Practical Issues Arising from the Introduction of the Euro

581 business days to go before January 1999

Issue No 2

16 September 1996

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CHAPTER 1: INTRODUCTION

1 In May the Bank published a first paper on the practical implications of the single currency for the UK, whether or not it became a participant; and proposed to publish a series of broadly quarterly updates reporting progress in the preparations. This is our second paper.

2 In addition to the issues discussed in the first paper we will also cover, in this and subsequent issues, the progress which has been made in the EMI's preparations for the future European Central Bank to begin its operations, particularly where this information might help practitioners in their planning.

3 In the Bank, we continue to see our main role as helping to prepare the UK financial and business community by:

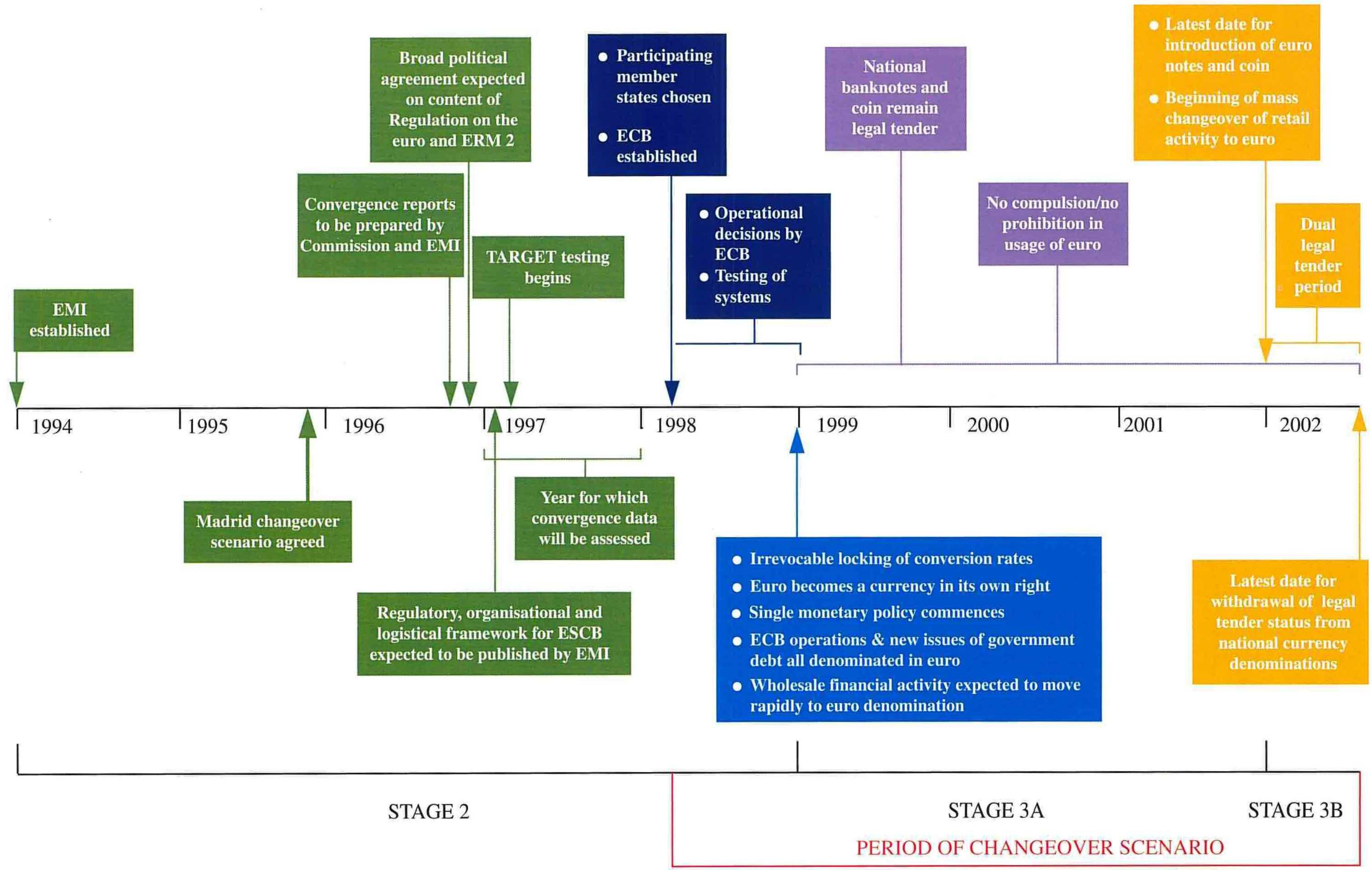
- disseminating information, communicating widely about the relevant issues and progress in addressing them;
- identifying where co-ordinated activity is needed, particularly in developing the infrastructure of the financial economy to embrace the euro;
- helping to ensure that the necessary work is agreed and undertaken;
- acting as a catalyst to stimulate private sector activity where necessary;
- putting groups facing similar or inter-related problems in touch with each other.

4 In pursuing this role the Bank has continued to hold bilateral meetings throughout the City; primarily with associations representing segments of the financial community but also with senior executives responsible for each financial and commodity market and exchange. We have also maintained contact with representatives of industry, retailers and consumers.

5 The nature of the transition scenario - summarised in Chart A and described in further detail in the attached offprint from the Bank's Quarterly Bulletin in February this year - means that, in the early years of Monetary Union, use of the euro would be largely confined to **wholesale** areas - the banking and payments system, and financial and other markets. We would expect use of the euro to spread significantly into the **retail** sector only after euro banknotes and coin become available, some three years after the start. This is helpful, because it means that preparations in the UK can focus now on **wholesale** developments, where preparation is necessary **whether or not** the UK participates; whilst much of the work at the retail level can be delayed until it becomes known whether the UK will choose to opt in, since the retail sector is unlikely to be much affected if the UK instead opts out.

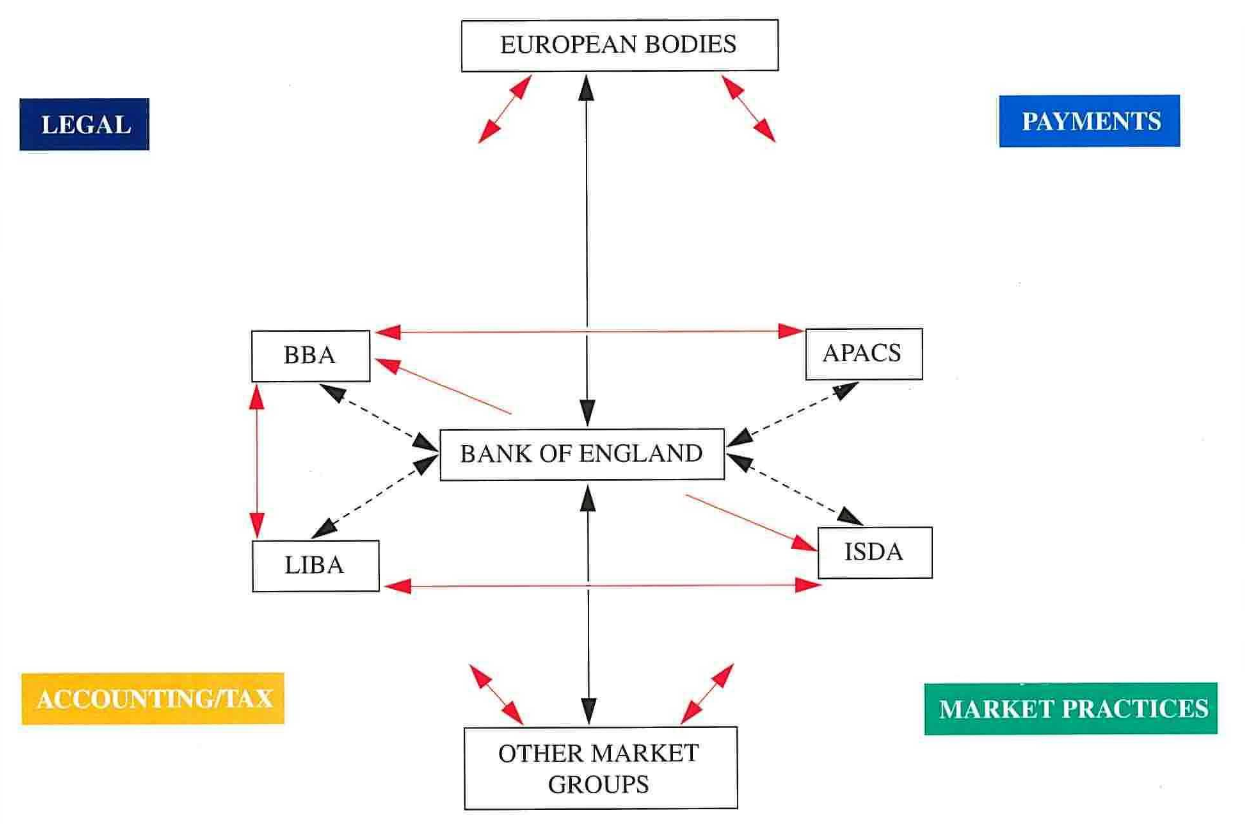
Planned timetable for the introduction of the euro

Chart A



6 Work across the financial industry as a whole to develop the necessary infrastructure to ensure that the euro may be used, whether the UK is in or out, has intensified. Much is being undertaken through private sector groups which are coalescing to focus on particular issues as they arise. The major banking and market associations, including the BBA, LIBA, APACS and ISDA, are heavily involved. The Bank is associated with most of these discussions in one capacity or another. The broad inter-relationships are illustrated in Chart B; Chart E in Chapter 3 provides more detail.

Inter-relationships between associations and the Bank **Chart B**



7 We believe that, as a result, planning to develop the financial infrastructure is now well in hand to ensure that the euro **may** be used in the UK at the wholesale level, in the payments system and across markets, by the beginning of 1999. In addition there is now a much more general acceptance at the level of individual firms of the need to analyse, plan and undertake practical preparations here, whether or not the UK participates, in order to maximise the business opportunities created by the introduction of the euro. We believe that there has been a shift of gear in many individual banks' and other financial institutions' preparations.

8 Whilst the financial sector inevitably remains the focus of the initial preparations, industry and commerce are now also seeking more information on the practical implications for them of the single currency. The BBA is planning various initiatives to help its members prepare for the single currency, including a rolling programme of seminars on EMU-related matters. Individual banks are considering preparing guides on the facilities which they will make available. Clearly in this area some other countries' banks are further advanced and have already published such

information. The Bank has decided to assist the process of informing business by preparing, in conjunction with the CBI and the British Chambers of Commerce, answers to the questions about the euro most frequently asked by business; a similar product may be developed with the Consumers' Association and British Retail Consortium for the retail industry and individuals. These broader initiatives are aimed at ensuring, so far as we can, that planning is based on proper information and at eliminating any misunderstandings, including about what must happen by when.

9 In addition to continuing to hold bilateral meetings with representative bodies across the City, the Bank has been proactive in filling gaps in the practical preparations where we have identified them. Two particular examples illustrate the approach we are taking. First, we established in May a small working group of Bank officials and outside practitioners with mathematical expertise, to consider 'rounding' conventions, given that rounding issues arise in many areas. Their work is described in Chapter 5. Second, the Bank also proposed in June to the Gilt-Edged Market Makers' Association (GEMMA) that we establish a joint working group, with other interested parties, to look at the practical issues for the gilt market to which the introduction of the single currency would give rise, as reported in Chapter 3. This group has now begun its work. Once the issues have been identified and possible solutions put forward, we hope within three months, we will consider how best to address the similar issues which arise across other UK markets; and then how to communicate to the relevant European bodies any consensus views developed from London's perspective as an international financial centre.

10 Separately from its work in helping to prepare the UK financial sector, the Bank has continued to play its full part in the preparatory work of the EMI in Frankfurt and of the Monetary Committee in Brussels; and we are also making our own contingency preparations so that we can play our part in the future European System of Central Banks.

11 *We would welcome assistance in circulating this paper as widely across institutions, and to as many individuals within institutions, as possible. Copies of the paper, including in bulk, may be obtained from the Bank's Public Enquiries Group (tel no: 0171-601 4878).*

12 *We would also welcome comments on the text, and more generally on the work in which the Bank is engaged. They 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).*

13 *We intend to publish the next paper in this series on 16 December. We would be happy to consider including in the next paper contributions from any association, to be provided if possible by end-November.*

CHAPTER 2: PAYMENTS ARRANGEMENTS

Wholesale payments

14 In our May paper we highlighted wholesale payments and settlements as one of the main areas on which immediate work was required in order to establish in the UK a capacity to make payments and settle in euro, whether or not the UK was an initial participant in Monetary Union. That remains our view.

15 A considerable amount of work has continued to be undertaken by the Bank, by APACS and in particular by the CHAPS banks (which own and run the UK wholesale payments system). This review first reports this work and the present state-of-play, before describing the discussions at the EMI on the European-wide dimension.

