Practical issues arising from the single currency

The Bank intends to publish a broadly quarterly series of papers as part of its efforts to ensure that the practical issues arising from the single currency, whether the United Kingdom is inside or outside the euro area, are fully understood and appropriate action is taken. This paper was originally prepared for the House of Commons' Select Committee on the Treasury, and subsequently made publicly available on 10 May. It reports the outcome of the Bank's discussions with banking and other sectors in the United Kingdom in the period up to May.

Introduction

Since the European Monetary Institute (EMI) concluded its work last autumn to define the way in which the single currency should be introduced, a framework subsequently endorsed at last December's Madrid Summit, the Bank has engaged in wide-ranging informal discussions with the trade bodies and associations representing many areas across the UK economy including, but going much broader than, the financial sector. We have explained what would be involved during each of the different stages identified for the transition to the single currency, on the basis of a short paper now published in the February 1996 *Quarterly Bulletin*; and invited each set of interlocutors to identify within their associations those areas where some form of collective or co-ordinated activity could be required, including the role for the authorities.

The banking industry is naturally at the centre of the preparations for the euro, and the Bank therefore regards it as essential to maintain a close relationship with the banking community on the practical issues raised by the single currency. Accordingly, with the Bank's encouragement and with Bank representation, the BBA established with APACS[(1)] last spring a European Monetary Union (EMU) Steering Committee to help formulate collective bank views on the practicalities of introducing the euro and to keep abreast of relevant developments in official thinking. Representation has recently been augmented to embrace LIBA. In addition to attending regularly the EMU Steering Committee, the Bank has initiated a series of meetings to exchange views with the participating banking associations and with a range of individual banks. A full list of those associations with whom we have conducted discussions, including those outside the financial sector, is attached in the Annex.
This work has helped to identify and clarify the areas where analysis, planning and development appear essential, whether the United Kingdom opts in or out, if the United Kingdom is to prepare adequately for the introduction of the euro. If Stage 3 begins without the United Kingdom's participation, the impact of the euro might be expected to be largely confined to wholesale financial market activity. If the United Kingdom participates, initially the euro is similarly likely to be a largely wholesale instrument, but it will thereafter permeate the whole economy, with much of the impact on the retail sector probably only after euro cash becomes available some three years after the start. That would clearly involve far wider changes, very substantial investment by both retail banks and non-bank retail organisations, and a public information campaign, all of which would no doubt require extensive co-ordination. But we believe the focus of preparations now and in the immediate future should be primarily on wholesale activity, where the Bank will aim to provide the necessary degree of co-ordination.

The areas we have identified so far as requiring a co-ordinated approach, and the issues for further study, are set out in the next sections which explain what the issues are, the efforts in hand to address them, and the bodies which we know are involved.

So long as the areas for co-ordination are adequately identified, the appropriate work is agreed and undertaken, and it is communicated to all who need to know, this should provide a sound infrastructure *permitting* the euro to be used in wholesale financial transactions in the United Kingdom. Then it will be for individual economic agents, including financial institutions, to determine the particular use of euro which they actually plan to make, and the kind of euro facilities they wish to provide, whether the United Kingdom is in or out, consistent with the 'no compulsion, no prohibition' principle which underpins the EMI's scenario for the introduction of the euro.

Financial sector

Wholesale payments and settlements

It is clear that, whether or not the United Kingdom is a participant, the present sterling real time gross settlement (RTGS) system will need to be adapted to cope with euro-denominated payments. If the United Kingdom chooses to opt *in*, whether initially or subsequently, there will inevitably be a period, potentially quite long, when sterling and euro-denominated wholesale transactions could

(1) There are a range of acronyms used in this note: they are explained in the Annex.

co-exist before the entire payments and settlement system becomes exclusively euro-denominated. If the United Kingdom opts *out*, it will be important for London still to have the capacity to trade in foreign currency instruments denominated in euro, which would be supported by associated UK payments arrangements.

Many payments will continue to be within the United Kingdom, between UK customers, where the domestic payments system is the obvious medium for effecting settlement. But whether the United Kingdom is in or out, there will be a number of competing ways to make cross-border payments to countries participating in the euro area. As now, there will be the possibility of correspondent banking relationships, or the use of banks' own foreign branches or subsidiaries with direct access to local payment systems; but the Bank believes that it is important to provide in addition a direct link from the UK (euro) RTGS system to the RTGS systems elsewhere in Europe through the TARGET project (which will interlink European RTGS systems). It has been agreed that Member States outside the euro area will have access to TARGET, although the terms and conditions of such access have yet to be determined. We will be seeking to ensure in the forthcoming EMI discussions that the principles of the single market are upheld. The particular mechanism chosen by banks to effect individual cross-border payments will depend on relative efficiency and cost considerations.

