ISDA

International Swaps and Derivatives Association, Inc.

EMU GUIDEBOOK

DISCLAIMER

This Guide does not purport and should not be considered to be a guide to or explanation of all relevant issues or considerations in connection with EMU. Parties should therefore consult with their legal advisers and any other adviser they deem appropriate prior to using this Guide. ISDA assumes no responsibility for any use to which any documentation or any definition or provision contained therein may be put.

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FOREWORD

Efficient and integrated financial markets play a crucial role in the work of the European Monetary Institute. The set of monetary policy instruments which the EMI is in the process of developing for the future European System of Central Banks (ESCB) is in conformity with the market principles enshrined in the Treaty. The ESCB will mainly use open market operations to implement the single monetary policy and will rely on market forces for an efficient allocation of liquidity, thus ensuring the prompt transmission of monetary policy signals and uniform monetary conditions throughout the euro area. The dynamics of the scenario for the changeover to the euro, as developed by the EMI, was motivated by the considerable scope given to market forces and competition in this complex and unprecedented process.

The EMI has long been aware that markets' preparations for the changeover to the euro will need to be supported by the provision of timely information on the ESCB's monetary policy instruments and procedures. It has, therefore, released a number of reports containing a significant amount of technical information, including the specification of the operational framework of the single monetary policy in January 1997 and the General Documentation on the ESCB's monetary policy instruments and procedures in September 1997.[1] Any outstanding issues will be decided by the ECB, which will complete and finalise the terms and conditions for the single monetary policy to be followed by the ESCB.

While it has been the policy of both the EMI and the EU NCBs to emphasise that the organisation of the future single money, bond and foreign exchange markets should be the initiative and responsibility of the financial industry itself, the progress of the preparations has been closely monitored. To this end, the EMI has initiated a dialogue between the EU-wide banking and financial associations and the central bank community on issues concerning the changeover to the single currency. It has acted as a forum for the mutual exchange of information and views and encouraged the individual associations to establish harmonised market conventions.

ISDA has made an invaluable contribution to the dialogue with the EMI, and its activities have been instrumental in increasing market participants' awareness of the need for adequate preparations for EMU. The commitment of ISDA to ensuring timely preparations for EMU has been a source of considerable relief and encouragement for us, as we have been grateful over recent years to know that our extraordinarily heavy burden of work has been shared with professionals genuinely interested in making the financial markets' changeover to the euro a success story.

Frankfurt, March 1998

H. K. Scheller
Secretary General,
European
Monetary Institute

[1] Since January 1998 these documents have been available on the EMI's Web site (www.ecb.int), together with further information dedicated to the changeover to the single currency, which provide 200 hyperlinks to the Web sites of other public and private institutions offering technical information on the changeover to the euro.

Section I

INTRODUCTION

INTRODUCTION

The introduction of the single currency in Europe will have profound implications for the financial markets, none more so than trading in privately negotiated derivative transactions. Indeed, the flexibility of derivatives and their application to an array of underlying risks means that the changes unleashed by the euro in the money, foreign exchange, bond and equity markets are all relevant to derivatives. The implications of the euro for trading, settlement, documentation, operations, accounting, tax, capital and risk management in all these markets need to be considered. This presents the practitioner with the need for information from an number of public and private sources in order to get a clear picture of the changeover process.

This book is designed to address this need, by providing ISDA members and other market participants with a comprehensive guide to the impact of EMU on derivatives businesses and with copies of the key reference documents that are needed to plan for the changeover.

ISDA's Role in Preparing for EMU

This guide represents the culmination of two years of work by ISDA members, staff and consultants to address the implications of EMU for derivatives. From an early stage, ISDA has taken an active role in preparing for the euro, forming a number of key task forces (see Figure 1) and focusing on the practical implications of the new single currency for our industry. This work has been guided by a desire to promote legal certainty for the new currency, to ensure a parallel transition for the cash and derivatives markets, and to provide ISDA members with early, authoritative information about the mechanics of the changeover.

I am proud of the Association's considerable achievements over the past two years in these areas. We have led the successful effort to adopt legislation ensuring continuity of contracts in both the European Union and New York. We have succeeded in establishing common market conventions for the euro. We have achieved significant progress in resolving the problems raised by disappearing price sources. We have clarified tax implications of EMU. We have also provided a mechanism for members to address the impact of EMU on outstanding transactions and have published comprehensive guidelines for the operations implications of EMU.

Organisation of this Guidebook

All of this work is either described or reproduced in this guidebook – along with the many other areas of ISDA's EMU activities.

This guidebook is organised as follows:

- In the following section, ISDA provides a market-by-market overview of the impact of EMU, summarising the key transition issues and implications for derivatives. This is designed as a high-level overview and refers the reader to relevant documents or source material (much of which is reproduced) in order to look into any particular question in further detail.
- ISDA then looks at a number of over-arching issues relating to EMU: the legal, accounting, tax and risk management implications. This includes a user-friendly summary of the main provisions of the EU regulations on the legal status of the euro.
- Section V of the book reproduces the full text of ISDA's guidance on the

implications of EMU for derivatives back office operations. This reflects the consensus of the Association's EMU Operations Task Force, following lengthy discussion and consultation, and provides an outline of the common approach market participants expect to take on numerous detailed operational issues.

- The annexes to this book reproduce key EMU source material that market participants need to prepare for the transition, including copies of relevant EU and New York legislation and information on price sources, bond redenomination, harmonised market conventions and other matters.

- Lastly, the guidebook includes a user-friendly glossary and a reference to other important EMU sources.

These achievements were only possible because of the major contribution made by ISDA members. I am therefore very grateful to all those individuals who attended and took part in our various EMU Task Force and Working Group meetings. In particular, I am grateful to the current and past Chairmen of our EMU Task Forces, Stephen Greene and Jeanette Whomersley of CSFP, Anneli Peshkoff formerly of Citibank and now of the EIB, Neil Abrams of Goldman Sachs, Yasumasa Nishi of IBJ, Jane Carlin of Morgan Stanley, Simon Peerless of NatWest, Cathryn Field of Paribas, and Colin Parry of SBC Warburg. Also, special thanks are due to Ulrich Parche of Bayerische Vereinsbank, Dermot Drysdale of Chase, Jean Granoux of Credit Agricole, Malcolm Jones of HSBC, David Lewis of JP Morgan, Geoff Pennells of Salomons and Eric Rabin of Sociéte Générale.

We have also been grateful to have had a close and productive working relationship with many member state national central banks and governments, the European Commission and the European Monetary Institute. We would like to take the opportunity to thank these organisations for the assistance they have provided and, in particular, the EMI for kindly providing a foreword to this book. Also, thanks are due to the many other market associations with whom we have co-operated on EMU issues.

Finally, I would like to note the important contributions made by ISDA's staff and consultants to our EMU work. In particular, special thanks go to Jeffrey Golden, Edward Murray, Richard Tredgett and the other members of the Allen & Overy team and to Angela Papesch and, in particular, Matthew Elderfield of ISDA's European Office.

While our work on EMU is continuing, I believe that this guide provides an excellent reference for ISDA members and other market participants, as each of you prepare for a single currency for Europe. I hope that you agree and find this guide a useful resource for the months ahead.

London, March 1998

Gay H. Evans
Senior Managing Director, Bankers Trust International and Chairman of the Board of Directors, ISDA

Figure 1

ISDA's EMU Activities

The Association's EMU activities have been organised as follows:

Accounting Tax and Capital Task Force
This group has responded to EU accounting proposals, commented on Bank of England and EU capital adequacy proposals and worked with the UK Inland Revenue to develop guidance on tax issues. We have worked closely on the latter issues with a number of other UK-based market associations.

Documentation Task Force
This group has examined the impact of EMU on ISDA documentation, publishing the ISDA EMU Continuity Provision and developing the ISDA EMU Protocol. Further language to be used for bilateral amendments will also be developed.

Legislative & Regulatory Task Force
This group co-ordinated ISDA participation in the City of London Joint Working Group and other bodies looking at changes to EU and national law in the light of EMU.

Market Practice Task Force
This group has led ISDA's efforts in a number of areas, including harmonised market conventions, price sources, bond redenomination and reserve requirements.

Operations Task Force
This group has acted as a forum for discussion of back office issues and authored the ISDA EMU Operations Guide, reproduced in Section V of this book.

New York EMU Working Group
This group, involving participation by the NY Foreign Exchange Markets Committee and the New York State Bankers Association, examined the New York implications of EMU and successfully lobbied for New York continuity legislation.

Japanese EMU Working Group
This group works with the Ministry of Finance and other bodies to examine legal and other local issues posed by EMU and has authored an EMU Derivatives Q&A in Japanese.

City of London Joint Working Group on EMU Legislation
ISDA has acted as secretary to this group, which represents the UK financial markets on EMU-related legal issues. The group led the successful effort to obtain EU regulations on continuity of contract and the legal status of the euro.

Figure 2

EMU TIMETABLE

	Public EMU Timetable	***Derivatives Timetable***
2-3 May 1998	• Brussels Summit agrees participants • Bilateral Exchange Rates Fixed	• ISDA EMU Protocol open for adherence
30 September 1998		• ISDA EMU Protocol closed for adherence • Consensus deadline to agree euro SSIs, nostros
31 December 1998	• Irrevocable fixing of exchange rates to euro • ECU replaced by euro one-for-one • Non-business day for some markets	
1 January 1999- 3 January 1999	• Conversion Weekend	• Systems ready for new euro trading • Trading and risk management systems treat legacy currencies as euro • ECU contracts switch to euro • Apply successor reference rate sources • Convert and reconfirm barriers
1 January 1999- 1 January 2002	• Start of Stage 3 and legal transition period • ECB sets monetary policy • TARGET operational • All new government debt issued in euro • Wholesale markets deal and settle in euro • "No compulsion, no prohibition" on use of euro • Commercial banks obliged to credit accounts in national currency or euro • National notes and coins retained, but national currencies are subdenominations of euro	• Adjust bond option strikes if necessary • Cash out rounding errors on bond options if necessary • Convert share option strikes if necessary • Redenominate by agreement • Change SSIs, nostros by agreement/notification • Close out "in"/"in" deals by agreement
1 January 2002	• Date for introduction of euro notes and coins • End of legal transition period	
1 July 2002	• National notes and coins no longer valid	

Section II

FINANCIAL MARKETS OVERVIEW

1. Money Markets

ECB Monetary Policy

From the start of Stage 3, the European System of Central Banks will conduct joint monetary policy operations in the euro area to establish a common short-term interest rate. Monetary policy will be executed primarily by repo operations; details of the proposed approach to monetary policy operations (including information of repo mechanics, other means of intervention, forms of eligible collateral, etc) have been set out in the EMI's publications on 'The Single Monetary Policy in Stage Three'[2]. Final decisions on monetary policy will be made by the ECB Governing Council, including whether or not to impose reserve requirements and, if so, at what level, on which instruments. ISDA has expressed concern about the prospect of reserves on derivatives (see Figure 3).

Development of an Integrated Euro Money Market

Also from the start of Stage 3, TARGET becomes operational for making payments and effecting monetary intervention. This and other payment mechanisms (see Figure 4) will allow arbitrage of euro rates in different financial centres and, in conjunction with the ESCB's coordinated monetary intervention, will permit the formation of an integrated euro money market in the euro area from the start of Stage 3. It is as yet unclear whether this will concentrate in any particular financial centre. Euro money market trading will also take place "offshore", principally in the City of London.

[2] See 'The Single Monetary Policy in Stage Three: Specification of the operational framework' - January 1997 and 'General documentation on ESCB monetary policy instruments and procedures' - September 1997 by the EMI

Figure 3

Reserve Requirements and Derivatives

Reserve requirements are currently used by a number of EU member states as an instrument of monetary policy, but it is still uncertain whether they will be employed by the ECB. The EMI has nevertheless planned for the use of reserve requirements and has prepared EU legislation which would provide the power to assess reserves against both on and off balance sheet liabilities in euro (see footnote 2). This legislation should be adopted shortly after EMU participants are named in May 1998; the same time as a final decision on the use, scope and level of reserve requirements will be taken by the ECB Council.

ISDA is deeply concerned by the prospect that reserves might be assessed against derivatives and has written a position paper (17 July 1997), addressed to the EMI and other interested parties, noting that:

- Reserve requirements would have a massive dislocation effect, driving euro derivatives business offshore and therefore hurting the financial markets and economy of the euro area. We provide data showing that in high volume, plain vanilla markets, even setting reserves at a low level which is itself partly remunerated would still be damaging
- There is no or marginal euro liquidity creation generated by derivatives which would justify imposing reserves
- It would be difficult to find an appropriate measure of derivatives for the application of reserves in light of notional principal values and net and gross replacement values
- It is unnecessary to fear the use of derivatives to avoid reserves against on-balance sheet liabilities: moving business offshore is a preferred method of avoidance, as experience with DM reserves has shown
- ISDA could find no precedent for reserve requirements on derivatives

We urge members and other interested parties to join in expressing the above concerns to national central banks.

Figure 4

TARGET and Euro Payment Arrangements

After EMU, firms will have a wide choice for cross-border euro payment arrangements:

- The ESCB will operate TARGET (Trans-European Automated Real-time Gross settlement Express Transfer). TARGET will:
  - Link national RTGS settlement systems in all EU member states (not just EMU participants) allowing transfer of high value euro payments on a fully collateralised (settlement risk-free) basis between central and commercial banks in different countries
  - Provide a mechanism for adding and withdrawing liquidity as part of monetary policy operations in participating member states
  - Operate on all days except weekends, 1 January and 25 December. This will in turn form the basis for euro business days for all financial markets. National RTGS systems do not have to be open on every TARGET day, but competitive pressures mean that they are likely to be open and that national commercial banks will also be open for settlement
  - Operate during the hours of 7 a.m. to 6 p.m. ECB (European Central Bank) time

- The Euro Banking Association will operate a euro clearing system with the following features:
  - Transfer of euro payments via EBA member clearing banks in different countries on a net, end-of-day settlement basis
  - Operation on all TARGET opening days

- Individual banks will also continue to offer correspondent banking services, now in euro

Market Conventions for the Euro Money Market

Market associations and authorities have recognised the importance of common market conventions for the euro money market. A joint statement by ISDA and other associations sets out the recommended standards for the euro money markets[3]. The standards have already been adopted for ECB repo intervention and Euro Libor and Euribor reference rates[4].

Implications for Reference Rates

The creation of an integrated euro money market has implications for reference rates: ECU rates and, in some cases, national currency rates will be replaced by euro rates. Also, in some countries, national financial centre rate panels may disappear. These changes have implications for existing derivatives contracts (and indeed loan agreements or FRNs and MTNs) that refer to euro area rate sources and which mature after the start of Stage 3, as a new rate source may need to be employed for these "legacy" deals. ISDA has identified two broad areas of concern in this area:

- The need for information about disappearing and successor rates: Market participants need to know exactly which rates will change or disappear, whether an official successor as been designated and how prices will be displayed. ISDA has published a report outlining the status of existing price sources[5].

- The need to address any potential legal concerns: As explained in a further report by ISDA, issued in August of 1997[6], there may be potential legal uncertainty raised by switching from a national to a euro price source if a change has occurred to the panel sponsoring the rate source. Market participants may however address this concern and

[3] See Annex D
[4] See Annex G & H
[5] See Annex F
[6] See Annex E

confirm the successor rate to be used as part of ISDA's EMU Protocol[7].