Necessary development of the UK RTGS system

(i) Preparations whether UK is 'in' or 'out'

16 Whether or not the UK adopts the single currency, the UK RTGS system will be linked to other EU RTGS systems through the Interlinking network, in a pan-European system known as TARGET (an acronym which stands for Trans-European Automated Real-time Gross-settlement Express Transfer). From the beginning of Monetary Union, the UK will need to be able to settle wholesale payments denominated in euro, both within the UK and cross-border; and the UK RTGS system will be developed to allow this. As explained below, cross-border settlement can however be achieved in a variety of ways already: it could also be achieved in future through TARGET, if this proves commercially viable.

A brief explanation of RTGS and TARGET

In a Real Time Gross Settlement (RTGS) system, payment instructions are transmitted on a transaction-by-transaction basis between direct members of the system and are settled individually across central bank accounts in real time (with, in most systems, full collateralisation of any intraday central bank credit extended to participating banks). This eliminates intraday settlement risk between the direct members of the system (ie the risk of losses which might otherwise arise through a bank failing during the day and so not being able to honour the payment messages it had previously sent), which is present in alternative net end-of-day settlement systems.

RTGS systems are being developed in all European Union countries as a means of reducing **inter-bank** settlement risk between members. Most often they have either replaced, or sit alongside, electronic net (end-of-day) settlement systems. Many of the payments put through the RTGS systems are not time-critical within the day and the development of these systems does not, of itself, affect the speed with which a payment **needs** to be made. But central banks encourage the use of RTGS systems because of their benefits in eliminating settlement, and hence minimising systemic, risk.

TARGET extends across national borders the risk-reducing benefits of RTGS systems, allowing banks to receive and give intraday value for cross-border payments. For this reason, central banks should wish to promote its use. But, as with domestic payments, potential users generating payments which are not time-critical may see no reason to change their present arrangements.

17 The Bank has agreed with the CHAPS Company how best to co-ordinate the relevant project work: the Bank has responsibility for connecting the UK's central RTGS Processor to the Interlinking network, while the CHAPS Company (within APACS) is responsible for enhancing the existing network arrangements to embrace the euro. In this respect, the Bank has continued its strategic discussions with CHAPS in relation to both TARGET and the means by which CHAPS intends to link to the RTGS processor. There have also been regular meetings at a technical level to discuss the systems implications of particular proposals, and the respective project managers in the Bank and CHAPS are liaising closely.

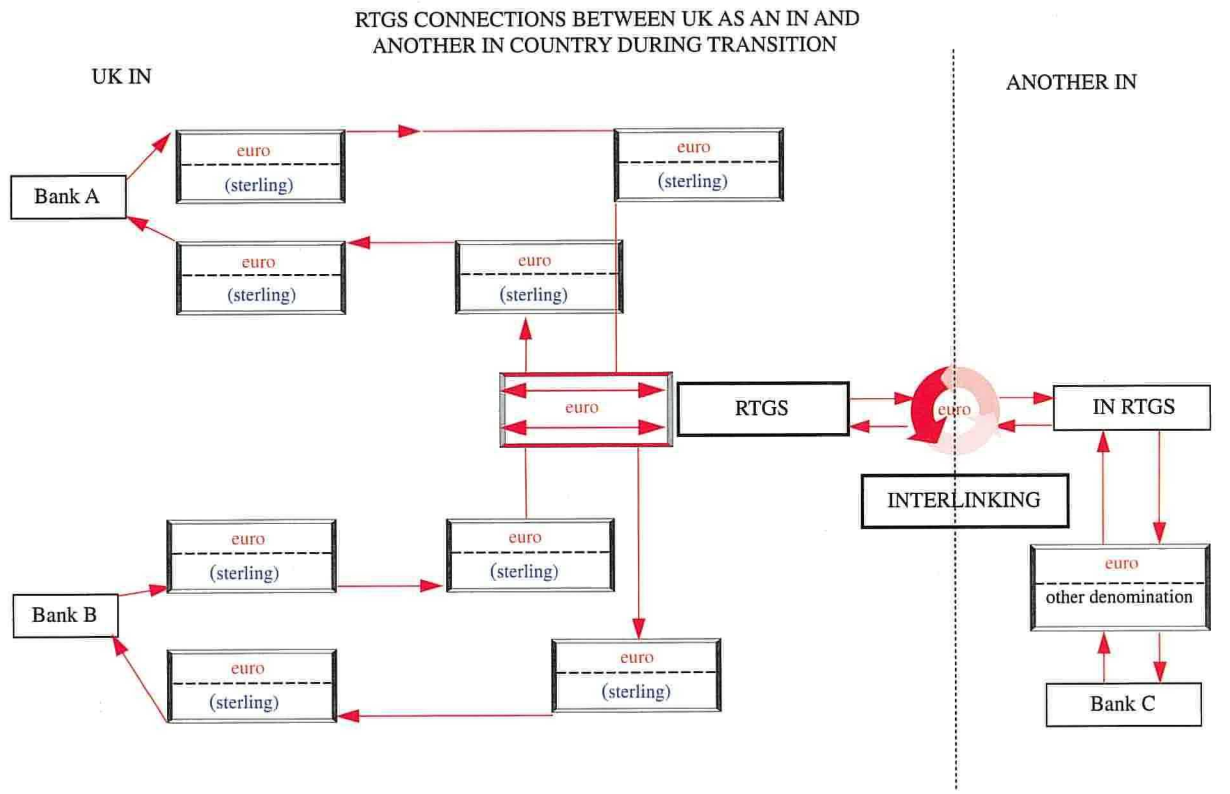
18 Following an initial CHAPS report in March 1996 setting out a range of options (under both UK in and UK out scenarios), a detailed feasibility study has been in train for developing a euro facility from 1 January 1999. It is expected that final decisions on the basis of this study will be taken within the next few months.

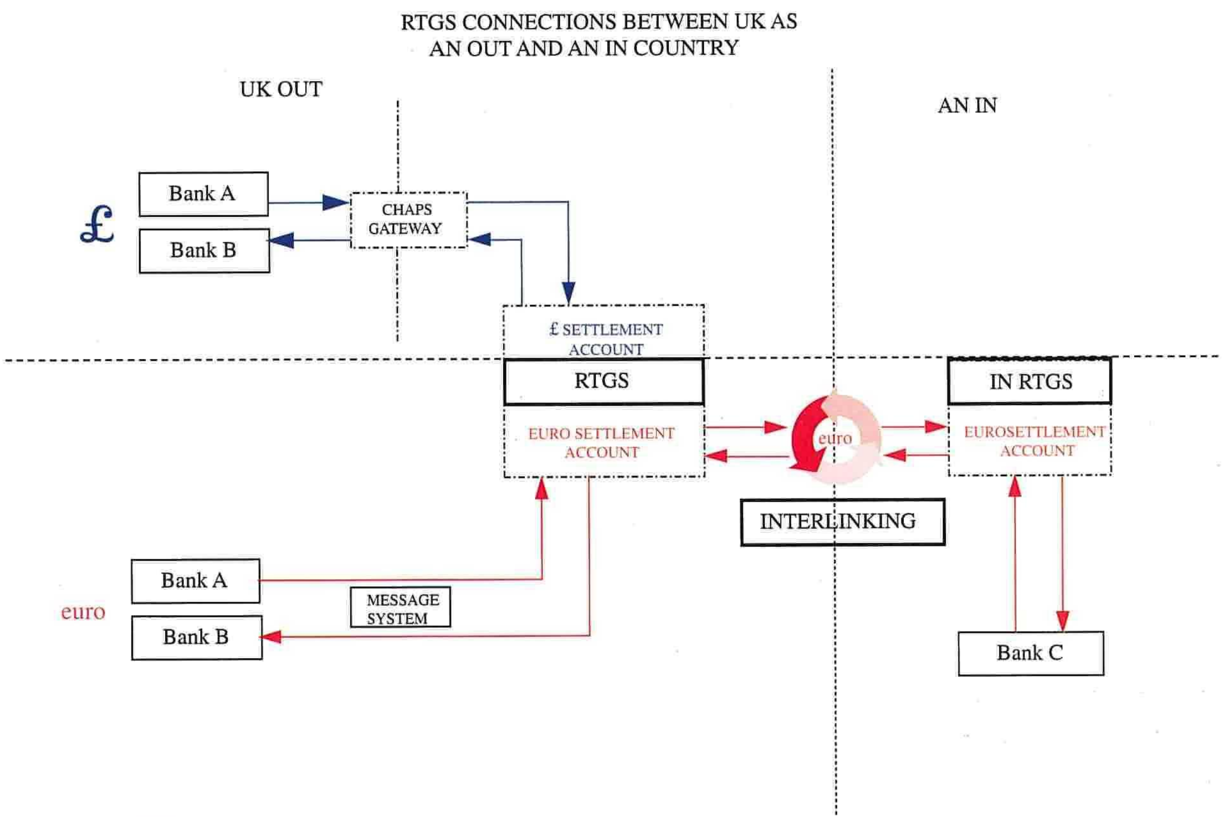
19 The interface to TARGET from CHAPS will be via the Bank of England: as far as CHAPS banks are concerned therefore, any payments to be made to or received from other countries will be sent to or received from the Bank of England. Discussions are under way to map TARGET message formats on to CHAPS message formats and vice versa.

20 CHAPS members will hold euro settlement accounts at the Bank of England, across which euro payments will settle in real time. Any intraday euro liquidity provided by the Bank of England to these accounts would be by means of intraday sale and repurchase agreements, as currently for sterling RTGS. Any liquidity provided on the basis of repoed securities would have a margin applied to account for market risk (and, where appropriate, exchange rate risk), as now in the sterling RTGS system.

21 Chart C shows schematically payments flows in the UK and, through TARGET, between the UK (whether it is in or out) and another country.

Payment flows in the UK and cross-border **Chart C**





(ii) Preparations for UK 'in'

22 If the UK adopts the single currency, the current CHAPS view is that customers of CHAPS banks (including banks participating indirectly in CHAPS through CHAPS member banks) will be able to send and receive payments in both sterling and euro denominations during the transition period. The aim is to allow those indirect participant banks which wish to do so to leave unchanged their present sterling systems during the first part of the transition period. However, settlement between CHAPS members and the Bank of England from 1 January 1999 would be exclusively in euro, so that CHAPS members would need to convert payments originating in sterling to euro denomination before they enter the CHAPS network. Separate message fields would exist to continue carrying the sterling denomination during the transition period as required (for example to obviate rounding difficulties).

(iii) Preparations for UK 'out'

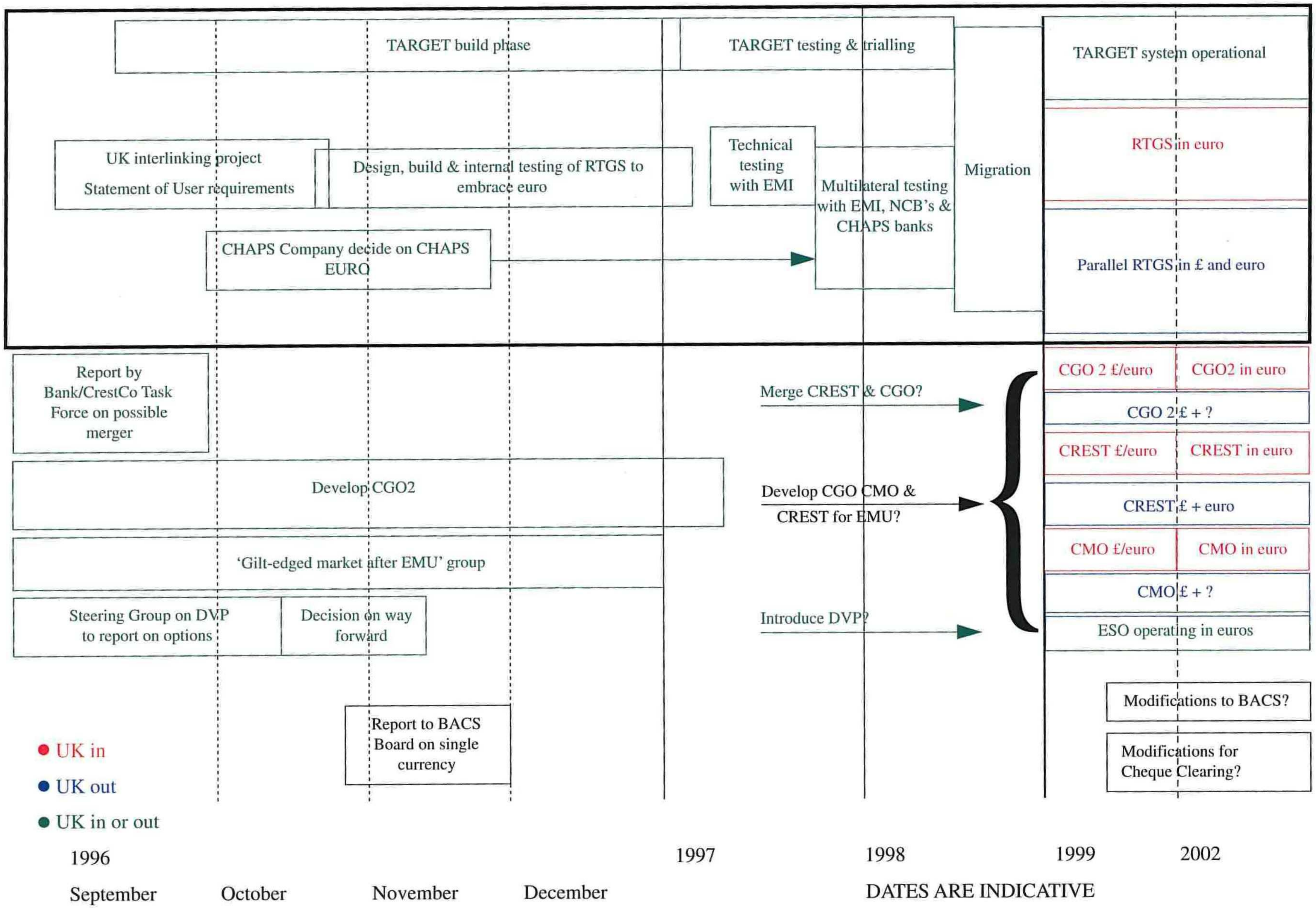
23 If the UK does not opt in, it will still be necessary to establish arrangements to handle euro, albeit as a foreign currency. Current thinking is that this may be best achieved by developing a separate, parallel, CHAPS euro system, which could be based on a number of options. These include an off-the-shelf product, a clone based on the existing CHAPS network for sterling, or modified versions of other systems. CHAPS intend to have decided on their preferred option within the next few months. Discussions are in train with CHAPS on the new interface that would be required at the Bank between such a CHAPS euro system and the Bank's central RTGS processor.