The Bank has been in dialogue with CHAPS, whose board commissioned in December 1995 a study to review the high-level business and technical options for CHAPS euro facilities and to identify the associated critical paths for the planning and implementation of these options. The study has been completed and last month the CHAPS board accepted its recommendations.

These involve a two-pronged strategy. To cater for the situation where the United Kingdom is *within* the euro area, they have identified that CHAPS message formats could be amended in a relatively straightforward way so that both sterling and euro denominations could be handled interchangeably (which would be necessary during the $3^1/_2$-year transition period). There is sufficient time to plan and undertake the necessary development so that it is ready for the beginning of 1999.

On the other hand, if the United Kingdom is *outside* the euro area, the domestic payments network would need to be able to handle euro as a foreign currency. This could involve the addition of a parallel payments arrangement for euro, alongside that for sterling. The CHAPS board has agreed that this second strategy should be further studied before any decision is taken, presumptively in the autumn. Both of these options will require access to euro-denominated settlement accounts, which will be provided by the Bank.

Aside from the need for payments system development, there are separate, though potentially related, questions about the development of facilities to settle euro-denominated securities. If the United Kingdom 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 more uncertain issue is to what extent settlement facilities for euro securities will be required if the United Kingdom is out. The Bank's wide-ranging discussions with practitioners have revealed quite a wide range of views. Some argue that such facilities would be an important element in sustaining the City's competitive position; but others argue that we already have satisfactory ways of settling deals in European currencies, in respective Continental centres, which do not inhibit London from having a significant, and sometimes dominant, share of trading in these instruments. Discussions about the options which the markets would like to have available, and what the various securities settlement systems could be capable of delivering, are still at a relatively early stage.

The main bodies involved in the payments area are the Bank and APACS, particularly the CHAPS Clearing Company. These bodies are also involved with securities settlement issues, together with CREST for equities, and the London Clearing House for various commodity and derivatives markets.

There has been good progress to date in the analysis and thinking of those responsible for the payments system, and this work is set to proceed at a satisfactory pace. We will continue our dialogue with those directly involved, primarily CHAPS. We will also continue to encourage those with an interest in, or responsibility for, securities settlement to consider the issues raised by the introduction of euro-denominated instruments, with the aim of determining the extent of the desired provision for the euro.

Market and exchange infrastructure

We believe it important for the City and the United Kingdom that financial markets should have a capacity to quote prices in, and trade, euro-denominated instruments, whether or not the United Kingdom is a participant in the euro area. We have therefore invited a wide range of market associations and exchanges, responsible for a broad spectrum of markets, financial and commodity, cash and derivatives, to consider the associated practical questions. In some areas further encouragement, which the Bank will continue to provide, is required. But many markets and exchanges are already actively considering what might be involved.

Some issues will be relevant whether or not the United Kingdom is participating, like the capacity to provide price or interest rate quotation in euro-denominated instruments and the need for standardised terms and conditions in relation to the underlying instrument (for example whether there is to be a 360 or 365-day year for interest calculation or the treatment of securities due to mature on non-business days, not least because Bank Holiday dates vary across

Europe). These are largely issues for market practitioners, in the United Kingdom and elsewhere in Europe, to address.

If the United Kingdom opts in, it is probable that many markets may switch from sterling to euro-based quotation quite quickly, or even immediately, but it is important to consider any problems which might arise in the event of co-existing quotations in two denominations. If the United Kingdom is out, markets and exchanges will need ongoing facilities to allow price quotation and trading of both sterling and euro-denominated securities but in most cases that should be a quite straightforward adjustment to make, since it would involve simply substituting euro-denominated quotations for those securities and financial instruments at present denominated in the participating currencies, at a pace no doubt determined by the speed of changeover in the relevant overseas markets. Corresponding issues will arise in both cash and derivatives markets.

In almost all of this work, market practitioners are, in our view rightly, in the lead. Nevertheless our discussions have helped to identify a number of practical issues and we will give what help we can to market associations and exchanges to address them, including making connections between those facing similar problems or bringing together all the parties necessary to resolve particular questions.

