, Paris - fax: 33-1-53670707.

account approach. The Bank will also seek to ensure that the settlement arrangements do not discriminate in any way against EBA banks based in ‘out’ countries.

CORRESPONDENT BANKING

1 The introduction of the euro offers scope to rationalise correspondent banking arrangements, although this is unlikely to happen fully at the start of Stage 3.

2 Many cross-border payments are currently processed initially via accounts denominated in likely ‘in’ currencies and held by banks with other banks for this specific purpose - so-called nostro (‘our account with you’) accounts - before being submitted to the clearing. Banks have at least one nostro account for each EU foreign currency, and sometimes more - either to segregate certain types of payment or for historical reasons (eg for reciprocity purposes). Banks which do not have direct access to their domestic payments system may also have nostro accounts in their domestic currency with a bank which does.

3 Given that the UK will not be an initial participant in Stage 3, sterling nostros are not expected to be affected. However, nostro accounts in the participating national currencies will become multiple accounts in different denominations of the same currency, which could be inefficient and risk complicating the cash management process. All wholesale clearing systems will operate in euro and most, and possibly all, will be able to handle ‘in’ denominations as well. Thus if multiple nostro accounts are held, how will payments be routed, to which account will receipts be requested, and how will funding of multiple accounts be achieved?

4 Banks will face a number of possible options. They could:

- Open new nostros in euro to run in parallel alongside each existing nostro account in a participating currency, with outstanding and new transactions in national denominations being paid or received on the old account and new euro transactions being paid or received on the new account. The old accounts would only be closed when transactions in national denominations cease.
- Convert each nostro in a participating national currency to euro, where necessary, and convert all items on receipt into euro.
- Leave the old nostros unchanged for the clearance of outstandings, closing them only when they become dormant, but open a new euro nostro with just one bank for new business and for settlements after 1 January 1999, with both euro and national denominations being paid out of, or received into, the euro account.
- As above, but open a range of national currency accounts and the euro account with just one bank.
- As for the last two options above, but close old nostros so that outstanding items need to be cleared via the new bank.

5 There are many factors to consider in making the decision, so this may vary from one branch/entity of a bank to another:

- Whilst wholesale clearing becomes ‘pan-euro’ from 1 January 1999, the same is not true for all banking activities, eg cheques and mass payments. Multiple nostros may need to be retained for these purposes.
- Full migration to euro nostro accounts for the first day of Stage 3 is likely to require greater planning and preparation than remaining with national currency accounts, augmented by a euro account for euro-denominated business.
- The number and type of accounts outstanding.
- The business mix and systems/operational environment of the branch/entity.
- The services available from potential providers. Fundamental changes are taking place and it is important to verify that providers have the required level of service, eg on all euro working days.

6 It is evident that large-scale changes in bank relationships are likely from 1 January 1999, responding to the fundamental changes taking place in wholesale cash clearing. Banks need to be explicit in their notification of changes, and counterparties must be vigilant in their responses. This should help to minimise the risks on and after 4 January 1999.

D SECURITIES SETTLEMENT IN THE UK

28 Following the Government’s clarification of the UK position, CMO and CGO are considering the desirability of, and probable demand for, facilities to settle euro-denominated securities in a UK ‘out’ scenario from 1 January 1999.

29 It is clear that a facility to allow settlement of euro-denominated securities in the money, bond and equity markets should be available in the UK from 1 January 1999; but there are a number of alternative possibilities and these are currently being examined in the light of the Chancellor’s October statement.

30 CMO had in any event been consulting its members on their likely demand for a euro service. A consultative paper was issued in August entitled *CMO and the euro.* The majority of those who responded indicated support. Because CMO can only settle non-fungible paper, like eligible bills and CDs, further discussions will be pursued to establish how much of such paper denominated in euro will need to settle in the UK. If there is likely to be sufficient demand to warrant such a facility, a ‘clone’ of the CMO will be developed, as described in previous *Practical Issues,* to operate in parallel with, but discrete from, its sterling counterpart. Such an approach would also facilitate a seamless transition to the single currency for CMO, should the UK join EMU at a later stage.

31 Demand for settlement in the UK of fungible euro market instruments can be satisfied by other settlement systems, including CGO and/or CREST.

32 In the light of the Government’s decision initially to opt ‘out’, plans for the conversion of CMO to a single euro-denominated system, which were being prepared against the possibility of the UK joining at the start of EMU, have been set aside.

33 The CGO service upgrade, which went live on 10 November, includes multi-currency software which may be used to provide dual-currency functionality from 1 January 1999. This functionality is capable of handling transactions in either euro or sterling-denominated securities, and could offer members the option of settling trades against sterling or euro consideration.

34 CGO is now reviewing the options for its service in the light of the Chancellor's statement. The options need to be assessed in the context of a possible merger in the medium-term between systems which currently handle the different types of security (CGO/CMO/CREST). Such a merger would have strategic attractions but would not be possible before 1 January 1999.

35 CREST is already a multi-currency system, settling securities denominated in sterling or Irish pounds against payments in sterling, Irish pounds or US dollars; and will settle euro-denominated securities from 1 January 1999. CREST will offer euro as an additional settlement currency.

E SETTLEMENT OF NCB OPERATIONS IN EMU: EMI PREPARATIONS

36 EMI preparations for securities settlement are focusing on three issues:

- The definition of the procedures to be used for the settlement of operations involving eligible collateral located outside the country of the NCB that advances the credit: ie the Correspondent Central Banking Model.
- The establishment of standards against which to assess which securities settlement systems will be eligible for use in the settlement of NCB operations from the start of Stage 3.
- Consideration of the procedures which NCBs may use in the medium-term for the settlement of cross-border collateral transactions: ie alternatives to the Correspondent Central Banking Model.

The Correspondent Central Banking Model (CCBM)

37 As reported in earlier editions of *Practical Issues*, NCBs will use the CCBM where they advance credit in monetary policy operations or for intraday liquidity needs in TARGET against eligible collateral held in a securities account abroad (for operations involving collateral located in the home market of the central bank, existing settlement arrangements will be used). Each NCB will act as correspondent (ie as local agent) to the others for the delivery of securities in its local market. The objective is to ensure that all assets on the ESCB's Tier 1 and Tier 2 eligible collateral lists can be mobilised by all ESCB counterparties in the settlement of credit operations, wherever those assets are located[2].

38 The main features of the NCBs' procedures in operating the CCBM (eg roles of lending and correspondent NCBs, S.W.I.F.T. message flows etc) have now been finalised. Timetables for the settlement of operations in foreign collateral under the CCBM are now being prepared to reflect the daily schedules of each national market (deadlines for input of trades into settlement systems, the time at which settlements are final etc) and the time required for NCBs to process message

2 Details of the categories of asset that will be eligible for use in ESCB operations are set out in the EMI publication *General Documentation on ESCB monetary policy instruments and procedures* page 37-46; counterparties will in principle be able to use all assets on a cross-border basis, although cross-border use of 'foreign assets' (those issued by a borrower outside the euro area denominated in a currency other than the euro or located outside the euro area) may not be allowed.

flows. It is unclear whether it will be possible for counterparties to use foreign collateral in all national markets for all types of ESCB credit operation without having to deliver the assets to NCBs in advance (ie predeposit them). Guidance on these issues will be published by the EMI in due course.

39 Further details of the scope of the model have also been agreed: for example, 'out' NCBs will act as correspondents to 'in' NCBs, if eligible assets on 'in' Member States' Tier 2 lists are located in an 'out' Member State. (It is not clear yet whether any NCB that will be 'in' from 1 January 1999 will place UK assets on the eligible collateral list.) 'Out' NCBs that wish to take 'foreign' collateral against any intraday liquidity provided in TARGET can in return call on the services of 'ins' if they wish. In addition, eligible securities held in the International Central Securities Depositories (Euroclear and Cedel Bank) may be mobilised there using CCBM procedures, although it is likely that many NCBs will choose to take securities directly on to their accounts there, without the use of another NCB as correspondent. Otherwise this will be the NCB of the country of issue of the securities or the National Bank of Belgium or the Luxembourg Monetary Institute. Procedures are still being defined for the cross-border use of certain eligible non-marketable assets; the main issue is how to mobilise ESCB counterparties' claims on French corporates, which the Bank of France has said it will place on its Tier 2 list.

Standards to be applied to settlement systems

40 Assets included on the ESCB list of eligible collateral may be mobilised only in settlement systems or depositories that meet certain risk-related standards. The scope and content of these standards have now been agreed, following discussion with system operators, and a paper will be published by the EMI in January. The standards are aimed at limiting the ESCB's risks in settling operations and in holding securities in depositories. They will address the key risks that users of securities settlement systems face, including:

- *Legal risk:* the legal basis of central banks' entitlement to securities held within a system will have to be sound (eg it must confer a proprietary right rather than a contractual claim on the system operator), as will the legal basis for finality of deliveries in the system.
- *Settlement risk:* DVP procedures will be used only against settlement in central bank money; in the medium-term, the ESCB will expect systems to operate on the basis of real-time DVP.
- *Custody risk:* system operators will have to show that the risk of loss due to insolvency, fraud or negligence on the part of a depository (or a third party appointed by it) has been addressed, eg through segregation of participants' securities from those of the system operator or any sub-custodian it may use.

41 Only systems that are subject to external supervision will be used (except of course where a system is run by a NCB). Operating hours and days will have to meet NCBs' needs in respect of TARGET, and the technical facilities should have a proven reliability and back-up capability. Finally, systems will be required to have established risk management procedures to cope with defaults.

42 After publication of the standards, there will be a process of assessment of systems' compliance with the standards leading to publication of a final list of eligible systems in the

second half of 1998. The assessment process will take into account the limited changes that systems can reasonably be expected to make before the start of Stage 3. An important element of the assessment will be an examination of the reliability of the links between CSDs.

Alternative (or longer-term) approaches to cross-border transactions

43 The CCBM was chosen by NCBs because it will ensure comprehensive access to collateral located abroad with minimum technical development before the start of Stage 3. But it is not the only approach that will be used for cross-border collateral transactions. As mentioned above, it will not always be used where securities are mobilised in the ICSDs.

44 Alternatives to the CCBM are now increasingly available to NCBs: national depositories are planning to enhance their links between each other, and in many cases to build new links, although it is uncertain to what extent these will have been completed by the start of Stage 3 (see below on the initiative of the European Central Securities Depositories Association - ECSDA). These links will enable NCBs to take delivery in their local CSD of securities issued into foreign systems. The ICSDs already have links to all national markets in the EU. Opportunities for remote membership of CSDs are opening up as a result of changes in CSDs' membership policies in favour of foreign participants, as well as technological development.

45 Nor is the CCBM the only procedure that counterparties may want to use to mobilise collateral located abroad in ESCB operations: they may prefer to take advantage of the TARGET system to obtain credit from the NCB of the Member State in which they hold eligible assets and to use a TARGET payment to transfer the cash to wherever it is required.

46 The implications of these developments for the choice of procedures for use in cross-border collateral transactions will be reviewed and a further EMI paper published next year. The EMI is planning a seminar in the New Year to discuss the issues with settlement systems operators, potential ESCB counterparties and others.

F THE ECSDA INITIATIVE

47 As reported in the August edition of *Practical Issues*, the new association of private sector CSDs, the ECSDA, has been developing plans for comprehensive links between its member CSDs. CREST is the UK member of the association. The objective would be to enable potentially all ESCB collateral assets to be settled in each participant CSD regardless of where the assets were originally issued. A draft report was published in August setting out some high level proposals for such links. These proposals are now being elaborated in working groups considering specifically the legal and communication requirements of the model. The latter working group is chaired by CREST.

48 The ECSDA's plans are initially aimed at providing for the settlement of NCB transactions. This reflects the interest that the EMI and many NCBs have taken in the use of such links to replace in due course the CCBM: comprehensive links would enable NCBs to settle operations against any collateral asset on a DVP basis in their local CSD. But use of the links would not be restricted to NCB transactions. Initially, the model will provide only for free-of-payment deliveries between the participants of two different CSDs. But cross-system DVP would be

introduced as a second stage in the development of the links and the normal DVP arrangements would be available within each CSD.

49 The proposed links would be based on a cross-membership approach, under which each CSD would open an omnibus (ie nominee) account with each of the others, through which its own participants' holdings in securities issued into the other CSDs would be held. This standard approach may be varied depending on the requirements of securities and collateral law in each Member State (the use of an omnibus account may be inconsistent in some countries with legal requirements to segregate holdings of pledged securities in an account in the name of the pledgee). Participant CSDs will provide collateral management and custody facilities in securities held by their participants via a link.

50 The ECSDA will require those CSDs which wish to be members of their network to meet certain minimum standards. These will include standards related to risk management (which are likely to be similar to those referred to above that the EMI is developing). To avoid settlement risks, all participant systems will need to have RTGS facilities, providing for securities transfers to be settled against payment in central bank money and with intraday finality (ie without the possibility of an unwinding of the transfer later in the day). Participant systems will have to be subject to external supervision.

51 The ECSDA is now discussing its draft report with NCBs, including those like the Bank which themselves operate securities settlement systems, and with the ICSDs which are not represented in the association. It is unclear either how quickly in practice the links will develop, or the extent to which they will be based on standardised arrangements (eg for message flows or for providing collateral management services). Much work still needs to be done on defining the technical details of the links and on the legal aspects. The French CSD (Sicovam) and the German CSD (Deutsche Börse Clearing AG) have said that they plan to create a DVP link during 1998.

52 Although the impetus for the ECSDA initiative has come from the preparation for Stage 3, there is no reason to believe that UK systems will be precluded from participating in the links as a result of the Government's decision initially not to join. 'In' CSDs are likely to want links to UK systems, particularly if their NCBs include UK assets on the Tier 2 list. In the UK, CREST has made clear that they are interested in creating links to EU settlement systems as a means of developing their services to members. The Bank is participating in some of the technical discussions on the ECSDA initiative in order to keep open the possibility of CGO involvement.

53 The case for increased links between UK and foreign securities settlement systems will be covered in the Bank's forthcoming consultative exercise aimed at determining an agreed set of priorities for the future development of UK securities settlement systems.

G S.W.I.F.T. MESSAGE STANDARDS

54 S.W.I.F.T. has issued guidelines on how to use S.W.I.F.T. messages during conversion to the euro. These guidelines were endorsed by the S.W.I.F.T. EMU Standards Working Group, all major European custodians, and the International Securities Services Administration (ISSA) Board. In addition, S.W.I.F.T. has developed market scenarios illustrating the various

information flows during the transition period. These scenarios can be found in the S.W.I.F.T. Guide: *Converting to the euro*[3].

55 The changes to message standards to reflect the introduction of the euro are being kept to a minimum. No new messages or fields are needed; but new code words will be introduced in order to support the communication of 'Euro-Related Information' (ERI). In particular they will allow S.W.I.F.T. users to specify both euro and national currency values in messages if needed for settlement purposes.

56 The new currency code (EUR) is being implemented on the S.W.I.F.T. network. Since August 1997, it has been available for testing; from April 1998 it will be available for live use for settlement messages carrying a value date on or after 1 January 1999. (For each message, S.W.I.F.T. will check use of the EUR code against settlement date.) The EUR code can, however, be used for 1998 trade dates for non-settlement messages such as trade confirmations.

57 The national currency codes of 'in' currencies, and the XEU code for the ECU, will remain on the network until the maintenance agency of the ISO currency codes advises that they should be deleted.

58 ERI will allow transport of euro-related information, in particular the original currency and amount, and (for payments messages) optional transaction charges, in the free text fields of S.W.I.F.T. messages. Recently-developed messages already have the necessary fields for referencing a second currency. The basic principles of ERI are that:

- Its use is optional: institutions will decide with their correspondents if they wish to use it.
- It may only be used when the settlement amount is expressed in euro and the original amount is in an 'in' currency denomination.
- It may be used only in messages which do not have an existing field to specify the information.
- It is for information purposes only, so that in the case of a discrepancy between the ERI and the settlement amount (or net proceeds) message, the settlement amount will prevail.

S.W.I.F.T. has published a list of those messages likely to be used for ERI. S.W.I.F.T. advises, however, that users should not assume that a counterparty will automatically read ERI provided in free text fields. Messages can be processed without checking these fields.

3 The S.W.I.F.T. Guide, *Converting to the euro,* can be obtained from fax number +32 2 655 4459 or e-mail address euro@swift.com

CHAPTER 3: FINANCIAL MARKETS AND EXCHANGES

- The EMI Council and the Commission have welcomed market associations' proposals for harmonised market conventions for the euro. To achieve harmonisation in practice, the proposals now need to be adopted by issuers.
- The Bank and the BBA support the proposal that the euro should be quoted against sterling on the basis that '1 euro = £x'. It is recommended that all those operating in London adopt this convention to avoid the risk of confusion and error.
- Plans in London for euro LIBOR are clear. The market needs to know urgently how disappearing price sources will be treated elsewhere.
- The market also needs to know urgently how 'in' governments intend to redenominate their outstanding securities.

A FINANCIAL MARKETS

Harmonised market conventions

1 The EMI Council decided in September to 'welcome and support' the harmonised market conventions proposed by the market associations, and the Commission has also endorsed them[1].

2 Issuers now need to adopt the recommended conventions in practice. Most EU governments have either already decided to use the harmonised conventions for new government debt in euro (Belgium, Finland, France, Luxembourg, Portugal, the UK), or they are currently studying the question (Austria, Germany, Italy, the Netherlands, Spain and Sweden). IPMA intends to produce a manual for issuers of euro securities shortly. ISMA also plans to publish recommendations before end-year on how to trade euro bonds. Both of these documents will be consistent with the agreed market conventions.

Quotations for sterling

3 The Bank of England and the BBA support the recommendation, made by market associations and endorsed by the EMI, that the euro should be quoted in foreign exchange markets on a 'certain for uncertain' basis (ie 1 euro = x foreign currency units). The current basis for quoting *sterling* is not consistent with this recommendation (for example £1 = DM2.93). It is clear that on the Continent all euro quotes, including against sterling, will conform to the recommended harmonised convention ('1 euro = £x').

4 The Bank therefore proposes to adopt this convention in its own dealings in euro, including in its banking, foreign exchange and reserves management operations. And the Bank and the BBA believe that it would be helpful, in order to avoid the risk of confusion and errors that might arise if quotes were to continue simultaneously on both the present and recommended future bases, if all those operating in the foreign exchange market in London were to follow the Bank's

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1 'Recommended market conventions for the euro': *Practical Issues*, August 1997, page 31.

lead. A consistent approach to foreign exchange market quotation would also help provide clarity in other financial markets where products are priced directly or indirectly from foreign exchange rates.

5 The Bank and the BBA recognise that significant systems development may be required to introduce this change. That is why it is important to clarify the point now, to help those designing financial market screens and support systems to incorporate consistent presentation and methodology for euro exchange rates; and so that individual institutions can make the necessary amendments to their own internal systems.

6 It is also important to note that this proposed change in convention would *only* affect sterling quotations against the *euro*: sterling will continue to be quoted on its current basis against all other currencies, including any residual quotations during the transition period against national currencies which participate in the single currency (eg £1 = DM2.93). There is however also a question about the basis of trading the dollar against the euro, which market practitioners have yet fully to consider.

Disappearing price sources

7 The BBA has published its proposals for euro LIBOR following the consultation exercise referred to in the August edition. The BBA's proposals can be summarised as follows:

- When Stage 3 begins, the BBA will cease to fix LIBOR for the ECU and replace it immediately on the same screen page with a LIBOR fixing for the euro (one for one). The ECU LIBOR fixings on the last two London business days of 1998 will be for settlement in euro on the first two euro business days of 1999.
- Euro LIBOR will be fixed 'spot' (ie for value in two euro business days). If and when sterling becomes a participating currency, sterling LIBOR would be rebased on a spot basis. A cash (ie same-day settlement) euro fixing will also be provided if there is sufficient market demand. The BBA expects that euro business days will be those on which TARGET is open: that is, each weekday on which RTGS payments systems in at least two participating Member States are open. In practice, this is likely to mean every weekday except Christmas Day and New Year's Day. The BBA also expects that London banks will trade on each euro business day.
- The day-count basis for calculating interest accrual for euro LIBOR will be the actual number of days elapsed divided by 360. Sterling and escudo LIBOR rates, which are currently based on an actual/365 basis, will be rebased on an actual/360 basis if and when the currencies concerned participate in Stage 3.
- Euro LIBOR will be fixed on the basis of quotes from the London offices of 16 major banks active in the euro market at 11.00 am London time on all London or euro business days. The BBA will determine the composition of the panel next year. The panel will consist of banks which are broadly representative of the market's liquidity at the time. Foreign as well as domestic banks in London will be eligible. If there is a cash fixing, the panel may not be the same as for the spot fixing.
- Settlement rates for national currencies for which LIBOR is currently calculated and which participate in the euro will continue to be fixed during the transition period.

The rates for national currency units will be identical to those for euro units. There will not be separate panels for rates in national currency units. All rates in national currency units will be quoted on a 360 day basis.

8 While the position in London on the replacement of LIBOR is thus clear, this is not yet the case with price sources in some other centres. The EMI published in September a preliminary list showing which current price sources will remain in Stage 3, which will disappear and what will replace them. The list was based on information provided by market associations and NCBs. Market associations may update it as decisions are taken and more information becomes available. Decisions by price sponsors are needed by the market urgently, because screen providers, those promoting standard contracts and preparations in individual firms are all dependent on price sponsors' decisions.

9 Some specific issues remain to be addressed. A key issue for derivatives contracts is whether successor rates will be shown on the same screen page, as contracts refer to specific pages. The legal risk in replacing a price source appears to vary between jurisdictions. What is relevant is the jurisdiction specified in the contract rather than the nationality of the price source. Some lawyers consider that there are risks attached to the replacement of a price source based on a national panel by one based on a pan-European panel, such as EURIBOR. Legislation is under consideration in a number of Member States to overcome the problem. The risk would be reduced if the market regarded EURIBOR as credible.

10 The EBF and ACI are taking forward work on EURIBOR. They have agreed on the number of banks which will participate in the panel of reference banks. They propose that a system of national quotas will be used at the outset for banks in the euro area. If all Member States were to participate in the euro area, there would be 58 banks on the basis of national quotas. The banks will be selected at national level by the respective banking associations. In addition, 3 global banks from the USA, 2 from Switzerland and 1 from Japan will be invited to join the panel. A very limited number of banks may be added from non-participating Member States. If this happens, the total quota of 58 for participating Member States will be reduced. At a later stage, when a homogeneous money market is established in the euro area, the system of national quotas will be superseded by a mechanism of selection of sample banks which will depend solely on their activity in the markets, though with at least one bank representing each Member State in the euro area. Full technical details of EURIBOR, including the methodology for computation and the range of maturities, are expected to be made public soon.

11 ISDA proposes to amend the ISDA Master Agreement to include a contractual provision to specify what happens if a price source disappears, and give an option to change price source by mutual agreement. ISDA is also considering the practical problem of amending large numbers of existing contracts, and contemplating the use of a protocol which would allow firms to amend their master agreements with all signatories. The timing is tight. Even when decisions on the replacement of price sources have been taken, firms must still audit their transactions to see which of them are affected, amend agreements and undertake the necessary systems work.