24 The extent to which the Bank will be able to receive intraday liquidity in euros from central banks within the euro area is currently a matter of debate within the EMI Council (see below). Work is separately in hand at the Bank, in co-operation with CHAPS, to consider whether there are advantages to the banks in pooling the collateral which they offer the Bank of England, and the liquidity granted against it, for both sterling and euro transactions.

25 Chart D illustrates the timetable for the development of the payments and settlement system.

Timetable for payments and settlement system development

Chart D



TARGET

26 In addition to the above ongoing preparatory work within the UK, discussions amongst central banks have continued at the EMI on the detailed design of TARGET. The TARGET project will provide connections between EU-wide RTGS systems, which would allow high value payments to be made in real time across borders within the EU, rather than just in individual countries in the single currency area. TARGET will comprise one RTGS system in each EMU Member State and an Interlinking mechanism to connect them: Member States not in EMU will be entitled to connect to TARGET. The essential purposes of TARGET, in connecting national RTGS systems, are to eliminate settlement risk in cross-border payments and to facilitate the operation of the single market. It would also allow arbitrage flows between different financial centres which could be important in linking together national euro money markets. How much use will be made of TARGET in practice will depend on its cost and efficiency in comparison with the range of alternative ways of making cross-border payments which will continue to be available.

Alternative ways of making cross-border payments

Correspondent banking, the ECU clearing, and direct access to other payments systems are all used by banks at present to make cross-border payments. Correspondent banking is the most widely used current mechanism - banks use, as their agents, banks in other countries with access to the local payments system. This mechanism will continue to be available in Stage 3. Whilst it is relatively efficient and cost-effective, particularly where same-day value funds are not essential, it leaves a bank exposed to settlement risk vis-a-vis its correspondents.

The ECU clearing, which is a mechanism run by the ECU Banking Association for settling transactions denominated in the basket ECU, is expected to develop into a euro clearing system, with end-of-day net credit and debit balances settling across TARGET. As with all such end-of-day net systems, it does not eliminate settlement risk between direct members or provide intra-day finality of funds.

Direct access to other countries' payments systems (RTGS or other) will also be available to banks with subsidiaries or branches in other countries, and through remote access from a bank in one country to another country's payments system.

27 In August the EMI produced its first progress report on TARGET, following an initial report in May 1995.

28 The progress report describes the operational design of the TARGET system (and the appendices to the report describe the technical specifications of the Interlinking in some detail). The Interlinking project has now entered the development phase, which is due to be completed in July 1997; this will allow testing and trialling to take place before Monetary Union starts. The UK will play its full part in the development, testing and trialling phases.

29 The EMI, in promulgating the report, reiterated that banks in non-EMU countries will be able to connect to the TARGET system and that the conditions under which they can make and

receive euro payments within the single market will be as equal as possible to those offered to banks within the EMU area.

30 A number of issues are uncontroversial and have been readily agreed, including that:

(i) intraday liquidity may be provided to participants in payments systems by means of either collateralised intraday overdrafts or intraday sale and repurchase agreements, and participants may use intraday their positive balances at the central bank, including any resulting from reserve requirements;

(ii) there should be long operating hours with a common closing time of 6.00 pm CET (5.00 pm UK time), and opening times about 11 hours earlier (6.00 am UK time);

(iii) pricing policy should have as its aim full cost recovery; and

(iv) all cross-border large-value net settlement systems operating within the euro area should settle across the TARGET system, using normal TARGET transfers.

31 However, two main issues remain outstanding, both of which make it more difficult for banks to plan. First, the detailed pricing methodology is yet to be determined, and in particular whether to establish common prices for cross-border transactions through TARGET. The Bank would prefer a common price to cover only the cost of the Interlinking component, leaving the rest of the charge to differ in order to reflect the relative costs and efficiency of national RTGS systems. There are as yet no data available on the likely costs of using TARGET; and this makes it difficult even in principle for banks to know how much they would ideally wish to use TARGET as against other available cross-border payments mechanisms.

32 Second, whilst it has been decided that central banks in non-EMU countries within the EU may connect their own RTGS systems to TARGET, the terms and conditions for access to intraday liquidity remain undecided. The box elaborates the issues. All options remain open, for further discussion at the EMI. It would in our view be helpful to resolve the outstanding issues as quickly as possible, to assist banks in their planning and for the sake of the project itself, which is subject to tight time constraints; but in practice a conclusion is likely to take some time.

Access to intraday liquidity

The main point at issue in the EMI debate is whether non-EMU central banks should have access to euro intraday liquidity on the same terms as central banks within the euro area. We have argued from principle that such access should be available, because intraday liquidity helps ensure a fully efficient payments system, speeding the flow of payments and avoiding potential gridlock. And more generally that it is in central banks' interests to encourage maximum use of RTGS systems, including TARGET, to remove daylight exposure between the settlement banks, in order to minimise systemic risk. These are matters of principle and apply to countries within the MU and without, and irrespective of which countries belong to MU. We have therefore fully supported the development of TARGET with as wide access to, and use of, it as possible, as part of the ideal EU-wide infrastructure for the single market.

In our view there are no monetary policy issues which arise from the provision of intraday liquidity **per se**; but we accept that, if intraday liquidity were to spill over into **overnight** liquidity, this could potentially affect monetary conditions in the euro area. In practice this would be so only if spillovers were significant in scale and persistent: we do not believe that any short-lived spillover would have any lasting effect on monetary conditions. Thus in the present UK system settlement banks should be in credit on their accounts at the Bank at the close of every day; but very occasionally, when technical difficulties occur either in an individual bank or because the Bank has not provided sufficient overall liquidity through its money market operations, an overdraft may arise. It is cleared the next day, has no effect on market interest rates and we do not judge that monetary conditions have been disturbed.

The monetary policy implications of any spillover would be identical whether it occurred inside or outside the euro area - there is nothing inherently more damaging from a spillover on the outside. And in practice the likelihood of a spillover may be greater **within** the euro area if banks would have an **automatic** right (limited only by available collateral) to translate intraday liquidity into overnight liquidity through an ESCB lending facility. No-one is arguing for 'outs' to have access to any ESCB overnight facility.

In our view the best way to minimise the risk of spillover is to apply a penal interest rate to act as a deterrent. That should suffice, and no other measures are necessary, or could be justified, on monetary policy grounds. Any attempts to introduce differential terms for 'outs' compared with 'ins' would be discriminatory and be likely to contravene both the single market legislation and EU competition law.

In any event any attempt to erect barriers to try to prevent use of the euro outside the euro area would be most unlikely to succeed. The aim in Monetary Union is to establish a euro area which is large and successful, and it is inevitable that its currency, like the dollar, will be traded widely throughout the world, particularly in countries which are close and have strong trading links. There are in any event likely to be large-scale holdings of euro outside the Monetary Union even without TARGET.

In sum, we believe that all RTGS arrangements are highly beneficial in reducing systemic risk, and we wish therefore to see as wide access to, and use of, TARGET as possible. We will continue to work constructively, both in Frankfurt and with the banking community in London, to develop a practical, efficient and cost-effective system for euro which banks throughout the EU will wish to use, and which will be fully accessible to UK banks whether the UK opts in or out.

Retail systems

33 Work has also been going on within the other clearing companies under the APACS umbrella to consider the development of UK retail payment systems. The Cheque and Credit Clearing Company is investigating four main technical options for handling sterling and euro during the transition period if the UK is in. A detailed analysis is in preparation, for discussion by the Board later this year. In addition consideration is being given to whether euro cheque facilities would be required if the UK is out. BACS is considering its technical options for responding to the potential demand for a medium to low value euro payment service in both 'in' and 'out' scenarios. We have had discussions with their representatives, in which we explained that we could see no reason why banks could not settle BACS-type payments for small business and retail customers across the euro settlement accounts which we intend to provide.

34 Separately APACS' Card Payments Group has also been discussing the impact which the introduction of the euro might make to the UK card payments industry and to establish the potential industry-wide changes that may be required to enable card issuers to offer plastic card services in euro if the UK joins, and at what point during the transition sufficient demand might be generated for such services. The central issue is whether, as we expect, retail customers will only switch their business to euro when euro banknotes and coin become available. If so, payment at point of sale should not move (much) to euro until, presumptively, 2002. So if the UK meets the convergence criteria and decides to opt in in early 1998, this would still give the retail sector some four years to prepare. However if, contrary to this expectation, incipient retail demand develops earlier, there may be pressure on providers of card payments services, and particularly electronic purse products, to play a role. But this could raise a number of complex technical issues, including in shops where present 'point-of-sale' machines cannot at present accommodate dual currency (denomination) operations. A working group has been established within APACS to consider the issues raised, including those aspects which need to be handled collectively. In due course it may be helpful to arrange a meeting for all representative groups with a retail interest, including APACS, BBA, the British Retail Consortium and the Consumers' Association, to discuss these issues.

35 APACS Cash Services Group has also been considering the requirements for the introduction of euro notes and coin and the withdrawal of sterling notes and coin. APACS has already been liaising with ATM suppliers and others on this issue.

CHAPTER 3: FINANCIAL MARKETS AND EXCHANGES

Overview

36 As explained in the introduction, a great deal of highly focused work is now under way throughout the financial industry, organised primarily through the banking and other associations, which are increasingly working together and with the Bank. This work is described below.