It is anticipated that there will be two principal euro reference rates as of the start of Stage 3. The Banking Federation of the EU and Association Cambiste International will be the principal sponsors of a Euribor rate. This will be a domestic rate for the entire euro area, based on quotes from a panel drawn from banks in all participating member states plus international banks[8]. The British Bankers' Association will sponsor a Euro Libor rate (which will succeed the BBA's ECU Libor). This will be an offshore rate based on quotes from London banks only[9]. An effective overnight rate (as opposed to the indicative rates above) will also be launched for the euro. The rate will be named EONIA and will be organised by the Euribor sponsors using Euribor panellists. However, collection of data and calculation of weighted effective rates will be done by the ESCB for confidentiality reasons[10].

Implications for Futures Markets

The formation of an integrated money market and common interest rate policy will also have implications for futures exchanges, particularly for their existing short-term interest rate contracts. Competition is expected to be intense between the leading exchanges such as DTB, LIFFE and MATIF. Each will have a flag-ship euro rate contract as the successor to their ECU contracts; LIFFE and DTB plan to use Euro Libor for settlement, MATIF instead will use Euribor. Also, each have mechanisms to allow conversion of existing national currency interest rate futures into euro contracts[11].

7 See Section III.3
8 See Annex H
9 See Annex G
10 See Annex H
11 Matif, DTB & Liffe all publish bi-monthly newsletters in which they not only outline their own preparations for EMU, but report on other relevant developments

2. Bond Markets

From the start of Stage 3, governments participating in EMU will issue new debt in euro. This new euro bond market is expected to rival the US and Japanese market in size and importance[12]. Similarly, it is expected that corporates will fall in line with their government and also issue any new debt in euro.

It is expected that the introduction of a single currency will have a considerable impact on the existing stock of government as well as corporate debt. A number[13] of governments are expected to redenominate their outstanding debt for two main reasons. Firstly, from a political perspective, such action would emphasise their commitment to the introduction of the euro and secondly, on a more practical level, this would prevent a split in the liquidity of the bond market. Corporate debt might also be redenominated during the transition period, for similar reasons. However, this is likely to be decided differently by each institution.

Market Conventions

In line with the foreign exchange and money *markets, common* market conventions have been agreed for bond trading in euro. Most importantly, the agreed conventions suggest the use of act/act as a calculation basis to bring the market in line with US and Japanese government bond markets. The joint statement on harmonised market conventions[14] outlines these and other relevant changes. It is expected that debt offices will also apply these new conventions: A report by EU government

12 For more details about the impact on the bond market see IPMA: 'The International Capital Market - An EMU Position Paper' – Autumn 1997; 'EMU and Outstanding Eurobonds - A Guide for Issuers' – Spring 1998
13 See Annex I
14 See Annex D

debt offices shows near unanimous support for all the proposed conventions.[15]

Legal Issues Raised by Redenomination

Article 8(4) of the 109 l(4) Regulation empowers governments and others to redenominate debt during the transition period as an exception to the "no compulsion" principle. However, to appreciate the legal issues in any particular case surrounding redenomination, it is important to distinguish carefully between currency conversion, renominalisation and reconventioning[16]. Furthermore, it is important to be aware of the varied approaches adopted by different jurisdictions. Depending on the governing law of the bond (not the currency or the country of the issuer), redenomination and potentially reconventioning can either be easily affected or amount to a complex procedure (e.g., under English law, redenomination might require approval at a bondholder meeting[17]). Most participating governments are in the process of issuing national legislation to facilitate redenomination and even reconventioning[18].

Technical Issues Raised by Redenomination

Further issues are raised by the different methodologies that could be adopted to redenominate bonds and the effect different rounding methods would have on underlying derivative instruments. In essence, two main approaches have been identified. Over recent months, issuers have extensively examined whether renominalisation should be to the nearest eurocent or euro[19]. The eurocent approach is seen to cause minimum disruption to the value of the individual bondholdings, but could, in turn, pose problems for systems which could not handle decimals. Regrettably, despite the desire for operational reasons to keep the number of methods applied to a minimum, no one method has prevailed and different countries have now adopted varying approaches. ISDA has called upon bondholders and issuers to make their intentions known. A working group of the EU Monetary Committee, supported by the Commission, has brought together government debt offices to publish information about the decisions of different governments. ISDA has furthermore identified potential implications redenomination might have on bond options and asset swaps, which are outlined in ISDA's Operations Guidance paper[20].

Formation of a Benchmark Euro Yield Curve

While all government debt will be denominated in euro, differences in credit standing and liquidity will affect spreads between different issues and raises the question as to which government debt will form the basis for the benchmark euro yield curve. There is as yet no consensus on this question. Some commentators look to German debt as forming the benchmark, due to credit considerations. Others point to France, as the French market is more developed across a fuller range of maturities. It is also possible that a combination of issues will form the benchmark or, indeed, that the euro swaps curve will provide the common benchmark.

Implications for Futures Exchanges

The above developments have implications for existing bond futures and options traded on exchanges where the underlying instrument is redenominated into euro, as strike prices may need to be adjusted in the light of reconventioning. More generally, the exchanges are considering their strategies for new euro bond contracts, in terms of competition for the benchmark instruments and the possibility

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15 See Annex I, table 17

16 See Glossary

17 See Section II, Legal and Documentation

18 See Annex I

19 See Annex B – Question 32

20 See ISDA's Operations Guidance paper - Section V

of basket contracts. No decisions had been taken by April 1998 on this issue.

3. Foreign Exchange Markets

Rate Fixing and ECB Intervention

Over the weekend of 2-3 May 1998, Finance Ministers of the newly announced EMU participating states will announce fixed bilateral rates for all "in" currencies. Fixed rates for "in" currencies versus the euro cannot, however, be anticipated ahead of Stage 3, as the Maastricht Treaty requires both that the ECU be replaced by the euro on a one-for-one basis and that the external value of the ECU is not changed at the point of fixing. Given that the ECU contains non-participating currencies, it is only possible to fix bilateral rates ahead of time.[21]

The fixing of rates between all participating currencies and the euro will therefore only take place at the start of Stage 3 on 31 December, 1998 (effective 1 January 1999). The exact timing of the fixing has not yet been decided and has implications for the exact amount of time available for the conversion weekend.

When rates are fixed, the ESCB will conduct foreign exchange intervention activities as appropriate to influence the value of the euro, including the use of foreign exchange swaps.[22]

Market Conventions

In line with the bond and money markets, common market conventions have been agreed for foreign exchange trading in euro. These include most notably a change from uncertain quotation (e.g., 1 USD = X national currency units) to certain quotation (1 euro = X USD). The joint statement on harmonised market conventions[23] outlines the relevant changes.

Market Impact

Fixing of rates will eliminate foreign exchange dealing between "in" currencies. However, the volume of intra-EU currency trading is small and will likely be compensated by any increase in euro/$, euro/yen and other trading. Any legacy currency foreign exchange transaction agreed before the start of Stage 3 for settlement afterwards, will settle as dealt after the conversion weekend.[24]

Impact on Derivative Contracts

ECU foreign exchange derivative contracts are to be treated as euro contracts after the start of Stage 3. Similarly, any reference to an "in" participating currency can be read as euro amount at the official conversion rate, in the case of any contracts involving both an "in" and an "out" currency. However, complications do arise for foreign exchange barrier options.

It is anticipated that a number of counterparties will wish to close out "in"/"in" currency foreign exchange contracts. However, there should be no presumption of this, as a counterparty may still have a reason to preserve the transaction.

See Section V.3.C for a detailed discussion of these issues in the guidance on back office implications of EMU.

[21] See 'Fixing conversion Rates at the Start of EMU', by Malcolm Levitt – June 1997

[22] See footnote 2

[23] See Annex D

[24] See Bank of England's PIQ No 7 - March 98

4. Equity Markets

The introduction of the euro will have implications for the denomination of equity trading and share capital, for settlement arrangements and for equity-based derivatives instruments traded on exchanges or privately negotiated between counterparties. The exact consequences will vary depending on whether the equity market is within the euro zone or not. Market characteristics will, at least at the outset, remain fundamentally national, with local exchanges continuing. Nevertheless, EMU raises the prospect of further cross-border trading links and increased interest in pan-European share indices.

Share versus Trading Denomination

In considering the impact of EMU on the equity markets, it is important to distinguish between the denomination of a company's share capital and the denomination of its equity trading on an exchange or referenced in a derivatives contract. The two need not changeover to euro at the same time and, indeed, trading is likely to switch to euro more quickly than share capital. The discussion in the sections below focuses on trading denomination, as this has implications for related derivatives instruments.

Regarding share capital denomination, this will be governed by national legislation in each member state, either automatically converting all share capital into euro or permitting firms to switch to euro share capital on an individual basis. The latter approach is to be pursued under English law, and the UK Department of Trade and Industry is consulting on the implications for English Company Law, including the prospect of nil-par value shares[25].

[25] DTI: Consultative Paper on the Redenomination of Share Capital – January 98

Trading Practice in Participating Countries

All exchanges in participating countries are expected to switch to euro denominated share trading immediately at the start of Stage 3. An outline of the changeover process is provided by the Federation of European Stock Exchanges[26]. Indices are also expected to switch to euro as of the start of Stage 3, in all participating countries, reflecting the change in trading denomination of the constituents. Futures exchanges will also switch to euro trading for listed options and futures contracts on individual shares and indices.

Trading Practice in Non-Participating Countries

The implications for trading practice in non-participating countries is expected to vary considerably from market to market. Some may provide for individual shares to switch to euro trading on an individual basis, others may provide dual national currency/euro price display. The London Stock Exchange is consulting on the possibility of separate sterling and euro order books for very liquid shares. Share indices will therefore also be affected in different possible ways. If the sponsor of the index decides that the appropriate price for an individual consistent is the euro price, then taking this euro price into account for the purpose of calculating the index will introduce a currency risk effect not currently present. This is the so-called "euro creep."[27] The larger the number of euro constituents introduced is, the larger the potential currency risk effect is on the index. What matters for this purpose is not the denomination of a constituent share, but the currency in which it is traded, which may not be the same.

Impact on Derivatives Contracts for Participating Countries

New contracts will refer explicitly to euro values for derivatives contracts referenced

[26] See FESE – Second Report 'The Transition to the Euro' - February 1998

[27] See discussion of legal issues in Section III.1 below

to shares or indices listed in participating countries. In the case of legacy derivatives contracts, it is generally accepted that these will be treated as euro transactions at the relevant fixed conversion rate. Strike prices therefore need to be adjusted[28].

The position may not be so straightforward in the case of the fundamental changes to the composition and structure of an index in case, for example, existing national share indices merge in due course.[29] However, ISDA has been advised by the FESE that there are no plans of this sort currently contemplated.

Impact on Derivatives Contracts for Non-Participating Countries

New contracts will refer to either a euro or national currency value of an equity, depending on the underlying denomination of the traded equity and the preferences of the counterparties, in cases of derivatives on shares listed in non-participating countries. Legacy contracts will be unaffected, unless the underlying equity switches to euro trading. In these cases, strike prices need adjustment into euro[30].

Derivatives referenced to indices in non-participating countries will be affected by "euro-creep", raising implications for the "adjustment of index provision" of the ISDA equity definitions[31] and for the back office treatment of these instruments.

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28 See part C.2 of Operations Guidance Paper - Section V

29 ISDA: EMU and Equity Derivatives Memorandum – 19 January 98

30 See part C.2 of Operations Guidance Paper for discussion of the timing and procedure of such an adjustment – Section V

31 See Section III – Legal and Documentation

Section III

LEGAL AND DOCUMENTATION

1. LEGAL FRAMEWORK

Overview of Legal Issues

Early in the transition process, it became clear that EMU posed two fundamental questions regarding 'legacy' contracts in place on and maturing after 1 January 1999. First, would the introduction of the euro or any related event such as the irrevocable fixing of conversion rates cause a contract to be discharged on the ground of a general legal doctrine such as impossibility or frustration of contract? Secondly, where a contract did continue, how would performance of the contract be affected by the introduction of the euro or a related event, such as the disappearance of a price source or a change to market practice in relation to day count conventions?

Most jurisdictions have a doctrine recognising that in some circumstances a contract should be discharged or a party excused from performing it where it has become impossible or, in some sense, unfair, due to some fundamental change of circumstance, for performance of the contract to be enforced. While it seemed reasonably clear under the laws of most European Union member states that the introduction of the euro should not trigger the application of such a doctrine, it was also apparent that such a possibility could not be completely ruled out.

It is important to be clear, however, on what basis such a doctrine might be triggered. There is virtually no risk that the continuity of a contract would be affected merely because the currency of an obligation was replaced by the euro. It appears to be the case that the courts of all Member States of the European Union would defer to the law of the relevant currency (the *lex monetae*) to determine what constitutes the relevant currency at the time a particular payment obligation is to be performed. It would not, therefore, be impossible to repay a Dutch Guilder loan simply because the Dutch Guilder had been replaced by the euro. Repayment would occur in euro. Where there is some uncertainty, however, is where the purpose of a contract has been frustrated by the introduction of the euro or any related event such as the irrevocable locking of conversion rates between old national currencies and the euro. Some jurisdictions have quite broad change of circumstance doctrines that could also be triggered, given the enormous impact EMU will have on virtually every aspect of economic life.

In addition to this general uncertainty, lawyers have raised concerns with a number of more specific questions: what would be the precise relationship of the euro to the participating national currencies during the so-called transitional period; how would the announced conversion of one ECU to one euro at one-to-one be enacted as a matter of European law; how should conversions between participating national currency units (NCUs) or between an NCU and the euro be made and what would be the rules for rounding when making these conversions.

Background to Euro Regulations

Uncertainty on these and related points raised serious questions over the affected contracts. ISDA's Legislative and Regulatory Task Force was therefore set the task in January 1996 to resolve these issues and was soon expanded to encompass a number of other bodies and form the CLJWG (City of London Joint Working Group), which includes representatives from the British Bankers' Association, the City of London Law Society, the International Primary Market Association, the London Investment Banking Association and various other trade associations.

Following intense consultations with the European Commission and the European Monetary Institute, as well as HM Treasury, the Bank of England and other member state governments and central proposal to the Commission for a form of draft Regulation addressing continuity of contracts, the conversion of ECU to euro at one-to-one and various related matters. A Regulation was proposed to have direct and immediate effect in all Member States, without the need for implementing legislation.

The European Commission subsequently proposed draft Regulations in June and October 1996. Ultimately, two European Regulations were formally proposed to deal with the uncertainties mentioned above. It emerged during the course of the consultations that the provision of the Treaty of Rome (as amended by the Maastricht Treaty) on which the introduction of the euro itself would be based, Article 109 l(4), was unsuitable as a basis for a Regulation on continuity of contracts. There were several reasons for this, the principal ones being that a Regulation based on Article 109 1(4) could only be voted on by the participating Member States, which would only be chosen in early 1998, that a Regulation based on Article 109 1(4) could not come into effect until 1 January 1999 and that the Regulation would not apply in the UK, if it chose not to participate in the first wave, under the terms of the UK "opt-out" protocol to the Maastricht Treaty.

European Council Regulation on Continuity of Contracts

It was therefore agreed that another provision of the Treaty of Rome was needed as a basis for the Regulation on continuity of contracts. The basis finally chosen was Article 235, a general provision of the Treaty empowering the Council to take appropriate measures "to attain, in the course of the operation of the common market, one of the objectives of the Community".