12 A particular concern for IPMA relates to the price sources for FRNs and floating rate MTNs. Most of these use LIBOR, but a minority use other national price sources, and they are currently traded on the same basis. IPMA would prefer agreement on one or a small number of common approaches so as to avoid the need to consult bondholders on each issue. But the approach

adopted may have to vary depending on the language in the prospectus (eg if the prospectus refers explicitly to banks located in one centre) in order to reduce the risk of legal challenge.

Effective overnight rate for the euro

13 The EMI has responded positively to a market request that the ESCB help compute an effective rate for the euro area. The working assumption in the EMI is that market associations will provide the methodology to be used to calculate the average rate paid on all overnight deals undertaken by a defined set of banks. They will also decide the panel (which is expected to be the same as the EURIBOR panel), and they will publish the rate. The role of the ESCB will be to collect the data from the panel banks and to make the calculations.

Conversion of repo transactions

14 A market group in London, led by representatives of Morgan Stanley and Credit Suisse First Boston, has been considering the conversion of repo transactions which straddle the start of Stage 3[2]. The conversion of pending repo activity from the national ('legacy') currency to the euro is more complex than the conversion of pending cash trades. This is because any change to the repo trade details on internal computer systems has to be replicated back to the original transaction. Repos are often repeatedly rolled over. It is clearly undesirable to unwind a series of linked repo transactions. The group has therefore looked at alternative solutions.

15 Any solution to the repo conversion process should aim to avoid the need to reprice and reconfirm every pending repo trade on the first business day after the euro is introduced. It is therefore important that the conversion process should be *invisible to the market*. There should be no need to send amended trade confirmations or new clearing instructions to clearing systems or agent banks. Proposed solutions should be internal, in the sense that they are designed to create updated trade and accounting records on the computer systems of market participants, while any automated confirmations and clearing instructions arising from this activity are suppressed.

16 The group proposes a menu of three options, all of which are internal, and suggests that market participants should choose whichever option is most appropriate for their own volume of business and internal computer systems. It is not necessary to have a single solution. The menu of options is not intended to be exhaustive. It is important to note that the accounting entries shown for each option will vary according to the method used to reflect the conversion process on internal book-keeping systems.

17 The example chosen to demonstrate the three options is a German Government bond which is redenominated on 1 January 1999. The same process would apply to any other redenominated security, though no attempt is made in the examples to deal with the 'cashing out' of small odd lots from the redenomination process (ie where redenomination is to the euro rather than the euro cent). For bonds which are not redenominated, where only the cash amounts arising from the net proceeds of the repo transactions are therefore affected, the third option is not relevant, and the first and second options need to be modified to convert cash proceeds only.

2 Following this work, the Broker Group/ISMA Repo sub-committee is expected to publish before the end of 1997 a paper on *Impact of the introduction of the euro on finance trades*.

OPTIONS FOR PROCESSING REPOS OVER THE CONVERSION DATE

Example used in each option

Firm repo (sells on first leg, buys on second leg)
Repo trade date: 18 December 1998
Onside* value date: 21 December 1998
Offside* value date: 21 January 1999
Repo interest rate: 3.5%
Collateral: 10 million DM Bundesrepublic 8% 21 January 2002
Onside amount: DM 10,000,000
Offside amount: DM 10,030,138.89
Offside collateral (redenominated) in €: 5,086,413.07
Offside amount (converted) in €: 5,101,748.15
Euro/DM fixed conversion rate: 1.96602

* 'Onside' refers throughout to the start date of a repo; 'offside' refers to the maturity of a repo.

Option 1

The repo is not changed on conversion date. Two further outright trades are booked on 1 January 1999 for the same value as the offside of the repo. One outright trade exactly offsets the repo trade in legacy currency. The other outright trade reflects the actual settlement in euro. This option would suit a market participant with a relatively inflexible repo booking system, and low repo volumes. It assumes the most manual intervention on the offside settlement date.

Outright trade 1

Firm sell, dummy customer
Trade date: 1 January 1999
Value date: 21 January 1999
Nominal: 10,000,000 DM bonds
Amount: DM 10,010,138.89

Outright trade 2

Firm buy, dummy customer
Trade date: 1 January 1999
Value date: 21 January 1999
Nominal: 5,086,413.07 euro-denominated bonds
Amount: €5,101,748.15

Settlement method

1 January: none
21 January (DM cash & bonds): net offside repo proceeds against outright trade 1 (internal book-keeping only)
21 January (euro cash & bonds): settle outright trade 2 with counterparty

Main features of option 1

- does not require repo trade to be cancelled and corrected
- involves two dummy cash trades to be booked
- clearing instructions for dummy trades must be suppressed
- requires dummy cash trade to be 'settled'; audit trail is potentially confusing

Option 2

The repo trade in legacy currency is 'closed out' on 1 January 1999. A new repo trade is booked, using the net proceeds from the closed out repo, but converted to euro. The offside value date of the new repo is the same as the offside value date of the original repo. The new offside repo proceeds are pre-figured to agree with the original proceeds, converted from legacy currency to euro. The repo transaction is now accurately reflected on internal book-keeping systems as being denominated in euro from 1 January 1999. This option would suit a market participant with more automated computer systems and potentially with a higher volume of pending trades. It assumes a flexible repo booking system which allows offside cash proceeds to be over-ridden and repo interest rates to be imputed.

Original repo

Offside amount on 1 January 1999: DM 10,010,694.44
Repo interest rate: 3.5%

New repo

Onside amount on 1 January 1999: €5,091,857.89

Offside amount on 21 January 1999: €5,101,748.15

Converted nominal: 5,086,413.07

Repo interest rate: 3.5%

Settlement method

1 January (DM cash & bonds): convert proceeds of closed-out repo to euro (via internal book-keeping)
1 January (€ cash & bonds): net converted proceeds of closed-out repo against onside proceeds of new repo (internal book-keeping only)
21 January (€ cash & bonds): new repo settles in euro with counterparty

Main features of option 2

- Original repo trade is closed out on conversion date
- New repo trade is booked on conversion date
- Offside proceeds of *original* repo trade in legacy currency are paired-off against onside proceeds of *new* repo trade in euro, using internal book-keeping only; additional entries may be required to account for repo interest realised between the original onside date and 1 January 1999
- Offside proceeds of *new* repo are pre-figured to agree with the original repo trade, converted to euro
- Clearing instructions for the closing out of the original repo, and the booking of the new repo, must be suppressed

Option 3

The repo trade is left in the original currency until the offside value date. As the bonds are re-denominated on 1 January, this event is processed as a collateral substitution. The repo transaction is therefore accurately reflected on internal book-keeping systems as being denominated in euro from 1 January 1999. Since an internal currency conversion would be required on the offside value date, this option has a significant manual component. This option would suit a market participant possessing internal systems which efficiently process collateral substitutions, but without the additional functionality to over-ride standard repo parameters (as required by option 2).

Original repo

Collateral prior to 1 January: DM 10,000,000

Substituted repo

Collateral on and after 1 January: €5,086,413.07

Settlement method

1 January (DM cash): cash entries are netted in DM
1 January (DM bonds): normal automated substitution book-keeping is entered
1 January (€ cash): no entries
1 January (€ bonds): normal automated substitution book-keeping is entered
21 January (DM cash): DM proceeds are converted to euro via internal book-keeping; euro funds are then paid to customer
21 January (euro bonds): euro-denominated bonds settle with customer

Main features of option 3

- repo trade is booked assuming collateral substitution will take place
- a collateral substitution is made on 1 January when bonds are redenominated
- instructions to the clearing agent are suppressed
- On the offside of the repo, DM funds are converted to euro, before being paid to customer

International Securities Identification Numbers (ISINs)

18 A continuing area of some uncertainty relates to whether the ISIN codes for securities will be changed on redenomination. The rules for ISINs are set by the Association of National Numbering Agencies (ANNA), which is responsible for administering ISO 6166 on securities. The LSE is the UK NNA; Euroclear is the numbering agency for all Eurobond issuers.

19 Current ANNA guidelines already allow for single issues with different denominations, and these state that a new ISIN is required only when the security in the new denomination is not fungible with the security formerly available. If an entire issue of securities is fungible, redenomination into euro will not modify the rights of the holder. Its terms and conditions will remain the same, and the value of the security is unaltered. Investors should be indifferent to the change of denomination, in which case fungibility is maintained and there is no need to create a new ISIN. Accordingly, ANNA has recently concluded, after discussion and consultation with the securities industries of the countries involved, to recommend no change in ISINs for redenominated securities, except in the case of conversion offers. This is in line with the recommendation in the August *Practical Issues*.

20 All of the Member States which have to date announced their approach have decided not to change ISINs, except France. Unless the French decision changes, this means that market participants will have to manage the redenomination process in two ways, both for securities whose ISINs change, and for those which do not, if they are active in the international markets. S.W.I.F.T.'s corporate action messages (MT551, MT562 and MT563) will allow the transmission of old ISINs (in the standard ISIN field) and new ISINs (via a structural message in a narrative field). The LSE will not change SEDOL numbers of non-UK securities which have been assigned new ISINs.

Standard methods of redenomination of government bonds

21 The governments of participating Member States will redenominate some or all of their existing securities under their national law soon after Stage 3 begins. But, as reported in previous editions, the market needs to know in detail what methods of redenomination governments propose to adopt: the fewer methods the better, so as to avoid the risk of confusion in the market. The Commission has recommended that governments declare before the end of the year their intentions on the methods of redenomination they propose to adopt, and the Monetary Committee has set up a group to exchange information between government issuers. The Bank's understanding of the latest position, using publicly available information from a wide range of contacts, including overseas Embassies, central banks, governments and the ICSDs, is summarised in the table.

Standard prospectus language on redenomination of Eurobonds

22 Many Eurobond issues have recently included terms providing for redenomination into the euro. However, several different approaches to redenomination, and the related renominalisation and reconventioning, have been used. IPMA believes that a uniform approach and standard form language will be of benefit to issuers and investors. IPMA does not make any recommendation as to whether issuers should include redenomination terms in bond issues and MTN programmes.

TABLE: REDENOMINATION PLANS OF EU MEMBER STATES WISHING TO JOIN EMU ON 1 JANUARY 1999

	Plans to redenominate all/some government debt	**Status of redenomination decision**	**Proposed redenomination date**	**Method of redenomination**	**Redenomination basis**	**Rounding rule for converted nominal amounts**	**New minimum nominal amount**	**Cash compensation**	**Will ISINs change following redenomination?**	**Official publications**
Austria	Probably only liquid government issues	Finance Ministry has not yet made firm decision		Conversion of book entries	Probably minimum denomination	Probably round to nearest euro cent	One euro cent	N/A	No	
Belgium	Dematerialised public debt securities: linear bonds (OLOS) and Treasury certificates	Intention to redenominate and methodology stated by Euro Commission in Interim Report October 1997; Royal Decree of 16.10.1997	1.1.99	Conversion of book entries	Investor holding ('Line by line in each client account')	Round to nearest euro cent	€1000; odd lots of up to 999.99 will be repackaged by Securities Regulation Fund for holders of securities accounts on a voluntary basis, who will do the same for their customers	N/A	No	Euro Commission Interim Report October 1997
Finland	Markka - denominated serial bonds in book entry form and short term treasury bills	Economic Policy Committee announced on 28.10.97 intention to redenominate methodology not announced yet	1.1.99	Conversion of book entries	Probably investor holdings	Probably round to nearest euro cent		N/A		
France	All negotiable government debt	Intention to redenominate announced in March; methodology on 9.7.97	4.1.99	Conversion of book entries	Investor holdings	Round down to nearest euro	One euro (except OAT stripped coupons: €0.25)	Fraction of a euro balance paid to investor in cash by banks	Yes	
Germany	Listed Federal government bonds (Federal Government bonds, MTNS and treasury notes)	Draft act on introduction of euro states that redenomination will occur but methodology not yet confirmed	1.1.99	Conversion of book entries in Federal Debt Register	Investor holdings	Round to nearest euro cent	One euro cent	N/A	No	Draft Act on Introduction of the Euro (article 6)
Greece		No official information								

	Plans to redenominate all/some government debt	Status of redenomination decision	Proposed redenomination date	Method of redenomination	Redenomination basis	Rounding rule for converted nominal amounts	New minimum nominal amount	Cash compensation	Will ISINs change following redenomination?	Official publications
Ireland	General government debt	Decision taken on methodology	4.1.99	Conversion of book entries	Investor holdings	Round to nearest euro cent	One euro cent	N/A	No	
Italy	Marketable government debt	Methodology not yet final but possible approach set out in Euro Committee report ‘From the Lira to the Euro’ July 1997	1.1.99	Conversion of book entries	Minimum nominal amount	Round to nearest euro cent	One euro cent initially; possibly subsequent repackaging	N/A	No	Euro Committee report ‘From the Lira to the Euro’ July 1997
Luxembourg	All dematerialised linear bonds		4.1.99	Conversion of book entries	Investor holdings	Round to nearest euro cent	One euro cent	N/A	No	
Netherlands	All tradable government debt	Methodology not yet decided finally	1.1.99		Probably investor holdings	Probably round down to nearest euro	Probably one euro	Probably yes at the level of each bank		
Portugal	Tradable government debt		4.1.99	Conversion of book entries	Investor holdings	Probably round down to nearest euro	One euro cent		No	
Spain	All government debt registered at book entry system for Government securities	Intention to redenominate and methodology published on 25.09.97	4.1.99	Conversion of book entries	Investor holdings	Round to nearest euro cent initially	€100 for Government bonds and €10 for T-Bills; odd lots in euro cents will be repackaged by primary dealers	N/A	No	Paper published by Ministry of Finance on 25.09.97

But IPMA will make available standard form language for use by issuers who wish to provide for redenomination.

23 The Market Practices Committee and the Currency Continuity Working Group of IPMA are developing this language providing for redenomination, renominalisation and reconventioning. A draft has been circulated to interested market participants, including the national and international clearing agencies, IPAA, ISMA and ISDA. In IPMA's view, the market appears to be in agreement that:

- Redenomination should only occur on an interest payment date.
- Redenomination is at the issuer's option, does not require bondholders' consent and requires 30 days' notice.
- If a bond issue is redenominated, it should also be renominalised and the new harmonised market conventions for the euro should be adopted going forward.
- For many practical and cost reasons, redenomination, renominalisation and reconventioning are easiest if the notes are held in permanent global form. Most issues to date have provided for a permanent global note. The practicalities of renominalisation where definitive notes are in circulation will need to be worked out by the paying agents and the relevant clearing systems.
- Interest payable on the interest payment date on which the bonds are redenominated should be payable in the national currency unit and not in the euro unit.
- Redenomination and renominalisation should be to the nearest euro cent.
- MTN programmes require special attention to be given to the programme documentation and individual drawdowns if provisions for redenomination are to be made.
- Similarly, great care must be taken in structuring repackaged, securitised, asset-swapped and structured products where the underlying or linked assets include securities which permit redenomination, renominalisation or reconventioning.
- New ECU/'euro-style' bond issues should provide for reconventioning from the first interest payment date after the start of Stage 3.

24 The draft language does not cover FRNs or the consolidation of several euro-redenominated issues, pending agreement on successor price sources and the practicalities of consolidation. It is being prepared on the assumption that the harmonised market conventions for the euro which IPMA and other international trade associations have recommended will be accepted by EU Member States, other issuers and the markets generally. Many Member States and market participants have already confirmed to IPMA their intention to use these conventions. IPMA is optimistic that the remaining major participants will shortly follow suit. The proposed language will be submitted to the market for comment as soon as it is ready.

Synthetic history of the euro

25 On 30 October, the banking supervisors issued preliminary guidance on *The Impact of the Euro on the Capital Adequacy Framework* (see Chapter 7). As this explains, the Bank believes that, in the temporary absence of historical foreign exchange and interest rate data for the euro

immediately after the start of Stage 3, banks which use internal models to calculate their capital requirements should develop their own proxy series. In November, Reuters published the results of a poll of 20 risk managers and EMU policy co-ordinators on how, in the absence of actual data, a synthetic history for the euro should be constructed. Half of the respondents said that they would prefer a synthetic euro history based on a weighted pool of the national currencies of participating Member States, a small number preferred an ECU or single national currency basis (either DM or FF), and a few declined to specify a preference.

B EXCHANGES

LIFFE

26 As the start of Stage 3 approaches, LIFFE is setting a series of daily and monthly trading records in those contracts that are listed on potential 'in' Member States. In addition, LIFFE continues to hold a dominant market share in post 1 January 1999 delivery months for European exchange-traded money market contracts, by capturing more than 90% of the market, as market participants' confidence increases for maturities in 1999 and beyond.

27 *Bobl*. On 18 September, LIFFE listed a futures and option contract on the 5-year German Government bond ('Bobl'). Key to that listing was an innovative market-making scheme, which has ensured a high level of liquidity since the first week of trading. The scheme includes two 'designated market makers', one for the futures and one for the option contract. In October, the futures contract had an average daily volume of around 15,000 lots and at the end of the month had an open interest of around 20,000 lots; whilst the average daily volume for the option was more than 4,000 lots and end-of-month open interest was around 46,000 lots. The launch of LIFFE's Bobl contracts has been well received, as part of LIFFE's aim to complete its coverage of the DM yield curve which already includes LIFFE's 1 month and 3 month Euromark contracts and the LIFFE Bund.

28 *Short-Term Interest Rate (STIR) contracts*. Some decisions on the technical aspects of LIFFE's STIR contracts can only be made once the participating Member States are known. Decisions will then be made on:

- Parallel listing of national currency and euro unit contracts.
- Giving LIFFE's euro contract the same characteristics as its present Euromark contract, with effect from 1 January 1999, and conceivably before.
- Harmonisation and reduction of initial margins to the LCH.
- Amendment of contract specifications of post 2001 delivery months.

29 In particular, research has been carried out by LIFFE's staff in co-operation with market participants and the Contract Design Working Party, on transfer mechanisms for the 'migration' of open positions into LIFFE's ECU/euro contract. The research suggests two main options that could be made available to market participants, each on a voluntary basis:

- A s*pread trading facility* (ie a single transaction encompasses two different contracts), which would be made available in the pit at market prices to all members.

- *Voluntary position conversion* (ie an opportunity to convert contracts in participating national currencies into euro without transactions on the floor), which would be defined together with LCH.

30 *Bonds*. LIFFE is similarly considering, with market practitioners, a number of potential developments for Europe's bond markets after 1 January 1999. Among the issues under discussion are the possible launch and timing of a futures contract which is either deliverable into the bonds of a single 'in' government issuer or more than one 'in' government issuer.

31 *Equities*. Provisions have been made in all index contracts for possible changes to the pricing of the index and potential settlement in euro rather than in sterling. Further consultation with the market and the LSE is continuing in order to establish appropriate provisions for the settlement of LIFFE's individual equity option contracts.

32 Discussions on new index products are continuing with index providers, particularly with FTSE International, MSCI, Dow Jones and Standard and Poors). FTSE Eurotop indices, which appear to be the main pan-European indices, are already available. In addition, the feasibility of launching new pan-European stock and sector indices, if there is sufficient market demand, is being researched. Some LIFFE members have already established licence agreements to trade OTC products on pan-European indices, which in turn could create the opportunity to provide liquid exchange-traded derivatives.

33 *Commodities*. All LIFFE's commodity contracts are based on the price of an underlying commodity and physical delivery. Therefore the only necessary amendments are to reflect any change in the currency of the tick value and settlement. In addition, LIFFE's contracts with delivery months in 1999 and beyond have been amended such that (in the event that the UK participates in EMU) there is already provision for payment in euro.

The London Stock Exchange

34 In previous editions, we have discussed whether or not equities should be redenominated and whether par values should be replaced by 'no par value' shares. The DTI is expecting to publish shortly a consultation paper on these questions. The consultation paper will ask whether, while the UK is 'out' and also if it eventually goes 'in', there is support for a change in company law to make it easier to redenominate sterling share capital into foreign currencies, including the euro. There is an existing route, via a cancellation and reissue of shares. The question is whether legislation is desirable to make redenomination easier (eg by empowering directors to redenominate without shareholder approval); and whether the Companies Act should be amended to prescribe conversion and rounding rules to enable companies to deal with consequential changes in share capital. The consultation paper will also consider the issue of no par value shares.

Unit trusts and investment funds

35 The Association of Unit Trusts and Investment Funds (AUTIF) represents about 98% of the UK investment funds industry consisting of authorised unit trusts ('unit trusts') and open ended investment companies ('oeics'). The introduction of the euro will have an impact on investment

funds whether the UK itself is ‘in’ or ‘out’, and AUTIF set up a euro working party in May 1997 to consider the implications.

36 *Regulatory and constitutional issues.* Conversion of the base currency of an authorised fund from sterling or another national currency to euro will require alteration to the trust deed of a unit trust (or to the instrument of incorporation of an oeic) and approval by the Financial Services Authority (FSA). This is the equivalent to a redenomination of share capital for a Companies Act company and is an event which would normally also require unit holder or shareholder approval.

37 While the UK is ‘out’, redenomination of base currency will remain a matter of choice. In the case of oeics, the current regulations specifically require shareholder approval for a change to the base currency. If the UK is ‘in’ at a later stage, AUTIF would support any general moves, including legislation where necessary, to simplify procedures by allowing redenomination of share capital or changes to base currency of a unit trust or oeic without needing separate unit holder or shareholder approval. The FSA is also to review the unit trust and oeics regulations to see if amendments are required to take account of the euro.

38 *Information for investors*. Firms which redenominate will need to decide on the appropriate euro figure for minimum investment or regular contributions. Another issue under consideration is whether, while the UK is ‘out’ or during any transition period if the UK goes ‘in’, information, including price displays, should be shown in both euro and sterling. The working party is also currently examining possible methods of measuring past performance of funds in order to be able to compare, in a way which is not misleading and which will be easily understood by investors, funds which have euro as a base currency and funds which remain sterling-based.

39 *Systems and reporting.* The working party is actively encouraging member firms to tackle, at an early stage and at a strategic as well as a technical level, the special systems challenges created by the euro. One particular issue which the working party will highlight is the need to ensure that the systems and conversion procedures of fund managers and trustees (or depositories) are compatible.

40 There are some concerns in the working party that there is very little information about accounting requirements for the ‘out’ countries. The working party has suggested to the regulators that the Statements of Recommended Practice (SORPs) for unit trusts and accounts could offer some practical guidance. As a matter of commercial practice, a number of firms believe that accounts may have to be prepared in both sterling and euro to meet the needs of certain customers even while the UK is ‘out’.

CHAPTER 4: THE CONVERSION WEEKEND

- The ‘conversion weekend’ between 1998 and 1999 will involve redenomination into euro of some or all of the outstanding marketable debt issues of ‘in’ governments and some other issuers together with a conversion into euro of some cash accounts in central securities systems.
- All those operating in the wholesale securities markets in London need to understand in detail how the conversion weekend is expected to work, to minimise the risk of confusion and error.
- All the conversion procedures need to be carefully prepared and tested well before the end of 1998. Preparations for testing in London are likely to be co-ordinated by a working group with broad market representation; the Bank stands ready to help where it can.