37 It has involved primarily over the last few months work on:

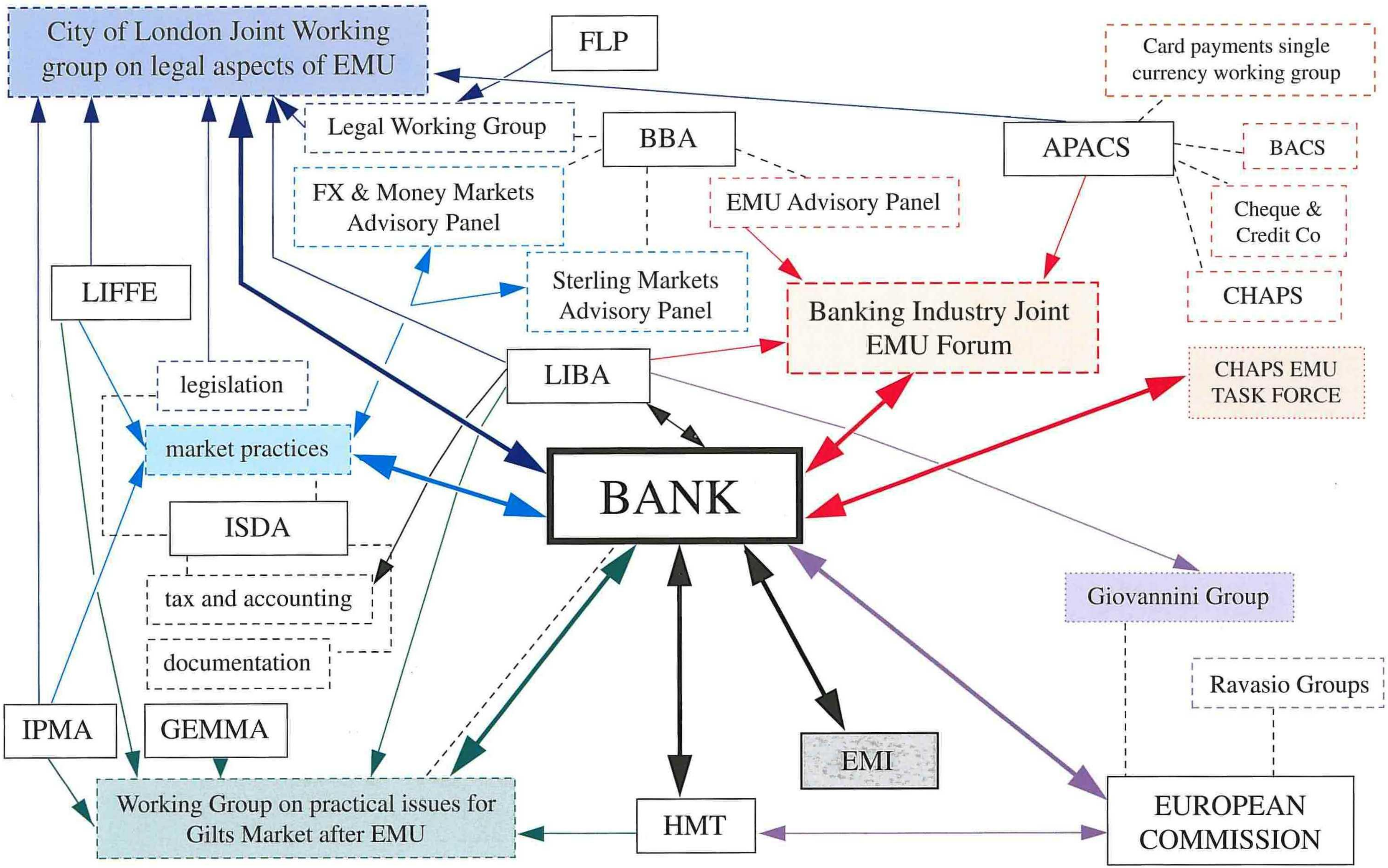
- the development of the payments system already described;
- the legal changes necessary to introduce the euro;
- rounding; and
- tax and accounting issues.

Attention is now moving on to market conventions and securities settlement, where our proposed approach is described further below.

38 The executive of each organised financial exchange has now undertaken work to begin analysing and planning for the single currency, both in terms of the practical preparations and its business strategy, where this is necessary. However some (primarily dollar-based) exchanges have, reasonably enough, concluded that the single currency would have no impact, and that no specific preparations are therefore necessary.

39 The inter-relationships between the various groupings and associations across and beyond the City working on the practicalities of the single currency are illustrated below.

Cross-membership of EMU working groups **Chart E**



The Bank's approach

40 Our approach is to work alongside the banking and market associations, ensuring that **they** are kept in touch with relevant progress at European level in the single currency framework and that **we** are aware of, and contribute as necessary to, their own plans. Where we have identified particular gaps, we see it as our role to ensure they are filled.

41 We also propose to address, with market practitioners, both market conventions (see box) and securities settlement issues. First, in relation to market conventions (an issue which a number of banking associations have raised, as discussed below), we decided to focus our initial effort on the gilt market, where some other issues also arise. We therefore indicated in June to GEMMA that we proposed to establish a working group to consider all the practical issues for the gilt market after EMU, whether the UK is in or out. This 'Gilt Market after EMU' group is chaired by the Bank and includes representation from, inter alia, HMT, GEMMA, the Stock Exchange, LIBA, LIFFE and end-users. The group has now begun to meet.

42 The group's remit covers market convention issues, but also extends to the timing and methodology of redenomination of outstanding debt. **New** issues of government debt by 'in' countries will be denominated in euro from the beginning of 1999, but participating Member States may decide themselves at what point during the transition period they wish to convert their **existing** debt into euros. Various factors will influence this decision, including the payment arrangements that are available during the transition (particularly for the retail sector), and the implications for existing prospectuses and investors. Other issues to be addressed include how to deal with rounding and the use of decimals versus fractions.

43 We intend the group to identify the full range of practical issues and to offer solutions, completing its work quickly - within the next three months or so - so that we can disseminate the conclusions more widely across other markets in the UK, where similar market convention issues will arise. We appreciate that a broader working group may well need to be established at this point, consistent with LIBA's recommendation in its recent report on securities settlement.

44 The ideal might be harmonisation of market conventions across markets and across the EU. The introduction of the single currency is an opportunity to seek such an outcome and we will do what we can to ensure that the view of London's international financial markets is put forward at the European level (the European Commission is beginning to work on these issues with practitioners - see below).

45 Second, on securities settlement, we accept that there will be a need for co-ordination. It is clear that, particularly if the UK is in, there could be a demand for settlement facilities to handle both sterling and euro-denominated securities and their associated payments during the transition period. The Bank is taking the lead in developing a future payment and settlement strategy for the UK, in discussion with the securities industry, including introducing full delivery versus payment (DVP) in domestic securities settlement systems. Any requirements arising from the single currency will be embraced in this work. One material consideration will be the technical arrangements for the cross-border use of collateral in monetary operations in Stage 3 and, as soon as the EMI's work in this area becomes sufficiently firm, we hope within the next few months, we will consider with practitioners the implications for UK securities settlement systems and the best way of ensuring appropriate co-ordination of any necessary developments with all those

involved, both domestically (CGO, CMO, CREST, ESO and the LCH) and internationally (Euroclear and Cedel).

Market conventions

Day counts used in calculation of interest

Practice varies between financial centres and even between markets within some centres. The question arises as to whether a harmonisation of day count practice is necessary, or desirable, and if so whether a consensus can be found between all those responsible for determining conventions. A second question is whether the choice between actual/365, 30/360 or actual/360 should turn on majority practice within Europe, or whether the opportunity can be taken to harmonise with the US and Japan, on actual/365. The ease with which a change in market practice can be accommodated also requires examination in relation to both systems implications and the treatment of outstanding instruments. The BBA and LIBA are considering this issue, and ISMA is currently canvassing views, together with IPMA, on the feasibility and desirability of standardising on actual/365 with semi-annual interest. The 'Gilt Market After EMU' group will also address these questions.

Interest-rate fixings

Practice varies again on the time period between interest-rate fixing and settlement. If harmonisation is desired by market practitioners, care will be needed to ensure that any change is practical. For instance, those accustomed to working with a two-day lag may not have the facility to harmonise on the same-day convention used by others. Risk considerations may also influence preferences.

Price sources

How to deal with price sources which may disappear is also under consideration at ISDA. Assuming that the Regulation on the euro ultimately contains provisions so that contracts may not be frustrated by the changeover, an understanding on fall-back sources for such contracts will be needed. Discussions have also begun on the alternative possibilities for panels, and whether they should differ by market, have Europe-wide membership, be composed only of banks from 'in' countries, etc.

Bank Holidays/time differences

The differences in Bank Holidays throughout Europe could cause more problems under a single currency than at present. The private ECU clearing and settlement system is one of the systems that presently has to cope with this issue, as will TARGET. Means of adjusting for non-uniform holidays will need to be found as the near-term likelihood of their harmonisation seems negligible. There are also obvious time differences between the UK and Continental Europe, the implications of which may need to be considered.

Work of major market and banking associations

46 The **International Swaps and Derivatives Association (ISDA)** has been particularly proactive: they have established four working parties to deal with various aspects of EMU - Market Practice, Documentation, Legislation, and Tax, Accounting and Capital. The Bank is in close touch with the work of all these groups.

47 Several aspects of concern to these working groups are mentioned elsewhere in this paper. The **legislation** sub-group has been much involved in the City's input to the consultation on the draft Regulation on the euro (see law section below). The **documentation** group has been focusing on how contracts should be amended from now on in order to minimise difficulties if contract continuity is not adequately preserved in the euro Regulation. In relation to ECU contracts ISDA, jointly with the **International Primary Markets Association (IPMA)**, published on 31 July an updated version of their standard version of the ECU for use in terms and conditions of securities and derivatives contracts (replacing that of 8 December 1995). Following consultation, the recommendations - which reflect the Madrid Summit confirmation of one-to-one continuity of the euro and the official ECU - were confirmed in early September.

48 The definition is as follows:

> *The ECU in which the [securities] are denominated is the same as the ECU that is from time to time used as the unit of account of the European Communities. Changes to the ECU may be made by the European Communities, in which event the ECU will change accordingly.*

49 It is intended that the standard definition should be identical both in securities issues and in swap and derivatives contracts; and that the revised recommendation will not be inconsistent with the treatment of the ECU in existing contracts and securities issues.

50 Parties to new contracts denominated in EU currencies should consider what explicit provision to make for the introduction of the euro. ISDA's documentation group circulated draft language on this point earlier in the year.

51 The **tax and accounting** group (which includes the BBA and LIBA) has been particularly concerned to identify possible tax complications arising from EMU (see below). Finally, the **market practice** group has focused on market conventions, rounding and pricing sources. Representation on this group has been expanded to encompass IPMA and LIFFE with a view to securing common agreement where possible. This is considered important to avoid mismatches arising from different conventions applying to derivatives and to their underlying cash instruments. Given the cross-market significance of a number of these conventions, the group will continue to seek co-ordination with other relevant bodies and associations. ISDA is also examining the implications for the swaps market of the existence of more than one underlying government curve on which to base valuations.

52 IPMA is fully involved in the work of cross-market bodies on legal issues and market practices. The possible harmonisation of market practices is seen as generally beneficial, although applying a new standard retrospectively to outstanding bonds would be difficult as the

consent of all bondholders would normally have to be obtained. IPMA is also involved in checking possible tax issues.

53 The **British Bankers' Association (BBA)** continues its work on a number of fronts. In addition to a number of advisory panels it has established, together with APACS and LIBA, a Banking Industry Joint EMU Forum to discuss issues of common interest and to maintain a co-ordinated dialogue with the Bank. We welcome this development, and would hope that it will prove possible for the Bank to meet this joint industry grouping, on a regular basis, monthly, from now onwards.

54 BBA, APACS and LIBA expect to publish shortly a joint working group report on the implications of EMU for the banking and financial markets in the UK. Their work has confirmed the need for co-ordination in a number of areas: most of this co-ordination is already under way but we will discuss with the Forum any areas where gaps remain. The areas they have identified include wholesale payments and settlements; euro securities settlements; euro trading conventions; the needs of the corporate sector; legal issues; redenomination of existing securities; retail payment systems (under the in scenario); and euro reference rates (such as euro LIBOR). In relation to the latter, the BBA will address the technical and market issues related to its intended provision under either scenario of a euro LIBOR reference rate in consultation with market bodies.

55 The **Foreign Banks and Securities Houses Association (FBSA)** maintains contact with the BBA, and directly with the Bank, and is preparing to increase the information flow to its members on relevant developments. The **Building Societies Association (BSA)** provides its members with a periodic circular summarising relevant developments and maintains dialogue with members on European issues, including EMU, via a separate European Working Group. Many issues will only arise for its members under the UK in scenario, in view of their greater focus on the retail market.

56 Aside from its joint work with APACS and the BBA, the **London Investment Banking Association (LIBA)** has produced two reports this year, the latest on the subject of securities settlement issues. This makes many detailed recommendations concerning markets and systems, including the need for co-ordination of the process of redenominating national currency instruments. Many of their recommendations are already included in work programmes, but we will consider with LIBA how best to address any that are not. Their study is addressed to both system operators and their members. In its earlier papers, LIBA noted: the need for a common interest accrual basis; common rules for settling instruments on non-business days; the importance for bond markets of being able to trade fractional amounts of redenominated existing national debt; the desirability of removing existing differences between trading centres in relation to quotations in fractions or decimals; and the potential for 'seepage' between wholesale and retail sectors in the context of equity quotations and payment of dividends in euro, with consequential implications for retail banking facilities.

57 Their latest paper, which many other parties are using as a base for further work, helpfully addresses the systems for different markets in turn. The analysis in relation to CREST, the International Central Securities Depositories (ICSDs) and the London Clearing House (LCH) is summarised below.