Figure 5

Council Regulation (EC) 1103/97 of 17 June 1997
on Certain Provisions Relating to the Introduction of the Euro

- Published in the Official Journal of the European Communities on 19 June 1997 and came into effect the next day
- *Article 2* provides for references in contracts to the official ECU to be replaced by the euro at a rate of one-to-one, provided that, if the contract does not expressly refer to the official ECU (as defined by Article 109g of the Treaty of Rome and Regulation (EC) No. 3320/94)), the presumption that the parties intended to refer to the official ECU may be rebutted
- *Article 3* provides that the introduction of the euro will not affect the continuity of contracts, subject to whatever the parties may have otherwise agreed
- The *Recitals* to the Regulation make it clear, among other things, that nominal fixed rates of interest are not changed by the introduction of the euro, oral contracts are covered by the Regulation and that force majeure clauses in contracts should not be triggered, unless they expressly refer to the introduction of the euro
- *Article 4* deals with the mechanics of converting a participating national currency to euro or to another participating national currency, providing among other things that:
  - such conversions to and from euro should be done using "six significant figures", using only the official conversion rates and not inverse rates
  - conversions between national currencies must be made via the euro (this has come to be called "triangulation" in the markets)
  - no alternative method of calculation may be used, unless it produces the same result as the method mandated by Article 4
- *Article 5* provides for amounts to be paid or accounted for in euro to be rounded to the nearest eurocent

On 20 June, 1997, Council Regulation (EC) 1103/97 came into force[32]. The principal provisions are summarised in Figure 5.

Proposed European Council Regulation on Legal Framework for the Euro

As noted above, Article 109 l(4) of the Treaty provides the basis for the introduction of the euro and a Regulation based on Article 109 l(4) will be used for that purpose. As it can only be voted on by the participating Member States, to be chosen in May 1998, it has not yet been enacted. The text of the Regulation (often referred to as "the Article 109 l(4) Regulation") was, however, agreed at the Amsterdam Summit in June 1997 and was published in the Official Journal of the European Communities on 2 August, 1997[33]. Its principal provisions are summarised in Figure 6.

Impact of Fall on Price Sources

As noted above, the impact of EMU on price sources raises a number of concerns. The legal issues are as follows:

- Could the disappearance of a price source referred to in a legacy contract affect the continuity of the contract?
- Assuming the legacy contract continues by substitution of a successor price source, how can the appropriate successor price source be determined with certainty?
- If a price source continues but is substantially modified, how does the modification affect continuity or performance of the legacy contract?

Although there are cases in the United States in which the disappearance of a price source resulted in a contract relying on it being discharged, it is generally thought that under the laws of most European member states, the disappearance of a price source for a participating national currency unit, for example, the Paris interbank offered rate for French Franc deposits (PIBOR) as published by the Association Française des Banques (AFB), would not affect the continuity of a legacy contract that refers to it, even in the absence of express fallback provisions in the contract. Of course, if there are fallback provisions in the contract, then they would govern. Otherwise, it appears that the courts would substitute an appropriate successor rate.

In the case of a rate such as PIBOR, as published by the AFB (AFB-PIBOR), it is thought that an English or a German court would most likely substitute a provision under which PIBOR is determined by seeking quotations from leading banks in the Paris interbank market. This type of provision is often referred to as a "reference banks provision".

There are at least two potential difficulties with having a contract fall back to reference banks. First, based on current information, many of the standard interbank offered rate (IBOR) price sources for the likely participating member states will be disappearing on or shortly after 1 January 1999. This will affect an enormous number of contracts. Falling back to reference banks for such a bulk of contracts will not be practical. It will be too burdensome not only for an individual institution that has to gather in the necessary quotations, but also for the leading reference banks, which will be inundated with requests for quotations that are purely for price-setting and not for dealing purposes.

Secondly, the advent of EURIBOR and EONIA[34], raises a question as to whether or not one of these rates will be a more appropriate successor to, say, AFB-PIBOR than PIBOR determined using reference banks in Paris. The principal argument against a rollover from AFB-PIBOR to EURIBOR would be that AFB-PIBOR is a

[32] See Annex A

[33] Ibid.

[34] See Annex H

Figure 6

Proposed Council Regulation on the Legal Framework for the Introduction of the Euro

- Political agreement on the text reached at the Amsterdam Summit in June 1997 and text published in the Official Journal of the European Communities on 2 August 1997
- To be voted on by the participating Member States, once chosen by the EU Heads of State or Government at the Brussels Summit on 2 and 3 May 1998 and to take effect on 1 January 1999
- Introduces the monetary law aspects of the euro
- *Articles 2 and 3* introduce the euro as the currency of each participating Member State replacing the old national currency at the official conversion rate
- *Article 4* makes the euro the unit of account of the European Central Bank and the central banks of the participating Member States

Articles 6 to 9 deal with arrangements for the transitional period:

- *Article 6* provides for the old national currency units to remain as denominations of the euro, in their respective Member States
- *Article 7* provides that the introduction of the euro shall not affect the denomination of legacy contracts
- *Article 8(1)* sets out the well-known "no compulsion, no prohibition" principle, namely, that amounts denominated in a national currency unit shall be performed in that denomination and amounts denominated in the euro unit shall be performed in that denomination
- *Article 8(2)* provides that the parties are free to contract out of Article 8(1)
- *Article 8(3)* provides that, notwithstanding Article 8(1), an amount denominated in a national currency unit or in the euro unit may be discharged by payment in the national currency unit or the euro unit, provided that payment is made "by crediting an account of the creditor" and that the account is located in the Member State of that national currency unit. "Crediting an account" is thought to include payments by wire transfer and, subject to some doubt as to the drafting of the Regulation, payments by cheque, but not payment by credit card, debit card or in cash. Article 8(3) imposes the onus on the creditor's receiving bank to convert the incoming payment to the denomination of the creditor's account.
- *Article 8(4)* provides that Member States may take measures to redenominate their own debt into euro, to permit private issuers to do the same and to permit organised markets and clearing systems to change their unit of account to the euro. In relation to bond redenomination, the Regulation makes it clear that Article 8(4) only contemplates redenomination in the narrow sense of currency conversion and not renominalisation or reconventioning.
- *Article 8(6)* confirms that netting and set-off are not affected by the introduction of the euro.
- *Articles 10 to 12* deal with the future introduction of euro banknotes and coins
- *Article 14* provides that on and after 1st January, 2002 references to participating national currencies shall be read as references to the euro, effectively ending the limited role of participating national currency units as denominations of the euro
- *Articles 15 and 16* deal with the eventual withdrawal of banknotes and coins denominated in the old national currency units

rate for deposits in the interbank market in Paris determined by a relatively small panel of banks. EURIBOR will be a rate for interbank deposits in euro determined for the euro-zone as a whole by a relatively large panel of banks. It is thought that this difference in geographic scope and panel size will weigh heavily with a court that is inclined to a more literal reading of the contract.

The principal argument in favour of EURIBOR as the appropriate successor to AFB-PIBOR is that AFB-PIBOR was the representative rate for the relevant market at the time the contract was entered into. After the commencement of the third stage of EMU, the representative market will be the interbank market for the euro-zone and not the Paris interbank market. The difference in panel size is explained by the fact that the market for which the rate is determined is now greatly expanded.

Both arguments are based on a construction of the parties' likely intent in having referred to AFB-PIBOR in their legacy contract. Which argument would prevail in the event of litigation on the point would depend on the facts of the relevant case and on whether the court were inclined to take the more literal and conservative line of the former argument or to accept the more conceptual and progressive line of the latter argument. It has been suggested that English, German and Spanish courts, among others, would be more likely to prefer the former argument, while French courts might incline to the latter.

This uncertainty as to the appropriate legal successor to a disappearing domestic IBOR is troublesome to the markets, and legislative as well as contractual solutions are being considered in various markets. These are discussed below.

Finally, in relation to disappearing IBOR sources, it should be noted where it is clear or has been agreed that EURIBOR is the appropriate successor, it may nonetheless be the case the disappearing IBOR source was quoted on the basis of a different day count fraction or fixing period from EURIBOR. Where that is the case, the parties need to consider whether and, if so, how to adjust for such differences.

Equity Indices

As far as substantial modification of existing price sources is concerned, the principal question appears to be in relation to equity indices, where there is some concern as to whether indices will be re-based or even perhaps merged as a result of the changing nature of the European equity markets after the introduction of the euro. So far ISDA has not been informed of any such plans by any recognised sponsor of a European equity index.

There is also some concern about the possibility of shares traded in euro being taken into an "out" currency equity index, such as the FTSE 100. FTSE International, sponsor of the FTSE 100, has indicated that if components of the index begin trading in euro, and that becomes the principal market for those shares, then it may alter its rules to take such shares into the index at their euro price. While this would have no effect on the index at the time of such inclusion, over time a difference would arise between the level of the index, including the euro-priced shares, and the level that would have prevailed had those shares continued to be taken in at a Sterling price, due to fluctuations in the euro-Sterling rate of exchange (this effect has been referred to as "euro-creep"). The change of rules together with the euro-creep effect might trigger the "adjustment of index" provision in documentation incorporating ISDA's 1994 or 1996 Equity Derivatives Definitions. Whether the parties would want an adjustment to be made to eliminate the euro-creep or would, instead, prefer to take the index "as is" would be a commercial question. Parties wishing to take the index "as is" would need to amend their contracts to eliminate the triggering of the adjustment provision.

Business Days

Here the key issue is one of clarifying the effect of definitions which rely on banks being "open for business" or able to "settle payments" in the "principal financial centre" of the relevant currency of payment. In relation to the euro, there will be no clear "principal financial centre" for this purpose. Also, the advent of TARGET and increased unification and competitiveness of the European financial markets as a result of EMU are accelerating the pace of change, resulting in banks opening more and more of their operations on days that have traditionally been national holidays. It is clear that in relation to legacy contracts, the general commercial intent is to preserve national holiday calendars. Parties need to ensure their contracts achieve this. ISDA's efforts in this regard are summarised below.

Bond Redenomination

Bond redenomination raises a number of interesting and potentially difficult issues. As noted above, Article 8(4) of the Article 109 l(4) Regulation provides only for redenomination in the strict sense of converting bonds from a national currency unit to the euro unit. It is generally thought, however, that issuers wishing to redenominate their bonds will also want to amend the nominal amounts of the bonds, at a minimum by rounding investor holdings of the bonds to the nearest eurocent or perhaps one euro. Some issuers might perhaps wish to change nominal amounts to facilitate trading to, say, round amounts of 500 or 1,000 euro. Such a change is often referred to as "renominalisation"[35]. Finally, some issuers might wish to go still further to amend the conventions on which a legacy bond issue is based, for example, in relation to day count fraction, business day, fixing period, coupon frequency or the like, generally to bring the bond in line with the harmonised market conventions for the euro[36]. This further change is often referred to as "reconventioning".

ISDA and other markets groups have firmly recommended against renominalisation, except in the limited sense of rounding investor holdings to one eurocent or one euro, and reconventioning of legacy bond issues. This is because of the severe operational and systems effects such changes would entail, as well as the severe adverse economic impact such changes could have on related contracts such as bond options, asset swaps, repackagings and the like.

Redenomination in the narrowest sense, simple currency conversion, under Article 8(4) of the Article 109 l(4) Regulation, would probably be a matter for the law of the relevant currency (*lex monetae*), and courts in other jurisdictions would be expected to defer to such a change. Renominalisation, even to the limited extent referred to above, and reconventioning would both, however, be matters affecting the contractual rights and obligations of issuer and bondholders and would therefore fall to be governed by the governing law of the bond issue.

Parties to a legacy contract that might be affected by renominalisation or reconventioning should consider whether the contract should be amended to permit the calculation agent (or other appropriate entity) to adjust the terms of the contract to eliminate any adverse effect.

Other Legal Issues

The compliance function within each financial institution should be in a position to monitor new regulatory requirements accompanying the introduction of the euro. Regulators have rightly been concerned to ensure that institutions are properly preparing for the introduction of the euro, doing all in their power to ensure their documentation and systems are EMU-compliant. Other possible regulatory concerns include the imposition of reserve requirements[37] on certain contracts and

[35] See Glossary

[36] See Annex D

[37] See Figure 3 in Section II.1

possible amendments to reporting and capital requirements[36].

National Legislation on EMU within the European Union

A number of likely participating Member States have been considering the introduction of domestic legislation to facilitate bond redenomination and/or share redenomination and to deal with the potential problems caused by disappearing price sources. Draft legislation is being considered in Germany, France, Italy and is likely to be introduced in all participating Member States.

National legislation dealing with bond redenomination is largely intended to facilitate renominalisation and/or reconventioning, as these exceed the scope of Article 8(4) of the Article 109 l(4) Regulation, by permitting issuers to make such changes without the consent of the relevant bondholders. Since these are matters for the governing law of the relevant bond issue, German legislation, for example, of this type would only apply to bonds issued under German law. English law issues, even of Deutsche Mark denominated bonds, would not be affected.

National legislation on the price source issue is intended to clarify the successor to a national price source that disappears. It is expected that EURIBOR would generally be named as the relevant successor either in the legislation or by an appropriate authority given the power under the legislation to designate EURIBOR as such. Such legislation would, however, again only apply to contracts governed by the law of the jurisdiction. Thus, the draft German legislation would not affect an English law contract referring to the Frankfurt interbank offered rate, FIBOR. Also, the draft German legislation, which refers only to FIBOR, would not solve the difficulty of price source succession in relation to a German law contract referring to PIBOR.

As the United Kingdom will not participate in the first wave, it has been asked whether national legislation on EMU matters is necessary or desirable in the UK. Clearly, legislation is not needed on the matters covered by Council Regulation 1103/97, as that Regulation applies in the UK. The question is therefore whether there is a need to replicate part or all of the Article 109 l(4) Regulation, which will not apply directly in the UK. While much of that Regulation would apply indirectly to English law contracts under the principle of deference to the *lex monetae*, discussed above, there is some uncertainty as to whether Article 8 of that Regulation[39] would apply on this basis. However, as of yet, no pressing problem has been identified as arising even if it is assumed that Article 8 does not apply. There is likely to be some legislation in the UK to facilitate share redenomination, as part of a broader reform and updating of English company law.

Legal Impact of EMU outside the European Union

For reasons similar to those which motivated ISDA and other industry groups in Europe to seek legislative clarification on continuity of contracts affected by EMU, a working group was established by ISDA in New York to examine the case for similar legislation in New York. ISDA led a lobbying effort, including preparation and submission of proposed draft legislation to the New York State legislature in Albany that resulted in legislation coming into force in New York on 29 3uly 1997[40].

Similar legislation was adopted in Illinois on 30 June 1997 and is currently being considered in other US States. An ISDA working group in Japan has also considered the case for legislation there, but so far it has not been thought necessary. Similarly, ISDA has sought advice from its Swiss members as to the desirability of legislation there, but again so far it has not been thought necessary in

[38] See Section IV.2

[39] See Figure 4 5. Annex A

[40] See Annex C

Switzerland. ISDA continues to monitor deliberations of these working groups and similar working groups in other jurisdictions such as Canada and Australia.

In the UK the Financial Law Panel has been conducting a multi-jurisdiction survey of the potential impact of EMU on continuity of contracts in England and in a number of jurisdictions outside the EU. To date, it has only formally reported on the UK and Japanese positions.[41]

2. DOCUMENTATION

Introduction to ISDA's Documentation Work

When considering the potential impact of EMU on existing documentation, an institution is faced with the decision of whether to attempt to examine individually each Master Agreement and Confirmation currently in place, to ensure that no difficulties arise in connection with the introduction of the euro or related events, or whether instead to review existing documentation on a more selective basis, in accordance with the institution's own prioritised list of perceived EMU issues.