Introduction

1 The August edition of *Practical Issues* covered a number of technical issues of concern to providers and users of the securities settlement systems which service London’s international financial markets. Since then, attention has been increasingly focused on the procedures to be adopted over the ‘conversion weekend’, spanning 31 December 1998 to 4 January 1999. The analysis has advanced as a result of two meetings of practitioners: one convened by LIBA and the other (the ‘Securities Conversion Workshop’) by a number of investment banks, organised by IBM and including the ICSDs[1]. The focus so far, reflected in this Chapter, has been on the handling of debt securities. Further work is expected on equities and derivatives, which we shall report in subsequent editions of *Practical Issues*.

2 It is expected that the conversion weekend will involve a conversion of cash accounts in the national central securities systems together with redenomination of some or all of the outstanding debt issues of ‘in’ governments and some other issuers (eg supranationals)[2]. Many different players will be involved in the conversion weekend: the Central Securities Depositories (CSDs) will be key, but securities will also have to be redenominated in the books of custodians and the customers for which they act. (For many market participants in London, the focus will be on their relationship with custodians rather than directly with a CSD.) Trades in the course of settlement (‘pending’ or ‘open’ trades), and their cash considerations as well as settled balances, may have to be converted. All the conversion procedures need to be carefully prepared and tested well before 31 December 1998.

3 Now that it is clear that the UK will not be participating in the ‘first wave’, the focus is on the treatment of non-sterling securities, particularly under English, French and German law. Correspondingly, the procedures of the respective CSDs in France and Germany - Sicovam and Deutsche Börse Clearing AG (formerly Deutsche Kassenverein) - are of particular interest, as are those of the ICSDs (Euroclear and Cedel Bank).

1 The report of the Securities Conversion Workshop may be found on the IBM website at (http://www.europe.ibm.com/euro).

2 The redenomination of goverment securities is expected generally to involve the conversion of book entries by investor holding, except in Austria and Italy (where minimum denominations and minimum nominal amounts are expected to be used respectively).

4 This chapter considers:

- The legal basis on which the conversion weekend will take place.
- Key points for the conversion weekend.
- The information currently available about how the conversion weekend is expected to work, from the perspective of issuers, CSDs and ICSDs, custodians, fund managers; and the use of S.W.I.F.T. in the conversion process.
- Proposals for how market testing might be taken forward.

The legal basis for the conversion weekend

5 The Bank's understanding of the legal basis for the conversion weekend is as follows. The authority to redenominate securities is given by Article 8(4) of the Article 109l(4) Regulation, first indent. Many Member States are introducing legislation to facilitate the process and specify how the redenomination of securities under their national law will be carried out. (This would be relevant particularly to the majority of securities in issue which do not have specific redenomination provisions already in their prospectuses.) The legal basis for the redenomination of securities will be the law of the country of the issue (ie its governing law) and not the law of the country of the issuer, the currency of issue, or the CSD into which the security is issued. So, hypothetically, if a French franc bond issued under German governing law by a Dutch borrower into Sicovam were to be redenominated, the method used would have to comply with German law on redenomination.

6 This means that CSDs and ICSDs need to be capable of handling different methods of redenomination[3]. In practice, however, that is unlikely to be a significant problem for issues being redenominated over the conversion weekend itself, so long as such issues are predominantly government issues under the government's own national law. There is also a question about whether non-government issuers will in practice choose to redenominate if the result would be different from the market practice in the local market in which the bond is traded and held.

7 In respect of cash conversion, the relevant provision is the second indent of Article 8(4), which permits a participating Member State to take measures that may be necessary to enable the change of the unit of account of the operating procedures of, *inter alia*, clearing and settlement systems. If a participant in the relevant market wishes to be credited with a legacy currency rather than euro, an obligation to convert is placed upon the provider of the participant's account by Article 8(3) of the same Regulation.

8 It is doubtful that Article 8(4) will apply under English law while the UK is 'out'. In that case, redenomination of securities issued under English law, of whatever currency denomination, would be possible only according to the terms of the relevant prospectus, unless domestic legislation were introduced to facilitate redenomination. At present, no such legislation is contemplated.

3 In addition, where securities issued into one system can be settled in another via a link between the two systems (for example, the ICSDs' links to national CSDs), both systems will clearly have to accommodate whichever method is chosen to redenominate such securities.

Key points for the conversion weekend

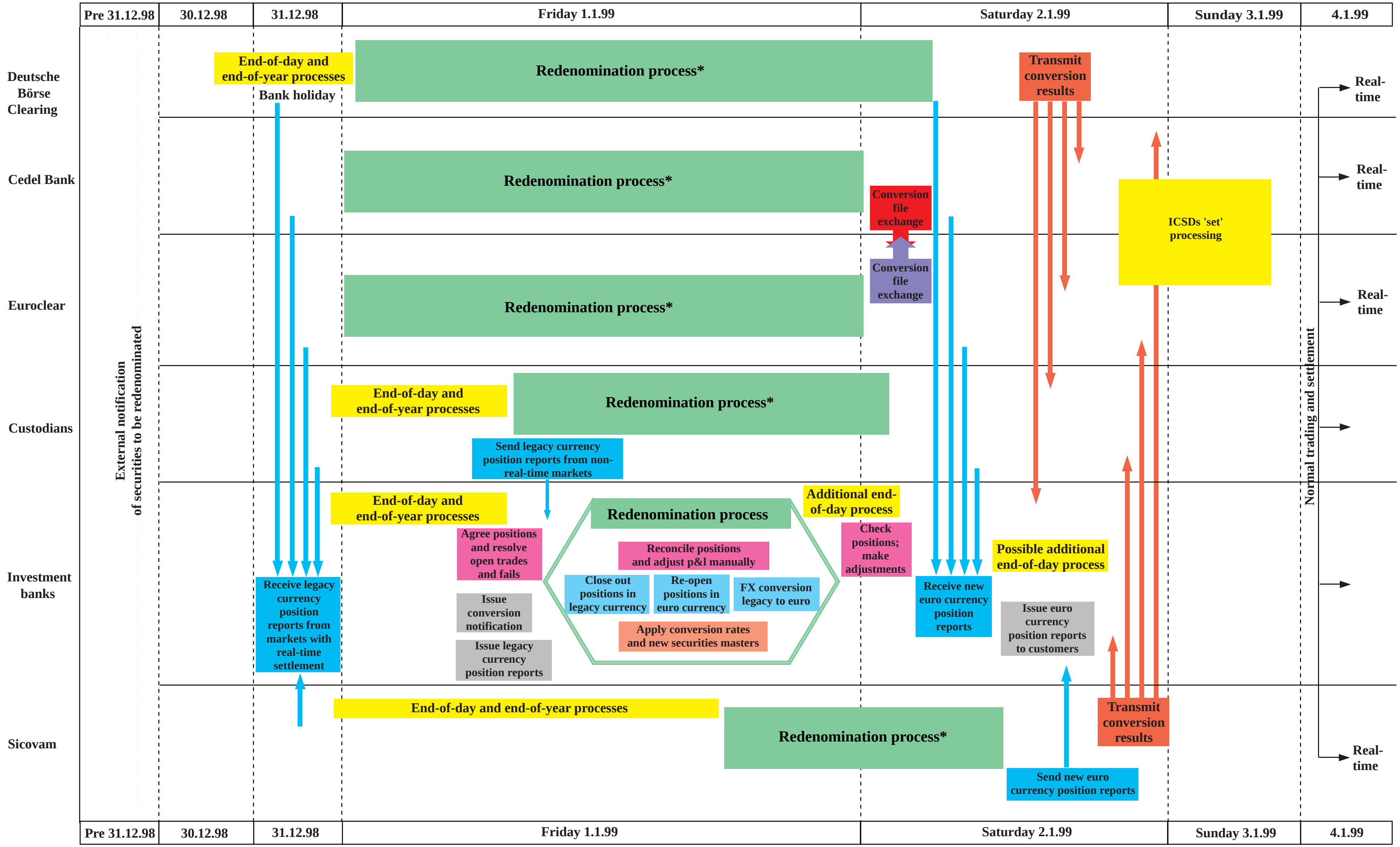
9 The detailed procedures for handling the conversion weekend are for market participants to decide. The following list of key points summarises our understanding of the current views of the experts who are closest to the planning of the conversion weekend in the London market. All the main firms operating in the wholesale securities markets in London need to understand in detail how the conversion weekend is expected to work to minimise the risk of confusion and error. The International Securities Markets Association (ISMA) has referred these points to its Market Practices Committee, which will be considering them at its next meeting. Chart B illustrates some of the processes involved.

Redenomination and reconventioning

- It is expected that 'in' governments and perhaps some supranational issuers will redenominate their debt securities over the conversion weekend. It would ease pressures on systems and back offices if corporate issuers were to delay any redenomination of their securities until at least a month after the conversion weekend, and if any redenomination were to take place over a weekend.
- In order to provide the market with sufficient preparation time, the experts consider that it is essential that issuers contemplating redenomination of their securities from the start of 1999 announce their intentions as early as possible in 1998, together with the detailed redenomination methodology to be used. A final list of the securities that each will redenominate should be published no later than 30 September 1998.
- Some issuers may be considering changing the conventions of their existing issues (to bring them into line with harmonised market conventions for new issues), as well as redenominating them. The experts, reflecting opinion in the market, are strongly of the view that the conventions of existing issues should not be changed. But if there is to be a change, it should take effect after the conversion weekend and should coincide with the end of an interest payment period. This would avoid mismatched hedges and the need to restructure derivative transactions; it would also help to minimise back office workloads.
- Information provided by issuers, depositories and any other intermediaries on the redenomination of securities should accord with the list of items published by Euroclear last August and now being refined in co-operation with other CSDs and S.W.I.F.T. Shorthand terms such as 'bottom-up' or 'top-down' should be used only where their meaning is defined. (A summary of the Bank's understanding of the current redenomination plans of Member States wishing to join Stage 3 at the start, in a format consistent with Euroclear's list, is included in Chapter 3.)
- Any new securities issued between 1 October and 31 December 1998 must, in the experts' view, be accompanied by detailed information meeting the same standards as those applying to the redenomination of existing securities.
- Published information should state whether the security's ISIN will change. Reference numbers (ie security identifiers) used in local markets may also change, even if the ISIN does not. In this connection, Deutsche Börse Clearing (DBC) have said that, for the German market, all reference numbers in their systems relating to redenominated securities will not change; there will be no change to the SEDOL codes assigned by the LSE for any redenominated securities.

SOME OF THE PROCESSES INVOLVED IN THE CONVERSION WEEKEND

CHART B



* Redenomination process applies to securities balances, open transactions and cash balances

Settled securities positions

- Where it is decided that securities will be redenominated at the start of 1999, the conversion will be undertaken over the weekend in a process involving simultaneous conversion of securities balances at the CSDs, the ICSDs, custodians, and other market intermediaries.
- Owing to the limited time available, all those involved in the process should convert their own records of securities to be redenominated as soon as conversion rates and closing balances on 31 December become available, and reconcile the resulting balances with those supplied by the CSD or custodian later in the weekend.
- CSDs and ICSDs should supply information on the results of the conversion process as soon as possible after the start of the weekend, and in any event no later than midday on 2 January 1999.
- Whichever method of redenomination is used, rounding will give rise to differences between nominal amounts of securities at different levels of holding: for example, at CSD level, between the total nominal amount of a security in issue and the sum of the CSD's participants' holdings; and, at custodian level, between the custodian's omnibus (ie nominee) account at the CSD (or sub-custodian) and the sum of its clients' holdings. Therefore, CSDs and custodians need to make clear the basis on which they will make the necessary adjustments to participants' or clients' holdings.
- Members of national CSDs need to be aware that, as well as their balances in redenominated securities being converted to euro, their cash accounts will be converted automatically from national denominations to the euro over the conversion weekend. But there will not be conversion of all cash accounts at ICSDs.
- All market participants need to ensure that Standard Settlement Instructions for securities transactions (as of course for other types of transaction) have been appropriately revised to reflect the introduction of the euro. Failure to do so could result in trades failing to settle. They should aim to have notified their counterparties of planned changes by 30 September 1998.

Open trades

- Many trades in redenominated securities outstanding over the conversion weekend are likely to arise from repo transactions. The redenomination of repo transactions is considered in Chapter 3.
- Where trades have been undertaken before the conversion weekend in euro-denominated securities that will be issued after 1 January 1999 (ie 'when issued' trades), settlement instructions should wherever possible be input into the CSD before the conversion weekend. Where this is not possible (eg because the CSD will not accept the EUR currency code before 1 January 1999), trades should be input as soon as possible after the start of the conversion weekend.
- Because settlement instructions to CSDs do not state the currency of the nominal amount of securities, safeguards are needed to ensure that CSDs can distinguish instructions relating to legacy currency nominal amounts from those relating to euro amounts, except in cases in which the ISIN will be changed, where the currency of the nominal amount will be evident. The experts consider that the most appropriate

procedure is for CSDs and custodians not to accept any instructions, at least in securities whose ISINs are not to be changed, for a period following a clearly defined cut-off time on the last settlement day before the conversion weekend. However, the conversion weekend should not be lengthened in consequence. All correctly formatted instructions received after this period should be taken as being denominated in euro.

- Conversion of open trades should be undertaken automatically and should not depend on reconfirmation by either party; nor should there be a need for customers to issue new instructions to their custodian, nor for the conversion to be reported for regulatory purposes. The SFA considers that, given the very precise methodologies for conversion laid down in the Article 235 Regulation, it is not necessary for firms to reconfirm in euro transactions which remain outstanding over the 1998 year-end. Firms are encouraged to consider the cost/benefit implications of reconfirming transactions, and the effect on their own back office workload and that of counterparties. SFA will similarly not require firms to report such transactions to it again; and nor will reporting to the LSE be required.
- All cash considerations denominated in the currencies of participating Member States against purchases of securities, whether redenominated or not, will be converted automatically into euro in both DBC and Sicovam. The ICSDs will convert the cash amount of transactions only where the securities are redenominated, or where the open trade is with a counterparty located in a national market which is converting all legacy cash accounts to the euro over the conversion weekend.
- Whichever method of redenomination is used, rounding will result in differences between the nominal amounts of securities that are the subject of open trades (eg where a custodian has an outstanding purchase and sale of the same securities, as the buy or the sell side may need to be split into a number of separate trades). As with settled securities positions, procedures need to be established by CSDs to ensure that the small nominal amounts of securities required to avoid such trades failing to settle can be reallocated to the participants that need them.
- The experts have considered the possibility that some market participants might scale back their activity, particularly in the repo market, ahead of the conversion weekend. If it becomes clearer that this is likely to happen, the implications for market liquidity would need to be considered.

Timetable

- In order to allow sufficient time for intermediaries to clear legacy currency business and to process settlement instructions before the conversion weekend, markets should close for trading on 31 December 1998 or at least by noon that day. (In Germany, 31 December will be a normal bank holiday.) CSDs and ICSDs should observe normal opening hours. The closure of markets on 31 December will not affect settlement cycles: ie trades transacted on 29 December 1998 for settlement on a T+3 basis will settle on 4 January 1999.
- Detailed timetables covering all the events of the conversion weekend should be available for each market by the end of February 1998, and sooner if possible.

- No announcement has been made yet on the timing of the release of the conversion rates from legacy currencies into the euro. The market will need to know well in advance of the conversion weekend the exact time as well as date of publication, which should be as early as possible during the conversion weekend, and the way in which the information will be distributed.
- Firms will need to ensure that resources available to them over the conversion weekend are sufficient and that adequate training is provided to staff beforehand.

Testing

- The conversion process is complex and must be adequately tested by CSDs and ICSDs, custodians and other market intermediaries well in advance of the conversion weekend, and should start at the latest by the end of September 1998. Testing will be led by the CSDs and ICSDs. Tentative timings have been announced in the German and the French markets and by the ICSDs.
- The experts expect that testing will be undertaken on a bilateral basis (eg between the CSDs/ICSDs and their participants and between custodians and clients). They expect that there will be no marketwide, multilateral testing. However, in the London market, the detailed preparation of testing with the ICSDs is likely to be facilitated by a working group with broad market representation. The Bank stands ready to help where it can.

LOOKING FORWARD TO CONVERSION WEEKEND?

How will the conversion weekend work?

10 This section sets out in more detail how it is currently proposed that the conversion weekend will work from the point of view of issuers, CSDs and ICSDs, custodians and fund managers. Investment banks are likely to be involved in a number of different capacities, so they are not identified separately.

Issuers

11 Issuers need to consider not just whether to redenominate their securities, but the detailed methodology to be used and the means by which their decisions on redenomination will be communicated to the market. Lead-times for the market to prepare for the conversion are long (many months rather than a few weeks), and there remains uncertainty about the details of the methodology to be used by issuers known to be considering redenomination (mainly governments) and whether the conventions on bonds are to change as well as the currency of denomination.

12 It is essential that all these uncertainties are resolved as early as possible in the New Year. This will enable CSDs and ICSDs and those involved in the conversion process to prepare the detailed processes needed for the conversion weekend and to publish timescales. It will not prevent issuers who have announced their decision to redenominate from making changes during the course of next year to the range of issues to be converted, provided that a complete list is ready by the end of September 1998.

13 It will be particularly helpful if there is a standard approach to the communication of redenomination information across the market. Euroclear published recommendations on minimum standards in this area in August, and these are being finalised in consultation with CSDs and S.W.I.F.T. They will set out the scope of the information to be communicated per security (eg redenomination date and method, and whether or not a new ISIN will be allocated to the redenominated security). Standard terminology should be defined to avoid confusion over terms such as ‘bottom-up’ and ‘top-down’. The final version of these communication standards is due to be published by the end of this year.

CSDs and ICSDs

14 The action to be taken by the CSDs and ICSDs over the conversion weekend will be key to the process of redenomination and settlement, and it is therefore important to have a comprehensive understanding of their plans. The Bank has accordingly had discussions with Deutsche Börse Clearing, Sicovam, Euroclear and Cedel Bank. The main features relating to debt securities in each case are set out below, preceded by the experts’ views on technical issues in common.

15 Many CSDs act as a numbering agency (ie in the allocation of ISINs) as well as depository and settlement systems for securities. The CSDs will therefore be a source of confirmed decisions, ideally well in advance of the conversion weekend, on which securities to be redenominated are also to have a new ISIN allocated (see Chapter 3).

16 Depending on whether new ISINs are to be allocated to redenominated securities, the experts consider that it will be necessary for CSDs to consider carefully the imposition of a

cut-off time beyond which all instructions received with respect to securities are taken to be in euro rather than legacy currency amounts. This issue arises because settlement instructions do not include a currency reference for the securities to be delivered or received - they are framed in terms of the nominal value of the securities to be settled. New ISIN codes for redenominated securities would signal the denomination and, as already indicated, they will be so assigned in France. In order to minimise the risk of national currency denomination instructions being wrongly interpreted as being in euro, it is important that CSDs and ICSDs have a cut-off point beyond which it is clear that all instructions will be treated as being in euro.

17 However, this might not be a fail-safe approach, and could open the way to fraud. A preferable approach is that there should be a procedure for rejecting all messages received after a given cut-off time and before a given restart time. All instructions received during this 'dead period' would automatically be rejected, with an appropriate message being passed to the sender. The sending institution should then convert the instructions to euro and resubmit them after the end of the 'dead period'. It is vital that each CSD and ICSD makes clear the approach it proposes to adopt, and specifies precisely any relevant deadlines.

18 CSDs also need to consider carefully the treatment of fractional amounts on odd-lots arising from the redenomination process:

- In markets such as France where the new nominal value of redenominated securities will be rounded down to the nearest euro, the resulting fractional amount will be paid out by issuers as a cash payment to holders (valued at market price) soon after redenomination takes place. There will also be odd-lots resulting from differences beween the redenominated investor holdings and the total nominal value of securities in issue.
- In some other markets, the new nominal value will be rounded to, or there will be a minimum trading amount in, whole numbers of euro with a minimum greater than one euro. This will give rise to significant amounts of securities with a nominal value lower than the minimum tradable amount. The question is how such odd-lots can be traded and settled in practice. One possibility is for an appropriate buy/sell mechanism to be established (if it does not exist already), through which custodians or CSDs can deal in odd-lots, which would have no minimum trading size in order to facilitate the clearing up of odd-lots as soon as possible after 4 January 1999.
- In yet other markets, the new nominal value will be rounded to the nearest cent. There will be no cash compensation. But again, there will be odd-lots due to differences between the redenominated investor holdings and the total nominal value of securities in issue.

19 Whichever method of redenomination is used, there will be odd-lots created by the fact that the rounded total of securities held by custodians on behalf of a number of clients will not, when redenominated, equal the sum of the individually redenominated client positions. The experts are concerned that this will lead to securities transactions unsettled over the conversion weekend (ie open trades) failing to settle. One approach might be for settlement systems to extend their matching tolerances - ie to settle trades even though nominals are not perfectly matched - but as such tolerances are not normally allowed, careful consideration would need to be given to the implications. An alternative is for a mechanism (called 'auto give/auto take') to be put in place to enable fractional amounts of nominal securities to be transferred, free of consideration,

between market participants to enable trades to match. Automated borrowing facilities for securities may provide an equivalent service.

(a) Deutsche Börse Clearing AG (DBC)

20 From the outset, settlement in DBC will be in euro. A total of some 500 issues (all bonds) are expected to be redenominated over the conversion weekend, including 150 listed government issues maturing after 19 January 1999, a number of 'Jumbo Pfandbrief' issues (mortgage bonds over DM l billion) and possibly some bonds of KfW, the EIB and World Bank. No corporates have announced the intention to redenominate bonds so far. On the *method of redenomination*, the conversion will be undertaken at the level of securities holdings. Following conversion of the DM nominal at the 6-significant figure conversion rate, the resulting sum will be rounded to two decimal places. ISINs will not change. Day-count conventions on redenominated bonds may be changed, but not until the next coupon date.

21 For *settled securities positions*, there will be a simultaneous conversion into euro of every position in redenominated securities and DM cash accounts immediately after 31 December 1998. This will be effected by debiting the old DM nominal securities and cash accounts, and crediting the equivalent euro accounts, with participants informed accordingly. DBC reference numbers (as well as ISINs) will remain unchanged. Physical debt certificates will not be re-stamped.

22 For *open trades*, no reconfirmation will be required on conversion to euro. For matching purposes, there is a built-in DM 50 tolerance for cash considerations. To prevent open trades from failing as a result of differences due to rounding, DBC will also introduce a tolerance in the cent range for nominal amounts of redenominated securities. Any discrepancies arising from the redenomination or matching processes between securities in issue and securities held by participants will be taken on to DBC's own books.

23 On the *timetable for the conversion weekend*, 31 December 1998 will be a bank holiday as usual. Thus batch processes will cease at the normal time (7.00 pm) on 30 December 1998. All data will be sent out, converted into euro, on 2-3 January 1999. Discussion continues as to whether the system will be open for enquiries during this period; but it will certainly not be open for live transactions. 4 January 1999 will be a normal working day. In all data-file transfers, 'DEM' will be replaced by 'EUR'.