CREST - UK equities and corporate debt

If the UK ***participates*** *in EMU, LIBA, in common with many others, expects the wholesale market to move rapidly to euro quotes and settlement, driven by the requirements of institutional investors dealing cross-border and corporate issuers deciding to redenominate their shares into euro and/or to make euro-denominated payments. With the possible exception of dividend payments, the move to euro need not impact the retail market as the retail investor will interface with the central infrastructure through intermediaries, who can be expected to offer sterling services. Whether or not issuers redenominate nominal share values poses no significant problems for CREST settlement, but there are legal issues to be examined. The issue of how to respond to demands for quotations in euro is a matter for the exchanges, as well as for quote vendor services. LIBA consider that it would be preferable for exchanges to quote a particular security in sterling or in euro rather than attempting to do both although, through the use of converters, inputs could be on an either/or basis. The brokers would then have to provide a bridge between euro central market pricing and sterling settlement for retail customers. LIBA recommends that the Stock Exchange consult market members and users concerning this prospect: the Stock Exchange is currently considering these issues (see below).*

LIBA suggests that the capability to convert sterling inputs into euro be provided centrally in CREST, rather than individually by each member (CREST are in dialogue with LIBA and APCIMS on this point). They note that they would like confirmation from regulators on the approach to be taken regarding contract notes and valuations issues to private clients in respect of underlying euro transactions or holdings - whether such information can be issued in either currency denomination, and the amount of explanatory information required. Where companies take early advantage of the single currency by advising and perhaps paying dividends in euro (which in Stage 3A would probably require shareholder approval for companies with a share capital denominated in sterling), such action will anticipate the time at which retail payment systems have been converted to euro. This issue is one which will be studied by BACS.

If the UK does not participate, CREST - which is a multi-currency system - could choose to offer a euro settlement option for equities and corporate debt quoted on euro-area exchanges (but this would be subject to resolution of certain legal issues - notably in relation to the treatment of foreign securities). CREST will need to provide this service anyway for Irish corporate securities which it will also settle.

Euroclear and Cedel (ICSDs) - bonds

These bodies face the same issues regardless of which Member States participate in EMU. The exact settlement infrastructure changes required will depend on the approach taken by in issuers to redenomination. At the start of the transition, all new government debt issues by in governments will be in euro, but EMU Member States have discretion as to when they redenominate outstanding debt during the transition, and outstanding issues denominated in national currency could continue to trade for some time. Euroclear itself is considering options for dealing with this, and for the fact that different issuers may opt for different approaches to redenomination.

Different approaches to redenomination could require changes to company law, revisions to instrument terms and the need for shareholder approval and meetings. IPMA is also aware of *these issues (see above). Industry bodies will need to assess the extent of demand for trading of odd lots (created by redenomination of instruments traded in multiples of minimal deliverable quantities) and the ICSDs will wish to consider whether to offer settlement facilities for odd lot amounts. LIBA believe the ICSDs should develop systems for matching euro and national currency instructions during the transition period, on the grounds that this would be more efficient than separate conversion facilities at each ICSD participant. LIBA recommend that the ICSDs study arrangements (such as a sweep facility) to offer cash management accounts which would provide 'integrated euro cash management', given fungibility between participant currencies, while still allowing national currency reporting.*

If the UK does ***not*** *participate in EMU, sterling instruments would continue to be settled throughout the ICSDs, with separate sterling cash accounts and payment system links: UK-based institutions could still have an account at the ICSDs so long as they had access to euro payment facilities.*

LCH - commodities and derivatives

LIBA raised four issues for the LCH: consideration of the provision of a converter facility; interchangeable use of euro and national currency denomination for cash and margin payments; provision of a euro cash account; and preparation for acceptance of euro- denominated securities. In reply, LCH has said that on the question of a possible 'converter' to allow, for example, participants to settle gilt futures in euro when quotation may be in sterling, they believe that this conversion is likely to take place within LIFFE's systems. They intend to offer euro cash accounts as soon as the euro comes into existence, regardless of which countries join EMU and which derivative contracts are so denominated. Variation margin must be denominated in the domestic currency, and LCH expects to enable settlements denominated in the euro or any national currency in EMU to be made in any other such currency denomination. Initial margin payments may be offered in any currency, on a cross-currency basis and the euro will simply be one more currency for this purpose. A decision on accepting euro denominated securities for margin cover would be taken independently of decisions regarding cash payment, but the LCH's intention would be to accept such securities as soon as the cash market is adequately established, and probably regardless of developments in the futures contracts themselves.

European-level initiative

58 The **European Commission** has established a consultative group of practitioners (under Alberto Giovannini) to consider the impact of the introduction of the euro on EU-wide money and capital markets: the UK is represented.

59 The main objective of the Giovannini group is to facilitate the exchange of views and co-ordination between market participants and between them and the public authorities; to identify technical solutions which may be used by other market participants or by other markets; and to identify whether there is a need for guidance from the public authorities. The group met once in July, and agreed a list of topics to be examined, for each of which a sub-group has been established. The priority topics are:

- the Government bond market, including in particular the question of issuance co-ordination, benchmarks, and the redenomination into euro of existing issues;

- fixed income markets, including derivatives;
- equity markets, including derivatives;
- repo markets;
- ratings;
- indices;
- conversion rates to be decided;
- changeover of the basket ECU market;
- framework for investor protection.

Organised exchanges

60 We noted in our previous report that the **London International Financial Futures & Options Exchange (LIFFE)** was further forward in its planning than some others. It has already amended its three-month interest rate futures contracts so that they convert automatically to euro-denomination when EMU starts with the particular currency in question a participant, reflecting the fact that since March 1996 LIFFE has been listing contracts that are due to mature after the beginning of 1999. LIFFE's continued forward thinking is designed to ensure it is well placed to remain the leading exchange in Europe, whether or not the UK is a part of the Monetary Union.

61 As noted above, LIFFE is fully involved in consideration of market practice issues with a view to the implications for its contracts. In addition it is examining what would be the most appropriate form of futures and options contracts for government bonds. The central issue is whether the market will perceive a significant difference in credit risk between different issues. Options include introducing more than one euro bond future, with separate deliverable baskets of bonds issued by each relevant government, or permissible groupings in a credit tier approach. Convergence of market conventions is also important for securing homogeneous baskets. Decisions on these issues are not as yet time critical. LIFFE has also initiated discussions with institutional investors on the implications for them of the introduction of the single currency.

62 It was noted in our first paper that the **London Metal Exchange (LME)** would have to address before the autumn the issue of conversion to euro-denomination of its 27-month DM and £ contracts in the event that either Member State adopted the single currency from 1 January 1999. (This is the same issue as that already addressed by LIFFE in relation to its contracts.) After further consideration, the LME has concluded that the requisite changes to the contracts need not be made in this timescale, but they will continue to assess the appropriate means of making such changes in due course. The LME is also considering with its banks how to calculate forward rates for euro against US dollar (or other European currencies not changing over to euro) at forward prompt dates beyond 1 January 1999, for those contracts which will (eventually) extend beyond this date.

63 The **London Stock Exchange (LSE)** has set up an in-house task force to assess both its business strategy for the advent of the single currency, and to consider the practical implications. The LSE has prepared a paper on the listing implications of the single currency for HMT, and has provided input to the European Focus Group of the Chancellor's City Promotion Panel and the forthcoming EMU paper to be published by the British Bankers' Association. The LSE is also a contributor to the Bank of England's working party on practical issues for the gilts markets after EMU. The LSE is compiling a list of issues, questions and implications which it will discuss with its members and other market constituents, covering those issues needing preparation, for example regarding quotations in both the in and the out scenarios. The different options for share capital redenomination and the attendant legal issues will be addressed by the LSE in conjunction with issuers and investors, as well as intermediaries. Possible consequential changes to company legislation will be examined in conjunction with the DTI and legal specialists.

64 **Tradepoint Financial Networks**, which has now been operational for nearly one year, expects no particular difficulties in trading euro. Its systems are new and designed to cope with multiple currencies, and its design was conceived with diversification across instruments and currencies in mind.

65 The **International Petroleum Exchange** is unaffected by the changeover in relation to its existing contracts which are all traded in US dollars. However, it is planning two new gas contracts which will be priced in pence per therm. One will remain in pence per therm but the second, being more suitable for trading as a European contract, will probably be converted to euro at some date after its introduction. Its members are aware of the need to make such preparations for the single currency.

66 The **Baltic Exchange** is largely unaffected by the single currency, given the widely international, and wholly US-dollar-denominated, nature of its business.

Work of other associations

67 The Bank has had meetings recently with the **London International Insurance & Reinsurance Market Association (LIRMA)**, **Lloyd's of London (Lloyd's)**, the **Association of British Insurers (ABI)** and the **Institute of London Underwriters (ILU)**. Aside from overarching issues (such as continuity of contracts) and economic (as opposed to practical) issues regarding long-term liability, the wholesale insurance sector has very few difficulties to address. Provided the banking facilities which they will need for the changeover are in place, the insurance industry has little preparatory work of its own to undertake. The retail sector would face a greater task if the UK opted in, in relation for example to notification of policyholders.

68 The **ILU** uses the London Processing Centre, and has a central mechanism for making market payments denominated in four currencies: US$, Canadian $, sterling and 'convertible' sterling. The latter 'currency' covers payments in all other currencies. If significant EU currencies were replaced by the euro, there might be justification for creating a fifth currency (if the UK was out) or, if the UK was in, the sterling and 'convertible sterling' could be replaced by euro and 'convertible euro'. Running parallel denominations might be more difficult. Many London market reinsurance contracts are typically specified in three different currencies, with the exchange rate sometimes fixed at an artificial rate: eg £1=$2. A potential concern is that the

courts might not enforce contracts specifying exchange rates other than the irrevocable fixed parities. The ILU is alerting its members to this, and taking steps to ensure that this is taken into account in contracts well in advance of 1 January 1999.

69 **LIRMA** also uses the London Processing Centre and will be able to accommodate the addition of another currency; and its payment arrangements, which are based on traditional correspondent banking, should be relatively straightforward. LIRMA, like others, is concerned to ensure that there is continuity of contract, although as most contracts in the wholesale market are annually renewable, they believe this may not be too great a problem. LIRMA is however giving further thought to the question of long-term liability, where there may be some economic issues to address.

70 **Lloyd's** believes it will face few practical problems, as its business is already multi-currency (and again uses the London Processing Centre). The Trust funds are run in Canadian dollars, US dollars and sterling, and all other currencies are converted through these. If the UK stays out, the euro could be converted through the Sterling Trust Fund. If the UK participates, the fund itself could be converted to euro. There need to be some changes to the rules and regulations regarding permissible assets, but the matching of obligations is already covered in the Trust Deeds and solvency requirements are already denominated in a relevant currency. Reserving requirements will not change. Lloyd's will give consideration to the need to quote in euro, whether the UK is in or out. Lloyd's will shortly be circulating its members with a paper on these issues.

71 The **National Association of Pension Funds (NAPF)** is considering how best to raise the profile of single currency practicalities with its members.

72 The **London Bullion Market Association (LBMA)** has concluded that no issues arise for the bullion market from the introduction of the single currency itself, given that the market is wholly US dollar-based.

73 The **Association of Unit Trusts and Investment Funds (AUTIF)** has identified few major issues peculiar to unit trusts. Most funds are currently in either US dollars or sterling, but it is possible to denominate new open-ended funds in different currencies, such as FF or DM. In addition, ranges of currencies will be easier to deal with within new open-ended investment companies. If the UK is in there will be implications for accounting systems and there is a need to examine the implications of different tax regimes as it will no longer be as easy to distinguish, by reference to the currency of issue, between investments attracting different taxable treatment as all such issues will be in euro.

74 The **Association of Corporate Treasurers (ACT)** has been keeping its members informed, and an ad-hoc working group has been examining practical issues. The main focus to date has been on cross-border payment and settlement services and liquidity issues. The ACT has been addressing legal concerns through its membership of the City of London Joint Working Group on Legal Issues. It is also keen to see the issues surrounding market conventions addressed. The ACT has held a single currency debate for its members this month, and intends to provide a guide to practical issues for its members in its next Handbook.

75 The **Finance and Leasing Association (FLA)** is considering potential tax, IT and legal issues relating to leasing and consumer credit. The **International Money Market Trading Association (IMMTA)** and the **Institutional Fund Managers' Association (IFMA)** have also both raised practical issues related to tax. Some IFMA members have started work on the implications for their business of the establishment of a single currency area, particularly in the context of clients' requirements for matching assets and liabilities. The **Futures and Options Association (FOA)** is proposing to hold a second open meeting for its members to discuss practical issues raised by the introduction of the single currency.

Regulators

76 The **Securities and Investments Board (SIB)** is convening a meeting with SROs and exchanges to discuss practical issues. The Bank will attend. Issues to be addressed include investor concern over contracts; settlement and denomination of currency; pricing, including dual quotes; information for investors (clarity and restraint on misleading information, drawing on lessons learnt from decimalisation); and the impact on market contracts and market structure. A number of these subjects were raised by LIBA in its recent document.

CHAPTER 4: BUSINESS, RETAIL AND THE PUBLIC SECTOR

Business preparations

77 Business, not surprisingly, is generally less advanced in its technical preparations for the single currency than the financial sector. In part this is because much of the planning is naturally sequential, with developments in the banking and payments infrastructure necessarily initially taking the lead. But it is also, as noted in the introduction, because the spread of euro beyond wholesale transactions is likely to await the availability of euro cash, and so at least those involved in the UK retail sector should have three further years to prepare. Nevertheless for many companies, particularly those with significant international commercial activity within the likely euro area, it would not be premature to focus on the practical and business implications now.