In either case, to assist in conducting due diligence, some institutions have developed a "contractual filter", being essentially a list of key EMU-related issues of the type discussed above, in Section III.1 on the Legal Framework and below on the EMU Protocol in the form of a decision-tree.

In relation to ISDA documentation, such a filter might be construed by reference to the issues covered in the EMU Protocol, together, perhaps, with any additional

Figure 7

EMU and ISDA Documentation

ISDA publishes a wide range of standard form documents for use in documenting privately negotiated derivative transactions. These include:

- *Master Agreements* setting out the essential credit and other general terms governing the relationship between the parties. The master agreement typically governs all transactions between the parties and includes early termination and close-out netting provisions. The most widely used form is the 1992 ISDA Master Agreement (Multicurrency - Cross Border).
- *Booklets of Standard Definitions* for different types of transaction that may be entered into under an ISDA Master Agreement, including definitions booklets for interest rate and currency swap transactions, foreign exchange spot and forward transactions, currency options, equity derivatives, bond options, bullion trades, swaps and options and commodity derivatives. These booklets typically include short-form templates for use in preparing Confirmations for transactions of the relevant type. ISDA has also recently published a stand-alone long-form Confirmation for Credit Default Swap Transactions. This form will eventually be incorporated into a booklet of definitions for credit derivative transactions, including short-form templates.
- *Standard Form Credit Support Documents* for documenting collateral arrangements securing or supporting the obligations of the parties under an ISDA master agreement.
- *User's Guides* to the above publications and a number of miscellaneous additional standard form documents are available, all as detailed in the Guide to ISDA Publications 1998, available from ISDA's executive offices in New York and London.

ISDA continues to develop documentation for new products, such as energy derivatives and credit derivatives, as well as to update existing documentation.

[41] FLP Reports: See References

issues relating to equity derivatives or other matters. The contractual filter may be applied to all contracts or selectively to contracts thought to raise a higher risk of requiring amendment or other action as a result of EMU. The filter may be applied to distinguish and prioritise counterparty types. This decision, as noted above, will need to be made by each institution on the basis of its own assessment of the risks and the level of cost associated with the contemplated scope of due diligence.

Having conducted the internally agreed level of due diligence, the question arises as to what should be done next. In some cases, the most sensible course of action may be to close out an affected transaction, particularly where negotiating amendments would be difficult. This is, of course, a commercial decision that must be made on a case-by-case basis. More often, amendment of the relevant ISDA documentation will be indicated. In that case, the institution should strongly consider entering into the ISDA EMU Protocol[42], as this deals with many of the issues of most direct concern. Where a counterparty is not a party to the Protocol or the issue requiring contractual amendment is not covered by the Protocol, the parties will need to negotiate a bilateral amendment. ISDA is currently also developing standard form provisions to facilitate bilateral contractual amendment outside the Protocol on EMU-related issues.

2. EMU PROTOCOL

As outline above, the single currency will affect existing contractual arrangements and market participants may identify certain ways in which the terms of the affected contracts could be adapted in light of EMU. Specifically, in regard to derivative transactions and the ISDA Master Agreement, it has emerged that amendments to such current standardised derivative documentation may be desirable to eliminate any legal uncertainty. As outlined below, ISDA has devised some contractual provisions to facilitate the amendment of existing contracts and clarify contracting parties' intentions.

Standardised Language

In July 1997, ISDA published the EMU Continuity Provision[43] for use in existing and future ISDA Master Agreements. The clause was designed to enable parties to confirm in their ISDA Master Agreements that EMU will not give either party the unilateral right to walk away from, or modify the terms of, any transaction governed by that agreement. ISDA has also published, jointly with IPMA, an updated standard definition of the ECU[44] for use in derivatives contracts and the terms and conditions of securities. The update takes account of the European Council Regulation No. 1103/97[45] on certain provisions relating to the introduction of the euro, which came into force in 1997[46]. In addition, ISDA is developing contractual language to address changes to current national rate sources, payment netting, business day definitions and the definition of ECU Settlement Day.

EMU Protocol

Having recognised that there are a number of issues arising in light of the introduction of the euro, which could usefully be clarified for existing transactions, and having established standardised language to achieve this clarification, the question becomes one of how, practically, to implement this language. The individual negotiation and amendment of all outstanding deals would be very time consuming and expensive.

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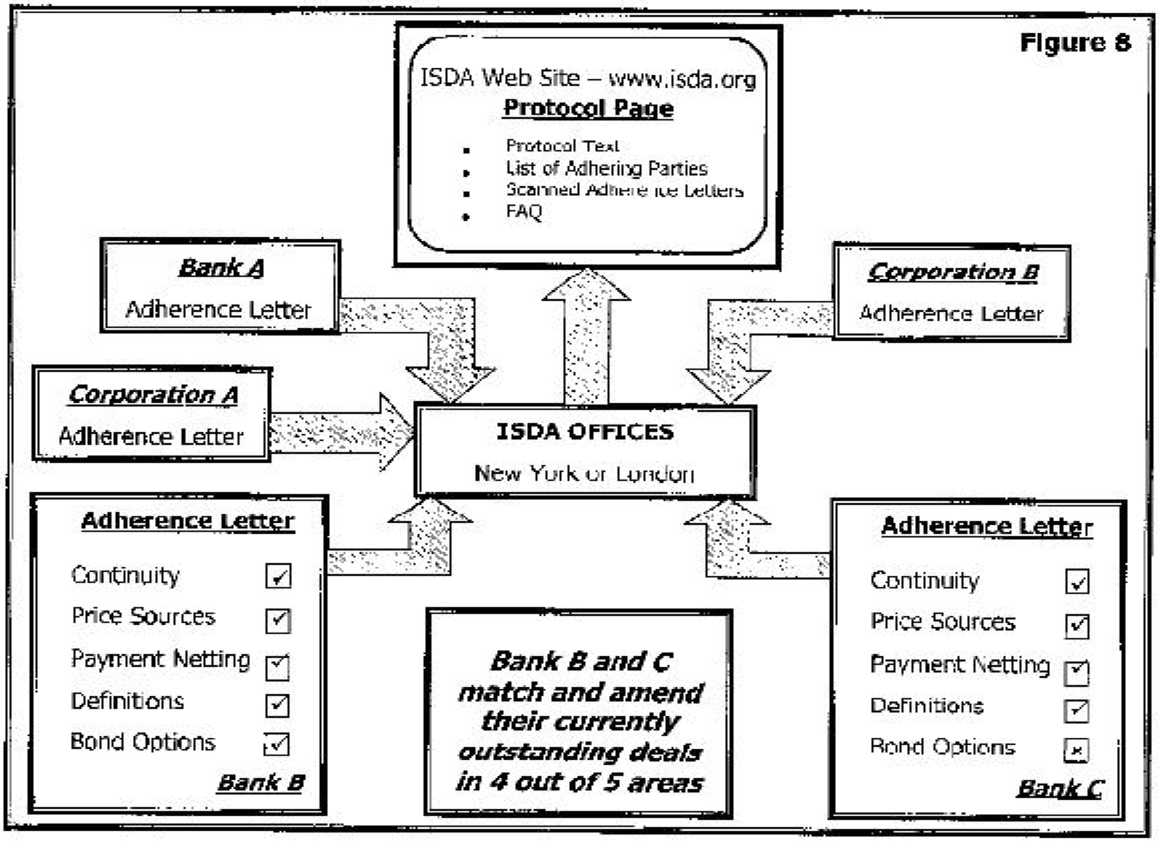
42 See Section III.3

43 ISDA Continuity Provision - 8 July 1997

44 ISDA/IPMA Joint Statement on the Legal Definition of the ECU - 10 March 1998

45 See Annex A

46 See Section III.1



ISDA is therefore sponsoring an innovative solution to this practical concern. A multilateral protocol has been developed which will enable individual institutions to agree amendments to their outstanding contracts. Participants will select from a list those provisions which they wish to adopt. Once two parties have made their selections and submitted an Adherence Letter to ISDA, any Master Agreement between them will be amended by the terms of their selected provisions to the extent that both parties have made matching elections. Adherence to the Protocol therefore enables amendment of existing contracts between all adhering parties without the need for individually negotiated bilateral amendment agreements. This, in turn, represents dramatic savings in terms of manpower and resources. As a result, outstanding contracts will be affected as soon as both counterparties to a specific contract make the same election in their 'Adherence Letter' (see Figure 8).

The EMU Protocol will consequently greatly reduce the cost of amending outstanding deals in areas where there is broad market consensus that changes would be useful.

Protocol Adherence

Interested parties can access ISDA's web site and obtain the EMU Protocol from there. Attached to the document is the Adherence Letter, which only needs to be completed and delivered to one of ISDA's offices in order to facilitate adherence to the EMU Protocol. ISDA will then post a conformed copy of that Adherence Letter on its web site and parties can follow up on which parties have in fact adhered, as well as the actual amendments affected. The Adherence Letter will furthermore specify contact details of a nominated person who will be able to provide any signed copies or additional information that should be required in regard to their own institution.

ISDA EMU PROTOCOL
Frequently Asked Questions[47]

Introduction and Overview of Protocol

Why is the USDA EMU Protocol necessary?

The introduction of the euro raises certain issues in relation to derivatives transactions entered into under ISDA Master Agreements, where the transaction was agreed before the start of the third stage of EMU but continues after 1 January 1999. There is a strong market consensus that simple amendments to the terms of these transactions would help to eliminate any remaining uncertainty. Through ISDA's EMU Documentation Task Force standardised amendments have been drafted. These are as follows:

- Confirmation of continuity of contract
- Confirmation of applicable successor price sources
- Clarification of payment netting between participating currencies
- New and amended definitions for Euro, ECU, ECU Settlement Day, Business Day and Banking Day
- Allowance for adjustment to bond options in the light of redenomination of underlying bonds

However, to amend all affected contracts to incorporate these standard amendments would be extremely time consuming and expensive if undertaken through bilateral negotiation between all counterparties. ISDA is therefore sponsoring a multilateral amendment mechanism – the ISDA EMU Protocol.

How does the ISDA EMU Protocol work?

The Protocol reflects an innovative procedure which allows for the amendment of ISDA Master Agreements in light of the introduction of the euro. It builds on the simple principle that parties to such agreements may make an offer to one ore more of their counterparties to amend any outstanding agreements that are affected by EMU.

A bank, corporation or other derivative user would indicate its participation in the Protocol arrangement by sending an adherence letter (a signed original, together with a conformed copy) to ISDA's office in London or New York. This allows the firm to specify which of five standardised amendments it wishes to make with other Protocol adherents. By submitting the adherence letter, the firm agrees that each outstanding Master Agreement is amended in all areas where an election made in its adherence letter matches that made in an adherence letter submitted by one of its counterparties. The amendment and adherence process, among other matters, is set out in the Protocol itself, which is published on the Association's web site, along with a form of the adherence letter.

Names of adhering parties are listed on ISDA's web site, where there is access to scanned copies of adherence letters. For security reasons only the conformed copies of adherence letters will be displayed. Protocol adherents therefore simply monitor the web site to determine which of their counterparties have adhered and to check for matching elections.

The Protocol will be open for adherence between 6 May and 30 September 1998. This allows three months before the start of Stage 3 of EMU for any follow-up documentation and operations work.

Protocol adherents may elect some or all of the standardised amendments, may send subsequent adherence letters covering new amendments and may specify a cut off date in respect of their own adherence. Protocol adherents may not revoke agreement with matches once they are made and may not vary the standardised clauses (except of course through direct bilateral negotiation and agreement).

Whom is the ISDA EMU Protocol designed for?

The Protocol is designed for all types of users of derivatives: banks, corporations, governments, investment firms, insurance companies, pension funds and other firms with derivatives contracts documented using ISDA documentation that may be affected by EMU. The Protocol saves your firm money by cutting down on the cost and time involved in negotiating and agreeing contractual changes bilaterally with all your counterparties. It provides an easy way to monitor changes through the web site. It reflects market consensus on standardised changes to ISDA documentation in light of EMU.

[47] Please note that FAQ will be updated over time; see ISDA's web site for most recent FAQ

Does the Protocol address all my firm's EMU documentation concerns?

No! Use of the Protocol is designed to be used as part of an overall legal and documentation EMU changeover plan. For example, firms still need to monitor adherence, match adherence letters, satisfy themselves as to signing authority, and negotiate with partly matched and non-adhering counterparties where necessary. However, even with these steps and procedures, the Protocol provides for significant cost savings over bilateral negotiation.

Protocol Mechanics

Why is there a limited adherence period for the Protocol?

The adherence period ends on 30 September to allow time to make the systems changes following from the amendment of agreements and to negotiate and agree changes bilaterally with any non-adherents or partial matches.

Are all my ISDA transactions covered by the Protocol?

All outstanding transactions governed by any ISDA Master Agreement between two adherents will be amended to the extent adherence letters match and to the extent that the matched amendments apply to those transactions.

Can only English and New York law contracts be covered by the Protocol?

No. The Protocol is intended to cover ISDA Master Agreements, regardless of the governing law of the agreement.

Can my firm modify the wording of the Protocol or the substantive clauses?

No. Any changes to the standardised wording set out in the Protocol or to the standard form adherence letter will be considered invalid. (Counterparties can, of course, negotiate and agree any changes bilaterally outside the scope of the Protocol. The Protocol in no way inhibits this freedom of contract.)

Does my firm have to accept all of the Protocol provisions?

While it is expected that most adherents will opt for all five of the standardised amendments, firms do not have to accept them all and the adherence letter allows adherents to elect one or more of the amendments. A decision not to elect one or more of the standardised amendments should not be understood to constitute a rejection of the principles embodies in those amendments. Such a decision may be based on an assessment that existing statute or other law is sufficient.

Does participating in the Protocol create any "negative inferences"?

The Protocol is designed to amend existing contracts and in a number of cases merely confirms the position under the contract. No negative inferences should be drawn from the fact that other contracts do not include such provisions. A decision to elect a particular amendment should not be understood to suggest that the position at law would otherwise give rise to a different result. It may be that parties have chosen to deal with the issue within the four corners of their contracts.

Can my firm revoke its participation in the Protocol?

Once an adherence letter has been accepted by ISDA, a firm is bound by all amendments elected by way of the matching procedure with counterparties which have already adhered to the Protocol or which adhere before the end of the Protocol adherence period, 30 September.

However, a firm may send a further notice to ISDA, specifying an earlier cut-off date in respect of their own adherence. The effect of such a letter will be to withdraw adherence as of the future date specified. Although amendments already made will not be revoked, any subsequent adherence by one of the firm's counterparties will be ineffective in respect of an ISDA Master Agreement between them.

Is ISDA providing accompanying legal opinions on the Protocol?

ISDA's London and New York counsel have prepared legal memoranda on the effectiveness of the Protocol arrangement under English and New York law. Other local ISDA member groups are discussing local law enforceability.

How can I check the signing authority of other Protocol adherents?

For security reasons, adherence letters on the ISDA web site will have signatures conformed into type and signing authority information will not be displayed. Any supporting documents delivered to ISDA will not be made available (except in special cases). However, should firms wish to take steps to ascertain signing authority, the posted adherence letter will include a contact name and details.

Can my firm get copies of supporting documents or hard copies of adherence letters?

Should firms wish to obtain hard copies, each adherence letter posted on ISDA's web site will include a contact name and details of the person who can send them these documents. In special circumstances only (e.g., litigation), ISDA can provide certified copies of the documents held.