(b) Sicovam

24 As in DBC, all settlement in Sicovam will be in euro from the beginning of 1999, and redenomination will take place at the level of securities holdings. Of 2,500 listed bonds held in Sicovam, no more than 200 are likely to be redenominated over the conversion weekend (representing 80% of the value of listed bonds). All will be government issues - half will be OATs, with the rest being BTFs, BTANs and perhaps CADES (and EIB) issues. The *method of redenomination* will be to round down to the nearest whole euro, with resulting differences being paid out in cash. Specifically, the French franc nominal will be divided by the 6-significant figure conversion rate. The new euro nominal will be the whole euro amount after truncating everything after the decimal point. The decimal remainder will be grossed up by interest on an actual/365 basis running up to 6 January 1999, rounded to two decimal places. ISINs will

change, with the new code numbers being assigned at the end of the first half of 1998 (for use only in transactions settling from 4 January 1999). No corporate issuers are expected to redenominate their bonds over the conversion weekend, but many are expected to do so early in 1999. There will be no reconventioning: the recommended euro market conventions are already substantially followed in the French bond market.

25 For *settled securities positions,* there will be a simultaneous conversion into euro of redenominated securities positions and all French franc cash accounts immediately after 31 December 1998. Sicovam will send a message showing that the French franc securities accounts have been debited and the new euro securities accounts credited with the appropriate number (in the case of OATs) or nominal value (in the case of other Government issues) of bonds, and with euro cash balances credited with the rounded decimal difference. Participants will be informed accordingly. Meanwhile, Sicovam members should have calculated their expected positions, and will then reconcile their expectations with the Sicovam messages.

26 For *open trades*, redenomination will be automatic, and no reconfirmations will be required. A problem could arise from rounding differences if a purchase is then split for re-sale (or vice versa), such that for one or more of the re-sales the rounding leads to there being a one bond shortage. To avoid blocking the system, Sicovam will have available an inventory of bonds to make up the difference (which will be delivered to those purchasers who are short of a bond, and paid for by the cashback they would have received). This facility will be available in the period 4-8 January 1999.

27 On the *timetable for the conversion weekend*, all organised markets will be closed for trading on 31 December 1998, whilst the money markets and Sicovam will be open. Sicovam will relay end-of-day accounting data at 8.00pm on 31 December. All Sicovam databases will be converted on 1 January, and Fininfo (a data vendor) will disseminate updates of securities data-feeds as of 8.00 am that day. On 2 January, the conversion of government debt will take place. There will be pre-opening procedures at the end of 2 January, with simulations to check that intermediaries have made correct conversions. No new instructions will be accepted by Sicovam until 8.00 pm on 3 January. (There is no risk of confusion of the currency of the nominal because of the change in ISIN codes.) All markets will be open on 4 January.

(c) Euroclear

28 Euroclear has issued a document explaining how it will handle the conversion to the euro and subsequent settlement[4]. The key features of Euroclear's plans are summarised below.

29 Euroclear will collate details of the redenomination of securities by individual ISIN from national markets and will distribute and update this information as soon as it is available. A number of distribution methods - Internet, fax, CD-Rom - will be used to facilitate use of the information by market participants. This information will be in the recommended format. The earlier this information is available, the lower the operational risk will be, and issuers are urged to make final decisions and communicate them as early as possible. If such information is not available in sufficient time, this will seriously jeopardise testing of systems by market participants, ICSDs and CSDs.

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4 *Opening the door to the euro*, September 1997, with subsequent monthly updates, available on the internet at (http://www.euroclear.com).

30 Euroclear will not be assigning new ISINs for the Eurobonds for which it acts as the numbering agency. It will, however, provide information on any new ISINs for other bonds eligible in the Euroclear system where applicable.

31 For *settled securities positions*, Euroclear intends to debit customer accounts with the quantity of securities denominated in legacy currency and then credit them with a corresponding amount of securities denominated in euro, rounded to the nearest euro or euro cent as appropriate. Members will be informed of the individual debits and credits.

32 For *open trades*, in respect of instructions received before a 'dead period' beginning with a final cut-off time overnight on 31 December - 1 January, Euroclear will assume that the nominal amount is expressed in the original legacy currency and redenominate the instructions accordingly. In other words, the instructions will automatically be cancelled and replaced by new instructions (containing the participant's original reference) in which the nominal amount will be expressed in euro. Instructions received in the 'dead period' will be rejected. Any instructions received after the end of the 'dead period' will be deemed to be in euro.

33 The settlement currency and the cash amount will also be converted into euro for instructions for settlement within Euroclear (and over the bridge with Cedel Bank) if the settlement currency in the instructions is the same as the denomination of the issue, and if the security is redenominated. The cash consideration will be converted to euro, in the case of instructions with a local counterparty in a market being converted over the conversion weekend, whether the security is redenominated or not. For matching purposes, there is a $25-equivalent matching tolerance on the cash side. To cope with rounding differences on the securities side, Euroclear's normal automatic borrowing and lending programme will be available to those signed up to the service.

34 On the *timetable for the conversion weekend*, final balances will be confirmed on 31 December 1998 provided that settlement with domestic markets is confirmed by that time. Redenomination of securities balances will take place early on 1 January 1999; and redenomination reporting will take place on 2 January, after which there will also be a window to correct instructions. There will then be a normal batch settlement process on 3 January, followed by settlement reporting.

(d) Cedel Bank

35 In all essential elements, Cedel Bank and Euroclear intend to pursue parallel approaches. There should therefore be no problem of compatibility across their bridge.

Custodians

36 The role of custodians, as the intermediaries between the depositories and investors, will be critical to the conversion process, whether they are global custodians (ie acting directly for investors in a variety of different markets) or sub-custodians (ie representing global custodians or the ICSDs in the national markets).

37 The key requirement is that custodians ensure that their end-of-year positions are correctly reconciled with those of the CSDs and those customers which elect to have their positions

converted, including global custodians, as early as possible in the conversion weekend. Sub-custodians are likely to provide cash and securities S.W.I.F.T. balances and transaction listings as at the close on 31 December 1998 in legacy currency. Once conversion rates into the euro are known, they should provide the redenomination information in the format agreed by S.W.I.F.T., using MT551 and MT563 message formats, or alternatively in a form that is relevant and agreed with their counterparties. It is probable that, before the start of business on 4 January 1999, sub-custodians will also provide their clients with cash balances, listings of pending trades and asset holdings in the euro denomination (in line with S.W.I.F.T.'s recommendation). Global custodians should adopt the same procedures.

38 Where there is a cash compensation element in the redenomination methodology - as will be the case in France and probably in the Netherlands - this will be explicitly part of the information set in the appropriate S.W.I.F.T. message format. The cash-back will include accrued interest from the last coupon date to the date on which the cash is paid.

39 Custodians will have notified relevant parties before the weekend of which issues are going to be redenominated; but the key detail of the conversion rate will not be known. Global custodians and investment banks are likely to require information on all securities being redenominated, not just those they may hold at that particular time. Whether this information is provided by fax, by S.W.I.F.T. message, or through the Internet, will have to be decided by each client on a case-by-case basis. Subsequently, confirmation of redenomination, security by security, should be reported via S.W.I.F.T. MT563 standards (or similar media agreed bilaterally between sub-custodians and their clients).

40 The process of redenominating settled positions and pending trades, and the conversion of cash balances, will generate significant volumes of traffic through S.W.I.F.T. over the conversion weekend. Most intermediaries will wish to limit the transmission of information over the weekend to that which is critical to the proper control of normal end-of-year processes and to redenomination.

41 Custodians will convert customers' accounts and the proceeds of any related pending trades into euro only when requested to do so. Some custodians will be prepared to cash out a client's odd-lots, but the facility will be subject to negotiation. Otherwise, recourse could be had to the facilities mentioned above.

Fund managers

42 Fund managers, or their agents, will first have the task of reconciling existing holdings. The experts consider that they should not await advice from CSDs/ICSDs and custodians, but should redenominate and/or convert their positions, open trades and accounts as soon as possible over the conversion weekend and then reconcile with the information received from the custodians and securities depositories when received. Where a nominee account is redenominated, the parallel redenomination of the individual accounts will give rise to rounding differences which will have to be addressed. In those cases where the client rather than the fund manager chooses the custodian, the onus will be on the client to check that the custodian has made adequate preparation for the conversion weekend.

43 A comprehensive before/after reconciliation process will be required over the conversion weekend with the custodians. Reconciliation will be further complicated if there have been trade failures ahead of the weekend, the risk of which will be increased to the extent that fund managers are unwilling to have securities out on repo at that time.

44 As regards settlement, some fund managers rely on the proprietary software of the custodian to provide instructions, and it will be necessary to ensure that the software is capable of handling the information necessary to enable a trade in a euro-denominated bond to settle either in euro or legacy currency, as desired. A further level of complication would arise from block trades if settlement were to be required in a mixture of euro and legacy currency.

45 For the sake of clarity, it will be vital that the currency of settlement be agreed at the point at which the trade is struck. How a trade is reported and finally settled will be a matter for agreement between the fund manager and the client, and could differ from the trade modality itself.

Use of S.W.I.F.T. in the conversion process

46 A variety of messaging systems will be used by market participants to convey information about the redenomination process and the results of the conversion. These will include proprietary systems used by CSDs and ICSDs to communicate with their members. However, S.W.I.F.T. is likely to be most widely used. As reported in Chapter 2, S.W.I.F.T. has issued guidance on the use of its messages with the euro, including the introduction of 'Euro-Related Information' (ERI).

47 An important application of ERI will be to convey information about redenomination. New code words have been introduced for S.W.I.F.T.'s Category 5 messages - Securities Markets - to allow this. Notification of redenomination may be made in up to three different message types:

- MT551: initial notification of a redenomination to take place on a single financial instrument.
- MT562: initial notification of a redenomination to take place on one or more financial instruments.
- MT563: confirmation of a redenomination, which has been completed, on one or more financial instruments.

48 S.W.I.F.T. is confident that the message volume over the conversion weekend can be managed. It recommends the following practices in order to contain message volumes, but these are of course not mandatory:

- Normal end-of-day/year reports should be used, delivered through normal methods of communication without generating the need for new processes over the conversion weekend.
- There is no need to re-announce corporate actions, such as redenomination, if they have already been advised by the end of November 1998.

- Custodians should not send MT531 and MT532 messages for each debit and credit generated as part of the conversion process, but instead utilise MT563 redenomination messages and/or valuation reports in legacy currency and euro.
- Institutions should not re-send confirmations to ICSDs or custodians for converted open trades.
- Custodians and ICSDs should not re-match, thus avoiding the need to send a matching acknowledgement.

Proposals for market testing

49 There are various proposals for co-ordinated testing in Europe. DBC hopes to test by the end of the second quarter of 1998. Sicovam will conduct two kinds of test in the second half of 1998. The operation of the conversion weekend itself will be tested with all members simultaneously. In addition, arrangements will be made to allow bilateral or multilateral testing by members with various counterparties, in order to check their readiness for the euro environment.

50 In London, the Securities Conversion Workshop concluded that a working group should be established to plan a testing programme, initially focused on debt securities. The terms of reference will be to devise a strategy for the development of a cross-border test for the procedures of each institution with regard to the conversion weekend process. The working group would facilitate the communication between institutions, CSDs and ICSDs, and maintain a link with other groups having a similar agenda. The test will specifically focus on the conversion weekend, and not the 'steady state' period thereafter.

51 A synchronised 'street test' is not envisaged because of the complexity of organising so many participants who will not all be at the same stage of preparedness. Instead, the group will create a set of test cases which any market participant will be able to use as references to check that their internal conversion and redenomination processes are working correctly and can be reconciled before they test with each other. This will involve the ICSDs running a conversion of holdings and open trades as at close of business on a specified date, with market participants reconciling at times of their own choosing (in co-ordination with other institutions as appropriate). Efforts will be made to co-ordinate also with CSDs.

CHAPTER 5: FINANCIAL INSTITUTIONS' PREPARATIONS

- Thorough and substantive preparations for the introduction of the euro are in hand amongst banks and securities houses in London; preparations amongst many fund managers and insurance companies appear rather less well advanced.
- It is clear that the pace of the preparations is intensifying and that 1998 will be a very demanding year.
- This Chapter includes contributions from ABN AMRO Bank NV, Deutsche Morgan Grenfell, Lloyds TSB Group, Morgan Stanley and NatWest Group.

AN OVERVIEW

1 In mid-1997, the Governor wrote to a sample of over two dozen major financial institutions in London to confirm that their preparations for EMU were on track for 1 January 1999, and that they would be able to make full use of the wholesale financial infrastructure being developed for the euro. The responses received were broadly reassuring, and also helpfully identified the main issues that they considered remained to be addressed by the authorities. The Bank is conducting a series of bilateral meetings with these institutions. The meetings have confirmed that, amongst the banks and securities houses, thorough and substantive preparations are in hand, even though there are a number of pressing outstanding issues. Elsewhere, preparations appear rather less well advanced. In particular, in many cases fund managers and insurance companies are relying heavily for their preparations on their banks. In our view this should complement - rather than substitute for - the preparations which they need to make themselves. It is clear that the pace of the preparations is intensifying and that 1998 will be a very demanding year, with institutions' competitive positions at stake.

UK position

2 The Chancellor's October statement has been widely welcomed for its clarification of the UK position for the immediate future, thus providing a firmer basis on which institutions can plan. This is especially important for those banks and other financial institutions with significant retail operations in the UK, given the high systems and accounting costs which would be associated with UK entry. Some banks would support a relatively long period between an initial announcement to join EMU and the actual date of UK entry itself, followed by a relatively short transition period thereafter; but others are prepared to contemplate a shorter notice period. Uncertainty regarding UK entry had been, not surprisingly, much less important for institutions' wholesale financial market activity, given the need to prepare in any event.

Individual institutions' preparations

3 All the institutions consulted wish to ensure that they are able technically to conduct wholesale operations in euro from 1 January 1999. In order to achieve this, each has created an organisational structure to facilitate project planning and implementation. Several have stressed the importance of including from the outset front office dealers as well as back office and IT

personnel, not least to minimise the risk of the front office pressing, on business grounds, for systems amendments at an unduly late stage.

4 A common problem is how to forecast with confidence the range of euro products and services that will be demanded in Stage 3. Flexibility will be important. Many firms are naturally trying to improve their planning assumptions by providing practical information to customers and clients to enable their likely needs to be better gauged - for example on invoicing in euro in the case of corporates. Influenced by the message from Siemens and others (see Chapter 6), a number of institutions predict that there may be significant corporate demand for euro facilities in Stage 3, including from small corporates (eg with £1-25 million turnover). Others are more sceptical. But they all agree that the earlier any such customer preferences can be identified and built into their preparations, the better. Separately, several institutions fear that, whilst they will be ready on time, their customers may not be.

5 A number of institutions face the question of whether or not to provide a dual currency capability in various facets of their business, eg bank statements, functional currency for internal accounting, settlement currency, etc. Customer preferences are important but hard to assess now. At one extreme, one bank expects that 70% of corporates will require euro accounts from 1 January 1999, even though the UK will be ‘out’; but the majority expect much less demand and a much slower build-up.

6 Most institutions see preparing for EMU not just as a technical systems matter but as a major strategic opportunity, and are planning accordingly. Competition in financial services will intensify across the EU as a whole. They also consider that training their staff for the introduction of the euro is critical. Many are holding conferences for all key staff, but also using other communication methods including intranet, internal television channels, and dedicated guides and circulars.

Payments systems

7 Most institutions envisage that they will use a variety of systems to effect euro payments in Stage 3, including CHAPS euro, TARGET, the EBA Clearing and correspondent banking, with the choice for any particular payment being determined particularly by relative cost. They are confident that they will be able to meet the payments requirements of their customers and counterparties. Some plan to review their overall payments arrangements with the introduction of the euro, eg by retendering their business and reducing the number of correspondent banking relationships (see box in Chapter 2). Finally, information is needed about any days when national RTGS payments (and securities settlement) systems are to be closed beyond the two TARGET ‘holidays’.

Financial markets

8 It is recognised that a number of questions relating to financial markets remain outstanding:

- It is regarded as particularly important for governments to provide detailed information on how they propose to redenominate their own debt securities, where they have not already done so, and to stick to their decision. There is support for restricting the number of different redenomination methods to the minimum (eg to only the ‘French’ and ‘German’ models).

- Some institutions consider that the tax and accounting implications of the small residual amounts left after redenomination warrant further investigation.
- Most institutions remain unclear as to whether redenominated debt securities will retain their ‘old’ ISIN numbers (see Chapter 3).
- One institution has said it does not propose to trade and settle in fractions of the nominal value of euro-denominated bonds in Stage 3. If others follow suit, odd-lots would disappear quickly.
- While message-type standardisation is not a problem *per se*, S.W.I.F.T.’s planned changes to 50 message types at the beginning of Stage 3 require careful preparation.
- And there is a concern that the move from a number of national IBORs in the euro area to EURIBOR could be problematic for some contracts.

Conversion weekend

9 A number of institutions have flagged the risk of market difficulties arising in the period surrounding the ‘conversion weekend’ (see Chapter 4). In order to minimise this risk, several institutions support prior agreement on procedures and market testing of them through a ‘dress rehearsal’. Some firms propose to scale back their trading during this period in order to minimise potential problems.

Legal issues

10 Some institutions are concerned that continuity of contract may not be assured in some non-European jurisdictions, while there is a degree of residual uncertainty as to whether an EMU continuity clause should be inserted into contracts, including under EU jurisdictions, and if so in what circumstances. However, most institutions appear relatively relaxed that the legal environment for the euro will be secure.

11 It is considered important that the burden of additional statistical requirements on financial institutions arising from EMU should be minimised. There is also some interest in how an institution may redenominate its share capital into euro under the Companies Act, should the UK enter EMU and possibly before.

Regulation

12 Institutions have requested clarification on the supervisory treatment of national currency and euro-denominated instruments. (The banking and SFA supervisors have recently issued statements: see Chapter 7.)

The euro and the Year 2000

13 All institutions emphasise that there are huge challenges involved in preparing simultaneously for both the euro and the Year 2000. A number of institutions will have no spare IT resources for other discretionary projects in 1998. Several are concerned about shortages of

IT personnel in 1998. Where new systems are being installed, it may be possible to combine the two projects in order to produce savings. But this will often not be possible with the development of existing systems.

Follow-up

14 We propose to have further meetings, both with the firms consulted to date and others, in order to continue to assess the state of their preparations, to learn of any concerns as they develop, and to assist the preparations where we can.

ABN·AMRO Bank

A: A CONTRIBUTION FROM ABN AMRO BANK NV

Introduction

15 The implementation of EMU is seen by ABN AMRO as one of the most important developments of the century for business as a whole.

Planning assumptions

16 Since 1996, the bank has assumed that EMU will happen, on time, with the Netherlands an initial participant. The UK has been assumed initially to be ‘out’, consistently with the Government’s recent decision, but preparing to be ‘in’.

17 As regards the City of London, where the bank has major investments of staff and capital, it has been assumed that the ‘London financial infrastructure’ - including the Bank of England, LIFFE, CREST, APACS, CHAPS amongst others - would be ready to serve the financial community in euro with effect from 1 January 1999, despite the UK being ‘out’.

18 In terms of the impact on the UK, the expectation is that there will be a ‘cascade effect’ caused, at one end of the spectrum, by EMU ‘first wave’ corporates insisting on paying in euro, and at the other end, EMU private individuals as tourists for example creating increasing pressure for euro-compatible payment facilities.

19 Given the above, ABN AMRO has taken the view that the euro will impact all aspects of its business, both as a corporate in its own right as well as a global banking institution. The bank must therefore prepare itself on a world-wide basis to optimise the opportunity presented.

Organisational structure

20 Headed by a member of the Managing Board, the bank has created a matrix organisation of steering committees and project offices in each of the four main divisions - Netherlands, International, Investment Banking & Global Clients, Resource Management - to ensure effective co-ordination both vertically within the divisions and their lines of business, but also laterally

between the divisions themselves. There is also a Corporate Project office which facilitates the operations of the committees and the co-ordination of tasks at corporate level.

21 Overseeing the UK, the International and Investment Banking & Global Clients' divisions have appointed two senior managers, who ensured that project plans were prepared earlier this year by the lines of business and that effective progress is being made.

22 In the UK, a network of individual steering committees has been established. A key element is to ensure that the technical back office preparations, which are well advanced, keep pace with the evolving commercial demand from the client base.

Detailed euro preparation

23 ABN AMRO in the UK has devised a series of inter-locking procedures and activities to ensure maximum euro effectiveness - in sequence being:

- Intense and continuing corporate and financial institution client analysis as to requirements to meet both threats and challenges of EMU.
- Raising of commercial issues identified from clients with both front and back office specialists to produce concrete solutions.
- Logging of the solutions in an internal database with global access - and a pro-active capability of advising staff of items that arise and impact on their area.
- Ensuring continuing internal awareness - in depth - via a series of monthly newsletters and quarterly briefings and training.
- In parallel, providing a series of client workshops to highlight new issues and to validate product innovations.

24 Given the bank's approach that EMU will have a universal impact on its business and that of its clients, from the commercial perspective, ABN AMRO in the UK identifies four main areas of euro product activity.

Strategic

25 EMU is causing corporates, both domestic and multinational, to reassess the fundamental logic of their areas of operation, internal structure and sources of capital raising. The creation of the single currency market, even of the 'first wave', is anticipated to increase US investor interest, acceleration of the move from debt to equity, and a cheaper cost of funds due to the enhanced depth and liquidity of the financial markets in Europe.

Commercial

26 As EMU causes sales and marketing to be enlivened by the transparency of the new market, so the need arises for both product and service providers to review both the upward and downward supply chains to ensure best positioning as a result of EMU. Furthermore, opportunities for more pragmatic handling of books of receivables will come into play - ranging from simple receivable purchase facilities via receivable finance through to full-scale asset securitisation.

International cash management

27 *A*s various polls amongst leading European corporates have indicated, the increasing likelihood of EMU is causing an accelerated evaluation of the transactional services provided by banks and other financial institutions. For example, the RTGS standards anticipated of TARGET are likely to create a market-wide demand for payments to be irrevocable, final and with data immediately transmitted to both payer and beneficiary. As such, payments traffic will become 'commoditised' - and banks will need to decide where they wish to invest in systems/staff or outsource. Further, the logic of pooling euro balances across Europe will become more evident.

Business management

28 It is further recognised that a growing number of multinational corporates are already considering the benefits of internal accounting in euro, assisting internal transparency, as well as considering the increasing prospect of fiscal alignment as the probable successor to monetary alignment.

Product preparation

29 In terms of cash management, ABN AMRO is preparing itself as a prime pan-European bank, to be able to meet the needs of its clients who can elect during Stage 3 at which point they switch their accounts with the bank from legacy currency to euro. The systems already being prepared to be effective from 1 January 1999 are designed to provide the opportunity for dual account management, balance reporting and settlement of intra-EMU payments, as well as between EMU and non-EMU countries. Straight-through processing with increased functionality is intended, anticipating shorter time-frames, increased volumes and greater competition on pricing from the market. While national zero-balancing and pooling will be provided to handle the euro, ABN AMRO is also dedicating considerable resources to the creation of a single account structure, allowing clients multiple access, as well as cross-border pooling as and when outstanding fiscal and regulatory issues are clarified and resolved.

30 As regards clearing, ABN AMRO will be prepared to take advantage of TARGET with access to the high value clearings in all 15 EU countries, with the additional benefit in the UK that it has just become a direct member of CHAPS. It is also a member of EBA clearing and has numerous correspondent banking relationships, thus allowing it access to competitive options. For many banks, it is decision time. Invest and become a network provider; form alliances to reduce costs; or remain a niche player.