78 As mentioned in paragraph 8 above, the **CBI** and the **BCC** plan to set up a steering group to look at practical implications for the corporate sector of the introduction of the single currency (whether or not the UK is in). Bank of England representatives will also attend. It is anticipated that this group will oversee a series of regional workshops in late October and November at which there will be presentations by the CBI and BCC, as well as the Bank. It is hoped that there will be a couple of company case studies presented as well. These will be followed by further discussions leading to the drafting of an information pack for companies on the practical implications for business of the euro, which will be distributed early in the new year. In addition, the CBI will be updating its November 1995 economic brief on EMU during the autumn. Finally, the CBI issued in June an information pack and video, entitled Business in Europe.

Retail preparations

79 The **Consumers' Association** is preparing a position paper on possible consequences for consumers under both the in and out scenarios. Its future efforts are likely to concentrate on information provision, and stressing the need for transparency and choice for consumers.

80 While not participating in the debate about the desirability of a single currency, the **British Retail Consortium (BRC)** has established a working group, and has appointed a consultant, to complete a report on the cost implications of the move to the single currency. In addition, it maintains a dialogue with APACS, and plans to discuss the practical issues with a major retail company, with a view to establishing the likely demands which such companies would place on centralised systems, such as payment and card facilities.

81 The BRC have emphasised the need to choose a date for the introduction of euro notes and coin at an appropriate point in the trading year. They remain concerned (as we reported in the first paper) about the interaction between the Unit Pricing Directive and any requirements for dual pricing. They hope that some flexibility will be possible, but it will be necessary to reconcile this view with consumers' interests.

82 At a more prosaic level, the need for a symbol for the euro in cash tills and computer/typing keyboards has been raised with us by the British Retail Consortium and we have pursued this

issue with the EMI, who are now in touch with the European Commission. In view of the lead-times for such hardware, an early decision on this point would be very helpful.

Public sector preparations

83 It was recognised at the European Council in Madrid in December 1995 that public authorities in Member States which participate in the single currency will need to be ready to handle the euro. In line with the Government's policy that the United Kingdom should be fully engaged in preparatory work leading up to EMU, the Government has been represented at working group meetings with representatives of other Member States to discuss the practical issues involved. National differences in how public authorities operate will require decisions to be made at a national level. Public authorities will need to take account of the ability of their 'clients' in deciding how and when to make the changeover. The transition scenario agreed at the European Council in Madrid envisaged that the bulk of activities in which public authorities are involved would change denomination at or during the final stage of the transition. Many members of the public are likely to become familiar with the euro only after euro banknotes and coins are introduced. In general, public authorities will face many of the same practical issues as private organisations.

CHAPTER 5: OVERARCHING ISSUES

84 In our first paper we identified three overarching issues with wide ramifications - the law, accounting, and rounding. A significant amount of progress has since been made in identifying many of the major points and moving towards their resolution.

The law

85 As foreshadowed in the Bank's May paper, attention has focused on the draft Regulation setting out the legal framework for the introduction of the euro. This is broadly satisfactory, although a few contentious points remain unresolved. The drafting of the Regulation is in the hands of the Commission, although the EMI has made significant input with national central banks' assistance.

86 The latest draft Commission text of the Regulation has been provided for comment to a range of bodies, official and private; and the Commission has held a number of informal meetings. The subject is expected to be discussed at the September informal ECOFIN in Dublin. The procedure thereafter is not yet certain, but it is likely that the text will be examined in a Council Working Group.

87 In the first paper we explained that if the Maastricht Treaty basis of the Regulation were to be Article 109(l)4, it would not apply to the UK if it opted out. Another disadvantage of Article 109(l)4 is that it cannot be used before participants in Member States have been chosen and, taken literally, the Regulation could not be enacted until Monetary Union actually begins. These considerations reinforce the argument for using another Article, such as Article 235, for as much of the legislation as possible, because that would facilitate early adoption, provide market certainty and ensure full geographical coverage in the EU. A decision has yet to be taken.

88 The City of London Joint Working Group (CLJWG) on EMU legislation has been fully involved in the consultation exercise, along with the Financial Law Panel. The CLJWG have commented in detail on the text, and we have made input directly ourselves. A number of other associations have also provided comments directly to the Commission.

89 The issue of most concern to practitioners in the City is contract continuity, relating both to the substitution of the euro for national currencies and to its substitution for the ECU. In both cases, there are issues of concern with respect to the foreseeability of EMU, the possibility of contract frustration by introduction of the euro, and of termination by reference to a force majeure clause. Whilst one-to-one continuity between the official ECU and the euro is assured, some ECU contracts have the additional complication of being subject to definitions of the ECU which may not correspond to the official ECU, or in some cases may have no definition of the ECU at all. There is clearly a spectrum between giving absolute primacy to the terms of individual contracts, on the one hand, to overriding them completely to provide continuity, on the other; and it is possible to debate the most appropriate position for the Regulation within that spectrum.

90 One particular concern is that, under the English common law doctrine of frustration, which has no direct parallel under the civil code used on the Continent, obligations under a frustrated contract are discharged by operation of law and not by either party exercising a right to do so. In the view of the CLJWG, therefore, it is essential that the Regulation should indicate clearly that the introduction of the euro should not have the effect of discharging any legal instrument.

91 The Regulation makes clear that, during the transition period after the introduction of the euro, participating national currencies will be regarded as denominations of the euro rather than as parallel currencies, although they will still have legal tender status until up to six months after euro notes and coin have been introduced. There is a debate as to when the transition period should be held to be legally terminated. Under the Madrid changeover scenario, it was implied the transition ended when national notes ceased to be legal tender, up to six months after the introduction of euro notes and coin; but the latest draft of the Regulation suggests that the relevant date should be simultaneous with the introduction of the euro notes and coin. We believe this raises practical issues for banks and consumers which have not yet been explored: it would mean that, for example, retailers would have to draw up accounts in euro and all bank accounts would be in euro, even though physical euro cash was not circulating at that point in time. We have urged the Commission, the EMI and relevant UK associations to focus on the practical implications of this issue.

92 The draft Regulation seeks to embrace the 'no compulsion, no prohibition' principle underlying the transition, although questions remain as to how coherently this is achieved. It also includes, inter alia, references to the redenomination of outstanding debt (although it needs to be clarified whether this is a Member State's own debt in its national currency or its own debt in any relevant currency, or any debt - including corporate - in the national currency), accounting (see below) and rounding (see below). There is also a provision designed to allow the 'governing bodies of organised markets' to impose the use of the euro within their respective markets, where further clarification is required.

93 With regard to continuity of contracts in jurisdictions outside the EU, we reported in May that the FLP had initiated a major study on the impact of a single currency in the main financial and trading jurisdictions outside the EU. As far as the legal position within the EU itself is concerned, the Commission has begun its own investigation. However, the FLP considers that the Commission's research will be less detailed than is required by participants in London's financial markets, and has therefore decided to have researched the possible effects of EMU on financial and commercial contracts entered into under English law. Issues will arise whether or not the UK participates in the single currency.

94 So far most of the private sector input to the draft Regulation has come from City-based lawyers and practitioners (although the CLJWG includes representation from the ACT, and it also consulted outside the City). It is important in our view that a wider constituency is involved before the Regulation is finalised, and we are therefore anxious to ensure that the Commission consults as widely as possible (during the Council Working Group stage). We remain willing to assist in whatever way we can to ensure that the views of London's international financial markets are fully taken into account within Europe.

Accounting and taxation

95 In our previous paper we reported that no issues of accounting principle had been identified. Our subsequent discussions with the relevant accounting bodies have confirmed that view. There will be a range of practical issues in terms of record-keeping to be resolved in respect of transactions recorded in national currencies which either span the start of EMU or take place within the transitional phase. Beyond that, however, current accounting principles are expected to be sufficiently robust to deal with the circumstances which will arise. It is important nevertheless to note that there will be accounting consequences for certain transactions even if the UK is not in the euro area.

96 The draft Regulation on the euro includes the following provision relating to accounting:

> ***Article 7***
>
> *For the purpose of complying with national legal provisions on the presentation and publication of accounts, the presentation in euro or in a national currency unit of assets and liabilities denominated in euro or in a national currency unit shall be achieved by arithmetical conversion at the conversion rates.*

This is sensible as far as it goes (although there is a question whether it belongs in legislation dealing with monetary law).

97 At a detailed level, it is expected that restatement of previous years' accounts into euro, if and when required, would be effected at the fixed conversion rates. This could present problems of interpretation in relation to the common practice of showing figures over each of the previous five years when that period spans the introduction of the euro. Users of accounts will have to keep in mind that the accounts of companies from different Member States will not be directly comparable simply because they are expressed in euro - because actual exchange rates between participating national currencies in those earlier years would almost certainly be different from the fixed conversion rates. Some sort of warning may therefore be necessary.

98 There already exists in Brussels a Contact Committee under the aegis of the Accounting Directives. That Committee has spawned a Working Party to consider 'problems in the accounting field relating to the changeover to the euro', under the chairmanship of DGXV. The next meeting of the Working Party will be in October, and the UK's DTI representative, with whom the Bank is in contact, will be submitting a paper reflecting the above considerations.

99 One potential consequence of any accounting changes relates to taxation. It is in this connection that most attention is actually being paid to the accounting aspects of the introduction of euro. The interpretation of the 'realisation test' for the recognition of profits may have tax consequences. With the removal of any currency risk between participating currencies on the fixing of conversion rates, profits may be capable of recognition earlier than would otherwise be the case. This is a particular issue in relation to certain derivative instruments, and a sub-group established by ISDA is examining the range of potentially affected transactions in some detail.

100 They have identified twenty-three different types of derivative transactions, of which they believe fifteen give rise to possible tax issues. The following examples are illustrative:

- A foreign currency fixed rate swap involving two 'in' currencies; with EMU, a profit or loss is crystallised for each of the parties (the swap in effect becomes an annuity); the question is whether it will be taxed differently as a result.

- A floating rate swap in an 'in' currency; the additional issue raised is what floating interest rate should apply to the floating leg of the swap (during Stage 3A); if it is the euro rate, for example because the national rate is no longer quoted, this could be seen as overriding the legal form of the instrument; would this constitute a realisable event and thereby trigger an immediate tax charge?

- A foreign exchange option involving two 'in' currencies; would a tax event or recharacterisation be triggered by the certainty of net payment stream?

101 The Bank and ISDA have drawn the attention of the Inland Revenue to some of these problems, and we stand ready to convey to the Revenue other EMU-related tax issues identified by practitioners in any area of activity.

Rounding

102 As noted in our first paper, the issue of rounding amounts converted at the fixed conversion rates will have wide ramifications throughout the economy. The Bank accordingly took the initiative in the spring to submit a paper on the subject to the EMI, which had been requested by the Commission to prepare technical advice on the subject. This paper was influential in stimulating the EMI to produce its own paper on the basis of which central banks consulted during the summer with small groups of experts in the financial community (although they were not easy to identify!). In our case, we established a small group with BBA and ISDA representation under Bank chairmanship to consider the issues and to provide comments on the EMI's work.

103 We found general agreement that there was a need for some EU-wide legislation on rounding, in order to ensure common standards, but equally that it should be narrow in its scope. The ISDA experts urged intermediate calculations to be distinguished from the ultimate calculation of payment amounts, with rounding ideally confined to the latter. Several other detailed points were made by both sets of consultees, and we submitted their comments to the EMI towards the end of July.

104 The arcane, but nevertheless important, point which we made in our original paper was that, in order to avoid rounding errors when converting from the euro back to national currencies, it was essential to **avoid** using **inverse** conversion factors: rather, the euro amount should be divided by the fixed conversion rate directly, rather than multiplied by a rounded reciprocal of it (ie an inverse conversion factor). This was accepted by the EMI, and has led them to suggest, inter alia, that there should be a legal prohibition on the use of inverse conversion rates.

105 The Commission's draft Regulation on the euro (see above) already includes two paragraphs on rounding:

> ***Article 12***
>
> *The conversion rates shall be adopted with six significant figures and shall not be rounded when making conversions.*
>
> ***Article 13***
>
> *The monetary sums to be paid or accounted for when a conversion takes place either way between the euro unit and the national currency units or between the national currency units shall be respectively rounded up or down to the nearest cent, as referred to in Article 2, or to the nearest sub-unit or to the nearest unit of the national currency unit according to national practices. If the application of the conversion rate gives a result which is exactly half-way, the sum shall be rounded up.*

106 It is possible that these will be supplemented by a prohibition on the use of inverse conversion rates, as suggested by the EMI. In addition, the legislation might include, again at the EMI's suggestion, a proviso that contractual parties might agree different rules from those contained in the Regulation, with the exception of the three basic rules (the number of significant figures used in the conversion rates, a prohibition on rounding them, and a prohibition on using inverse conversion rates).