Will the Protocol affect any credit support agreements?

The Protocol is designed to leave credit support agreements unaffected. Parties should, of course, consider this issue when adhering to the protocol and take any additional steps considered necessary.

Protocol Provisions

What changes will the Protocol make to my ISDA contract and transactions?

The Protocol only amends existing contracts by way of the standardised provisions where adherence letters match. The five possible areas of amendment are:

- Confirmation of continuity of contract
- Confirmation of applicable successor price sources
- Clarification of payment netting between participating currencies
- New and amended definitions for Euro, ECU, ECU Settlement Day, Business Day and Banking Day
- Allowance for adjustment to bond options in the light of redenomination of underlying bonds

Is the continuity language necessary?

While continuity of contract legislation has been adopted in the EU and some other jurisdictions (including New York), the continuity provision:

- Clarifies the position for other jurisdictions
- Confirms the provisions of EU and New York law
- Deals with continuity within the four corners of the contract

What will happen to the reference rates in a derivatives contract if Annex 2 is elected?

The price sources provision of the Protocol is designed to address cases where national currency reference rates disappear or change.

In a number of cases, domestic rates for participating currencies are due to disappear and be replaced by a euro rate for the whole euro zone: Euribor. The rates switching over to Euribor include French Franc Pibor and Deutsche Mark Fibor. Also, overnight effective rates, such as French Franc TAM, will be replaced by the euro overnight rate, EONIA. (BBA Libor rates will continue to be published for national currencies, but will be the same as Euro Libor.)

The price sources provision of the Protocol is designed to prevent any confusion over the switch to successor rates and to avoid over-reliance on reference banks. It therefore confirms that contracts should continue to function in the case of changing price sources by:

- Using the new rate appearing on the existing screen page in place of the old rate
- If not present, using the officially designated successor rate
- If not designated, using the Euribor screen page
- If not available, using reference banks
- The provision also clarifies that existing day count conventions and fixing periods shall continue to apply

The clause in no way constrains or limits any firm with regard to choice of price source for new euro deals: ISDA will provide separate definitions for both Euribor (the domestic euro rate) and euro Libor (an offshore rate) for firms to employ as they wish.

Details on changing and disappearing price sources may be found in Annexes E & F.

What changes are made concerning payment netting?

Without the amending language proposed, the current wording of Section 2(c) of the ISDA Master Agreement is expected to require netting of payments in participating currency units which were not the same currency prior to the introduction of the euro. As the market consensus is that back offices will not be ready for such payment netting between participating currency units, the amendment overrides payment netting in this limited case.

What changes are made to ISDA definitions for legacy deals?

The Protocol introduces a definition of the euro and makes standard changes to the definitions of ECU, ECU Settlement Day, Business Day and Banking Day as they are used in certain ISDA definitional booklets.

What changes are made for bond options?

In cases where a bond is redenominated into euro, the economic value of a bond option may be affected due to changes in conventions or renominalisation of principal amounts. This may require changes to strike prices or cash payments. The standard amendment under the Protocol empowers calculation agents to make necessary adjustments.

ISDA's Role and How to Participate

What is ISDA's role in the Protocol?

ISDA acts as an agent for participating firms. It will receive adherence letters, update the web site and scan conformed adherence letters. The Association also publishes the Protocol and provides information about the arrangement.

How can my firm participate in the ISDA Protocol?

Firms can participate by downloading all necessary information from the ISDA web site and then submitting an adherence letter, as well as a conformed copy of that adherence letter, to either ISDA's London or New York office.

Are parties required to provide evidence of authority to ISDA?

No. Parties can provide evidence of authority to ISDA if they choose, but are not required to do so.

What will ISDA do with evidence of authority submitted to it?

ISDA will hold any evidence of authority in its files for safekeeping. Copies of this evidence of authority will only be provided in special circumstances, such as litigation. Parties are encouraged to contact their counterparties directly if they require such evidence for their files. Each adhering party will provide in their adherence letter details of a person to contact regarding such information.

How much does the Protocol cost?

There is a flat charge of $500 for adherence. Each legal entity requires a separate adherence letter and separate payment.

How can I get a copy of the ISDA EMU Protocol?

Copies of the Protocol, the adherence letter and information about ISDA's role and other aspects of the Protocol are available from ISDA's web site, www.isda.org.

Section IV

ACCOUNTING, TAX AND CAPITAL

1. TAX AND ACCOUNTING

ISDA has taken an active role in addressing the tax and accounting implications of EMU. The focus of effort has been on ensuring that tax or accounting changes do not adversely affect outstanding derivatives contracts. The basic principle of continuity should, as far as possible, apply to tax and accounting treatment and ensure that there are no additional costs in the changeover to the euro. Underlying our representations with EU and other officials has been an emphasis on the importance of not disturbing hedging arrangements and not assuming that all cross-currency and rate agreements between participating currencies will be closed out. These instruments should not be recharacterised for tax or accounting purposes.

Guidelines for accounting for the euro have been published by the European Commission[48] and reflect in part the results of consultation with ISDA. These guidelines are summarised below. Also, the International Accounting Standards Committee is due to publish high-level guidelines for accounting for the euro.[49] These provide a good overview of the key accounting issues posed by the introduction of the euro. However, these are not binding on national accounting standard-setters or individual firms. Therefore firms should analyse the local accounting and tax regime carefully. Following consultation between the UK Inland Revenue and ISDA and other market bodies, initial guidance on UK tax issues has been published. This is reproduced in Annex J and is summarised below.

48 DG XV: 'Accounting for the introduction of the euro' - July 1997; available from DG XV's web site: http://europa.eu.int/en/comm/dg15/gd15home.html

49 IASC: 'Draft Interpretation SIC – D7, Introduction of the Euro' - October 97

European Commission Accounting Guidance

In July 1997, Directorate General XV of the European Commission published guidance on the accounting impact of the euro. This guidance is not binding on member states and therefore national accounting standards will prevail in case of differences. However, the guidance was developed in consultation with member state accounting representatives and provides a good overview of the impact of the euro on accounting arrangements.

The key elements of the guidance areas are as follows:

- No need for new EU legislation
- National legislation should be able to adapt to euro
- All accounts in participating currencies for period ending 31.12.1998 should be converted into euro at fixed conversion rate
- Guidance provided for translation of foreign currency assets and liabilities and of consolidation of financial statements of foreign subsidiaries.
- Concerning cross-currency foreign exchange positions and hedges:
  - Positions should normally be marked to market to reflect fixing of exchange rates
  - However,
    "Deferred recognition of exchange results in the profit and loss account may be appropriate when this leads to better matching of income and expenses." (Para 65 of DG XV paper); and
    "The exchange differences on... anticipatory hedges must be deferred when this leads to better matching of income and expense items." (Para 73c of DG XV paper)
- Also, member states may reserve a right to defer recognition of losses in order to alleviate the burden of recognition in particular cases

Statement by Inland Revenue

The basic issues to consider, in light of tax treatment, are ensuring certainty, as well as continuity of such treatment following the introduction of the euro, in accordance with the general principles followed on practical issues to date. Following concern raised by members, ISDA's EMU Accounting, Tax and Capital Task Force finalised a paper in July 1997[50], seeking to identify UK tax issues arising as a result of EMU.

The paper was prepared by the task force which also included representatives of the London Investment Banking Association, the British Bankers' Association, the International Primary Market Association, the International Securities Market Association and the American Banks and Securities Houses Association in London and was subsequently presented to the Inland Revenue for discussion. ISDA is very grateful for the co-operation of the associations and, in particular, to Deborah Chesworth of LIBA.

A number of specific issues were identified and discussed in depth with the Revenue and subsequently, ISDA's Task Force submitted two further papers to the Inland Revenue[51]. As a result, in January of 1998, the Inland Revenue published a question & answer paper[52] on EMU related issues. Even though the discussions continue and further matters need to be addressed, it is extremely helpful that some uncertainties have been resolved at this stage. It is to be expected that in due course other countries will also address the issues relevant to them.

The Inland Revenue guidance is attached as Annex J and covers the following points:

- Scope for and implications of euro local currency election
- Implications for anti-avoidance legislation
- Implications of redenomination
- That contracts involving two participating currencies continue to be treated as "currency contracts"

Consultations are continuing on legislation designed to ensure the basic principle that tax treatment follows accounting treatment. Legislation under consideration would:

- Allow for calculation of tax liabilities in euro
- Ensure bond redenomination does not normally give rise to a tax charge
- Ensure continuity in tax treatment of currency contracts

ISDA is ready to discuss tax issues in other jurisdictions at the request of members.

2. RISK MANAGEMENT AND CAPITAL ADEQUACY

The transition to the single currency requires changes to banks' risk management framework, and itself poses legal, operational and other risk that have to be managed during the changeover.

Market Risk

The fixing of exchange rates and establishment of euro-zone wide co-ordinated monetary policy and uniform interest rates will clearly affect the market risk profile of financial institutions. Most obviously, foreign exchange risk will no longer arise between "in" currencies.[53]

[50] ISDA Position Paper - 4 July 1997

[51] The first paper focuses on the effect of the conversion to euro on bonds and the second paper outlines the issues that have subsequently been agreed with the Revenue, i.e. specific questions and answers in regard to the impact of Foreign Exchange Legislation and Financial Instruments Legislation

[52] See Annex J

[53] This analysis is based on the assumption that EMU will be durable for participating currencies, in light of the legal commitment of

Also, common short-term interest rates and the convergence of government bond spreads will allow analysis of a common euro yield curve[54], and a common general interest rate risk profile for euro denominated interest rate instruments. However, credit spread differences between governments will still continue.[55]

While all equity trading within the euro zone is expected to move to the single currency, national market characteristics will continue to persist and national indices are to be retained. Thus, analysis of equity position risk is unlikely to change in the short term. However, pan-European benchmark indices are already emerging and the euro does have a longer-term potential to allow closer integration of national exchanges.[56] Also, fixing of rates will provide greater opportunities for diversification of equity portfolios into other euro zone national markets without becoming exposed to foreign exchange risk.

The transition to the euro poses difficulties for market risk management techniques based on historic data: any Value-at-Risk models (or indeed other models requiring historic euro data) will not have available the necessary euro forex or interest rate volatility information. For supervisory purposes, for example, one year of historic data is required, raising an issue as to the data to be used for calculating euro exposure VAR for regulatory capital during 1999. Market discussions have shown no consensus on a single approach and a strong desire for individual firms to be able to develop bespoke solutions to the data problem. However, typical approaches include (a) using DM (or some other national currency) data; (b) using ECU data; (c) using re-weighted ECU data, after eliminating "out" currencies and (d) creating an individually tailored weighting of participating currencies. Different screen service providers plan to offer different solutions. It seems clear that any approach may have to be adapted over time (and that problems might be limited through weighting of data in models).

Firms are also exposed to potential market risk in case an anticipated country fails to qualify for EMU. Stress testing techniques have been employed by some to assess the impact of such an outcome.[57] Some firms may also employ stress testing and monitor legacy currency positions to protect against "break-up" risk.

Credit Risk

The advent of the single currency also has implications for the credit risk profile of a financial institution. This is clearest in relation to the government bond market. The leading rating agencies have announced that EMU will mean a change to their standards for credit ratings of participating governments.[58] Also, the establishment of common euro-zone interest rates (and the agreement on common bond market conventions) means that credit spreads will principally determine differences between euro-zone government bond yields.[59]

The start of EMU will not in and of itself affect the credit risk profile of private names. However, the economic changes unleashed by EMU clearly have credit risk implications which require assessment and the changes to the rating framework for the euro will now mean that private names could be rated higher than their national government.

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the Maastricht Treaty and euro regulations, the political commitment of the participating governments and the economic convergence of participating economies. This approach also underpins supervisors' capital adequacy policies

54 However, please see the discussion of benchmark bond issues above

55 See discussion of credit risk below

56 See Section II.4 on equity markets

57 See 'Stress testing for EMU' by Shelley Cooper, CSFP - 12 September 97

58 For summary of the IBCA, Moody's and S&P approaches see Bank of England - PIQ No 7

59 See Section II.2 on bond markets

Given the elimination of certain aspects of market risk between "in" currencies, it is anticipated that firms will wish to close out transactions which become economically redundant in order to free up credit lines. However, there should be no presumption that counterparties will always want to pursue this choice.[60]

Credit mitigation techniques, such as netting and collateral, can clearly continue to be applied following EMU. However, the nature of collateral employed may be affected (e.g., due to redenomination or a change in credit rating). Also, note the proposed regulatory capital treatment of netting below.

Legal and Operational Risk

The transition to euro in and of itself presents legal and operational risks. For example, documentation for outstanding transactions may need to be adjusted or key front, back or middle office systems preparations may not be ready in time. This may lead to litigation, trade failures, lost business opportunities and damage to a firm's reputation.

This guide is designed to help firms address these concerns, by providing an overview of the back office changes required for EMU and describing the tools ISDA is providing to address legal risk.

Capital Adequacy Regulation

The above changes to the risk profile faced by financial institutions have been reflected in the capital adequacy rules for EMU agreed by supervisors. This is set out in guidance agreed by member states and published by the Commission,[61] which have in turn been adopted by national authorities.[62]

These rules specify that foreign exchange risk capital charges will no longer apply between participating currencies. Also, positions in all euro debt instruments and derivatives may be included within a single general interest rate risk maturity or duration ladder when calculating capital charges, therefore allowing greater scope for offsets. The supervisory guidance also notes the implications for VAR models used for capital purposes, in light of the problem of euro data. This places the onus on each firm to propose a reasonable solution to its supervisor.

The supervisory guidance also requires that derivatives involving two "in" national currencies or two rates that collapse to one should be treated as cash positions. Risk weightings must therefore be changed and netting disregarded within five years. ISDA strongly objects to this approach, as it disregards the continuing enforceability of netting, is inconsistent with existing capital rules where derivatives exposure is fixed and is at odds with the principle of continuity. At the time of going to print, European authorities were reconsidering this point at our request.

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[60] See Section V - ISDA's Operations Guidance paper

[61] DG XV: 'Implications of the Introduction of the Single Currency for Community banking Legislation' – October 1997

[62] SFA: (BN443) 'The Introduction of the Euro - Rule Guidance' – October 1997 & Bank of England: 'The Impact of the Euro on the Capital Adequacy Framework' – October 1997

Section V

OPERATIONS

OPERATIONS ISSUES FOR DERIVATIVE BUSSINESSES

1. INTRODUCTION

This section[63] is based on deliberations of ISDA's EMU Operations Task Force and is designed to give general guidance on the operations issues posed for derivative businesses by the introduction of the single currency. It sets out some of the key practical operational issues that are faced, where relevant describes the consensus within the Task Force concerning the optimal approach to the changeover in these areas and in some instances identifies important areas where work needs to be progressed by other public or market bodies.

It is important to stress that this is not designed as best practice guidance, as each market player will have its own individual EMU changeover plan that reflects its own particular business. Also, this memorandum focuses as much as possible on operations issues for derivative businesses only. While a number of subjects touch upon payment systems and the changeover in the cash markets are addressed, market players clearly need to have in place an integrated changeover plan which covers all business areas. In addition, it should be noted, that as new issues arise, the guidance provided here may need to be adapted or expanded.

It is hoped that ISDA members and other market players will find this memorandum a useful reference for assessing the comprehensiveness of their own changeover plans for their derivative business and for setting out the consensus that has been established by the most active participants concerning the approach to be taken in a number of these areas. The Task Force recommends that all interbank participants and end-users are treated alike and that these guidelines are applied equally.