31 In terms of fx and interest rate swaps, ABN AMRO is already advising clients on the effects up to 1 January 1999, during the transition phase, and after 1 January 2002. In terms of swaps, guidance is being given on the so-called 'convergence end-game' which will evolve between the nomination of 'in' countries in 1998 and 1 January 1999. At the same time, the bank is further contributing to the financial industry associations to ensure the most effective operation of the derivatives and securities markets once EMU is fully effected.

Conclusions

32 The overall planning of ABN AMRO as regards the euro in the UK is to ensure that they have committed sufficient resources and dedicated appropriate market product development in

order to be able to inform and if possible assist their clients in meeting the conversion issues of EMU, compensating for the loss of revenues due to monetary alignment, and ensuring best competitive realisation of the opportunities which EMU offers, while ensuring best euro compliance.

33 ABN AMRO regards EMU as having a global effect, and therefore its network is gearing up to providing euro-compatible services to Asian and American exporters and investors, for example, not simply those within Europe.

34 The preparations of London's financial infrastructure for EMU introduction provide a sound base for a bank such as ABN AMRO to deliver the most effective euro-compatible services both to UK and international clients.

Deutsche Morgan Grenfell

B: A CONTRIBUTION FROM DEUTSCHE MORGAN GRENFELL

Planning assumptions

35 Despite - or perhaps because of - uncertainty in a number of areas related to EMU (issues as fundamental as which countries will participate), Deutsche Bank began to prepare for EMU early in 1995. This was a world-wide effort, and therefore included preparations for Deutsche Morgan Grenfell (DMG). This effort intensified in early 1997.

36 In planning for EMU, we assumed initially that all EU countries will participate in EMU. This overly conservative assumption helped minimise the possibility of missing work that should be completed prior to 1 January 1999. We currently see the most probable scenario as an EMU with eleven countries (which excludes the UK, Sweden, Denmark and Greece). Therefore, the emphasis of the preparatory work is on products based in these eleven currencies.

37 This is not just a European effort. Preparation is taking place around the world in all of DMG's 47 offices, as customers and products are independent of the trading location.

Analysis of requirements

38 DMG started its preparations for EMU with a detailed analysis of the impact of EMU on its businesses:

- Direct impact from the changeover (eg system changes, procedural changes, contract continuity) on operating costs and product offerings.
- Indirect impact on products and services due to changed customer requirements.
- Indirect impact due to changes in the investment banking industry.
- Impact from different scenarios (eg countries participating in EMU).

EMU project organisation in DMG

39 Based on the above analysis, projects focus on four areas: training; infrastructure changes; marketing; and product development.

40 These projects are co-ordinated and globally managed by a Steering Committee with senior representatives from each division. In each division, managers have been appointed for one of the four above areas for their division, reporting to their divisional EMU manager and to the relevant task manager.

41 Additionally, in each office for each division, a local EMU manager was identified. This structure ensures full coverage of all areas and simultaneous global co-ordination.

42 The process is monitored at the EMU project office which has staff in Frankfurt and London. A status report is made to the DMG EMU Steering Committee. The chairman of that Committee communicates with the other group divisions of Deutsche Bank through periodic meetings of an overall co-ordinating group.

Training

43 Training is critical. Even now, we are surprised at the lack of information, or even the level of misinformation, that employees and clients have about EMU. Therefore, DMG is in the process of completing a general EMU awareness program for all staff world-wide. Between August and November, presentations have already been made in London, New York, Tokyo, California, Singapore and Hong Kong. In each location, between 25% and 35% of total staff attended presentations on EMU. It is expected that this introductory training will continue in other locations. Training in Frankfurt is being handled by the Deutsche Bank EMU project office.

44 Following the general training, staff are then given focused training in specific topics and for particular jobs.

45 Regular research brochures, internal communications and an Intranet site support this training and information dissemination.

Marketing

46 EMU not only affects financial institutions but most companies which are trading with or operating in EMU countries, investing there or issuing securities in EMU currencies. Therefore, DMG focuses significant attention on client support. EMU specialists have been made available to support customers in their preparation for EMU.

47 DMG offers tailored seminars, presentations and workshops. Competitive issues in the client's industry, new investment opportunities, operational issues and many other topics have been and will be covered. Presentations on EMU have already been made with clients on all continents.

Product development

48 EMU obviously has a significant impact on DMG’s products:

- A number of products cease to exist as foreign exchange rates are locked between EMU currencies.
- New euro products are required and will be offered.
- During the transition period, products can also be settled in the local national currencies to allow clients to choose according to the ‘no prohibition, no compulsion’ rule.
- With the increased importance of the euro (as compared to the current fragmented currency markets), many clients world-wide will develop an increased interest in European products.
- Some clients, currently investing in European products, might become more interested in other markets, partly due to the decreasing interest rates in Europe, partly due to their doubts regarding EMU.
- Falling entry barriers for local markets and increased possibilities for economies of scale will change the competitive environment.

Infrastructure

49 For each product, a working group of business professionals, IT, operations and controlling staff has been put together. These groups began with an analysis on how EMU influences the individual product flows. A project plan based on this analysis was then developed, including milestones, dependencies and assumptions.

50 The infrastructure requirements (ie system changes, process changes, legal requirements) are mainly driven by local requirements, but global consistency must be guaranteed and synergies exploited as far as possible. This should be ensured by a matrix structure: global product responsibilities and local responsibilities.

51 The IT project starts with the current systems regarded as ‘frozen’ for the time being. Only after effective deal processing, risk management and limit reporting post-EMU (including dual-currency handling) is totally ensured can additional development be started.

52 As the extent of the project is dependent on the outstanding decisions regarding EMU mentioned earlier, the current plan is based on the highest possible workload. Some of the required changes are already decided; development work is concentrating on these. In the UK, systems used solely for sterling products can remain unchanged. However, all systems used in the UK for multi-currency products still need to be amended.

53 As not all systems can be changed at the same time, testing for data integrity needs to be repeated for each step. This integration testing is the largest current bottleneck. It is also a challenge to find sufficient management time for this essential project in addition to on-going daily responsibilities.

54 Many of the required process changes are decided along with the IT changes. New working procedures have already been discussed. A legal team supports the product teams in legal and regulatory questions.

Conclusion

55 Organisationally, DMG is much better prepared than even a few months ago. Although a significant amount of work remains, it is manageable. As decisions about EMU are finalised (eg the participating countries), the effort - both internally for ourselves and externally for our clients - can focus even better on the appropriate systems and products. With little more than a year remaining, however, we can begin to see how this will come together, and are confident that we will be prepared for the new currency on 1 January 1999.

Lloyds TSB Group plc

C: A CONTRIBUTION FROM LLOYDS TSB GROUP

Introduction

56 Two sets of assumptions underlie Lloyds TSB's work on the single currency:

(i) that EMU will start on 1 January 1999, notwithstanding a possibility that the start date may be delayed; and

(ii) that, if EMU starts in January 1999, and pending the Government's decision as to when it intends the UK to join EMU, Lloyds TSB needs to:

(a) undertake necessary changes under an initial UK 'out' scenario, with focus on 'market', 'wholesale' and 'international' activities and in support of industry payments system developments; and to

(b) undertake the essential groundwork for a UK 'in' scenario to be ready for when the UK joins EMU.

Organisational structure

57 Having collaborated over recent years in UK banking sector research and preliminary costings, early last year Lloyds TSB conducted a comprehensive internal study of the effect that the introduction of a single currency could have on Group activities. This led to a full impact analysis using conventional project methodology, as a result of which around 5,000 issues were identified.

58 A Group-wide EMU Steering Committee was formed to direct the Group's initiatives. It is chaired by the Director of IT and Operations.

59 A central programme management team is also in place to lead and co-ordinate Group preparations for EMU. The central team works with more than 70 business and administrative units across Lloyds TSB Group and its subsidiaries, each of which has designated one or more project managers to act as euro co-ordinators. The central team assists them in establishing individual plans to introduce the euro in their respective areas and monitors progress against milestones. It has developed internal information strategies, supports business units in formulating their external communications initiatives, acts as custodian of the budget, revisits Group planning assumptions, and records/reviews Group issues and risks.

60 Regular updates on external developments and internal progress are provided to the Group Executive and the Board.

Technical preparations and outstanding issues

61 The focus of attention has been on preparing the Group to trade in euro from 1 January 1999. Wholesale, Treasury and International Clearing are the units which have been the most involved, undertaking specialised impact analyses and producing plans to underpin development and test programmes over the next 15 months.

62 Considerable support has been given to industry payments systems initiatives. Progress is on schedule in all major developments, notably those of CHAPS which will ensure the industry infrastructure is capable of dealing with euro transactions in 'wholesale' markets by January 1999. Lloyds TSB is preparing to use CHAPS euro, including for cross-border transactions through its connection to TARGET, but also to use the alternative mechanism to be provided by the EBA Clearing.

63 Within Lloyds TSB, activity at business unit level has taken account of different UK entry scenarios, eg 'out', 'in', 'in later', and has evaluated the distinct ramifications for individual business units. While we can progress plans in wholesale activities, we are conscious that, until Government announces its decision on the timing of UK entry, planning and financial commitments in relation to certain specific activities - and to 'retail' activities generally - entail the risk that scarce resources may be wasted. While a three year transition equivalent to Stage 3 appears sufficient to change over retail activities after a UK entry decision has been taken, our intuitive appraisal of the transition environment is that one or more of the following conditions may occur:

- Suppliers of financial services may face demand for the euro sooner rather than later in Stage 3, from small or medium-size companies affected by the requirements of large corporations adopting the euro from the start.
- If the UK enters EMU later, the transition period may be shorter than three years, which could possibly be influenced by the desirability of avoiding protracted and even more costly dual accounting and parallel systems during the transition.

The euro and our customers

64 The advent of EMU, and the transparency resulting from the elimination of national currencies substituted by a single currency, will provide cost savings and commercial opportunities for UK companies. However, before, they need to prepare to change over to the

new currency for when the UK is ‘in’, and be capable of dealing in it while the UK is ‘out’. It is therefore a concern to us that UK companies may be insufficiently prepared to address these issues. Aspects at the forefront of our mind include:

- A sense of responsibility to provide best service.
- A determination to adopt best practice across our Group.
- A need to inform our customers, and train our staff.

65 One initiative we have recently undertaken is based on these premises. We have provided our commercial medium-sized customers with a *Practical Guide* to assist them in identifying and recording the likely impact on their companies of the introduction of the euro.

66 Presented in ‘kit’ form, our Guide adapts some of the methodology used in our own internal work, and introduces a planning process built on a series of sequential steps. They include:

- A set of guidelines towards understanding the subject of EMU.
- A process to brainstorm the issues specific to the company.
- Planning the way forward by ordering the issues according to their relative impact, and timing the various changes required.
- Identifying key dependencies, concerns and unanswered issues/questions.

67 This project management procedure is designed to support our commercial customers in addressing and familiarising themselves with the fundamental issues and planning the potential preparations they face, while recognising the decision on UK entry to EMU - and its timing - remains to be announced by Government.

68 At the same time we are continuously developing and expanding internal communications for our staff to facilitate their information, understanding and appreciation of Group policy.

MORGAN STANLEY

D: A CONTRIBUTION FROM MORGAN STANLEY

69 Morgan Stanley has been building the possibility of EMU into its business plans for some time. As part of this ongoing strategic planning work, we have engaged in a senior level scenario planning exercise to focus management’s attention on the business decisions critically dependent on EMU. In parallel, Morgan Stanley has been working to enhance its infrastructure to ensure the firm is prepared for the introduction of the euro on 1 January 1999.

70 Connecting the strategic business decisions of the firm and the infrastructure project is critical to ensuring that business opportunities are identified early and that the project itself is appropriately prioritised and resourced.

Project structure

71 The overall EMU project in Morgan Stanley is directed by a firm-wide Steering Committee comprised of 16 Managing Directors with responsibilities for the main European divisions including both front and back office functions. Reporting into this Committee are two project teams covering (i) infrastructure and (ii) legal issues.

72 The infrastructure initiative is led by a dedicated core team drawn from Operations and Information Technology. The core team co-ordinates and manages the firm's overall approach to implementing EMU compliance.

73 Working with the core team are a number of dedicated project teams which have been involved in scoping and preparing the implementation work. Each of these teams is responsible for a number of specific systems and is headed by designated EMU business owners (EBOs) and EMU system owners (ESOs).

Preparing for EMU compliance

74 The EMU project team began to design and build the required infrastructure for the euro in January 1997. Their approach is summarised in the five main stages illustrated below:

Towards an EMU infrastructure

Stage I	Stage II	Stage III	Stage IV	Stage V
Impact analysis	**Initial estimation**	**Practical solution**	**Build the infrastructure**	**On-going work**
Explore implications of EMU for Morgan Stanley's systems	Assessment of how much work is involved based on worst case assumptions	Based on refined assumptions: - set budget - marshall resources	Building and market testing phase	
Jan 1997	May 1997	Aug 1997	Oct 1997	Jan 1999 →

Stage I - impact analysis of EMU

75 In Stage I, the EMU project team tried to answer the question of what the impact of EMU would be on Morgan Stanley's business processes. This included analysis of the scale of the impact on how we conduct and settle securities transactions. To deliver the impact analysis we conducted over 70 workshops with 300 Morgan Stanley business and technology participants.

76 These workshops were conducted as brainstorming sessions to produce a detailed analysis of 13 'key themes' identifying the key issuers for systems development, for example: (i) bond redenomination, (ii) reconventioning, (iii) rounding, (iv) handling historical data, (v) identifying programs which connected country of settlement with currency, etc.

Stage II - initial estimation of resource requirement

77 In the next stage we addressed the issue of resource, ie the required investment to make the firm EMU compliant. To resolve this issue we produced a list of questions and guidelines structured around the 13 central EMU themes that had been identified in Stage I. This analysis was distributed to 80 pairs of EBOs and ESOs who were asked to estimate, by theme, the effect of EMU on specific systems in their business areas.

78 The results of this exercise were collated and refined through a series of 'townhall meetings' in which the results were tallied and reviewed by divisional leaders and technology experts to ensure consistency of approach to subject the numbers to a reality check. The output of the townhalls was presented to the EMU Steering Committee. The aggregate requirement for IT resource reflected a 'worst case' given that maximum system flexibility had to be assumed to cover a number of uncertainties in the EMU process in connection with both government actions and market practice issues.

Stage III - practical solution to EMU compliance

79 To refine the scoping exercise, estimating teams were given greater clarity in terms of the business assumptions they should work under to simplify the process.

80 For example, we have taken the position that: Morgan Stanley has a preference to settle all trades denominated in euro-area currencies which are dealt after 1 January 1999 in euro rather than the 'legacy' currency.

81 This assumption underscores the benefits of:

- A broad and timely adoption of the euro by the wholesale financial markets bringing a level of credibility and stability to the new currency.
- Streamlined operations and settlements activities reducing the potential for unmatched trades and fails caused by the changeover to the new currency.
- The firm being able to avoid a part of a sizeable IT investment that will have a short useful life.

82 These business decisions reflect discussions with counterparts at other financial institutions, official bodies, market practitioner bodies (ISDA, IPMA, etc) and our legal advisers. The simplifying assumptions have resulted in a significant lowering of the assessment of the need for IT resources.

Stage IV and V - build the infrastructure and on-going work

83 During Stages II and III, the EMU project team worked with the various EBOs and ESOs to develop implementation plans for the full scope of systems that will be impacted by EMU. Some systems development work is already in process. By 1 November all the project teams had moved into actual development work. The activities of the various groups will be centrally co-ordinated by the EMU project team to ensure we meet the EMU timetable up to and post 1 January 1999.

84 A project risk management system is in place to identify and monitor critical path events and a communication strategy is being developed to ensure consistent communication and education for both internal and external audiences.

85 In conclusion, Morgan Stanley sees EMU as a tremendous opportunity for the firm to develop its pan-European franchise. To this end, senior management has recognised that it is critical to the firm's strategy that funding, resourcing and management attention for EMU infrastructure preparation is prioritised over competing discretionary initiatives.

NatWest Group

E: A CONTRIBUTION FROM NATWEST GROUP

Introduction

86 At NatWest we believe that we and our customers are in Europe and must plan for an EMU world from 1999; irrespective of whether the UK joins EMU, we see EMU planning in the wider context of European business development. A successful EMU within the European Union will be an accelerator of other strategic changes - the completion of the Single Market, demographic changes, the growth of direct financial services enabled by new technology, and so on.

87 NatWest supports European integration through the Single Market, which we believe benefits the UK economy, our customers, and, indeed, the UK financial services industry.

88 However, EMU has still to prove itself and its ability to withstand external shocks. If successful, it will increase competition and change the terms of trade, potentially putting downward pressures on pricing. Some businesses may not be able to withstand these changes and may fail to adjust. There are likely to be winners and losers - the economics for business are finely balanced.

Core planning assumptions

89 In the light of this strategic view, NatWest's core planning assumptions are straightforward:

- Sound EMU conversion planning is a necessary, but not a sufficient, condition for business success.
- EMU will start in 1999, and will probably be tested fully. All scenarios should be considered and a flexible approach is essential.
- The pace and priority of EMU change is primarily a matter for each business unit, each facing different customer demands as a result of the EMU process, taking account of likely EMU membership, the expected rate of euro demand in each customer market, and competing strategic priorities for each business.

- We aim to minimise investment which would be wasted under highly unlikely scenarios.
- Accordingly, we had only contingency plans in place for UK entry in 1999 which we regarded as unlikely.
- Now that the Government has announced that it would in principle like the UK to enter EMU early in the next Parliament, we are reconsidering our plans for UK entry, but timing of entry will need to be more certain before we commit the necessary investment for full-scale euro preparation in retail banking.

Organisational structure

90 Our organisational structure to deliver EMU supports this approach.

91 The Group Chief Executive led a major scenario planning exercise in early 1996 to ensure that top management across the Group built a common picture of the strategic changes under way in Europe, including the effects of EMU.

92 Business Unit chief executives then assumed primary responsibility for EMU change and delivery to customers alongside their other objectives. Their plans are reported to the main Board every six months. It should be noted that the businesses in NatWest Group have operational responsibility for almost all functions, including IT, so chief executives are fully empowered to manage developments and trade-offs.

93 A small Group team champions EMU development, ensuring that it remains at the forefront of attention through this critical period, and represents NatWest at industry bodies.

94 A Group Steering Committee (with membership from each business) is responsible for:

- Updating EMU assumptions.
- Setting and monitoring quality standards for plan development and implementation.
- Ensuring consistency where required and maximising shared learning across businesses.
- Reviewing investment/risk proposals from businesses to ensure that the Group as a whole is properly prepared for all likely scenarios.
- Maintaining focus on strategic development alongside EMU conversion issues, and the right balance between EMU and other strategic issues, such as the Year 2000 project.

95 Day-to-day responsibility rests with full-time EMU Programme Managers at Group level and in all businesses, and well over 150 staff are currently engaged full-time on EMU preparation throughout the Group.

Customers, products and services

96 In the *London financial markets* - foreign exchange, money markets, bonds, derivatives, equities - NatWest will be fully prepared for EMU, with a full range of euro products, in January 1999. We believe that London will thrive whether the UK is ‘in’ or ‘out’ of EMU, but we shall also be ready where we are represented in other European centres, and especially in

Dublin where Ulster Bank Markets offers a full range of services in a country almost guaranteed to be in the first wave of EMU.

97 *Corporate banking* is critically affected by EMU, and NatWest's Corporate Banking Services will have euro products and services ready in 1999, even though the UK will stay outside EMU. We believe that there will be early and extensive demand for euro services in this segment. EMU is not a customer-led project overall and our concern is to ensure that all our customers are ready, particularly the mid-corporates. An extensive communications programme is under way and will continue in 1998. Staff training is also key and an extensive training programme is under way.

98 *Fund management* is an area too often neglected in the EMU literature. Some in the industry have felt that the impact in this sector will be rather less than in other areas of financial services. However Gartmore at NatWest believes there will be considerable change on two fronts - operational and technical.

99 It is a priority to ensure that the needs of existing clients can be met from January 1999. This means ensuring that systems and procedures are in place to handle, for example, the issues of redenomination, securities settlement, historic performance analysis and multiple base currency client reporting.

100 The wider impact of EMU on the business, in terms of strategy and products, is also being assessed. The UK market is likely to become more accessible to Continental European competitors and vice versa. We see this, coupled with market developments driven by such issues as demographic changes, as opening up significant new opportunities for UK managers for both institutional and retail products. While the pace of change is uncertain, planning is needed at an early stage.

101 For *retail banking* in the UK, entry into EMU is the critical factor. We do not believe that there would be strong demand for euro services from most personal and small business customers until towards the end of any transition period. Given the low probability of entry in 1999, we had allocated only minimal investment to this sector on a contingency basis. Conversion here will require a major national campaign, not just by individual banks. Indeed, the competing business priorities of the retailers to prepare seriously ahead of a Government decision to join EMU has been, in our view, a key economic risk of very early EMU entry.

102 In the Republic of Ireland, however, our subsidiary Ulster Bank will be delivering retail euro services from 1999, and NatWest should subsequently benefit from this experience in building services for our UK customers, if and when the UK finally decides to enter EMU.

Technical preparation

103 NatWest's technical preparations are essentially geared to support our views of market changes and customer needs outlined above.

104 It is worth noting that EMU and the Year 2000 project are very different in this respect. Year 2000 has a straightforward business requirement, ie no-one should notice any impact on the

business. By contrast EMU is designed to improve economies and the business environment. It must and will come to customers' attention and provides opportunities as well as threats.

105 NatWest's response is to manage the two programmes separately, but to ensure periodic review both at executive level and at local IT management level to maximise common solutions and minimise resource contention.

106 Finally, the importance of staff communication needs to be emphasised. NatWest Group's world-wide Staff Council received an EMU presentation early this year, and this has been followed up in various businesses as the need for active contact with customers increases. For example in Corporate Banking Services, the Customer Guide, seminars for over 1,000 corporates, and regular customer bulletins, are being matched with a programme of staff awareness - over 5,000 front-line staff are receiving initial training in the final quarter of 1997 and early in 1998 in this business alone.

107 Excellent internal communication at every level will be essential in meeting our business goals, and enabling our customers to adopt the euro easily and efficiently.

CHAPTER 6: BUSINESS, RETAIL AND PUBLIC SECTOR PREPARATIONS

- The Government has set up a Business Advisory Group to help businesses in the UK to prepare.
- Retail payments in euro will be possible from 1999, although significant demand may only materialise later.
- HM Treasury is co-ordinating public sector preparations.

A BUSINESS PREPARATIONS

1 The Government has made three key decisions: to declare in principle for the euro; to make the UK's economic requirements the decisive test for British membership; and to provide a period of stability and certainty to prepare for a decision early in the next Parliament. Businesses need to:

- Prepare to be able to trade in euro and compete in the changing economic environment of the Single Market, from 1 January 1999, depending on the type of their activities.
- Think about actively preparing for the possibility of the UK joining from early in the next Parliament.