107 A question remains open as to whether bilateral conversion rates between pairs of participating currencies (as opposed to rates between each participating currency and the euro) should be published, and whether there are ways that rounding problems arising from their use can be overcome. We have suggested one particular methodology to the EMI which we expect them to adopt in the final paper they are preparing for submission to the Commission.

CHAPTER 6: WORK OF THE EMI

108 The EMI is charged under the Maastricht Treaty with preparing by end-1996 the regulatory, organisational and logistical framework for the European System of Central Banks (ESCB) to function as a central bank. The EMI intends to publish a 'blueprint' early next year. This document is unlikely to be complete, or fully articulated, but it is hoped that it will embrace the EMI's recommendations for the broad framework for operating monetary policy in Stage 3. However decisions will be for the European Central Bank (ECB) - specifically its Governing Council, comprising the ECB's most senior executive and Governors of the participating central banks. Progress in some of the EMI's work, on payments systems, legal issues and rounding, is reported elsewhere in this paper; other material aspects are covered below. (Further background is available in the EMI's Annual Report, published in April 1996.)

Operational framework for monetary policy

109 The ESCB's primary objective, as set out in the Treaty, is price stability. Discussion is now under-way in the EMI on how best to secure this objective. In practice, countries with inflation targets and those with monetary targets consider a wide range of data in coming to monetary policy decisions (including monetary data for countries with inflation targets and inflationary pressures for those with monetary targets). The precise formulation of the strategy to be adopted will be decided by the ECB, but the choice of strategy is unlikely to have many implications for the ESCB's day-to-day operations, which have been the focus of much recent work.

Monetary policy operations in Stage 3

110 The **primary aim of the operations** will be to implement the ESCB's monetary policy by steering short-term interest rates. The operational framework will also be designed to allow the ESCB to extract information from market developments, to allow the ESCB to manage the liquidity of the interbank market and to contribute to the smooth running of payments systems. It might also be designed to contribute directly to the control of monetary aggregates, but this is not agreed among central banks.

111 Monetary policy will be decided centrally by the ECB's Governing Council, but virtually all monetary operations will be decentralised to the national central banks (NCBs), to be conducted at uniform rates and on identical terms. The TARGET system will unify money markets throughout the euro area, by enabling same-day arbitrage.

112 The ESCB's main **instrument** will be open market operations to steer interest rates, but it will also offer standing facilities to its counterparties. **Open market operations** will be undertaken at the ECB's initiative, usually in the form of repos of eligible instruments and usually as tender operations (with bids submitted to national central banks). Open market operations will be undertaken regularly (perhaps weekly with a two-week maturity but also monthly to provide three-month maturity liquidity, but these details are not yet finally decided). They may also be undertaken on an irregular basis, either to fine-tune the liquidity of the market, or to influence liquidity over a longer-than-normal period.

113 There will be two **standing facilities**, a lending facility and a deposit facility, to be used by counterparties at their initiative. The maturity of the facilities is likely to be overnight, and the rates charged on the lending facility by the ESCB, and paid by the ESCB on the deposit facility, will respectively form the top and bottom of a corridor within which market rates will normally move.

114 Under Article 19 of the ESCB Statute, provision is made for the **possibility of reserve requirements** to be applied by the ECB within constraints set by the EU Council. The EMI is therefore required to undertake the necessary preparatory work so that the ECB has this option available to use, if it so decides. The schema under development allows the possibility of reserve requirements being applied on a wide range of liabilities, and also that reserve requirements might be remunerated. It is agreed among central banks that if reserve requirements were to be imposed, they would be based on liabilities measured under banking statistics definitions, and that they would need to be maintained not every day but on average over a period, enabling banks to draw on their positions at the ESCB on days when the money market would otherwise be tight. It is not ruled out that banks would be allowed to go into (collateralised) overdraft during any averaging period.

115 Other instruments will be available to the ESCB. These will include outright transactions, taking fixed-term deposits, issuing ESCB paper, and foreign exchange swaps.

116 All ESCB credit operations have under the Treaty to be adequately collateralised. National central banks presently have different practices with respect to the **eligible paper** they accept in their operations, and it is not expected that these practices can be entirely harmonised by the start of Stage 3. It is likely that there will be a set of high quality marketable paper (which can be handled swiftly in settlement systems meeting high standards) eligible for use at every central bank in the euro area. But central banks are likely also to be able to continue to accept high quality non-marketable paper, if they so choose. Paper of this kind would be eligible for use only at the central bank which chose to accept it. Both public and private sector paper will be eligible for use.

117 Regular open market operations and standing facilities are likely to be available to a wide range of **counterparties**, probably including all credit institutions. For fine-tuning operations and for operations involving foreign exchange (eg swaps undertaken for money market purposes), smaller groups of counterparties are likely to be used. These would be chosen for their ability to undertake operations on the scale and within the time frame required (which would be short for fine-tuning operations).

Preparations for the ECB's foreign exchange and reserves management operations

118 Under Article 30 of the ESCB Statute, up to ECU 50bn of reserves may be transferred to the ECB, with each participating NCB's share being determined by its proportionate share of the ECB's capital. The precise amount to be called up, and its composition, will only be finally decided by the ECB Governing Council. Work is in progress on this and related areas: the management of these reserves; guidelines for transactions in the reserves remaining with participating NCBs and Member States; the organisation of foreign exchange intervention; and finally, exchange rate co-operation between the euro area and other EU countries (see below). Given that it is for the ECB to make the final decisions, for example between centralised and

decentralised reserves management, the preparations are designed where possible to allow flexibility - so that the ECB Governing Council will be able to choose its preferred option; but in some areas the ECB's options, at least initially, may have to be curtailed to make the whole project manageable.

119 On the **transfer of reserves to the ECB**, the amount and currency composition of the assets to be transferred has not yet been determined. It depends on factors such as the initial size of the euro area, the ECB's likely intervention needs and its ability to call up additional reserves rapidly, if needed. Only non-EU currencies and gold will be eligible for transfer. Work is continuing on determining the currency mix, and on specifying the denomination and remuneration of the resulting NCB claims on the ECB. Preparations for the **operational framework for managing the ECB's reserves** are drawing on the general principles and practices of existing EU central banks, encompassing the setting of investment strategy, monitoring performance and managing various types of risk (eg currency, interest rate, credit). Experts are now beginning to draw up the technical requirements necessary for the conduct of reserve management.

120 **Transactions in reserve assets remaining with participating NCBs and Member States** could have implications for monetary conditions or market perceptions of the single monetary/exchange rate policies. As envisaged in the Treaty, guidelines are now being prepared to set up reporting arrangements and, in certain cases, prior approval procedures where transactions are of a size or type which might impact on the monetary base or market conditions.

121 In relation to **foreign exchange intervention**, it is envisaged that the ECB would have the capacity to intervene either alone or through participating NCBs. Preparatory work is now focusing on the necessary operational and telecommunications infrastructure. Work is in progress on the setting of criteria for selecting counterparties inside and outside the euro area; methods for monitoring counterparty risk; back office procedures; and enhancing the present teleconference network to facilitate the transmission of intervention instructions and reports of operations.

Statistical preparations

122 The EMI is required to prepare harmonised statistics in the areas within its field of competence. The EMI agreed with the European Commission in mid-1995 that the ESCB should have full competence in the broad area of money and banking statistics at EU level; and that balance of payments and financial accounts statistics would be areas where competence should be shared with the Commission (Eurostat). Prices, government finance statistics, and general economic indicators would remain the prime responsibility of Eurostat but would be of vital interest to the ESCB. In collaboration with the EMI, Eurostat has undertaken a programme to provide a range of harmonised economic statistics, including a harmonised consumer price index, in preparation for Stage 3.

123 A senior statutory statistical committee, on which both the Bank and the Office for National Statistics (ONS) are represented, has been set up by the Commission to oversee this co-operation (Committee on Monetary, Financial, and Balance of Payments Statistics).

124 The statistics currently used by the Bank of England in the assessment of economic conditions in the UK are similar to those which the ECB is expected to use in defining and implementing its monetary policy.

125 In making its preparations, the EMI has been concentrating on the harmonisation of the key statistics required for the conduct of the single monetary policy. Although the Treaty specifies the possibility of the direct collection of data from economic agents by the ECB, the premise that the national authorities will continue to carry out the tasks of collecting and compiling the required statistics at national level (prior to transmitting aggregated data to the ECB) underlies the preparatory work. Legal provisions to protect the confidentiality of individual data will be built into the system to cover occasions when the identity of individual reporters needs to be provided to the ECB to verify the end-product or to explain significant events.

126 If the UK were to opt in to EMU, there would need to be an expansion of the level of detail of **banking** statistics covering transactions and positions with residents of the single currency area to broadly the same level of detail as is currently provided for domestic residents. This would be needed to enable proper consolidation of the banking statistics and monetary aggregates at EMU level. In terms of the monthly statistical coverage of the UK monetary sector and the timeliness of data compilation, the current UK system is already broadly compatible. The EMI decision to introduce a statistical definition of a 'bank', known as a 'monetary financial institution (MFI)', will have little structural impact on UK statistics. Banks, building societies, and money market unit mutual funds are covered by the definition, but in the UK the latter are expected to fall below the de minimis level for monthly reporting. The EMI requirements also include a division of certain assets and liabilities of the MFI sector according to their maturity at the time of issue in order to accommodate the as yet undecided definition of the monetary aggregates.

127 For **balance of payments** statistics, the EMI has formulated a requirement for monthly key items as, unlike the UK, most EU Member States claim to use monthly balance of payments for monetary and foreign exchange policy purposes. The UK does not at present compile a monthly balance of payments, and questions the need for one for policy and operational purposes in the single currency area in Stage 3. The UK has undertaken to review its situation in 1998, and meanwhile will endeavour to make best estimates from the present reporting system. The ONS and the Bank are undertaking studies to see what could be produced monthly without new data collection.

128 Last month the EMI issued a booklet to the public explaining the statistical requirements for Monetary Union. The EMI has also made available a more detailed description of the statistical requirements, intended mainly as a reference document to enable national central banks to pursue technical discussions with national banking associations and other reporting bodies. These booklets have been issued now because of the long lead times for making changes to established statistical reporting systems. A major practical difficulty is that, in many statistical systems, the lead-time to introduce the required changes will exceed the period of time which there is expected to be between the formal announcement of the countries which will participate in, and the actual beginning of, Stage 3. Furthermore, on the assumption that Stage 3 will begin in January 1999, some statistics will be needed on the new basis from mid-1998 in order to provide the necessary basic level of detail from which to assess developments after the start of Stage 3.

ORGANISATIONS CONSULTED IN 1996

Wholesale payments and settlement

Association for Payment Clearing Services (APACS)
British Bankers Association (BBA)
Bulk Automated Clearing System (BACS)
Clearing House Automated Payment System (CHAPS)
CREST
London Clearing House (LCH)

Financial markets and exchanges, and other market associations

Association of British Insurers (ABI)
Association of Corporate Treasurers (ACT)
Association of Unit Trust and Investment Funds (AUTIF)
Baltic Exchange
British Venture Capital Association (BVCA)
Building Societies Association (BSA)
ECU Banking Association (EBA)
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)
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 Primary Markets Association (IPMA)
International Swaps and Derivatives Association (ISDA)
Lloyd's of London
London Bullion Market Association (LBMA)
London Discount Market Association (LDMA)
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)
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)
International Accounting Standards Committee (IASC)
Institute of Chartered Accountants in England and Wales (ICAEW)

Business and retail

British Chambers of Commerce (BCC)
British Retail Consortium (BRC)
Confederation of British Industry (CBI)
The Consumers' Association
Hundred Group

Regulators and Government

Building Societies Commission
Department of Trade and Industry (DTI)
Government Actuary's Department (GAB)
The Inland Revenue
Securities and Futures Authority (SFA)
Securities and Investment Board (SIB)
HM Treasury