Some exchanges are further forward in their planning than others. LIFFE is a good example. They have had to consider how to amend their three-year interest rate futures contracts to reflect the fact that from March 1996 onwards, all such contracts begin to mature after the beginning of 1999. We discussed with LIFFE the issues raised and the possible options available, and LIFFE engaged in extensive market consultations with their membership. They subsequently amended the terms of the contracts so that they will convert unequivocally to euro-denomination if EMU starts on time with the particular currency in question a participant. The contract amendments apply equivalently to LIFFE's interest rate futures contracts denominated in sterling, Deutsche Mark and lira.

The LME will have to address similar issues in relation to its contracts before this autumn. And in relation to off-exchange swap contracts, we have had some discussion with ISDA, and are participating as observers in two of their working parties (on market practices and legal aspects). *Inter alia* they have raised a question about the supervisory treatment of swap contracts between participating currencies which would effectively become annuities in Stage 3 and so might no longer be part of the trading book for Capital Adequacy Directive purposes.

Those exchanges and exchange associations we have consulted are the Stock Exchange (which is still considering its approach to EMU within the context of its overall strategy review), LIFFE, the FCA and the LME. The market associations with whom we have had discussions are GEMMA, LDMA, LIBA, IPMA, ISDA, IMMTA, the FOA and the FIA.

End-users of markets—insurance companies etc

End-users of markets of course have an interest in the infrastructure developments described above. In addition, individual sectors have problems specific to themselves. Our discussions have begun to identify these, but in several areas thinking is at too early a stage for concrete issues yet to have emerged.

Insurance companies and pension funds will be keenly interested, from a fund management point of view, in how the wholesale financial infrastructure adapts to the euro, but acknowledge that those responsible for the payments system and the relevant market authorities are in the forefront of planning. On the liabilities side of their business, no problems are foreseen in the insurance field at the underwriting level, whether the United Kingdom is in or out. Much business will remain denominated in non-EU currencies and the addition of the euro, or its substitution for existing denominations, would raise no difficulties of principle. It will, of course, be essential that the banks are in a position to provide the appropriate currency facilities. The only concern so far identified by the pension funds relates to the need for education of beneficiaries and contributors if the United Kingdom participates in the euro area. For both sets of institutions, there will be some regulatory issues to be addressed—for example, in relation to currency matching and solvency calculations (given that the basis on which contracts were drawn up might have changed). No concerns have yet been identified at the retail end of the insurance sector (although, as with pension funds, public education will be important), but thinking is still at an early stage.

The insurance representatives we have so far consulted are the ABI, ILU, LIIRMA and Lloyd's, while the NAPF has represented the pension funds. We have also spoken to the DTI and Government Actuary's Department on regulatory aspects.

Other end-user representatives—such as the BSA, FLA, AITC and BVCA—have also been consulted, but have not yet identified any significant issues beyond those identified elsewhere in this paper.

Overarching issues

Aside from the practical issues involved in preparing the wholesale payments system and markets to accommodate the euro, there are a number of overarching issues which will have far-reaching ramifications and where it will be important to develop close liaison between the authorities and the private sector.

The law

The first of these involves the precise manner in which the euro is introduced *under the law* to secure legally enforceable equivalence between it and the national currencies which it replaces; and how the continuity of contracts and financial instruments denominated either in national currencies or the basket ECU will be appropriately secured. The issue of continuity extends to non-EU jurisdictions, where markets will need assurance that the relevant third country (eg US) law under which contracts are drawn up will recognise the euro as replacing the existing currency in which obligations are denominated and treat the contract or instrument as non-revocable, subject to the individual terms of contracts. Separately, there will be issues relating to the effects of redenomination and rounding conventions on financial obligations (including registered stocks and shares); and there may be implications for netting arrangements.

The background to the general issues of the introduction of the euro under the law and continuity of contracts was set out in the Madrid Summit Conclusions; and, as requested by the Summit, work is in hand to draw up a draft Regulation by the end of this year. It will ultimately be for the Commission to introduce such legislation. EMI and national central bank lawyers are at present addressing the underlying issues, with Commission lawyers participating as observers.

There is one relevant legal technicality which is worth mentioning: this is that the precise Article of the Maastricht Treaty under which the Council Regulation for the euro is introduced has some significance. Article 109l(4) is the most obvious route, but this Article would not apply to the United Kingdom if it opted out. This could have implications not just for the United Kingdom but for all other European countries in relation to contracts subject to English law.