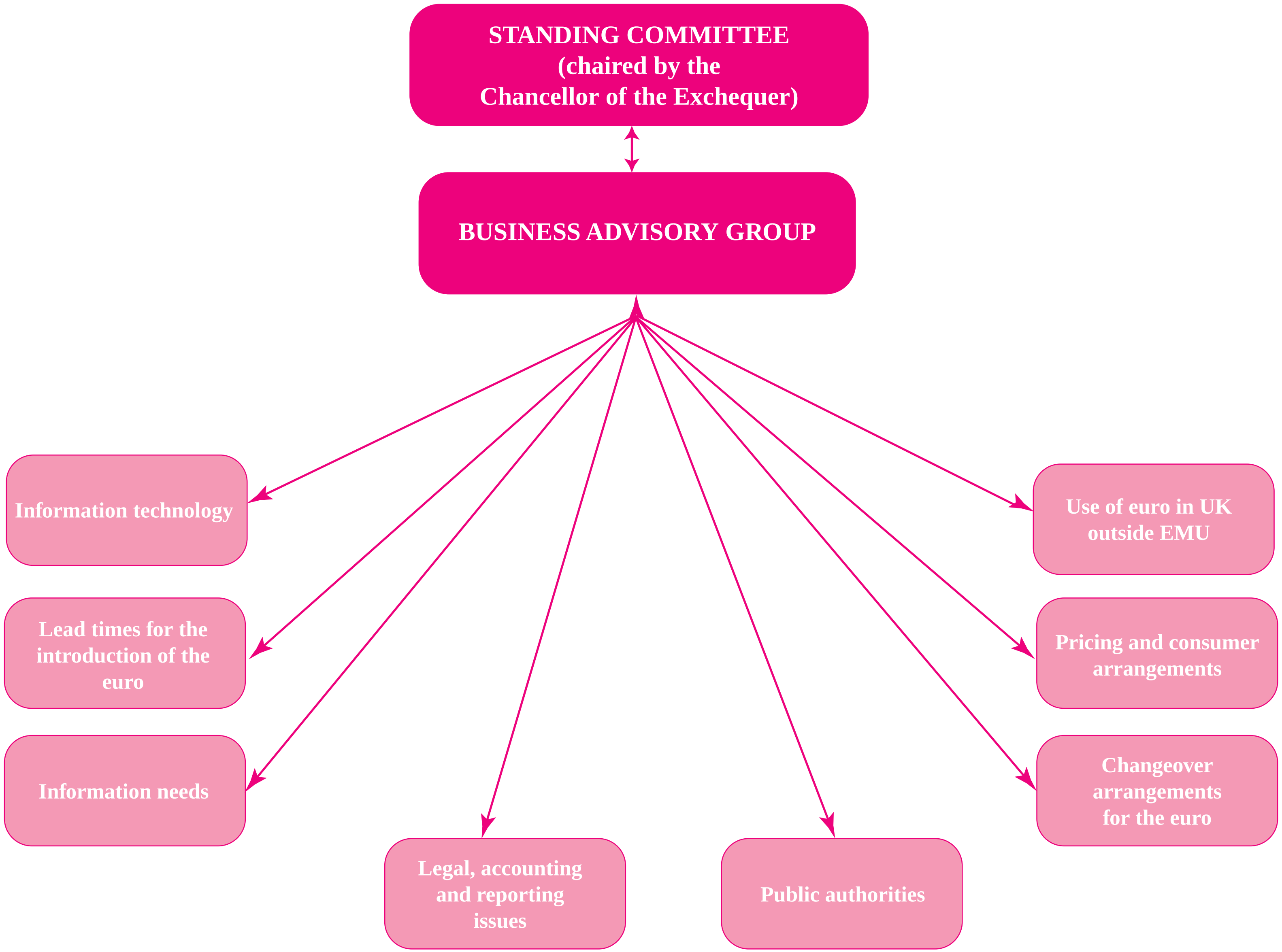
The Business Advisory Group

2 The Government has established a Business Advisory Group as a forum for discussion with business, consumer and trades union representatives about preparations needed for UK firms to trade and use the euro from 1 January 1999, and those needed before the UK would join the single currency. Following its first meeting in September, its work is being carried out in eight separate working parties (see below). They are due to report to the Advisory Group in December, and a summary of their findings will be published early in 1998.

3 Advice from business organisations is being used to inform the Government position in negotiations on EC legislation concerning the euro, on issues such as price displays. The Government participates fully in groups to learn from the experience of other EU Member States. From early in 1998, the Government will be arranging a series of regional euro conferences around the country to address general and sectoral business issues.

4 The Business Advisory Group will be providing the Government with further ideas to help firms prepare, and the Government will be actively considering recommendations from that group and from other sources. Views should be sent in writing to: EMU team, HM Treasury, Parliament Street, London SW1P 3AG.

THE NEW COMMITTEE STRUCTURE TO ADVISE GOVERNMENT ON BUSINESS PREPARATIONS CHART C



5 Examples of the subjects being considered in the working parties reporting to the Business Advisory Group are shown in the box below.

Working party	*Examples of subjects being considered*
Lead-times	How long would it take firms to be ready for the euro if the UK were to join?
Transition arrangements	When would be the ideal time to introduce euro banknotes and coins?
Information technology	What guidance do firms need to help them prepare their IT to handle the euro?
Use of the euro in the UK outside EMU	How widespread will the use of the euro be in the UK in 1999, outside EMU?
Pricing arrangements	How to educate and inform consumers without placing an unnecessary burden on businesses?
Legal, accounting and reporting	What are the legal, tax and accounting implications for firms? Do they need more guidance?
Information	What information is needed most urgently by firms?
Public authorities	What do firms expect from their relations with public authorities such as the tax authorities?

THE EURO AS A PARALLEL CURRENCY

1 When Stage 3 begins, the euro will be able to be used in the UK as a parallel currency alongside sterling. The extent of its use is likely to depend on how well EMU works and whether the UK is widely expected to join in the relatively near future. If a decision is taken to join, use of the euro in the UK may well spread in the run-up to entry.

2 From the start of Stage 3, the euro will be extensively used for the trading and settlement of wholesale financial transactions in the City. A ‘grey’ euro market may even develop during 1998. The euro is also expected to be used by many UK-based companies which trade across the Single European Market, and by companies from the euro area trading with the UK. For example, Siemens have indicated that they intend to introduce the euro as the official company currency in their subsidiaries outside the euro area on 1 October 1999. Some UK companies with no external trade may need to be able to cope with euro transactions, or at least with the sterling equivalent of transactions denominated in euro, even though they have not needed a foreign currency capability to date. There will be extensive competition between banks for euro business from multinational companies, in the UK as well as the euro area. Some banks (especially those from the euro area) may also use the euro as a marketing tool in competing for custom from smaller UK businesses.

3 It is much less likely that the use of the euro will spread much to the retail sector while the UK remains ‘out’. The euro is likely to be used in some high street retail stores, particularly in tourist areas, like Oxford Street in London, and in some card transactions, in much the same way that some foreign currencies are used at the moment. Marks & Spencer are upgrading their tills throughout the EU, including the UK, and the new tills will be able to handle foreign currency. It will be for management decision whether and when to accept particular currencies, including the euro. From the beginning of 2002, euro banknotes will be brought into the UK by tourists and other travellers. But it is important to remember that banks, bureaux de change and retailers will charge their customers an exchange rate ‘spread’ between the euro and sterling, and possibly a handling fee on top. This is likely to restrict the use of the euro, including in retail transactions, just as it restricts the use of foreign currency at the moment.

4 The extent of the use of the euro in the UK will influence who takes the exchange rate risk between the euro and sterling. At the moment, domestic UK businesses are largely insulated against exchange rate risk. That will no longer be the case if, as a result of competitive pressure, they decide to invoice in euro. On the other hand, the market exchange rate between the euro and sterling should become more stable, if and when a decision is made that the UK will join.

5 The extent to which the euro is used in the UK as a parallel currency will be influenced by the steps that the authorities take to facilitate it. The Bank has been involved in putting in place the necessary financial infrastructure for the use of the euro in the City for large-value payments, even though the UK is ‘out’. The Chancellor has announced that companies in the UK will be able to file accounts, pay taxes and denominate their shares in euro, in the same way they can use foreign currency today. The question in each case is whether more transactions will be denominated in euro after EMU begins than are currently denominated in ECU and the national currencies of participating Member States.

6 A particular question which the authorities are considering is whether the use of the euro as a parallel currency while the UK is ‘out’ will reduce the lead-time that banks and businesses require between the date of any announcement about UK entry, the date of entry, and the date when euro banknotes and coin are introduced in the UK as legal tender and sterling banknotes and coin begin to be withdrawn. This involves a judgment about how widely the euro will be used while the UK is ‘out’; and whether there is likely to be a significant increase in its use before the formal announcement that the UK will join, once the market anticipates this to be the case. It also involves assessing the systems changes that will still be required and the likely level of public awareness of the changeover in prospect. However wide the use of the euro as a parallel currency, the introduction of the euro as the single currency in the UK would be a proposition of a completely different order of magnitude.

B RETAIL PREPARATIONS

6 In the light of the Chancellor’s statement, those responsible for the retail payments infrastructure are reconsidering their euro strategy. Final decisions are awaited. From the beginning of 1999, there will be a capacity to make retail euro payments in some form; and the banks are likely to adopt a flexible approach thereafter that will allow the available euro service

to respond to demand as it develops. This section begins with an update on preparations for retail payments in the UK, followed by a brief section on broader issues of concern to retailers.

Retail payments

7 Work continues to reach industry agreement on how, and the timescales over which, the central payments infrastructure should be developed to accommodate the single currency. Individual banks will choose when to adapt their own specific applications and to launch euro-denominated products and services; this will vary according to the perceived needs of their specific customer bases.

8 In addition to planning for the likely demand for retail euro services for UK 'out', some of the plans incorporate a migration path to UK entry in order to economise on the necessary capital investment.

9 *Cheque and Credit Clearing Company*. A bulk paper exchange is being developed for euro-denominated domestic cheques drawn on a UK bank in a UK 'out' scenario. The process should also be sufficiently robust to process the likely demand for euro-denominated domestic cheques in the early part of any transition period if and when the UK is 'in'. Changes to the relevant APACS Standards will be completed for 1 January 1999.

10 The functional specification for an electronic solution (known as euro IBDE) to differentiating cheques in euro from those in sterling, will be completed by January 1998. The current planning assumption of implementing a euro IBDE solution by mid-2000 will, however, be reassessed in light of the Chancellor's statement.

11 There are no current plans to provide a pan-European cheque clearing service for Europe. One particular reason for this is the decline in the use of the cheque in the UK and Member States. Euro-denominated cheques drawn on foreign banks will, as today, be returned to the bank on which they are drawn for payment. The process will be similar for euro-denominated cheques drawn on a UK bank account. These cheques, where accepted in a participating Member State, will be returned to the UK bank on which they are drawn for payment.

12 *BACS and automated payments.* Following the Chancellor's statement, the BACS Board in November confirmed their plan to develop the central BACS infrastructure to allow it to handle euro transactions. Further work will be carried out on demand scenarios in order that plans can be agreed on the timeframe for introducing this service.

13 *Cards.* Cards have both a billing currency and a settlement currency, and can already cater for differences between them. A cardholder may be billed in a currency of his choice regardless of the denomination of the transaction, conversion being effected by the card scheme's central processing. Similarly, the merchant may settle with its own bank in the currency of its choice, and that bank settles with the card issuing bank in the currency they choose.

14 The international card schemes, VISA, and Europay/MasterCard, have confirmed their ability to cater for the euro as both a billing and settlement currency from 1 January 1999.

15 *Switch Card Services.* Switch is the UK's domestic debit card scheme and had been planning for some time on the basis that the UK might participate in EMU from 1 January 1999. Following the Chancellor's statement, Switch nevertheless expects to implement scheme changes during 1998. The infrastructure will then be in place for both sterling and euro transactions for acquirers and issuers. However, acquirers will decide when they start to pass euro transactions, and issuers when they convert cardholder accounts to euro.

16 *ATMs.* The ATM industry has prepared a blueprint defining a migration path for the move to the single currency, which is obviously only relevant in an 'in' scenario. Whilst the UK remains 'out', there is nothing to be done beyond ensuring that the blueprint remains up-to-date.

17 *Notes and coin.* APACS has set up a cash euro project team which is developing a blueprint for the withdrawal of sterling and the introduction of the euro, against ultimate UK entry. The key element of phase one was to obtain a basic understanding of the logistical and other factors affecting each key area and to identify all critical points of tension. This activity has been accomplished. A central aim of the second phase of the study has been to model the impact of the changeover on the transport and storage requirements. This project will report in early 1998.

Other retail preparations

18 *Issue date for euro notes and coin.* After agreement to this effect in the EMI Council, ECOFIN agreed that the issue date for euro notes and coin ('E Day') will be 1 January 2002. The EMI Council will so recommend to the Governing Council of the ECB. This does not necessarily have implications for the date which the UK will choose for its own E Day if and when it goes 'in'.

"HE LEFT A 10 EURO TIP
BUT I CAN'T SPEND IT
FOR FIVE YEARS"

19 *Length of dual circulation period.* Further discussion of the optimum period for the dual circulation of euro and national currency notes and coin (while the new notes are being introduced and the old notes withdrawn) has revealed varying degrees of enthusiasm for a very short time-frame, with the majority of parties wanting in practice to complete the change in a period shorter than six months. A decision on the maximum legal period of dual circulation will lie with individual Member States. The logistics of the final period need careful examination. APACS's technical study of the cash distribution process and modelling work will help ensure that UK decisions are based on a proper analysis of what is practical.

20 *Dual price displays.* The Commission considers that there is a general consensus that some form of dual indication in euro and in national denominations of revenues, values and prices is necessary to facilitate the understanding, acceptance and confidence of the public in the new currency. The Commission intends to clarify soon whether or not a common approach on dual display is considered necessary across Member States, whether such an approach should be enforced by legislation at the national or European level, or whether it can be left to market forces or voluntary agreements.

21 The HM Treasury working group looking at pricing and consumer issues is considering in parallel the balance between the dual objectives of providing transparency to consumers, without imposing unfair burdens particularly on small retailers, and creating an enforcement cost for local authorities. It will use the result of its enquiries to inform the Government's response to any proposals from the Commission. Separately, it will consider the extent to which existing legislation on price indications might need amendment in the wake of a decision to join.

BANKING CHARGES FOR CONVERSION TO THE EURO

1 The Commission established an expert group, consisting of bankers, company and consumer representatives, who served in a personal capacity and were supported by Commission and EMI officials, to consider banking charges for conversion to the euro. A report agreed by all members of the group was published on 28 November[1]. The report is mainly of interest to the euro area. But it is relevant to 'in' currency bank accounts in the UK from the start of Stage 3, and would be directly relevant if the UK were to join later.

2 In its report, the group emphasises the importance of subsidiarity. Its report is concerned solely with 'additional' charges levied on users by banks for conversion over and above any charges for the services themselves. The group's understanding of the legal position on charging for conversion is based on input from Commission officials:

- The euro Regulations do not explicitly authorise conversion charges, and they do not explicitly prohibit them.
- Banks are obliged to convert incoming participating national currency payments into euro, where that is the denomination of the customer's account, and vice versa. In some Member States, such an obligation may constitute a ban on charging for (incoming) payments. There are no legal restrictions on a 'one-off' charge for the

1 Available on the DGXV website at (http://europa.eu.int/comm/dg15/en/finances/banks/expert.pdf).

conversion of accounts during the transition period, though charging is not permitted at the end of the transition period, when the conversion occurs by law.

- Most NCBs do not intend to charge banks or the public for the exchange of other euro area banknotes for their own during the transition period, nor during the final period. Customers of commercial banks will have the right to pay national currency notes into their bank accounts and draw euro banknotes in normal volumes and frequency without a conversion charge.
- The conversion rate must be used, and the implication is that any charges should be separately identified, and not hidden in a spread.

3 The most important influence on whether banks charge for conversion in practice will be competitive pressure. The report says that, in the euro area:

- Banks do not in general intend to charge for the conversion of book money, whether in the form of incoming or outgoing payments, or in the form of accounts from national currency units to euro units, either during or at the end of the transition period.
- Most banks do intend to charge for the exchange of euro area national banknotes during the transition period. Some banks do not intend to charge customers for the exchange of national into euro banknotes and coin in the final period, except for unusual volumes and frequency. But in many cases the outcome depends on the degree of support from NCBs or governments, in view of the predicted increase in handling and transportation, especially of coins.

4 The Group recommends that the Commission should promote a standard of 'good practice' for conversion without charge. The standard would be advisory rather than binding. Banks complying with the standard should publicise this to reassure consumers. One way of doing so would be by displaying a 'conversion symbol', which could best be implemented at national level. Where banks charge for conversion, any charges should be transparent.

C PUBLIC SECTOR PREPARATIONS

22 The manner in which public authorities allow the use of the euro if and when the UK joins will be crucial to the speed of its introduction across the wider economy. The Government also needs to play a key role in informing particular business sectors. Preparations by public authorities are therefore important to preparations by business.

23 A network of 'euro co-ordinators' from each Government department has been established. Each individual department will be considering the implications for its internal operations - for example, its IT systems, its staff training, and legislation for which it is responsible. Following the first meeting in September of representatives from each major department, five working groups have been set up to bring together departments with common concerns. These groups will allow exchange of best practice and help to highlight where interactions demand coordination in the public sector's approach to the euro. Their initial survey of issues will have been complete by early 1998.

Working group	*Examples of subjects being considered*
Departments with major financial interfaces with the public	How and when would departments accept tax declarations in euro? When would social security benefits be paid in euro, if and when the UK joins?
Departments with special interest in particular economic sectors	What guidance and help should departments provide for businesses?
Departments with responsibilities for other public sector bodies	When should local authorities and hospitals, for example, account in euro, if and when the UK joins?
Departments with overseas responsibilities	From 1999, what changes to accounting systems will be necessary for departments with operations in the single currency area?
Departments with responsibilities for the government accounting and financial systems	How and when would Government accounts switch to the euro, if and when the UK joins?

CHAPTER 7: OVERARCHING ISSUES

- The European Commission has published guidance on its interpretation of the euro Regulations.
- The Urgent Issues Task Force of the Accounting Standards Board has issued draft guidance on a number of accounting issues arising from the introduction of the euro.
- The Bank and SFA have issued notices containing preliminary guidance on the impact of the euro on banks' capital adequacy rules.

A THE LAW

The euro Regulations

1 We reported in the August edition on the two Regulations to introduce the euro under the law. The first Regulation (under Article 235 of the Treaty) is now in force in all the Member States, including the UK. This Regulation ensures that:

- The ECU will convert into the euro one for one on 1 January 1999.
- There will be continuity of contracts. Financial contracts denominated in the national currencies of participating Member States will remain unchanged as a result of the introduction of the euro, except for the change in denomination and hence amount at the conversion rate.
- The conversion rates will have six significant figures, and may not be rounded. But monetary amounts will be rounded to two decimal places (ie to the nearest euro cent), with amounts ending in five being rounded up.

2 The second Regulation (under Article 109l(4)) is agreed but only the participating Member States can vote to adopt it. The Article 109l(4) Regulation:

- Provides legally enforceable equivalence, at the conversion rates, between national currency units and the euro unit during the transition period from 1 January 1999 until 31 December 2001.
- Obliges banks (and other account providers) to convert incoming payments from the national currency unit to the euro unit during the transition period, and vice versa, depending on the denomination of the customer's account.
- Allows issuers to redenominate into the euro unit their outstanding 'in' currency denominated debt securities (once the relevant Member State has redenominated some or all of its own sovereign debt under its national law) without a bondholder meeting, so long as there is no change in economic value involved.
- Establishes that the euro will become legal tender throughout the euro area when euro banknotes and coin are issued on 1 January 2002. Euro area national banknotes and coin will subsequently be withdrawn and cease to be legal tender by 30 June 2002 at

the latest. This final period may be shortened by individual participating Member States, if they so choose.

Application of the Article 109l(4) Regulation under English law

3 As the UK has opted 'out', the Article 109l(4) Regulation will not apply directly in the UK by virtue of paragraph 5 of the UK Protocol to the Maastricht Treaty. However, most of the relevant provisions will almost certainly apply indirectly because they are part of the monetary law governing the euro, and will therefore be recognised by the English courts. The principal possible exception is Article 8.

4 It is important to provide legal certainty and to give as sound a base as possible for transactions carried out under English law. Consequently, the Bank has consulted the City of London Joint Working Group and the Financial Law Panel about whether there is a need to introduce into English law through national legislation any of the provisions of the Article 109l(4) Regulation which will not otherwise apply. Their current view is that it is not essential to introduce such legislation. The Bank would be interested to hear any different view as soon as possible. It would of course be for the Government to consider, if there were arguments in favour of national legislation for this or for some other purpose relating to the introduction of the euro.

THE LEGAL FRAMEWORK FOR THE USE OF THE EURO

1 The European Commission has published, with a note of caution, a set of questions and answers on the euro Regulations. This section contains extracts from the questions and answers, in the Commission's own words[1].

2 In the introduction to the questions and answers, the Commission states: 'The answers provided in this document are preliminary considerations by members of the staff of the European Commission. They should be read under the twin provisos that the interpretation of legislation is in the final instance for the courts to decide and that the interpretations given do not represent an official opinion of the Commission as such. It should be recalled that the two regulations which form the legal framework for the use of the euro are not the product of the Commission, but the legislator, ie the Council.'

Payments in the transitional period

Is there an obligation for credit institutions to make conversions during the transitional period between the euro unit and the national currency unit?

3 Article 8 (3) of the draft Council Regulation on the introduction of the euro provides that amounts denominated in the euro unit or a national currency unit and payable within that Member State by crediting an account can be paid by the debtor either in the euro unit or in that national currency unit. The institution receiving a payment is, by virtue of Article 8(3), second sentence, obliged to convert, if necessary, the incoming payment into the denomination of the account of the creditor. At the same time, the receiving bank does not need the authorisation of

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1 The full text is published in *The legal framework for the use of the euro - Questions and answers on the euro regulations* Euro Papers, No 10. Copies can be obtained from the European Commission, Directorate-General for Economic and Financial Affairs, 200 rue de la Loi, B-1049 Brussels, Belgium.

the account holder to make that conversion. Article 8(3), second sentence is not explicitly addressed to banks, including national central banks; however, they will in practice be concerned almost exclusively.

Does Article 8 (3) only apply to domestic payments?

4 Article 8 (3) of the draft Council Regulation on the introduction of the euro applies not only to domestic payments, but also to certain categories of cross-border payments. The term 'payable within that Member State' should not be misunderstood to limit this provision to payments where both the account of the debtor and of the creditor are held in the same Member State. Recital (13) of the regulation confirms that the provisions on payments by crediting an account also apply to those cross-border payments which are denominated in the euro unit or the national currency unit of the account of the creditor, provided that in the latter case the account of the creditor is denominated in the national currency unit of the Member State where the account is located.

Does Article 8(3) apply to payments from or to non-EU countries?

5 Payments into and within non-EU countries are not covered by the draft Council Regulation on the introduction of the euro. Payments from such countries are on the contrary covered as soon as the payment arrives at an account located in a participating Member State, provided the payment is denominated in the euro unit or in the national currency unit of the Member State where the account of the creditor is located. In this sense, a contract stipulating a payment to be made in DM to an account located in Germany would fall under Article 8(3), first sentence even if the debtor is located in New York and initiates the payment from there in euro. The conversion obligation from euro to DM would of course lie only with the German bank. The application of Article 8(3) is dependent only on the location where the crediting of the account takes place. It is independent of the nationality or residence status of the creditor or debtor and also independent of the contractual law which underlies the payment.