This memorandum first of all analyses the impact of the euro on interest rate products, considering the following five situations:

A. "Euro Deals" - Transactions dealt <u>after</u> the start of Stage 3 of EMU

B. "Transitional Legacy Deals" - Outstanding transactions in "in" national currency denominations at the start of Stage 3 of EMU, but maturing <u>before</u> the end of the transition period

C. "Long-Term Legacy Deals" - Outstanding transactions in "in" national currency denominations at the start of Stage 3 of EMU, but maturing <u>after</u> the end of the transition period

D. "Legacy ECU Deals" – Transactions denominated in ECU at the start of Stage 3 of EMU

E. "Forward Euro Deals" – Transaction explicitly in euro entered into <u>before</u> the start of Stage 3 of EMU

The second part of this report then covers non-rate products: bond options (and issues posed for asset swaps), equity derivatives and foreign exchange derivatives. This section only considers the euro-related issues particular to these products: unless otherwise stated, the basic principles discussed for interest rate products would also apply. Finally, the last part of the report draws together the main tasks to be completed over the conversion weekend for derivatives businesses.

[63] This section has been published previously as a separate paper on ISDA's web site

2. INTEREST RATE PRODUCTS AND BASIC PRINCIPLES

A. "Euro Deals" – Transactions dealt after the start of Stage 3 of EMU.

Expected market practice

ISDA members expect that all transactions dealt in the interbank market after the start of Stage 3 of EMU will be traded in the euro unit. New transactions executed with corporates are expected to be increasingly denominated in the euro unit from very early in the transition period. However, new transactions with smaller corporates and retail counterparties may continue to be traded in a national currency unit denomination until much later in the transition period as they may take longer to changeover.

Market conventions

New market conventions for the euro will apply to all new transactions denominated in the euro unit. The Task Force notes the agreement of market associations to the joint statement published by ISDA and other market associations on market conventions for the euro bond, money market, foreign exchange and related derivatives markets. These new market conventions are now fully expected to be adopted in each market and are intended to apply to all new transactions in euro after the start of EMU. The Task Force notes the need to ensure that systems are put in place to provide for processing

Figure 9

Conventions for the money markets

Day Count Basis: Actual / 360
Settlement Basis: Spot = two days standard
Fixing Period for Derivatives Contracts: Two day rate fixing convention
Business Days: Target operating days are basis for euro business days

Conventions for the bond markets

Day Count Basis: Actual / actual
Quotation Basis: Decimals for bond quotation
Settlement Days: Trade date plus 3
Business Days: Target operating days are basis for euro business days

Conventions for the foreign exchange markets

Settlement Basis: Spot = two days standard
Quotation: Certain for uncertain (e.g., 1 euro = x foreign currency)

Conventions for swaps

Floating Side: Money market convention
Fixed Side: Bond market convention (with semi-annual payment)

Please note that as the joint statement of market associations did not agree on the need for the bond payment basis to be semi-annual, OTC agreements might need to vary in this respect and counterpaties will have to ensure that no mismatch occurs in regard to the underlying bond.

derivatives transactions subject to these new conventions, outlined in Figure 9.

Price sources[64]

The reference rates for euro denominated transactions are expected to be either

(i) Euro-Libor; or
(ii) Euribor

There will also be an overnight effective rate for the euro: EONIA. We also note that some local currency reference rates of “in” currencies may continue to be provided after the start of EMU.

The British Bankers Association has already expressed its intention to provide a euro Libor (EUR-LIBOR-BBA) quotation based upon a similar method of quotation, calculation and reference panel to those Libor rates currently calculated by it and published by a range of designated screen providers. Also, the ACI and the EBF have announced their intention to calculate a Euribor reference rate based upon quotations for relevant maturities received from a reference panel of up to 58 banks in the euro-zone plus up to 6 international market makers. The ACI and EBF will be the principal sponsors of an overnight rate for the euro, based on calculations provided by the ECB.[65]

Settlement of euro denominated transactions

Transactions denominated in the euro unit are most likely to be received in a nostro account denominated in euro (or sent directly via EBA clearing or TARGET rather than employing a correspondent bank; individual firms will, of course, decide which payment mechanism is most appropriate). This may be an existing nostro account which has been converted to euro by the party and its correspondent, or a new nostro account set up by the party with a correspondent specifically for the euro. It would be helpful if firms could advise their counterparties of the nostro accounts where they wish to receive euro as early as possible and by the end September 1998 at latest.

It should be noted that in some cases counterparties may continue to employ national currency denomination nostro accounts for receipt of payments on euro deals during the transitional period, given the ability to convert between euro and national currency units under Article 8(3) of the Article 109 l(4) Regulation[66]. However, this is likely to be rare and the Task Force recommends that all major market players avoid this approach.

Yield curve and revaluation of euro denominated transactions

The euro will require new yield curves to be created within each firm in order to price and revalue its euro-denominated positions. The exact rates and prices will be determined individually by each institution according to its own policies. However, again, clarity regarding the publication of euro rates, prices etc. is required well before 1999 so that firms have sufficient lead time to adjust their systems.

Operational actions required

The Task Force has identified the following tasks where firms may need to take action prior to the start of Stage 3 of EMU: (N.B. list is not exhaustive)

- Set up the new euro currency in their systems
- Set up all associated static data on their systems
- Set up holiday calendars for the euro in their systems
- Determine the firm's standard settlement instructions for the euro
- Determine the firm's cash and nostro management policy for the euro (including implications of increased number of business days)

[64] See Annex E & F

[65] See Annex G & H for more details on these initiatives

[66] See Section III & Annex A

- Ensure that a euro nostro account has been opened (or converted from an existing "in" currency nostro by its correspondent)
- Advise all counterparties of the euro nostro account to enable their counterparties to set up standard settlement instructions
- Set up new standard settlement instructions in their systems for both their own and their counterparties euro nostro accounts
- Agree appropriate yield curve and revaluation methodology
- Ensure that all systems can pick up the correct euro rates from the price sources in order to feed them into their various applications
- Ensure that their (automated) yield curve generators and revaluation programmes pick up the correct curves (and historic curves where applicable)
- Ensure that their payment mechanisms recognise the euro and route their payments in the manner determined by that firm
- Ensure that their credit and risk management and control systems deal with the euro appropriately (and for offices in "in" countries, calculate and report risks in euro)
- Ensure the currency is set up in the general ledger and other accounting, management information and reporting applications
- Ensure that appropriate accounting and reporting controls are set up to include the euro as a separate currency
- Ensure all statutory and regulatory reporting has been set up and is working effectively
- Provide training and information to staff and customers
- Determine human resources and legal implications of changes to business days
- Determine systems implications of overnight batch runs on national bank holidays

B. "Transitional Legacy Deals" – Outstanding transactions in "in" national currency denominations at the start of Stage 3 of EMU, but maturing before the end of the transitional period

A different set of challenges present themselves when considering how to deal with existing transactions which were traded before the start of Stage 3 of EMU in "in" national currency denominations. For example, one of the key issues is how do parties record and treat the transaction following the introduction of the euro. Does its introduction automatically change the way the transaction settles, is valued, should it be accounted for differently and does EMU fundamentally change the economic content of the transaction?

The EU Regulations on the introduction of the euro[67] should be noted when considering these operational issues. Generally speaking, the key provisions to note are as follows:

- Contracts are to continue regardless of the impact of the euro (Article 3 of Article 235 Regulation)
- Rounding rules are set out (Article 5 of the Article 235 Regulation)
- During the transitional period, the "no prohibition, no compulsion principle" applies: contracts continue to be performed in national currencies unless agreed otherwise by the parties (Articles 8(1) and 8(2) of the Article 109 l(4) Regulation)
- As an exception to this rule, there is an obligation for banks to convert incoming payments between the euro and the local national currency of the country where the account is located (Article 8(3) of the Article 109 l(4) Regulation)
- As another exception, bonds may be redenominated into euro under certain circumstances; this redenomination

[67] See Annex A

exception does not extend to derivatives (Article 8(4) of Article 109 l(4) Regulation)

- As a further exception, exchanges and systems for clearing, securities settlement and payment may change the unit of account of their operating procedures to euro (art 8(4) of Article 109 l(4) Regulation)
- At the end of the transitional period, national currency references in contracts "shall be read as references to the euro unit according to the respective conversion rates" and subject to rounding rules (Article 14 of the Article 109 l(4) Regulation)

In light of this legal framework, a consensus has formed within the Task Force and the following practices are expected to be adopted.

Expected market practice

The Regulations show that there is no intention to force counterparties in any way into a mass redenomination of their existing portfolio of derivative transactions. Instead, the "no compulsion, no prohibition principle" principle would apply.[68] Thus, the Task Force considers that parties will at the beginning of Stage 3, as a general principle, continue to record derivative transactions in the original national currency denomination together with all original terms and conditions, i.e. the same way as transactions had been booked prior to the start of Stage 3 of EMU.[69]

So, for clarity, the Task Force expects that DEM transactions would continue to be held in a firm's systems as a DEM transaction, settling on DEM-LIBOR-BBA, paying on Frankfurt business days on an actual / 360 basis with the floating rates fixing two days prior to the reset date, and importantly, that settlements under that transaction will be made to the accounts specified in the original transaction confirmation (or as subsequently amended) i.e., usually a bank in Germany[70].

However, while the nominal amount of the derivatives contract will remain unchanged and the key terms of the contract will also be unaltered, it is likely that in some cases certain elements of the contract will have to be changed. For example, changes may be necessary where the underlying price source disappeared and is replaced by another one, or, in the case of equity and bond derivatives, to adjust the strike price where the underlying asset is redenominated[71].

While there is no obligation to redenominate derivatives contracts under the euro Regulations and, as noted above, the Task Force expects that market participants will generally maintain references to existing currencies, parties of course still have the option to redenominate and some may wish to do so in some circumstances. In this respect it is important to be clear concerning the meaning of redenomination[72]: changes to the settlement instructions to specify use of euro are a separate matter discussed below. Redenomination would (under Article 8(2) of the Article 109 l(4) Regulation) require the consent of both parties and the Task Force recommends that sufficient notice be given of any such intention to redenominate. In that case, the redenomination will only apply to the notional amount of the contract and to the denomination of payments. All the other parameters of the transaction will remain the same: day-count fractions, calendar used, payments schedule, etc. Instead of

[68] See Annex A

[69] Indeed, redenomination into euro would not be permitted for derivatives without the express agreement of both parties. See also the discussion of front office and risk management systems below

[70] However, see the discussion of front office and risk management systems below which states that firms may effectively "redenominate" for internal purposes

[71] See below

[72] See Glossary for definitions of redenomination and related terms

exchanging a full confirmation after this redenomination, counterparties should exchange a more straightforward document. This document could take the form of the "audit-document" sent at the end of the year for audit and reconciliation purposes. The Task Force notes that there are no legal reasons requiring redenomination of existing transactions.

Market conventions

The joint statement on market conventions, in addition to the recommendations described above, also recommended that existing conventions apply to all legacy instruments entered into before the introduction of the euro.

This has particular implications for existing contracts which switch to new price sources, if the conventions applicable to the new price source differ from the existing conventions which are to be retained. For example, BEF money markets currently operate on an actual / 365F convention, while the new euro convention for money markets will be actual / 360. In these cases, it is anticipated that price sponsors and screen service providers will also provide euro quotations using existing conventions. However, firms will need to take care that systems do indeed refer to these price sources and not to the euro denominated quotations based on the new conventions.

A further example arises with regard to fixing periods: while FRF-PIBOR-AFB will be succeeded by euro Euribor, the former employs a one day fixing period and the latter a two day fixing period. This has led to some debate as to whether or not fixing periods should be adjusted for such transactions. However, the Association Française des Banques has recommended[73] (in keeping with the principle of retaining existing conventions for legacy trades set out in the joint statement on market conventions) that the one day fixing period should continue to apply for legacy trade, even when employing the new Euribor fixing. ISDA's EMU Operations Task Force has also considered this point and concurs with the AFB recommendation. The Task Force advises that firms take care to ensure that systems are adjusted to pick up correct rate resets appropriately, distinguishing between legacy Pibor transactions, using Euribor for one day fixing, and new Euribor deals, using two day fixing.

Similarly, business days for settlement and rate fixing of a euro transaction (Target operating days) will be different to those of an existing transaction, i.e. national holidays. This could cause the economics of a transaction to change and could result in a transaction and its hedge to diverge, unless both continue on the same basis. However, there may be confusion as to exactly what are national business days for purposes of transactions documented using the 1991 ISDA Definitions if, for example, a national RTGS system is open, but there is a national holiday upon which some or all banks are closed. The consensus of the EMU Operations Task Force is that, in line with the joint statement on market conventions, existing national business day conventions should be retained for legacy transactions in spite of any change to national settlement arrangements. ISDA is sponsoring an amending clause under the EMU Protocol[74] which achieves this[75].

These considerations apply equally to other conventions, and would also apply to legacy transactions redenominated into euro. So, the Task Force recommends that existing transactions should remain unaltered in each firm's records and should continue to be settled as before.

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[73] See AFB communique: Les modalités de passage de l'indice Pibor-AFB à l'indice Euribor

[74] ISDA's EMU Protocol is designed to allow counterparties to multilaterally agree to amend their existing ISDA Master Agreements, by electing the clauses specified in the Protocol (see Section III.3, further details are available directly on ISDA's web site, www.isda.org)

[75] Also, ISDA is working on standard definitions of euro business days and other terms

Price sources[76]

EMU raises the prospect that some national currency price sources will disappear outright or be replaced by a successor rate. This possibility has important potential business and legal implications and the picture is still not clear as to the exact price sources that will be affected by the changeover to the euro, how this will be effected, the details of the likely successor rate and the legal ramifications of the changeover.

Once these issues are clarified and the institution has satisfied itself concerning the position regarding its own trades, the changeover has significant operations and systems implications. The EMU Operations Task Force has identified the following key tasks that will need to be performed[77]:

- Set up the new reference rates and price sources in their systems
- Agree and set up appropriate yield curve and revaluation methodology and price sources
- Ensure that all (automated and manual) reference rate collation / feeds, yield curve generators and revaluation programmes pick up the appropriate rates / prices / curves in order to feed them into their various applications
- Immobilise old reference rates which should no longer be used for future transactions
- Provide training and information to staff and customers

In addition to these tasks, the change to price sources gives rise to a need to review existing contracts to determine which are affected and whether changes are needed to documentation.[78]

Nostro accounts

Currently, the ISDA transaction confirmations specify a particular account to which payments must be made arising from transactions under the agreement. The ISDA Master Agreement provides that a counterparty may change these instructions, so long as no reasonable objection is made by the other party within five days[79]. While EMU raises the prospect of the consolidation of nostro accounts and, as described above, the transmission of net (or gross) euro payments to a single account, the existing contractual obligation to send payments to specified accounts will remain in force unless the beneficiary decides to modify the account in which he expects to receive the settlement proceeds.

The Task Force expects that existing nostro account arrangements would generally remain in place at the beginning of Stage 3 and if modified, that notification would be made no later than end of September to allow for the required SSI changes to be made. It is recognised that this is a significant extension of the notification period envisaged under the ISDA Master Agreement, but the clear consensus is that this long implementation period is necessary given the pressures on systems in the immediate run-up to EMU. It is also felt that it may be worth seeking confirmation from counterparties to ensure an orderly start of the post euro area. Also, given the volume of SSI changes that will take effect from January 1999, counterparties should consider instructing their systems developers to create the functionality of forward value SSI change or, alternatively, create a duplicate database of all the new SSI changes and switch this over at the beginning of the year.