With the Bank's encouragement, the Financial Law Panel is playing a leading role in relation to the continuity issue, and has established a Single Currency Liaison Group, which includes academics, bankers and practising lawyers from the major financial centres of the European Union. This group has initiated a major study of the impact of the single currency in the main financial and trading jurisdictions outside the European Union. We understand that the Commission has put out to tender a parallel project examining EU and Member State law. Many other groups of lawyers are now becoming involved in this and related areas. A Joint City Working Group on EMU has also been established, chaired by ISDA, including lawyers from BBA, LIBA, FLP, IPMA, the FOA, the LBMA and the Bank. These groups will liaise with each other, as well as with the authorities.

Other groups involved in this area are the City of London Law Society (in particular the Banking Law Sub-Committee, which itself has a Single Currency Sub-Committee) and the Law Society's Company Law Standing Committee. The FLP will also be contacting certain other legal groups to check if they are engaged in any EMU-related activity or have any planned.

Accounting

Another overarching area relates to the possible implications for accounting standards and methodology arising from the introduction of the euro. Many of the issues will be relevant to the United Kingdom only if it opts in, and relate particularly to how the transition to euro accounts would be made during the changeover period. None of the issues so far identified is of fundamental principle. Specific questions include whether there should be dual company accounts; how the accounts of overseas branches of domestic companies should be converted for UK accounts purposes; how consolidation should be effected in relation to overseas subsidiaries (where the position under UK accounting standards is more straightforward than elsewhere in Europe); and the interaction of share capital redenomination with capital-maintenance requirements, because of possible rounding implications. If the United Kingdom were out, there could still be potential implications for UK multinational companies with subsidiaries in the euro area; but more generally the euro would be simply treated as a foreign currency under the appropriate accounting standards. There might also be issues in relation to tax accounting.

We are aware of the Federation of European Accountants' comments on last year's European Commission Green Paper on the single currency. And we have initiated discussions with the ICAEW, the Accounting Standards Board and the International Accounting Standards Committee, with a view to encouraging them to identify all the relevant accounting issues, including whether or not a harmonised treatment of the euro needs to be applied throughout the EU. We aim to make contact with the Consultative Committee of Accounting Bodies. The Bank also participates as an observer in a working party of the 'Hundred Group' of Finance Directors; and we have held discussions with the Association of Corporate Treasurers. We plan to meet the Inland Revenue.

Rounding

A third overarching issue, if the United Kingdom opts in, relates to *rounding* differences which may arise when converting values from national currency denomination into euro and vice versa, because the relevant conversion rate is unlikely to be a neat decimal. All wholesale or retail transactions would potentially be affected. Rules and conventions will need to be established and, at least in some areas, possibly enshrined in law. The precedent of decimalisation in 1971 may be of some help: then the rules to be applied in banking transactions were given legal force, but not the suggested conventions for retail transactions.

The Bank has prepared and circulated a paper to a number of interested parties in the United Kingdom, as well as to the EMI and European Commission, setting out some mathematical considerations relating to rounding. Anyone with an interest is welcome to have a copy (see contact number below). We know that the issue is of particular concern to IPMA and ISDA. We also know at the other end of the spectrum that the British Retail Consortium has concerns, especially against the background of the recent EU requirement for unit pricing.

The Bank has suggested to the BBA that, in order to progress work in this area, we jointly establish a small group of officials and practitioners with a remit carefully to specify the full range of rounding problems which could arise, to offer possible solutions, and to share these more widely subsequently to see if a consensus on particular solutions might emerge.

Other sectors

Corporate sector

It is evident, from discussions with the CBI and BCC, that the corporate sector is only just becoming alert to the potential implications of EMU, whether the United Kingdom is in or out. Both organisations are contemplating an educational programme, organising workshops/seminars, in order to raise the level of awareness. The Bank is willing to provide assistance where it can. In addition the CBI is considering the establishment of a working group on EMU, and we have discussed the possibility that they might produce in due course a practical guide on how companies might need to respond to the introduction of the euro. In addition we have offered to discuss the practicalities of the euro with the TUC.

Retail sector

As already noted, there is more time to address issues at the retail level because, even if the United Kingdom opts in, most of the issues raised will materialise largely or only during the final transition period. We have nevertheless had preliminary discussions with the British Retail Consortium. They are concerned about the possible implications of dual pricing which, coming on top of the new unit-pricing Directive's requirements, would lead to a proliferation of pricing displays. They are also concerned that credit contracts should not need renegotiation. The historical experience of decimalisation may contain useful lessons in this area.