What kind of payment systems are allowed to change over to the euro unit?

6 Article 8(4)b of the draft regulation on the introduction of the euro concerns not only interbank payment systems but all kinds of systems for the regular exchange, clearing and settlement of payments. By virtue of this article Member States are allowed to take measures to enable such systems to change over to the euro unit even if this means, for those participants which may not like the change, an obligation to use the euro unit. This provision therefore constitutes an exception to the general principle of Article 8(1) of the same regulation.

Continuity of contracts

Does the disappearance of reference rates affect the continuity of contracts?

7 The legal framework for the euro does not expressly address the issue of the disappearance or replacement of reference rates like interest rates or securities prices. This is because of the diversity of existing reference rates. They are often defined by private entities making it difficult to provide a single legislative solution for the replacement of these rates. Nevertheless, it appears that contracts including reference rates will not be discontinued because of the introduction of the euro. Many contracts include a fall-back clause which designates a substitute

for the original reference rate. Moreover, it can be expected that parties will agree on the replacement of a reference rate to execute the contract. For most reference rates close substitutes will be available.

May 'force majeure clauses' be triggered through the introduction of the euro?

8 Force majeure clauses in contracts generally excuse non-performance of a contract in case of circumstances beyond the control of the parties which prevent performance or which lead to a severe disruption of circumstances underlying the contract and which could not be anticipated by the parties. The conditions which might trigger these clauses are not met in the case of the introduction of the euro.

9 Clauses in contracts which expressly refer to the introduction of the euro and which foresee the right of a party to change the terms of a contract or to terminate it do of course continue to apply. Article 3 of the Council Regulation (EC) No 1103/97 of 17 June 1997 confirms that the provisions on continuity are subject to anything which parties may have agreed.

Can increased cost clauses be triggered by the introduction of the euro?

10 Increased cost clauses in contracts typically allow the lender to pass on increased costs associated with the loan. It depends on the wording of these clauses and on the particular circumstances which might happen in the course of the introduction of the euro if such clauses might be triggered. Increased cost clauses, which refer to changes in liquidity, reserve or similar legal requirements, will not be triggered by the introduction of the euro in itself and the implied change of the legal framework. If, on the other hand, regulatory changes were to occur after the introduction of the euro, the increased costs of refinancing thereby implied could, depending on the terms of the contract, be passed on to the borrower. The same reasoning applies to rights given to the borrower to unilaterally terminate a contract when interest rates have fallen significantly.

Does the principle of continuity also apply with respect to swap and other derivative contracts?

11 Swap and other derivative contracts are legal instruments in the sense of Article 1 of Council Regulation (EC) No 1103/97. Continuity of contracts will also generally hold for such agreements. A cross-currency interest rate swap, for example, which refers to two currencies of Member States participating in EMU will after the introduction of the euro merely be transformed into an obligation of one party to make a series of net payments to its counterparty. In such a case the contract continues but the parties may agree to close it out, perhaps with a single net payment because the economic effect or purpose has changed.

12 Even for contracts where the only purpose is the coverage of an exchange risk, the introduction of the euro does not make performance of the contracts impracticable. The risk that the exchange rates of the currencies referred to in the swap contract would become permanently fixed was one of the risks that the parties have taken by setting up such a contract. For most contracts involving European currencies, this risk was even well foreseeable.

13 Moreover, the original purpose of the contract, ie to avoid a loss or to make a profit by reference to comparative currency values, remains unchanged. Any balancing payment to be made by one of the parties is necessary to ensure that the hedge is effective at the level it was

intended by the parties. Parties may not therefore argue that the purpose of the contract is frustrated only because of the introduction of the euro and the irrevocable fixing of the conversion rates.

ECU - euro

How will ECU contracts which do not expressly refer to the official ECU be converted?

14 Article 2 of Council Regulation (EC) No 1103/97 establishes a presumption that references to the ECU in legal instruments are presumed to be references to the ECU as defined in Community law. This presumption applies to contracts which refer to the ECU or similar denominations like ecu, écu, Ecu, E.C.U. without further defining it. It also applies to legal instruments which refer to the ECU 'as used in the European Monetary System', to the ECU 'as used in the Community budget', etc.

15 While the presumption applies to all contracts, a party can rebut it by showing that the intention of the parties was to refer to something else, eg a fixed basket. Any evidence can be used to show the intention of the parties. The burden of proof in case of litigation lies on the party which intends to show that the intention was not to refer to the official ECU.

Will the 1:1 conversion from ECU to euro be recognised in third countries?

16 For contracts with reference to the ECU as defined in Community law, the conversion of the ECU to the euro at a rate of 1:1 will follow directly from the terms of the contracts and the application of Community law. If parties have made a link to the official ECU, a judge in a third country may be expected in case of litigation to look at Community legislation (Article 109l(4) of the Treaty and Council Regulation (EC) No 1103/97) for interpreting the corresponding provisions in the contract.

17 It can be expected that those ECU contracts under third countries' jurisdictions which include no clear reference to the official ECU will equally be converted to the euro at a rate of 1:1; in case of litigation a judge will probably refer to European law which establishes a presumption that all references to the ECU are references to the official ECU. In fact, although not being a lawful currency, financial markets have always treated the ECU as being very similar to a currency, which might therefore benefit from the application of *lex monetae*.

Redenomination of debt and rounding rules

Under which conditions are private issuers allowed to redenominate their debt during the transitional period?

18 Article 8(4) of the draft Council Regulation on the introduction of the euro gives a right to a private issuer of securitised debt to redenominate its outstanding debt; this right applies to debt which is negotiable in the capital markets and to money market instruments; the right can be exercised when the general government of the Member State in whose currency the debt is denominated has taken measures to redenominate its own debt, issued under its own contractual law. It is not necessary that the respective Member State has redenominated the whole amount of its debt. What matters is that a Member State has effectively redenominated at least part of its debt. Mere announcement by a Member State that it will redenominate its debt does not yet

allow other issuers to redenominate their debt issued in the currency unit of that Member State; preparations for such redenomination may already start beforehand.

19 The measure of redenominating public debt in a given Member State, which is relevant for the application of Article 8(4), has to be taken by the public authorities responsible for monetary law in that Member State. Article 8(4) does not entitle other entities belonging to the general government as defined in the European System of Integrated Accounts to trigger the process of redenomination.

20 As soon as the redenomination of public debt has become effective, other issuers are allowed to follow. This means that under Article 8(4) a Finnish issuer of a DM debt under Luxembourg law can redenominate his debt as soon as the German Government has effectively redenominated at least part of its DM debt issued under German law. The Finnish issuer can announce his intention of redenominating his debt and can start preparations before that date, but the redenomination cannot become effective before the date when the German Government has effectively redenominated at least part of its debt. The Finnish issuer would not need to have the approval of his investors (eg through bondholder meetings) to carry out the redenomination. Redenomination on the basis of EU monetary law would become effective through a unilateral declaration. The form which this declaration has to take is determined by the law which is applicable to the issue.

21 In cases where parties have agreed that redenomination should be possible and how it should be carried out, their agreement remains applicable. In these cases, redenomination can take place even if the general government of the Member State in whose currency the debt is denominated has not yet taken measures to redenominate its own debt.

22 The term ‘redenominate’ is defined in a narrow sense. According to Article 1 it only means changing the unit in which the amount of outstanding debt is stated from a national currency unit to the euro unit, as defined in Article 2. This means that redenomination in itself only consists of the division of amounts expressed in a national currency unity by the conversion rate. The question of rounding arises only when the resulting amounts expressed in the euro unit are to be paid or accounted for. The narrow definition for the term ‘redenominate’ was the basis for choosing the currency denomination as the criterion for allocating the right of triggering the process of redenomination.

23 Article 1 also states that the act of redenomination does not have the effect of altering any other term of the debt, this being a matter subject to the relevant national law. This is further explained by Recital (14), which states that any other measures to amend the terms of outstanding debt to alter, amongst other things, the nominal amount of outstanding debt (so-called renominalisation) are not addressed by Article 8(4). These measures continue to be subject to approval by bondholders and may be introduced by way of legislation.

24 Neither Article 8(4) nor the obligation to use the conversion and rounding rules of Council Regulation (EC) No 1103/97 prevents parties (eg through bondholder meetings) from deciding any subsequent measures which might be necessary after the conversion to ensure manageable currency amounts for trading and liquidity (for instance creating minimum nominal bond amounts of one cent or one euro).

25 The competence for adopting legislation which might facilitate or even impose a renominalisation of bonds, ie measures which lead to a change of the nominal amount in which bonds are held and traded, stays with the Member State whose law is applicable to the issue. In the example taken above of the Finnish issuer of a DM debt under Luxembourg law, it would be Luxembourg law which would govern any renominalisation of the issue.

B ACCOUNTING

5 Even though the UK will not initially participate in the single currency, many UK companies will need to adapt their accounting systems to record receipts and payments in euro. This will be straightforward for those with multi-currency systems.

6 Some companies may also wish to adopt the euro as their base accounting currency, especially if a large part of their sales is to ‘in’ Member States. They would then probably also wish to file accounts in euro. There should be no difficulty about this, since Companies House already accepts accounts in currencies other than sterling where there is good commercial reason. The timing of any switch would be for the company itself to decide. However firms with subsidiaries in the euro area should note that a number of EU Member States will not permit publicly filed accounts to be euro-denominated until after 1 January 2002, when euro banknotes and coin are introduced.

7 For financial reporting purposes, there should be little difficulty in encompassing the euro. The essence is that participating national currencies do not change but continue, albeit re-expressed in euro; and the ‘in’ currencies cease to move in relation to each other. It is immaterial whether relevant records are kept in the legacy currency or the euro, since they are legally the same thing.

8 On the treatment of foreign exchange gains and losses, there will be no reason to change the current UK approach, under SSAP 20: gains or losses will arise up to the date at which the ‘in’ currencies become fixed, and they will be measured and reported in the normal way. Under UK accounting principles, in contrast to some other EU countries, exchange gains and losses are almost always recognised as they occur, whether or not they are realised, and immediately recorded in the profit and loss account (non-financial companies using financial instruments for hedging can usually defer recognition of exchange gains and losses on these instruments until changes in the value of underlying assets and liabilities are recognised).

9 The Urgent Issues Task Force (UITF) of the Accounting Standards Board issued last month draft guidance on accounting issues arising from the proposed introduction of the euro. It is consistent with the principles set out in the Commission’s paper on *Accounting for the Introduction of the Euro* described in the August edition of *Practical Issues*. The UITF considered three questions:

- Should costs incurred in connection with the introduction of the euro be charged as an expense or capitalised as an asset?
- What impact will the irrevocable locking of ‘in’ exchange rates have on cumulative foreign exchange translation differences that had been recognised in periods before the introduction of the euro?

- What impact will the irrevocable locking of ‘in’ exchange rates have on anticipatory hedging instruments existing at the inception of the euro in respect of future transactions?

10 The UITF is seeking comments on its draft paper by 12 January. The UITF has reached a consensus, which if confirmed will be binding, that:

(i) the costs of making the necessary modifications to assets to deal with the euro should be written off to the profit and loss account except in those cases where (a) an entity already has an accounting policy to capitalise assets of the relevant type and (b) the expenditure clearly results in an enhancement of an asset beyond that originally assessed and not in the mere maintenance of its service potential. Other costs associated with the introduction of the euro should also be written off to the profit and loss account;

(ii) expenditure incurred in the year and commitments at the balance sheet date in respect of preparing for the changeover to the euro should be disclosed in the financial statements; other information and discussion on preparing for the changeover to the euro may be more appropriately located in any operating and financial review statement published by the entity;

(iii) following the principle set out in Financial Reporting Standard 3, cumulative foreign exchange translation differences recognised in the statement of total recognised gains and losses in accordance with SSAP 20 should remain in reserves after the introduction of the euro and should not be reported in the profit and loss account; and

(iv) where gains and losses on financial instruments used as anticipatory hedges are currently deferred and matched with the related income or expense in a future period, the introduction of the euro should not alter this deferral and matching treatment.

11 The UITF guidance also, *inter alia*, suggests that costs associated with the introduction of the euro be recognised as they occur, and that no provision should be made in accounts for estimated future costs (as proposed in the Exposure Draft of a Financial Reporting Standard on accounting for provisions and contingencies, FRED 14, issued in June 1997). But it has not yet proved possible to reach unanimity on this point.

C TAX

12 The Inland Revenue has been holding discussions with the Bank of England and a range of market representatives (ISDA, LIBA, BBA, IPMA, ISMA, IFMA and ABSAL) on some of the technical tax issues which will arise from the introduction of the euro, even though the UK is not to be an initial participant. The outcome of those discussions is expected to be announced shortly.

D REGULATION

13 In October, the Bank issued a notice containing preliminary guidance on the impact of the euro on banks’ capital adequacy rules. Consistently with the Article 109l(4) Regulation, the euro and its participant national currencies will be treated as the same for supervisory purposes during

the transition period. The main part of the notice is reproduced below. It should be noted that the proposed treatment of derivatives is consistent with the agreement reached at EU level by the Banking Advisory Committee, but London market associations have asked for the treatment to be reconsidered.

IMPLICATIONS FOR THE CAPITAL ADEQUACY FRAMEWORK[1]

1 *Foreign exchange risk*

It is currently envisaged that the single currency, the euro, will be introduced into participating Member States and will replace their national currencies from 1 January 1999. No foreign exchange risk will be deemed to exist between the euro and the participating national currency units and between participating national currency units themselves from that date. For the purposes of calculating capital requirements for foreign exchange risk (Chapter 4 of the 'Green Book', Implementation in the United Kingdom of the Capital Adequacy Directive, S&S/1995/2), the euro and the participating national currency units should be treated as the same currency.

2 *Interest rate risk*

For transactions in euro and participating national currency units, the particular unit in which traded debt positions are denominated will not be relevant for generating individual net positions after the introduction of the euro. For the purposes of calculating capital requirements for general and specific interest rate risk (Chapter 5 of the Green Book), the euro and the participating national currency units should be treated as the same currency.

The treatment as outlined below in section 5 (on the treatment of derivatives) will significantly reduce the capital charge for interest rate risk under the Basle/CAD standard approach. But this will not necessarily be accompanied by a commensurate reduction in interest rate risk. A case in point is credit spread trading, which is expected to increase in Stage 3 of EMU. The Bank may consider increasing trigger and target ratios for banks which are heavily involved in credit spread trading. Alternatively, these banks may wish to use internal models, since credit spread risk is captured by internal models that include specific risk.

3 *Equity risk*

Equity positions are allocated to the country in which each equity is listed and the subsequent capital calculations are applied to each country (Chapter 6 of the Green Book). As national equity markets will continue to operate in the participating Member States after the introduction of the euro, the country criterion will be maintained for calculating capital requirements for equity position risk.

1 Extract from Bank of England supervisory notice: October 1997.

4 *Historical foreign exchange and interest rate series*

The Basle internal models approach is expected to be introduced during 1998. In the temporary absence of historical foreign exchange and interest rate data for the euro immediately after the start of Stage 3, the Bank believes that banks which use internal models should develop their own proxies. The Bank will assess whether the proxies used are appropriate, but will not publish its own proxy series. The appropriate proxy for euro interest rates depends on the product that is traded.

The Bank believes that banks should consider the results of stress-testing in the run-up to, and the period immediately following, the third stage of EMU; banks should develop stress events designed to test that euro exchange rates and interest rates behave differently from those implied by the proxy indices. From the beginning of Stage 3 of EMU, banks should collect euro exchange rate and interest rate data and combine these data with their proxies.

5 *Treatment of derivatives*

Derivative foreign exchange contracts in ECU and participating national currencies may behave differently after the introduction of the single currency. A similar feature may also occur for certain interest rate derivative contracts with reference rates derived from the ECU and participating national currencies, if the rates collapse into one reference rate. It is anticipated that in some cases banks will choose to close out these contracts and settle the mark-to-market value, but they are not required to do so.

If those contracts that are not closed out continue to be treated as derivatives for accounting purposes, the capital requirements for counterparty exposure arising from these contracts will be as follows. Banks may apply the replacement cost method as set out in the Bank's derivatives rules (Treatment of potential future exposure for off-balance sheet contracts, S&S/1996/4) for a maximum period of five years. The replacement cost of contracts with a positive value will be based on the mark-to-market value of these contracts on 1 January 1999, but the add-ons for potential future exposure will no longer be applied as the future cash flows will no longer depend on market movements. The 50% counterparty ceiling will remain in place and netting with other derivatives will continue to be recognised.

Derivative contracts that are still outstanding after this five year period should be treated as cash claims or obligations based on the mark-to-market value of these contracts for capital adequacy purposes[2]. This means that the 50% counterparty ceiling will be lifted for these contracts. As netting between on and off-balance sheet items is not recognised under Basle and EU regulations, netting opportunities with other derivatives will be lost.

6 *Status of the European Central Bank*

The European Central Bank will be treated as a Zone A central bank for risk weighting and large exposures purposes.

2 Notwithstanding the supervisory treatment, the legal status of these contracts will not change. The principle of continuity of contracts, for example, is enshrined in the Article 235 euro Regulation.

14 The SFA also issued two Board notices in October. The first provides guidance on a number of areas which authorised firms need to consider in preparing for the euro. It concludes that: ‘if firms have not already done so, they should conduct a full audit of all their business lines to ensure that all systems (both IT and manual) will be fully euro-compliant by 1 January 1999. Firms will find it of assistance to familiarise themselves with the work of any relevant working parties and ad hoc committees which are active in their area of the financial services industry. Firms should follow the future deliberations of such working parties in order to ascertain on an ongoing basis how their business may be affected by the introduction of the euro. It would be imprudent for firms to draw solace from speculation that the implementation of the euro may be delayed; prompt action is required.’

15 The implications of the euro for the SFA’s financial rules are addressed in the second consultative Board notice, for comment by end-year. This confirms that, like the banking supervisor, the SFA will treat all ‘in’ currencies and the euro as one currency during the transition period. This will affect the capital requirements for both position and counterparty risk. The SFA note the potential for significant reductions in position risk charges for interest rate products: because the implied reduction in regulatory capital may not be accompanied by a matching reduction in risk exposure, the SFA will expect firms to be able to demonstrate how they are managing any credit spread risk which they may still have.

E CONVERSION AND ROUNDING

16 APACS and the BBA set up a joint working group on the practical implications of the conversion and rounding rules contained in the Article 235 Regulation. The group consisted of representatives of 6 UK-based retail banks, BACS, the BBA and APACS. It published a report in September, which identifies a number of practical problems in applying the rounding rules to banking and payments systems and recommends best practice in addressing them.

17 The report’s main conclusions and recommendations are summarised below. The thinking behind them will apply even while the UK is ‘out’, not least because the Article 235 Regulation itself applies to ‘out’ countries. But until the UK joins, they may in practice apply only to a small number of accounts denominated in participating currencies.

- *Statements*. Bank statements listing every transaction and running totals in both euro and sterling would be confusing for customers. This is because different sterling amounts, appearing adjacent to each other on the statement, could convert to the same euro amount after rounding. In addition, rounding could mean that the totals of the sterling and euro columns on the statement might not be consistent with the official conversion rate. The report recommends that amounts should be converted and rounded in accordance with the Article 235 Regulation, and not, for example, always rounded in the customer’s favour. Statements should be prepared in either sterling or euro, but not both. Transactions originating in euro posted to a sterling account should show the euro amount as a memorandum item, similar to current practice for overseas transactions on card accounts. The closing balance should also show the equivalent euro amount. Customer education would be required to explain that small rounding differences could arise, but that the overall effect should be neutral. Such customer education should be provided not only at the individual bank level, but also at industry and government level. A common language should be used across the various consumer education initiatives.

- *Conversion/reconversion*. Conversions from euro to sterling and back again would not necessarily yield the original amount. This could occur, for example, if a company were to bill a customer in euro, and the customer paid in sterling to the company's euro bank account; or if a business converted its accounting systems to euro but maintained its bank account in sterling. It could cause problems for businesses' automatic reconciliation software when euro payments were made using payments systems that would not record the original euro amounts (eg BACS, but not CHAPS euro). APACS is pursuing possible solutions with the Business Accounting Software Developers' Association and Computer Services and Software Assocation. These include using existing features of multi-currency reconciliation packages, or finding ways to pick up the original euro amount from a memorandum field within payments messages.
- *Settlement and reconciliation*. Netting payments systems, such as BACS, will convert the sum of sterling payments in each processing batch into euro for settlement. The recipient banks would post the individual sterling amounts to their customers' accounts, which might be in euro. But because of rounding, the sum of the individual amounts posted, converted separately into euro by the banks, might not equal the settlement totals. This would cause reconciliation problems, and the differences might sometimes be substantial. BACS is planning to undertake a simulation to assess the total financial effect, and the possibility of redistributing any large differences is being considered. The group recommends that individual members of the affected clearing companies assess their systems before deciding how to proceed.
- *National currency unit to national currency unit*. When calculating national currency unit to national currency unit conversions via the euro, people might obtain different results for the same calculation if they rounded the result of the intermediate step to a different number of decimal places, eg 4 instead of 3. The report says that individual members would need to check the constraints within their own systems, and to discuss the issue with their trading partners. There might be benefits in agreeing a market convention.
- *Returned payments*. The problem mentioned above about euro-sterling-euro conversions could also surface where euro payments to a sterling account were returned in sterling. The report says that, where possible, the receiving bank would need to ensure that the original amount was returned in the same denomination. This is the approach which BACS would adopt. APACS is pursuing with card schemes how this issue would affect them.
- *Charges*. Where a standard bank charge was incurred many times, the sum, converted to euro, of the sterling value of the charges might be substantially different from the sum of the euro values of the individual charges. Individual banks should check whether this problem could be avoided by holding the euro equivalent of bank charge amounts to three or more decimal places. Where this would not be possible, the conversion rules in the legal framework should be followed and customer education used as necessary to avoid confusion. There might also be merit in altering sterling bank charge tariffs so that they converted to convenient, round euro amounts.

- *Exception limits*. Convenient, round sterling amounts for exception limits (eg credit limits) might not convert to convenient euro amounts. In general, the group favours the principle of exact conversion according to the Regulation. Some banks use non-round sterling limits (eg £1001) to signal a requirement for special action. The signal would disappear on conversion to euro, so all banks would need to review such practices.
- *System constraints on the application of the rules*. Some bank systems might not be able to accommodate the six significant figures required for the conversion rates. All individual systems would need to be reviewed to identify any technical constraints, allowing sufficient time for systems alterations.
- *Card systems.* Card schemes like Visa and Mastercard convert all monetary amounts via the US dollar, which is against the Regulation. Visa and Mastercard are currently intending to address this issue.
- *Cheque guarantee cards*. The rules may require limits shown on cheque guarantee cards to be rounded to the nearest euro cent when converted from sterling. This would yield an inconvenient, non-round amount. The APACS Cheque Card Management Committee is considering options with a view to agreeing a way forward.
- *Issues which may arise during the transition*. During the period of dual currency circulation, someone converting sterling notes and coins into euro notes and coins could receive a different amount depending on which cash denominations they exchanged. In particular, it might be profitable to pay euro debts using small sterling denominations. A similar problem would arise for other payments media. For the vast majority of bank customers, the potential financial benefit of converting smaller amounts would not be justified. However, banks would need to be aware of the potential for abuse, and ensure sufficient audit checks and disincentives were in place.