ABBREVIATIONS AND ACRONYMS

ABI .... Association of British Insurers
ACT .... Association of Corporate Treasurers
APACS .... Association for Payment Clearing Services
APCIMS ...... Association of Private Client Investment Managers and Stockbrokers
ASB .... Accounting Standards Board
ATM .... Automated Teller Machine
AUTIF .... Association of Unit Trusts and Investment Funds
BACS .... Bulk Automated Clearing System
BBA .... British Bankers' Association
BCC .... British Chambers of Commerce
BSA .... Building Societies Association
CCAB .... Consultative Committee of Accounting Bodies
CGO .... Central Gilts Office
CHAPS .... Clearing House Automated Payment System
CLJWG .... City of London Joint Working Group
CMO .... Central Moneymarkets Office
DGII .... Directorate General II of the European Commission (economic and financial affairs)
DGXV .... Directorate General XV of the European Commission (financial services, etc)
DVP .... Delivery Versus Payment
EBF .... European Banking Federation
ECB .... European Central Bank
ECOFIN ...... Council of Finance Ministers of the European Union
EMI .... European Monetary Institute
ESCB .... European System of Central Banks
ESO .... European Settlements Office
FBSA .... Foreign Banks and Securities Houses Association
FLA .... Finance and Leasing Association
FLP .... Financial Law Panel
GEMMA ...... Gilt-Edged Market Makers' Association
ICAEW .... Institute of Chartered Accountants in England and Wales
ICSDs .... International Central Securities Depositories (eg Euroclear and Cedel)
IFMA .... Institutional Fund Managers' Association
ILU .... Institute of London Underwriters
IMMTA .... International Money Markets Trading Association
IPMA .... International Primary Markets Association
ISDA .... International Swaps and Derivatives Association
ISMA .... International Securities Markets Association
LCH .... London Clearing House
LIBA .... London Investment Banking Association
LIBOR .... London Inter-bank Offer Rate
LIFFE .... London International Financial Futures and Options Exchange
LIRMA .... London International Insurance and Reinsurance Market Association
LME .... London Metal Exchange
MFI .... Monetary Financial Institution
NAPF .... National Association of Pension Funds
NCB .... National Central Bank
ONS .... Office for National Statistics
RTGS .... Real Time Gross Settlement
SIB .... Securities and Investments Board
SROs .... Self Regulatory Organisations
S.W.I.F.T ...... Society for Worldwide Interbank Funds Transfer
TARGET ...... Trans-European Real-time Gross-settlement Express Transfer

SELECTED REPORTS ON PRACTICAL SINGLE CURRENCY ISSUES

Organisation	Title of report	Date
Bank of England	Practical issues arising from a single currency - issue 1	May 96
	Practical issues arising from a single currency - issue 2	Sept 96
LIBA	The practical implications of converting London's capital markets to a single currency	Oct 95
	UK non-participation in EMU: Possible Consequences for the City of London	Jan 96
	EMU and securities settlement	Aug 96
APACS	Consultation paper - implementation of the single currency	Nov 94
BBA/APACS/LIBA	The implications of European Monetary Union for the banking and financial markets in the United Kingdom	Forthcoming
EMI	Annual Report 1994	Apr 95
	The TARGET system	May 95
	Progress Towards Convergence (Article 7 Report)	Nov 95
	The changeover to the single currency	Nov 95
	Annual Report 1995	Apr 96
	The statistical requirements for Monetary Union	July 96
	Statistical requirements for Stage 3 of Monetary Union (implementation package)	
	First progress report on the TARGET project	Aug 96
House of Commons Select Committee on the Treasury	The prognosis for Stage 3 of Economic and Monetary Union	July 96
House of Lords Select Committee on the EU	An EMU of 'ins' and 'outs'	Jun 96
CBI	The transition to the single currency: a preliminary CBI view	Mar 96

Changeover to the single currency

The European Monetary Institute (EMI) published on 14 November a document ('The changeover to the single currency') setting out how a single European currency might be introduced within those countries participating in Stage 3 of Economic and Monetary Union (EMU). This was endorsed, with only small amendments, by the December European Council in Madrid.

This note, prepared by John Townend, a Deputy Director of the Bank and the Governor's Alternate on the EMI Council, describes the essence of the EMI paper, sets it in a UK context, and explains briefly the action which the Bank has subsequently taken to progress the work.

Introduction

The EMI paper explaining how the single currency might be introduced in practical terms addresses *technical issues only;* it represents a central bank contribution to the debate initiated by the European Commission in May 1995 when it published its 'Green Paper on the Practical Arrangements for the Introduction of the Single Currency'. Questions relating to the possible start-date for Stage 3 of EMU, or which countries might be eligible to participate, are for political decision and the EMI paper can offer no guidance beyond the Maastricht Treaty. The EMI paper, together with further input from the Commission, was discussed by Finance Ministers on 27 November and at the European Council in Madrid on 15–16 December. The changeover scenario adopted by the European Council is consistent with that described by the EMI. The European Council also decided to name the single currency the 'euro' and this name is therefore used here.

The United Kingdom is in a different position from other countries since it is not *required* to join the single currency area: this will be for decision by Government and Parliament. The United Kingdom is nevertheless fully committed to assisting in the technical preparations for Stage 3 so that the broad framework for the introduction of the euro would be technically satisfactory if it were to participate. The Bank of England has therefore been active in the discussions leading to the EMI document and supports its general thrust.

Where it helps the exposition, this note assumes that the United Kingdom is a participant in the single currency area in order to describe the relationship between transactions in sterling and euro during the transition when both denominations would co-exist: if the United Kingdom does not exercise its right to opt in, some, but not all, of the issues would remain relevant.

Timetable for the transition

The EMI paper sets out a provisional timetable for the transition, divided into three periods:

- a first period beginning with an announcement, some twelve months before the due date, that Stage 3 will start on that day and will initially comprise an identified group of countries: the European Central Bank (ECB) would be established early in this period;

- a second period beginning with the start of Stage 3, when participating countries' exchange rates (between each other) will be replaced by irrevocably locked conversion factors, during which the euro will begin to be used in the banking system alongside existing national currencies, but when there will be no physical euro banknotes or coin; and

- a final period which will begin with the introduction, no later than three years after the start of Stage 3, of euro banknotes and coin alongside existing national banknotes; and which will end, six months later, when national banknotes and coin cease to be legal tender. At that point the transition to the euro will be officially complete but central banks would continue indefinitely thereafter to exchange national currency notes and coin for euro.

Principles governing the transition

The paper sets out five basic principles to guide the transition process:

(i) it must be underpinned by a clear legal framework;

(ii) it must be as simple as possible and not confusing;

(iii) it must not impose unnecessary costs;

(iv) it must facilitate a single monetary policy; and

(v) there should be no compulsion to use, nor any prohibition from using, either the euro or the national currency during the transition.

What the transition might look like

The first period

The European Central Bank

Early in the first period, the ECB will be established and it will take final decisions, on the basis of preparatory work previously undertaken by the EMI and national central banks, on a wide range of operational issues to allow a seamless transition in the conduct of monetary policy for the euro area at the start of Stage 3. The date from which euro banknotes and coin will become available, no later than three years from the start of Stage 3, would also be announced by the ECB. The design of the notes would need to be finalised, together with the necessary preparations to allow production to begin.

Governments

During this period governments will need to effect the necessary legal changes, involving potentially both primary and secondary legislation at the European and national level, required to implement all aspects of the single currency.

A crucial element, which the EMI considers should be in the form of a Council Regulation with direct effect (an approach endorsed by the European Council), would be legislation to provide certainty about the status of the euro, in its irrevocably locked relationship to national currencies, to ensure equal treatment in law for transactions expressed either in national currencies or euro. The paper sets out a number of legal principles which any particular legal solution should satisfy, including that there should be legally enforceable equivalence between the euro and national currency units.

Conventions on rounding, for transactions which become redenominated from their original denomination into either national currency or the euro, would need to be established, and may need to be enshrined in law.

Private sector

The private sector, bank and non-bank, in the relevant countries will need to continue planning and preparing its response in the light of the announced framework for central bank and government actions.

The second period

At the start of Stage 3, participating countries' exchange rates (between each other) will be replaced by the irrevocably locked conversion factors. The euro will become a monetary unit in its own right: it will have a fixed conversion rate in terms of the monetary units of the participating countries.

Actions by central banks

The EU national central banks, together with the ECB, will constitute the European System of Central Banks (ESCB). The ESCB will begin to conduct a single monetary policy for the euro area. The ultimate objective of monetary policy, enshrined in the Maastricht Treaty, is price stability and this is expected to be achieved, as is the case generally now, by establishing short-term interest rates at the appropriate level. Work is in hand in transforming this objective into a detailed framework for the conduct of monetary operations.

The ESCB will denominate its own internal accounts and conduct its monetary operations, and any foreign exchange operations, in euro. But, as explained below, this would not necessarily mean that the Bank of England's market counterparties would immediately have to change their own operations or way of accounting, because the Bank would make available conversion facilities to redenominate euro amounts into the equivalent sterling amounts for any account holder which so wished. In other words, a counterparty could continue to denominate its accounts, and operate, in sterling even though the Bank of England was denominating its own operations in euro.

What happens outside the Bank would depend in any event on the development of the payments and settlements infrastructure. In the United Kingdom this is largely owned and run by the private sector. Arrangements are already in train for CHAPS, the present same-day payments system (which provides net settlement at the end of each banking day), to be modified and linked to a real-time accounting system at the Bank to produce a real-time gross settlement system (RTGS) in 1996.

It is essential that the RTGS system not be disrupted at the start of Stage 3. It is equally important that the system be developed to allow the processing of domestic payments denominated in euro while continuing to accommodate payments denominated in sterling. The way in which this dual functionality would best be achieved is a technical matter for discussion with the banks. Cross-border payments would be facilitated through a European-wide linking of RTGS systems (called TARGET), the details of which have yet to be determined. It would also be possible to link to TARGET even if the United Kingdom did not participate in the euro area.

The development of securities settlement systems would also need to be considered.

It is expected that the main markets (domestic as well as foreign exchange) in the euro area would quickly become dominated by transactions denominated in euro. It may be sensible in some areas to agree elements of market standardisation, for example in price or interest rate quotation. In the United Kingdom this would be for discussion between the Bank and the financial community. But the availability of conversion facilities would allow those banks which have not geared themselves as quickly as others to cope with euro denominations to participate in these markets on equal terms.

Recommendations for government action

Publicity

The EMI recommends that governments engage in a campaign of public information as an essential prerequisite for the successful introduction of the euro.

The law

As mentioned above, legislation would have to come into effect at the beginning of this period establishing clearly the legal status of the euro. The European Council added that the substitution of the euro for national currencies shall not of itself alter the continuity of contracts.

During this period national currency banknotes and coin would remain the only legal tender since at this stage there would be no euro equivalent. In the United Kingdom only sterling notes and coin would be legal tender during this period.

Public debt

The EMI expects that, from the start of Stage 3, governments would issue new public debt denominated in euro; and the European Summit agreed that new tradable public debt *will* be issued from then in euro—particularly debt coming to maturity after 1 January 2002. That does not mean outstanding national currency debt need be redenominated and the EMI suggests this question be studied further.

Other actions

The EMI recommends that there should be national discretion to allow public sector authorities to accept receipts denominated in euro, where they so wish during this period; but that public sector payments in euro would best be delayed until euro notes and coin become available from the beginning of the final transition period.

Banks and non-banks

Banks and non-banks would need to decide how to change their activities in the light of the actions by central banks and governments. Consistent with the no compulsion, no prohibition principle, banks would be free to make transactions, and offer facilities, in euro from the start of this period, but they would only *have* to do so by the end of the transition. There may be little retail demand for euro facilities until euro banknotes become available.

The final period of transition

Cash

This period will begin with the introduction, no later than three years after the start of the previous period (that is, by 1 January 2002), of euro banknotes and coin which would immediately be legal tender, temporarily alongside national currency notes and coin. Anyone who wished would be able to exchange on demand, at commercial banks and the Bank of England, national currency notes and coin for the new notes and coin. After six months, by 1 July 2002, sterling notes and coin would lose their legal tender status, although they would continue to be exchangeable indefinitely at the Bank of England.

Non-cash

The introduction of physical euro would give an impetus to banks to provide euro denominated accounts to their retail customers and for the spread within the retail sector of the use of euro.

As noted above, public administrations are recommended to switch to using euro for their payments (such as social security benefits, civil servants' salaries and pensions) on a particular date early in this final period. By the time national currency notes cease to be legal tender, all transactions involving the public sector should have become denominated in euro. The European Council agreed that all public sector operations will use Euro by 1 July 2002: EU legislation will define the time frame and might leave some freedom to individual countries.

Taking the work forward

The EMI will continue to work on the technical details for the introduction of the euro, consistent with its mandate. The Bank of England and other national central banks will continue to participate in its work.

Separately the Bank is also taking forward its own discussions with the UK banking community on the details of the possible transition to the euro for the United Kingdom; and widening these discussions beyond banks to include other sectors. The Bank has therefore held a number of meetings with the different interest groups, including banks, building societies, the CBI, the Retail Consortium and a wide range of market associations. In each case the Bank has invited participants to identify areas where it would help the private sector in its own planning for the Bank to specify more precisely its own operations and actions; and to identify those areas where, although the Bank is not directly involved, it might help to provide a catalyst for co-ordinating actions (including in the payments and settlements area and in markets) within the private sector. The Bank has also stressed the importance of considering these questions *both* in the context of the United Kingdom as a participant in Stage 3 and in the context of Stage 3 beginning but the United Kingdom exercising its right not to opt in.

PRACTICAL ISSUES ARISING FROM THE INTRODUCTION OF THE EURO

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