Regulators

Apart from legal issues relating to continuity of contracts, the financial regulators have not raised any concerns (save the comments on insurance/pension funds made above). Their own systems are capable of accommodating a new reporting currency. Clearly it will be necessary, if the United Kingdom is in, that sterling and the euro are treated interchangeably from a regulatory perspective during the transitional phase. We will take up with the banking and securities supervisors those policy issues which are raised with us.

Public sector

If the United Kingdom opts in, it is clear that the timing of the transition from sterling to euro for public sector receipts and, particularly, the myriad of public sector payments, will have considerable significance for the public. The EMI transition scenario allows Member States at their discretion to accept receipts denominated in euro from the start of Stage 3 but suggests that public sector payments should change to euro on one day in the final stage of the transition after euro cash becomes available. Further elaboration in this area will be required. There would clearly be a need for close co-ordination within the public sector of the vast range of activities involved, and between the public sector and the banking system.

Separately, it is also a feature of the changeover scenario that all new public debt issues—for an 'in' Member State—will be denominated in euro; but the precise timing of the redenomination into euro of the stock of existing public debt is for Member States' discretion. Decisions would be required on this in due course if the United Kingdom does join the euro area. It is not relevant if the United Kingdom exercises its opt-out. The Bank will be liaising closely with HM Treasury in these areas.

The way forward

As this paper makes clear, the Bank has been engaged in discussions with a large number of interest groups over the last few months on the implications of the euro for the United Kingdom, whether it is in or out.

We believe it important that the wholesale financial areas of the economy are adequately prepared technically for the introduction of the euro.

Given its position and wide-ranging contacts, the Bank believes it would be welcomed if it continued these discussions and continued to act as a focal contact point. We propose to do so. Any individual institution wishing to raise practical issues associated with the single currency should, in the first instance, approach its own representative body. The Bank would be grateful if these bodies could then draw any such issues to its attention: the focal point of contact in the Bank is John Townend, a Deputy Director (0171-601 4541).

The Bank will henceforth produce a regular, roughly quarterly, report on progress in the areas where co-ordinated or collective activity is required, identifying the issues and who is doing what to help resolve them. This is the first such report. We will circulate the report widely, including beyond the financial sector. We would like to use this report as a basis for regular meetings of the range of representative bodies with whom we have already made contact, and any other appropriate bodies if they are identified to us.

In addition the Bank will aim to participate in, and where appropriate organise, regional workshops and round-table discussions for the financial and business community, through the Bank's Agents.

Within this general framework, the Bank sees its role as essentially to:

- identify the areas where co-ordinated or collective activity is necessary;

- seek to ensure that the necessary work is agreed and undertaken, including by the Bank where appropriate;
- act as a catalyst to stimulate private sector activity where necessary;
- put in touch groups facing similar problems; and
- communicate widely about issues and progress to satisfy the thirst for information.

All this relates to communal activity. Once the necessary infrastructure is in place, it will be for firms' commercial decision how best to take advantage of it, consistent with the 'no compulsion, no prohibition' principle.

Organisations consulted

Wholesale payments and settlements

Association for Payment Clearing Services (APACS)
British Bankers' Association (BBA)
Clearing House Automated Payment System (CHAPS)

Markets and exchanges

Federation of Commodities Associations (FCA)
Futures and Options Association (FOA)
Futures Industry Association (FIA)
Gilt-Edged Market Makers' Association (GEMMA)
International Money Market Trading Association (IMMTA)
International Primary Markets Association (IPMA)
International Swaps and Derivatives Association (ISDA)
London Bullion Market Association (LBMA)
London Clearing House (LCH)
London Discount Market Association (LDMA)
London Investment Banking Association (LIBA)
London International Financial Futures Exchange (LIFFE)
London Metal Exchange (LME)
London Stock Exchange (LSE)

End users

Association of British Insurers (ABI)
Association of Corporate Treasurers (ACT)
Association of Unit Trusts and Investment Funds (AUTIF)
British Venture Capital Association (BVCA)
Building Societies Association (BSA)
Finance and Leasing Association (FLA)
Institute of London Underwriters (ILU)
Institutional Fund Managers' Association (IFMA)
Lloyd's of London
London International Reinsurance Market Association (LIRMA)
National Association of Pension Funds (NAPF)

The law

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

Accounting

Institute of Chartered Accountants in England and Wales (ICAEW)
Accounting Standards Board (ASB)
International Accounting Standards Committee (IASC)

Retail and corporate

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

Regulators

Department of Trade and Industry (DTI)
Government Actuary's Department (GAD)
Securities and Futures Authority (SFA)
Securities and Investments Board (SIB)