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[76] See Annex E & F

[77] Please note that the list is not exhaustive and institutions will wish to establish whether any additional work is required

[78] There are clearly a number of implications for documentation raised by EMU giving rise for a need for careful planning of the changeover process. This paper does not address these, as they are being considered by ISDA's EMU Documentation Task Force and may be the subject of a separate guidance paper

[79] See Section 2 (b) of ISDA Master Agreement

While current arrangements are likely to remain in place at the start of Stage 3 of EMU, over time it is increasingly likely that market participants will wish to rationalise their nostro account arrangements.[80] It is likely that market participants will realise the tremendous efficiencies to be gained, from a cash management perspective, by consolidating the number of accounts to be managed. There may also be incidental accounting benefits from taking such action. In spite of the five day standard in the ISDA Master Agreement, the Task Force believes that the potential systems burden raised by mass changes to settlement arrangements makes a thirty day notification period more appropriate[81]. The Task Force recognises that even within this time frame, some counterparties may not be ready to make any changes and may indeed raise a reasonable objection to the timing of the switch – particularly, say, if a number of other institutions request a change on the same date. The Task Force therefore stresses the importance of close communication between counterparties and careful coordination of changeover schedules. To facilitate the overall process, ISDA has developed a standard side-letter for parties to use to agree such a changeover. A copy of this is available on ISDA's web site.

Payment and settlement arrangements

Separate from the issue of the nostro account to which payments are made are two questions relating to payment and settlement arrangements more generally: the denomination of any payments sent and the denomination specified on any accompanying interest rate reset or payment advice (e.g., MT362 SWIFT message).

Given the legal framework for EMU and the practicalities of the euro payment arrangements, it is important to consider these questions separately. Concerning the denomination of the payment sent, the Task Force notes the importance of Article 8(3) of the Article 109 l(4) Regulation. This imposes an obligation on commercial banks to convert incoming payments between euro and the national currency of the country where the account is located. This means that counterparties in a derivatives transaction have full freedom to start making euro payments from the start of the EMU – without any need to redenominate transactions or advise counterparties of the new arrangements. (Parties are also free to request that their own banks convert incoming payments to euro, although the Article 109 l(4) Regulation does not require that the bank do so. In practice, it is likely that they will, however, agree to do so.) This is because the burden for conversion is on the correspondent bank processing the payment (that is, the recipient's bank). For example, consider the case of a DEM swap requiring DEM payments from Bank A to Bank B, by crediting Bank B's DEM nostro account in Frankfurt operated by Bank C. In this case, after the start of Stage 3, Bank A can send payments in either DEM or euro and, in practice, Bank B may instruct Bank C to credit all payments received by the Frankfurt account in either DEM or euro.

However, the position is different in the case of rate resets and payment advices. Here the exception to the "no compulsion, no prohibition" rule under Article 8(3) does not apply, as a cash/currency conversion is not being considered. Instead, the key question is the currency denomination shown on either of these documents that will be exchanged directly between the two counterparties. In this case, Article 8(1), which states that "acts to be performed in national currency units...shall be performed in that national currency unit" (i.e., the "no compulsion" principle), applies and means that existing national currency references must be retained,

[80] Firms should also take care to ensure that correspondent banks are able to support integrated euro liquidity and cash management if nostro accounts are rationalised

[81] Although, as noted above, the effective minimum notice period for changing SSIs as of the start of Stage 3 would be 90 days

regardless of whether settlement is instructed in the legacy currency or euro. Thus, in the example provided above, while Bank A may make payments in euro (per Article 8(1)), any rate resets and payment advice must continue to refer to DEM.

Counterparties may, however, decide to change the currency reference on any rate resets or payment advice by mutual agreement (as permitted by Article 8(2) of the Regulation). The Task Force anticipates that most market participants will indeed wish to do so. We would, however, encourage market participants that they do so over time in order to avoid to the potential gridlock which might otherwise be encountered at the end of Stage 3 when NCUs are replaced by the euro. In light of the advantages of rationalising settlement arrangements, it is anticipated that by the end of the transitional period most market participants will have amended payment instructions. ISDA's EMU Documentation Task Force is considering whether standard documentation would be helpful to achieve this.

It should be noted that some market participants may also show both euro and equivalent national currency amounts on rate resets and payment advices. This would clearly be compatible with the euro Regulations.

Payment netting

The introduction of the euro raises the prospect that amounts due to be paid in different euro area currencies on a particular day could be netted and a single euro (or national currency denomination) be paid instead. Indeed Section 2(c) of the ISDA Master Agreement already provides for payment netting in the event that two or more amounts are payable on the same date in the same currency under the same transaction. This type of payment netting (“Single-transaction Netting”) applies to all transactions. The classic example would be the netting of a floating amount and a fixed amount payable on the same payment date under an interest rate swap transaction. Operationally, this poses no difficulty as a general rule.

Section 2(c) also permits the parties to expand the scope of payment netting to allow payment netting of two or more amounts that are payable on the same date in the same currency but under different transactions (“Cross-transaction Netting”). Cross-transaction Netting is optional under the ISDA Master Agreement; in other words, it does not apply unless the parties actively elect for it to apply in Part 4(i) of the Schedule to the ISDA Master Agreement. Even where it does apply, the parties may elect for Cross-transaction Netting to apply within sub-groups of transactions (for example, between all interest rate and currency swaps and between all equity options) but not between sub-groups (so, for example, a French Franc amount due under a currency swap would not be netted against a French Franc amount due under an equity option). Operationally, Cross-transaction Netting is difficult, and many, if not most, financial institutions do not have the systems capability to implement it fully, although some are able to implement it within product areas, as described above.

On 1 January 1999, of course, the euro replaces all participating currencies. The fact that national denominations survive as non-decimal denominations of the euro does not alter the fact that, for example, FFR and DEM (assuming both are “in”) have become the same currency.
Accordingly, Single-transaction Netting under Section 2(c) will, on a literal reading, apply to all transactions involving the payment of two or more participating currencies on the same date. Thus a potentially large number of transactions to which Single-transaction netting did not previously apply would now be subject to it. Essentially, any cross-currency swap transaction involving “in” currencies will now be covered. Clearly, where Cross-transaction Netting has been elected by

the parties, even on a limited basis, the number of transactions affected will be even more dramatic.

The conclusion of the Task Force is that it is preferable for the status quo to be maintained and for common market practice, to effect settlements for each individual transaction, to continue to apply (unless already specifically agreed otherwise between the parties). Even where the parties have not elected for Cross-transaction Netting to apply, however, they should be aware that Single-transaction Netting will apply. Parties will therefore need to consider whether, during the transitional period, they wish to amend their ISDA Master Agreement to provide that national currency denominations of the euro will continue to be considered separate currencies for the limited purpose of Single-transaction Netting under Section 2(c).[82]

Applying netting to all euro area currency denominations would involve considerable additional operations work at a time of already serious resource constraints, as a dramatic additional number of transactions are likely to be involved, and would be inconsistent with existing market practice. It would also raise complications regarding identification of appropriate accounts for payment of the net amount: currently national currency cashflows will be sent to the relevant national currency nostro account of the counterparty, and, if a net euro amount were transmitted, it would be unclear which account should be designated to receive this payment (and the paying institution could be acting inconsistently with other terms of the contract which specify particular accounts for particular currency denominations). Also, the choice of account would have implications for the national currency into which the euro payment could be converted, due to the operation of Article 8(3) of the Article 109 I(4) Regulation. If the counterparty has entered into transactions to hedge an underlying national currency cash flow, receiving a net euro amount could well be unhelpful. Finally, any confusion regarding the precise amount of funds to be paid/received and precisely which nostro account is to be credited/debited as a result of transactions settling will result in a reduction in funding accuracy and potentially increase the number of post-settlement investigations.

While the above considerations explain the preference for retaining the status quo, i.e. the transmission of gross payments in national currency denominations of the euro, it is fully acknowledged that counterparties may wish to rationalise their payment arrangements and provide for transmission of net payments to a specified account. The Task Force emphasises that it is important for this to occur by way of mutual agreement of the counterparties. This agreement to switch to payment netting, either Single-transaction or Cross-transaction, could clearly be made at any time (prior to the introduction of the euro, during the transition period, or, after the end of the transition period). In these cases, it is suggested that counterparties carefully consider the relevant account location designated (given the currency conversion implications of Article 8(3)) and be clear whether payment netting would operate routinely or, as is current common practice, by case-by-case mutual agreement. Furthermore, parties wishing to elect full Cross-transaction Netting for all settlements arising from any euro and “in” currency payments for all products documented under the ISDA Master Agreement should be mindful that both they and their counterparties may need to spend significant systems development time to make such arrangements practicable, at a time when systems resources are strained due to other EMU-related development needs and Year 2000 compliance.

[82] ISDA's EMU Protocol provides for this – see Section III.3 above

The Task Force has therefore concluded that it would be preferable if at least 30 days notice were to be given of any move to change nostro account arrangements and to advise of new euro settlement instructions (during the transition period), due to the anticipated volume of such settlement instructions needed to be set up by each firm.

In addition, the Task Force has also concluded that it would be preferable if at least 90 days notice were to be given if the objective is to provide for full Cross-transaction Netting for all products from the start of EMU, given the other systems and operational changes required for that date. In such circumstances, the Task Force consider that it would be reasonable for a firm to decline its counterparty's request for cross-product multi-denominational payment netting of a portfolio of transactions to the euro unit until it was operationally practical for both parties to do so. This would avoid increasing operational, settlement and control risks and avoid potential operational gridlock. The Task Force also considers that it would be wholly impractical for all major players to choose Cross-transaction Netting or even Single-transaction Netting of “in” national currency and euro denominations in the first days of EMU.

Furthermore, the Task Force would encourage major market participants to consider the relative merits of leaving their portfolios of existing transactions denominated in “in” national currency denominations for a reasonable time during 1999 as (as has been shown above) this course of action appears unlikely to cause significant problems for parties and would facilitate a smoother operational transition.

Payment advices

SWIFT is shortly expected to publish a comprehensive guide to the impact of the euro on its message standards. This is welcome and we urge that this step be taken as quickly as possible.

Front office and risk management systems

While, as noted above, it is expected that legacy instruments will continue to be recorded and settled in existing national currencies, financial institutions will probably develop systems which show their net euro exposure for front office and risk management purposes. If the institution so desired, this could involve creating a “shell” systems structure that allows legacy national currency instruments to be expressed in euro equivalent positions and combined with similar legacy positions and new euro positions. This does not involve redenomination or formal conversion of payment arrangements to euro, but allows management to see a consolidated net euro position for, say, reporting purposes or in order to assess the net euro exposure that needs to be hedged.

C. “Long-Term Legacy Deals” – Outstanding transactions in “in” national currency denominations at the start of Stage 3 of EMU, but maturing after the end of the transitional period

As noted above, Article 14 of the Article 109 l(4) Regulation, specifies that at the end of the transitional period, references to existing national currencies “shall be read as references to the euro unit according to the respective conversion rates” and applying rounding rules.

Thus, the Article 109 l(4) Regulation applies a form of automatic redenomination at the end of the transitional period. More precisely, existing derivatives contracts would automatically have their notional principal values read as euro amounts, after applying the conversion rates, rounded (for purposes of payment or other accounting) to the nearest euro cent. As this redenomination would automatically be effected by the Regulation no legal agreement between the counterparties is necessary: contracts may still explicitly refer to national currency amounts, but these are now "read" as euro references.

Expected market practice

In light of the above, the Task Force anticipates that market participants will not amend existing agreements to redenominate them, as this would occur automatically under the Regulation.

Thus, generally, the same approach to the treatment of legacy instruments would apply as the case described above where instruments mature before the end of the transition period:

- Existing market conventions would apply (see discussion in part two above)
- Prices sources may have to change (see discussion in part two above)
- The impact on payment netting should be considered (see discussion in part two above)

The end of the transition period would require changes to settlement arrangements and in some other areas. However, the Task Force feels it would be premature to attempt to establish a market consensus in this area, as the experience of the initial changeover will provide valuable lessons which there is still time to reflect on before tackling end-transition period conversion issues.

D. "Legacy ECU Deals" - Transactions denominated in ECU at the start of Stage 3 of EMU

The Article 235 Regulations specifies that the euro unit will replace the ECU[83] on a one for one basis with effect from 1st January 1999 (Article 2 of Article 235 Regulation). This has important considerations for derivative businesses, as the ECU will cease to exist and would not be able to be settled in its current form following 1 January 1999.

Expected market practice

As the Regulation automatically prescribes the replacement of the ECU by the euro, all existing references to ECU in derivatives contracts should be read as references to euro following EMU. Accordingly, the Task Force does not envisage a need for market participants formally to redenominate or convert existing notional values in contracts to euro. However, as noted below, it is anticipated that parties will wish to change their settlement arrangements to refer explicitly to euro.

Market conventions

As with other legacy transactions, the basic principle from the joint statement on market conventions would apply in the case of the euro: that existing market conventions are to apply. In the case of day counts, this should be straightforward, as the planned switch from XEU Libor to Euro Libor or from XEU Pibor to Euro Euribor will be on the same day count basis.

However, the position regarding business holidays (or, more accurately, ECU non-settlement days) is less straightforward, as it will be impossible to continue to take account of ECU non-settlement days as these will no longer be set by the ECU Banking Association. ISDA has therefore written to the ECU Banking Association asking that they specify that, following EMU, ECU non-settlement days will be euro non-settlement days. Also, ISDA's EMU Protocol provides for clarification of the ECU settlement day.

Price sources

ISDA is aware that XEU Libor will be succeeded by euro Libor and that XEU Pibor will be succeeded by euro Euribor.

[83] This applies both to contracts directly referring to the "official" ECU and, subject to certain limited restrictions, other references to the ECU. See the text of the Regulations for more details

Payment and settlement arrangements and nostro accounts

The Task Force anticipates that all ECU rate resets and payment advices will be changed to refer explicitly to euro as of 1 January 1999. Counterparties are encouraged to notify this change in side letters.

Regarding nostro accounts, existing designated nostro accounts would be used unless notified of a change, as per the discussion on nostro accounts in part 2 above.

E. "Forward Euro Deals" - Transactions explicitly in euro entered into before the start of Stage 3 of EMU

It may be anticipated that some market participants wish to enter in forward euro deals before the start of EMU, whereby contracts explicitly refer to euro and will be settled in euro after the start of EMU. This may especially be the case after EMU participants are known and target bilateral rates are set in May 1998.

The Task Force notes that, given the legal requirement to convert ECUs to euro on a one-to-one basis, forward euro deals can in effect be entered into by agreeing a transaction which is booked in ECU, but which applies the new euro conventions. This could then be settled in line with existing ECU deals. However, care should be taken with regard to the choice of price sources in order to ensure that one of the new euro price sources would apply.

Alternatively, a transaction could explicitly refer to euro, employ a euro price source and apply euro conventions. However, euro settlement arrangements might not be known or in place if the deal is entered into sufficiently early in 1998. This should not in itself impose an obstacle, as these details could be supplemented at a later date. Also, care should be taken regarding the accounting implications of booking deals in euro before the currency is recognised for accounting purposes and also of the use of euro in confirms.