F INFORMATION SYSTEMS

18 Previous editions of *Practical Issues* have drawn attention to the need for businesses to address the IT changes required by EMU as early as possible. Two recent publications have also emphasised this point, and considered in some detail the steps that companies will have to take to ensure their systems are ready.

19 The British Computer Society (BCS) has produced, with assistance from the Bank, *Preparing for the euro - a practical guide for professionals and business managers*[1]. The guide is intended for both general management and IT specialists in businesses of all sizes. It provides advice and practical tools to help businesses analyse rigorously the impact of EMU on their systems, and to plan and project manage the necessary work. A number of checklists of key tasks, risks and issues are provided. Chart D, reproduced from the BCS Guide, shows a schema for business preparations for the euro, including IT.

20 The Commission (DGXV) has issued a draft paper on *Preparing Information Systems for the Euro*[2]. The paper offers guidance on the kind of IT changes that EMU is likely to require, and on strategies for implementing them. It also discusses the main technical problems involved

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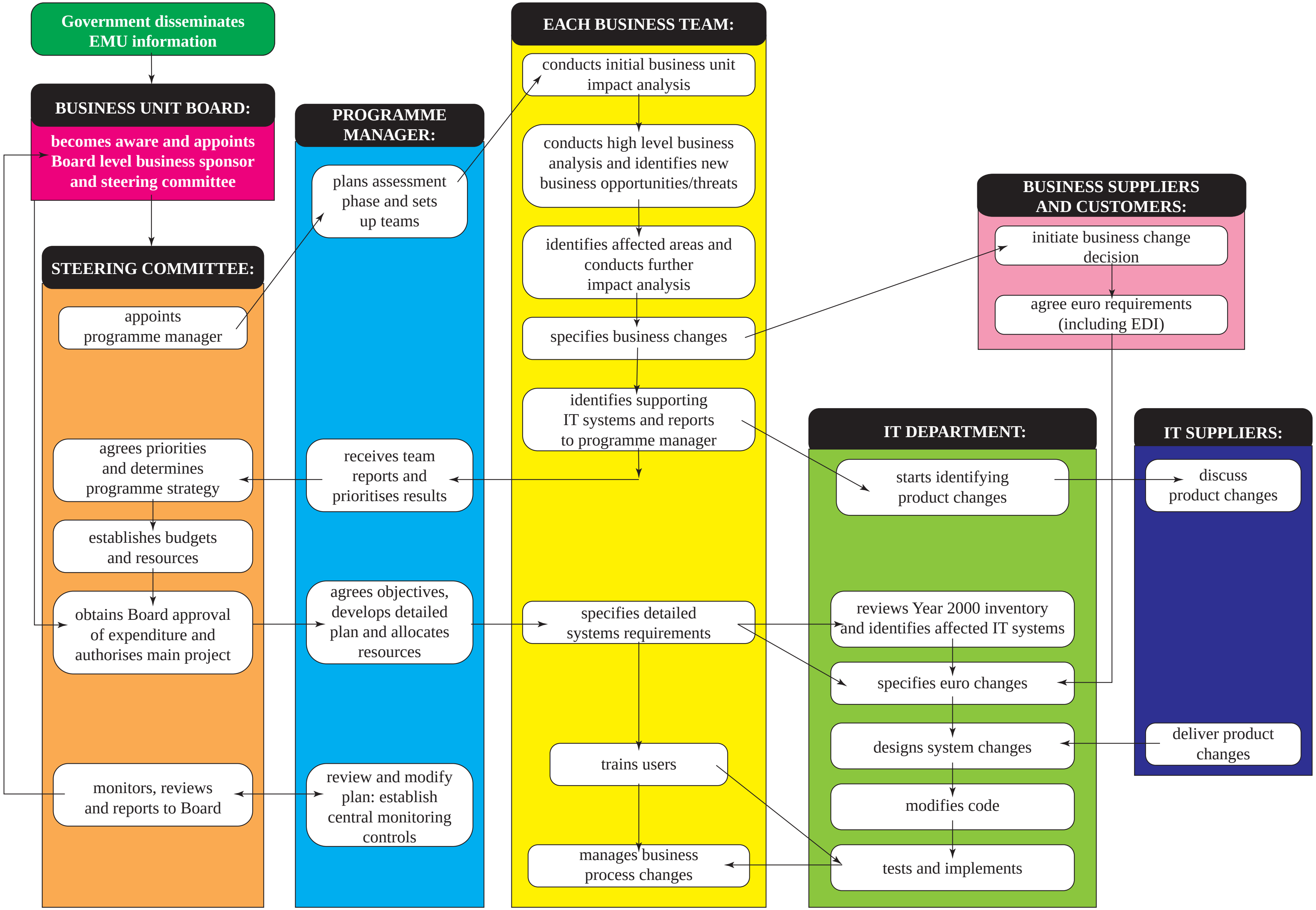
1 It is available from the BCS (tel:01793 471424, e-mail:ijones@bcs.org.uk).

2 Available from Unit D3-Financial Information, C100-03/133, 200 rue de la Loi, B-1049 Brussels, Belgium, or at (http://www.cordis.lu/esprit/src/wdiseuro.htm).

A SCHEMA FOR BUSINESS PREPARATIONS FOR THE EURO

CHART D



in considerable detail, eg applying the official rounding rules in software; managing electronic interfaces; displaying two currencies; and storing and converting historic data.

21 Both documents emphasise the size and importance for many businesses of EMU IT tasks, confirming the message of previous editions of *Practical Issues*. Given the long lead times, and the scarcity of IT resources caused by EMU and the Year 2000 problem, businesses should already be making preparations. EMU is far wider in scope than the Year 2000 problem. It will cause substantial changes in the trading environment for many businesses, even while the UK is 'out'. Companies may need to modify their strategies and business processes, with correspondingly wide-ranging effects on their IT needs. Companies need to consult other parties, including suppliers and major customers, about their likely use of the euro and plan carefully. Many will need an experienced and well resourced project team to handle a highly complex and difficult network of tasks. Failure to prepare is a very risky strategy; preparing well could provide competitive opportunities.

CHAPTER 8: MONETARY AND FISCAL POLICY

- The EMI has published more details about ESCB monetary policy instruments and procedures.
- Bilateral conversion rates from 1 January 1999 will be pre-announced when the participating Member States are chosen next May.
- The EMI has published a provisional list of monetary financial institutions (MFIs).

A MONETARY POLICY IN STAGE 3

1 In September the EMI published a booklet entitled *General documentation on ESCB monetary policy instruments and procedures*. This is narrower in focus than the EMI's *Framework Report*, published in January and described in the April *Practical Issues*, since it covers only monetary policy operations. But it builds on the earlier report by adding details on:

- The terms of the different open market operations (two week and three month repos and issuance of ECB debt certificates by *standard* tenders; fine-tuning repos, deposit-taking and fx swaps by *quick* tenders; and fine-tuning bilateral outrights).
- The timetables for standard and quick tenders and access to the overnight standing facilities.
- Eligible assets, which must effectively be:

  (i) issued by a non-bank and rated at or above a minimum threshold set by the ECB (expected to be investment grade, ie BBB-, Baa-); or

  (ii) issued by a bank, rated above the minimum threshold, traded on an ISD 'regulated' market and subject to the Prospectus Directive; or

  (iii) issued or guaranteed by an EEA central government; or

  (iv) a 'Pfandbrief'-type mortgage bond as defined in the UCITS Directive; or

  (v) issued by a non-bank and guaranteed by a euro-area bank that has a 'financial strength' rating at or above the minimum threshold set by the ECB.

- More details on a possible minimum reserves regime: the EMI approach is to set out a comprehensive menu from which the ECB can select its preferred outcome, so that it should not be assumed that any minimum reserves regime will be as broad as the broadest reserve base envisaged in the *General Documentation*.

2 Final decisions on the operational framework will be taken by the ECB Governing Council following its establishment next year.

3 The main change from the *Framework Report* relates to the specification of risk control measures, to protect the ESCB in its liquidity and payments operations. Following market

pressure, and with the full support of the Bank, the EMI has agreed to permit daily variation margins to replace its previous reliance on high initial margins only. There will be some variation between NCBs but the basic system is for:

- At least weekly (and possibly daily) revaluations and margin calls/returns.
- One initial margin for repos longer than overnight and another lower margin for intraday and overnight repos.
- Additional 'haircuts' related to the residual maturity of the assets.

The general documentation will not in itself confer rights on counterparties. The legal relationship between the ESCB and its counterparties will be established through contractual or regulatory arrangements. In addition, more specific documentation will have to be prepared for the implementation of certain aspects of the monetary policy framework, and this is in hand.

B ECONOMIC CO-ORDINATION

4 The Amsterdam European Council in June invited ECOFIN and the Commission to study how to improve the processes of economic co-ordination in EMU, both between the Finance Ministries of the Member States and between the ECB and ECOFIN. In addition, the European Council commissioned work on external aspects of EMU, including exchange rate policy. The particular focus is on the possible formulation, under Article 109(2), of 'general orientations' for exchange rate policy in relation to one or more non-Community currencies; and, under Article 109(4), on the position of the Community at the international level as regards issues of particular relevance to EMU, and on its external representation.

5 This work is under way, and a report will be presented to the December Luxembourg European Council. There were discussions at the Informal ECOFIN in Mondorf in September, and since then agreement has been reported between France and Germany on the establishment of an informal grouping colloquially known as 'Euro X', to discuss economic policy co-ordination. This has not yet, however, been ratified at the EU level and questions remain about the precise status of, and attendance at, such an informal grouping.

C EXCHANGE RATE POLICY AND RESERVES MANAGEMENT

6 In the context of the discussions commissioned by the European Council, the Presidency stated after the Mondorf Informal ECOFIN that, by unanimous agreement, the exchange rate of the euro should not be used as an economic policy instrument, and general orientations for the euro exchange rate would only be established in exceptional circumstances.

7 The Presidency also said that the bilateral conversion rates of participating Member States would be fixed and announced on the basis of a 'certain method' when the participants are chosen next May. Rates for each participating currency against the *euro* could only be fixed at the same time if all of the twelve component currencies of the basket ECU were to join EMU at the start of 1999. Assuming, for the sake of illustration, that three currencies included within the basket ECU do not participate in the 'first wave', the end-1998 exchange rate of the DM against the ECU (and hence the euro, because of the Treaty requirement that the adoption of the conversion rates should by itself not modify the external value of the ECU) can only be

determined when the end-1998 exchange rate of these non-participating currencies become known (as shown in the box).

IRREVOCABLE FIXING OF EXCHANGE RATES

Maastricht Treaty requirement: 1 basket ECU = 1 euro on 1 January 1999.
Assumption (for illustration only): three currencies included in the basket ECU, sterling, Danish krone and drachma, do not join EMU at the start.

Column 1		Column 2			Column 3	
Basket ECU components		**Value at 31.12.98 if bilateral rates pre-announced in May 1998**			**Value at 1.1.99 in euro**	
		Weight	Conversion/ exchange rates		Weight	Conversion/ exchange rates
1 ECU =	0.6242 German mark	= 0.6242	x 1 DM	conversion rates	= 0.6242	x A euro
	1.332 French francs	= 1.332	x S DM		= 1.332	x B euro
	151.8 Italian lire	=151.8	x T DM		= 151.8	x C euro
	0.2198 Dutch guilder	= 0.2198	x U DM		= 0.2198	x D euro
	3.301 Belgian francs	= 3.301	x V DM		= 3.301	x E euro
	0.130 Luxembourg franc	= 0.130	x W DM		= 0.130	x F euro
	0.008552 Irish pound	= 0.008552	x X DM		= 0.008552	x G euro
	6.885 Spanish pesetas	= 6.885	x Y DM		= 6.885	x H euro
	1.393 Portuguese escudos	= 1.393	x Z DM		= 1.393	x I euro
	0.08784 Pound sterling	= 0.08784	x J ECU	exch. rates	= 0.08784	x J euro
	0.1976 Danish krone	= 0.1976	x K ECU		= 0.1976	x K euro
	1.440 Greek drachmas	= 1.440	x L ECU		= 1.440	x L euro
		must total 1 ECU/euro			must total 1 euro	

If S to Z are pre-fixed in May 1998, then on 1.1.99 the DM/euro rate must be set so that (0.6242 +(1.332xS) + ... +(1.393xZ)) DM = [1–(0.08784xJ)–(0.1976xK)–(1.440xL)]euro.

Conversion rate A is the DM/euro rate calculated at the foot of column 2. Conversion rates B to I are calculated by multiplying A by conversion rates S to Z. This can only be done once J, K and L are known on 31.12.98.

8 Discussions have continued in the EMI on the design of the system to allow decentralised management of the foreign exchange reserves which will be pooled with the ECB, and a contract has now been awarded to implement the project.

D STATISTICAL ISSUES

9 In September, the EMI also published a provisional list of monetary financial institutions (MFIs) as at the end of 1996. The list currently contains only credit institutions as defined by Community law, covering banks and building societies in the case of the UK. The EMI expects to publish, before end-year, an extended list to include also money market funds (MMFs) and any other MFIs which are not credit institutions. This extension has however proved problematic because no Community-wide definition of an MMF exists. There is nevertheless a need to publish the list as soon as possible to help reporting agents' preparations to identify, for statistical purposes, MFI counterparties in other Member States.

10 Within the UK, the Bank has continued to pursue with the BBA the finalisation of the additional statistical reporting requirements which would be required to meet the UK's obligations in the field of money and banking statistics if it were to join EMU. The Building Societies Commission is also aware of the additional data needs. In view of the Chancellor's announcement, these requirements will not need to be introduced from end-December 1998. However the resulting reporting forms will be included within the Bank of England Statistical Returns folder to enable banks to plan for their introduction. Before implementation, further work on these additional reporting requirements may be required to reflect any subsequent changes in the ECB statistical reporting regime for the euro area.

11 Statistical coverage of the UK's external payments has in any event been significantly enhanced, from end-November, when the ONS began to publish a monthly estimate of external trade in services, compiled on an aggregate basis. Previously only trade in goods data were compiled monthly, with trade in services available only quarterly. Preparing these data is also an important step forward in developing estimates of a monthly balance of payments, required by the ECB, although the UK continues to question their use for policy purposes and has agreed only to provide the best possible estimates from existing data systems.

12 Work continues in the Committee for Monetary, Financial and Balance of Payments Statistics, on which the UK is represented, to advise EUROSTAT on the measures which it is valid to include in General Government Debt and Deficit under the European System of Accounts 1979 (ESA79).

PRACTICAL ISSUES ADDRESSED IN PREVIOUS EDITIONS

A number of issues explained in the last two editions remain relevant and readers may wish to refer back to them, using this list.

ORGANISATIONS INVOLVED

Wholesale payments and settlement

Association for Payment Clearing Services (APACS)
BACS Ltd (BACS)
Cedel Bank
Clearing House Automated Payment System (CHAPS)
CREST
Deutsche Börse Clearing (DBC)
ECHO
Euro Banking Association (EBA)
Euroclear
London Clearing House (LCH)
Sicovam

Financial markets and exchanges, and other market associations

American Banking & Securities Association in London (ABSAL)
Association of British Insurers (ABI)
Association of Corporate Treasurers (ACT)
Association of Unit Trust and Investment Funds (AUTIF)
Baltic Exchange
Bloomberg Financial Markets
Bridge Information Systems
British Bankers' Association (BBA)
British Venture Capital Association (BVCA)
Building Societies Association (BSA)
Council of Mortgage Lenders (CML)
Dow Jones
EBS Dealing Resources
EFFAS European Bond Commission
Federation of Commodity Associations (FCA)
Finance and Leasing Association (FLA)
Foreign Banks and Securities Houses Association (FBSA)
Futures and Options Association (FOA)
Futures Industry Association (FIA)
FXNET Ltd
Gilt-Edged Market Makers' Association (GEMMA)
Institute of London Underwriters (ILU)
Institutional Fund Managers' Association (IFMA)
International Money Market Trading Association (IMMTA)
International Petroleum Exchange (IPE)
International Paying Agents Association (IPAA)
International Primary Markets Association (IPMA)
International Securities Markets Association (ISMA)
International Swaps and Derivatives Association (ISDA)
Lloyd's of London
London Bullion Market Association (LBMA)
London Investment Banking Association (LIBA)

London International Financial Futures and Options Exchange (LIFFE)
London International Insurance and Reinsurance Market Association (LIRMA)
London Metal Exchange (LME)
London Stock Exchange (LSE)
National Association of Pension Funds (NAPF)
Reuters
Tradepoint Financial Networks

Legal groups

City of London Joint Working Group (CLJWG)
City of London Law Society (CLLS)
Financial Law Panel (FLP)

Accounting

Accounting Standards Board (ASB)
Consultative Committee of Accounting Bodies (CCAB)
Fédération des Experts Comptables Européens (FEE)
International Accounting Standards Committee (IASC)
Institute of Chartered Accountants in England and Wales (ICAEW)
Institute of Public Finance Ltd

Business and retail

British Chambers of Commerce (BCC)
British Retail Consortium (BRC)
Confederation of British Industry (CBI)
Consumers in Europe Group
Institute of Directors (IoD)
The Consumers' Association
The Hundred Group
The Simpler Trade Procedures Board (SITPRO)

Regulators and Government

Building Societies Commission
Department of Trade and Industry (DTI)
Export Credits Guarantee Department (ECGD)
Financial Services Authority (FSA)
Government Actuary's Department (GAD)
Inland Revenue
Securities and Futures Authority (SFA)
HM Treasury

Information Technology

British Computer Society (BCS)
Business and Accounting Software Developers Association (BASDA)
Computing Services and Software Association (CSSA)
Securities Industry Software Association (SISA)

ABBREVIATIONS AND ACRONYMS

ACI . . . . .The Financial Markets Association
ANNA . . . . .Association of National Numbering Agencies
APACS . . . . . . .Association for Payment Clearing Services
ASB . . . . .Accounting Standards Board
ATM . . . . .Automated Teller Machine
AUTIF . . . . .Association of Unit Trusts and Investment Funds
BBA . . . . .British Bankers' Association
BCC . . . . .British Chambers of Commerce
BCS . . . . .British Computer Society
BIS . . . . .Bank for International Settlements
BTAN . . . . .Bons du Trésor à taux fixe et intérêts annuels
BTF . . . . .Bons du Trésor à taux fixe et intérêt précompté
CADES . . . . . . .Caisse d'Amortissement de la Dette Sociale
CCBM . . . . .Correspondent Central Banking Model
CD . . . . .Certificate of Deposit
CGO . . . . .Central Gilts Office
CHAPS . . . . . . .Clearing House Automated Payment System
CHIPS . . . . .Clearing House Interbank Payments System (New York)
CLJWG . . . . . . .City of London Joint Working Group
CMO . . . . .Central Moneymarkets Office
CP . . . . .Commercial Paper
CSDs . . . . .Central Securities Depositories
DBC . . . . .Deutsche Börse Clearing AG
DGII . . . . .Directorate General II of the European Commission (Economic and Financial Affairs)
DGXV . . . . .Directorate General XV of the European Commission (Single Market and Financial Services)
DTB . . . . .Deutsche Terminbörse (Frankfurt futures exchange)
DVP . . . . .Delivery Versus Payment
EAF2 . . . . .Elektronische Abrechnung Frankfurt (net settlement system)
EBA . . . . .Euro Banking Association
EBF . . . . .European Banking Federation
ECB . . . . .European Central Bank
ECOFIN . . . . . .Council of Finance Ministers of the European Union
ECSDA . . . . . . .European Central Securities Depositories Association
EIB . . . . .European Investment Bank
EIL-ZV . . . . . . .Eiliger Zahlungsverkehr (RTGS system)
EMI . . . . .European Monetary Institute
ESCB . . . . .European System of Central Banks
EURIBOR . . . . .European Inter-bank Offer Rate (proposed)
EUROSTAT . . . .Statistical Office of the European Communities
FEFSI . . . . .Federation of European Investment Funds
FRN . . . . .Floating Rate Note
FSA . . . . .Financial Services Authority
FTSE . . . . .Financial Times Stock Exchange (indices)
IBDE . . . . .Inter-Bank Data Exchange
ICSDs . . . . .International Central Securities Depositories (Euroclear and Cedel)
IPAA . . . . .International Paying Agents Association
IPMA . . . . .International Primary Markets Association
ISDA . . . . .International Swaps and Derivatives Association
ISIN . . . . .International Securities Identification Number
ISMA . . . . .International Securities Markets Association

ISO . . . . .International Standards Organisation
KfW . . . . .Kreditanstalt für Wiederaufbau (German export credit agency)
LCH . . . . .London Clearing House
LIBA . . . . .London International Banking Association
LIBOR . . . . .London Inter-bank Offer Rate
LIFFE . . . . .London International Financial Futures and Options Exchange
LSE . . . . .London Stock Exchange
MATIF . . . . .Marché à Terme International de France
MSCI . . . . .Morgan Stanley Capital Index
MTN . . . . .Medium-Term Note
NASDAQ . . . . .National Association of Securities Dealers Automated Quotation System
NCB . . . . .National Central Bank
NNA . . . . .National Numbering Agency
OAT . . . . .Obligations Assimilables du Trésor
OEICS . . . . .Open-ended Investment Companies
OLOS . . . . .Obligations linéaires - lineaire obligaties (Belgian government bond)
ONS . . . . .Office for National Statistics
OTC . . . . .Over-the-counter
PIA . . . . .Personal Investment Authority
RTGS . . . . .Real-Time Gross Settlement
SEDOL . . . . . . .Stock Exchange Daily Official List
SFA . . . . .Securities and Futures Authority
Sicovam . . . . . . .Société Interprofessionnelle pour la Compensation des Valeurs Mobilières
SORP . . . . .Statement of Recommended Practice
SSI . . . . .Standard Settlement Instructions
STIR . . . . .Short-term interest rate (LIFFE contracts)
S.W.I.F.T. . . . . . .Society for Worldwide Interbank Financial Telecommunication
TARGET . . . . . .Trans-European Automated Real-time Gross settlement Express Transfer system
UCITS . . . . .Undertakings for Collective Investment in Transferable Securities

INTERNET ADDRESSES FOR INFORMATION ON THE EURO

General	
Bank of England	http://www.bankofengland.co.uk
HM Treasury	http://www.hm-treasury.gov.uk
European Institutions (general)	http://europa.eu.int/index.htm
European Comission	http://europa.eu.int/comm/
EMI	http://europa.eu.int/emi/
Payments and settlements	
S.W.I.F.T.	e-mail: euro@swift.com
Securities Conversion Workshop	http://www.europe.ibm.com/euro
Euroclear	http://www.euroclear.com
Retail	
European Commission (DGXV) (report on conversion charges)	http://europa.eu.int/comm/dg15/en/finances/banks/expert.pdf
Accounting	
FEE	http://www.euro.fee.be
FEE: UK help desk	e-mail: noel.hepworth@ipf.co.uk
IT	
British Computing Society	e-mail: ijones@bcs.org.uk
European Commission (DGXV) (report on IT issues)	http://www.cordis.lu/esprit/src/wdiseuro.htm

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