3. BOND, EQUITY AND FOREIGN EXCHANGE DERIVATIVES

A. Bond Options and Asset Swaps

This section considers the impact of EMU on bond options, asset swaps and repackaging structures involving derivatives, where the bond underlying the transaction has been redenominated from a national currency denomination into euro. Where no redenomination has taken place, EMU will have no effect on these transactions (although payments could be settled in euro, as per Article 8(3) of the 109 l(4) Regulation). In those cases where redenomination does occur, ISDA believes it is important to distinguish between instances where the economic value of the bond has been altered, due to reconventioning or renominalisation to greater than one euro, and those where this is not the case, i.e. no reconventioning and renominalisation only to the euro or euro cent. Each of these cases is considered separately below.

Given the added complication caused by reconventioning or significant renominalisation, the Task Force recommends that issuers avoid these approaches (or at least reconvention on a coupon date). The Task Force also calls on all issuers, both public and private, to give sufficient notice of their redenomination plans in full detail: for redenomination planned for the start of Stage 3 it is preferable that these complete plans are published by the middle of 1998 at the latest.[84]

[84] It is welcome that EU debt offices have published extensive details already; see Monetary Committee: Annex I

No reconventioning and non-significant renominalisation

a. Bond options: references to nominal amounts

In cases where redenomination occurs, but does not materially affect the economic value of the bond, the Task Force believes that existing references to nominal amounts of bonds in national currency denominations should, as common market practice, be simply read as equivalent euro references, applying the rounding/renominalisation rule of the underlying instrument. In the case of renominalisation to the euro, the cashed out euro cent rounding difference will not be taken into account. The Task Force does not believe it is actually necessary to redenominate or reconfirm the bond option itself, even if the ISIN number of the underlying bond has been changed by redenomination.

b. Bond options: strike prices

Similarly, the Task Force does not believe that there is a need to make any adjustments to the strike price for the bond option, given that the economic value of the underlying instrument has not changed. Since strike prices are usually expressed in terms of a yield or percentage, this would simply apply to the new euro value of the underlying bonds in question.

c. Bond options: settlement

Where cash settlement takes place, the Task Force notes that the option writer could fulfil his payment obligations by settling in either euro or the legacy national currency unit: given the provisions of Article 8(3) of the 109 l(4) Regulation (see discussion above), the recipient would be able to have his account credited in either denomination. The approach for rate products concerning payment advices (i.e., sending these in legacy national currency units) and nostro accounts (i.e., sending payments to existing accounts unless otherwise agreed) would also apply here.

In the case of physical settlement, the writer of the option would have an obligation to deliver the now euro-denominated underlying bonds in accordance with the previously agreed nominal amount (now also read as euro). In the case of renominalisation to the euro, there will be no payment of the cashed out euro cent rounding difference, as this amount would be immaterial. However, a greater difference may arise as a result of applying minimum lot sizes to the converted euro amount: for example, if conversion resulted in a euro value of 1,990, but the particular instrument has a minimum lot size of 1000 euro, then 990 euro would remain. The Operations Task Force recommends that, as a general rule, these rounding differences, at the exercise of the option, be ignored if less than 100 euro. However, firms should be aware that some corporate endusers may wish to receive full payment.

d. Asset swaps and repackagings

In the case of redenomination without reconventioning or significant renominalisation, there would be no material mismatch arising between the underlying bond and the associated interest rate swap. Consequently, the Task Force does not foresee a need to adjust existing arrangements by way of redenomination or reconfirmation of the swap. However, it is possible that even very minor rounding differences could trigger problems with some structures involving Special Purpose Vehicles (SPVs). The Task Force therefore recommends that firms carefully analyse the impact of redenomination on any SPVs (see below).

Reconventioning and significant renominalisation

a. Bond options: overview

Where reconventioning occurs or significant renominalisation takes place, the economic value of the underlying bond is changed and therefore the bond option is in turn affected. In the case of reconventioning, the Task Force believes that it is preferable to address this by allowing calculation agents to adjust the strike price, rather than by adjusting premiums. This is the approach that is also proposed under ISDA's EMU Protocol, by adjusting contracts to empower calculation agents to make such changes. For instances of significant renominalisation, the Task Force believes that it is preferable to retain the existing strike price for the new rounded nominal amount and to cash settle the value of the option on the cashed out element.

b. Bond options: references to nominal amovnts

As discussed above, the Task Force believes that references to nominal amounts in national currency units should, as common market practice, be read as references to euro amounts in accordance with the renominalisation rule of the underlying instrument. However, as renominalisation of greater than one euro will affect the economic value of the instrument, this change needs to be addressed. As noted above, the Task Force recommends that the existing strike price be retained and applied to the new rounded nominal amount.

In order to compensate for the change in nominal value, cash settlement would be made of the option value of the rounded/cashed out amount. However, the Task Force advises that amounts of less than 100 euro be disregarded, in line with the suggested de minimis for settlement of rounding errors due to applying minimum lot sizes (see above). (Note: this approach would also apply to options on bond futures; see below.) It should be noted that while this method has the advantage of retaining options parameters, it will involve early exercise of a part of the options book, as the cash settlement would be made at the time of redenomination. The Task Force recommends that transactions be reconfirmed at that time. Counterparties should also include provisions in new transactions to provide for the above approach.

c. Bond options: atria price

As noted above, the Task Force believes that calculation agents should be empowered to adjust strike prices in cases where reconventioning affects the economic value of an instrument in a material way. This adjustment of the strike price, by the calculation agent, would be made to ensure that the value of the options stays the same after reconventioning.

The Task Force has considered when it is most appropriate to make such changes and believes that while the adjustment need not take place over the conversion weekend, it should occur almost immediately afterwards (in order to allow prudent management of positions and to prepare for imminent exercises), and as a general principle not later than five days after reconventioning. Where a bond option may be exercised within the first few days of Stage 3, however, the adjustment would need to be made during the conversion weekend.

The Task Force recommends that any such adjustments to strike prices be reconfirmed at the time that they occur. Where no calculation agent has been named, counterparties should seek to mutually agree on the method for adjusting the strike price and employ arbitration in cases of disputes.

d. Bond options: sefflement

Settlement issues are the same as for bond options where the underlying has not been reconventioned or significantly renominalised.

e. Options on bond futures

Significant renominalisation raises similar problems for options on bond futures: renorninalisation could in these instances lead to significant changes in the nominal value of the underlying futures contract. The Task Force recommends that these contracts be adjusted in a manner consistent with cash positions described above: existing options parameters should be retained for the new rounded nominal amount, but cash settlement should be made of the option value of the rounded differences subject to a 100 euro de minimis. The transaction should be reconfirmed at this stage. In case of reconventioning, the strike price should be changed in line with the approach for cash positions, as described above.

f. Asset swaps and repackaging

Where reconventioning and significant renominalisation has taken place, it is likely that a material mismatch will occur between the underlying bond and the associated swap in an asset swap structure. As a matter of .law these two transactions are not linked. The Task Force recommends that firms carefully assess the implications of reconventioning or significant renominalisation on any relevant asset swap structures.

Repackaging and other structures involving SPVs may also be adversely affected by reconventioning and significant renominalisation. The Task Force recommends that firms carefully assess the impact on any relevant SPVs and closely study the detailed provisions of the transaction to see whether a minor mismatch or rounding difference could trigger problems. It is advised that this assessment take place as soon as possible, as in cases where problems do arise it may be difficult to contact trustees or other interested parties in time to make adjustments.

Internal pricinp and risk management systems

The Task Force notes that in addition to the adjustments described above, firms will also likely want to make changes to internal pricing and risk management systems for bond option positions to reflect the new euro-denominated underiyings for these transactions. It is anticipated that these changes will occur over the conversion weekend.

B. Equity Derivatives

In analysing the impact of EMU on equity derivatives, it is important to distinguish between instruments on underlying share or index positions in participating ("in") and non-participating ("out") member states. The position regarding "in" country markets is usually straightforward: all shares are expected to move to euro denominated trading in a Big Bang as of the start of Stage 3, simply involving conversion of strike prices at the fixed conversion rates. However, for "out" countries, different shares may switch to euro denomination at different times, raising questions as to the appropriate conversion rate to use for individual shares and the impact on indices that become affected by foreign exchange movements. The Task Force has considered each of these situations in turn and offers guidance below.

Options on individual shares quoted on "in"country exchanges

It is anticipated that all shares quoted on "in" country exchanges will switch to euro denominated trading (regardless of the underlying share capital denomination) as of the start of Stage 3. For options on individual shares on these exchanges, the Task Force has identified the only particular change reguired as involving conversion of strike prices from national currency denomination to the euro. In keeping with the approach outlined in the 1996 ISDA Equity Derivatives Definitions, the Task Force recommends that this conversion involves rounding to five decimal places.

Given the clear market consensus on the rounding approach, it is not recommended that changes to strike prices be reconfirmed. It is anticipated that firms will wish to adjust strike prices for internal management purposes during the course of the conversion weekend, but such conversion need not occur until the start of the exercise period.

Options on stock index for "in" country exchanges

ISDA is not aware of any particular impact that the introduction of the euro might have on indices comprised of shares denominated in a single "in"-currency. As an index is a relative measure of value, the introduction of the euro ought to have no direct impact of a disruptive nature.

The Task Force has therefore identified no need for redenomination, reconfirmation or adjustment of strike prices for these instruments. Internal risk management systems may have to be adjusted to account for the new underlying currency of the index.

If counterparties want to calculate the cash settlement amount in euro, they ought to use one of the following two methods: (i) calculate the cash settlement amount in 'in'-currency and then convert this amount into euro using the official conversion rate, (ii) convert the 'in'-currency unit into euro, do the rounding with enough decimals to avoid rounding errors (6 decimals is a minimum), then multiply by the strike price differential and the number of options.

The above conclusions would not hold true if an index were to be rebased or merged with another index to reflect the changed nature of the European equities market after the commencement of Stage 3 of EMU. However, ISDA has been advised by the Federation of European Stock Exchanges that no such plans are currently contemplated.

Options on single shares quoted on "out" country exchanges

Shares quoted on "out" country exchanges may well also be traded in euro, affecting the strike price of any related option in a manner similar to that for "in" countries. However, in these cases the timing of the switch to euro denomination is less certain and will likely vary from exchange to exchange and from share to share. This then leads to the question as to the appropriate conversion rate to be applied, as the exchange rate of the euro to a non participating national currency will of course continue to change over time. Unless other procedures have been agreed previously between the parties, the Task Force recommends that strike prices should be adjusted in line with the approach of the relevant futures market, in accordance with ISDA's 1996 Equity Derivatives Definitions. It is anticipated that strike prices will be adjusted at the time that trading in the underlying share switches to euro. Counterparties should advise the change via a short audit side letter; full reconfirmation is not considered necessary.

It should be noted that for some shares a dual order book might be maintained in both the legacy national currency and in euro. In these cases, the existing contract would continue to operate in the legacy currency with regard to prices from the legacy national currency order book.

Options on stock indices for "out" country exchanges

For indices for "out" country exchanges, a further complication is introduced: some of the constituent shares may move to euro trading while others do not, meaning that the value of the index will in part also be affected by the euro-national currency foreign exchange rate. Currently, calculation agents would probably be mandated to eliminate this "euro creep" effect under the provisions of the 1996 ISDA Equity Derivatives Definitions. However, as this effect will be manifest in the index and reflected in the futures market price (at least for the FTSE future traded on LIFFE), there is a need to adjust contracts to in fact retain this effect. Again, the Task Force recommends that these should be adjusted in line with the approach of the relevant futures market, in accordance with ISDA’s 1996 Equity Derivatives Definitions.

It is possible that an entire "out" country index will switch over to euro. In these cases the position would be the same as an "in" country index described above.

C. Foreign Exchange Derivatives

Existing contracts in ECU

Legacy foreign exchange derivatives contracts referring to the ECU will be treated in the same manner as interest rate contracts: all references to ECU should be read as euro on a one for one basis in line with Article 2 of the Article 235 Regulation. Similarly, all ECU payment advices should be changed to refer explicitly to euro as of 1 January 1999, with notification to counterparties being optional. (See part B.4. above.)

"In"/"in" currency contracts

In the case of foreign exchange derivatives contracts involving two "in" currencies, it is expected that firms will wish to rationalise their portfolios in order to remove transactions that no longer serve any economic purpose as a result of EMU. The Task Force would encourage firms to notify their respective counterparties in good time of their desire to close out certain transactions and to allow them sufficient time to calculate termination values and rehedge their positions as necessary. The Task Force recognises that there would be advantages if firms wishing to take such action were to indicate such a desire to their counterparties as soon as possible. This will enable parties to identify resource issues and plan accordingly. It is unnecessary to wait until after 1 January 1999 to give such an indication.

The Task Force notes, however, that there should be no presumption to close out these contracts. Any early termination would need to be by mutual agreement and in some instances a counterparty may wish to keep the legacy transaction intact despite EMU – in order, for example, to offset separate national currency cash flows that are continuing into the transition period or, perhaps, due to tax considerations.

It should be noted that some systems require positive volatility rates in order to function and in these instances may need to be adjusted to permit zero volatility to be recognised.

"In"/"out" currency contracts

a. Basic principles

In the case of foreign exchange derivatives contracts involving both an "in" and an "out" currency, any "in" legacy currencies should simply be treated as amounts in euro by applying the official conversion rate and by rounding in line with the euro Regulations, e.g. to two decimal places. No reconfirmation is necessary and payment advices, etc would retain national currency references.

Counterparties may however wish to mutually agree to amend existing transaction to explicitly changeover from the legacy national currency to euro. In these cases it is recommended that notional amounts only are amended in the contract, but that all payment and settlement arrangements also switch to euro. The Task Force advises that counterparties reconfirm such changes.

b. Barrier options

With the start of Stage 3, the interbank quotation and publication of "in" currencies will disappear. Thus, in the case of barrier options with a barrier in an "in" currency it will no longer be possible to track directly if this barrier has been reached or not on the interbank market. Thus, there is a need for a market convention for the conversion of an "in" currency into euro, that can be accepted by any counterparty and that does not need specific confirmation.

As the economic consequences of striking a barrier or not may be significant, rounding takes on great importance in making the change to barriers from legacy currency to euro. In some instances, it may appear that the converted (and rounded) barrier has been reached, while "reconversion" to the legacy currency might show the barrier has just been missed, leading to disputes. The following approach is therefore proposed: The converted barrier is calculated by applying the official conversion rate and should be expressed with enough decimals (more than the number of decimals in the interbank market) to avoid any possible dispute of reconversion. For the euro/USD, it means 7 significant figures (i.e., 1.234567), although, as a practical matter, 6 significant figures could be used, except in cases of dispute.

However, at the start of Stage 3, market conventions for forex quotation will change (in line with the joint statement on harmonised market conventions), so that previously uncertain quotation (e.g., 1 USD = 6.0026 FFR) will switch to certain quotation (e.g., 1 EUR = 1.0865 USD). Consequently, barriers will need to be adjusted, so that up barriers will become down barriers and vice-versa.

Although no reconfirmation is necessary, parties may wish to notify their relevant counterparties of the exact changes and reconfirm the new details of the transaction (as specified above under Basic Principles).

c. Average rate and similar options

In the case of average rate and similar options involving both an “in” and “out” currency a question arises as to how to calculate the average with a converted euro rate: conversion could occur either before or after averaging takes place. The Task Force recommends the former approach: euro screen rates should be converted to the legacy national currency each day and then averaged, assuming that averaging of daily quotes had been specified in the contract. Other average rate and similar backward looking products should take the same approach, converting on each relevant period and then averaging.

4. THE CONVERSION WEEKEND AND BEYOND

A. General Overview

The previous sections have provided a product by product analysis of the changeover requirements for derivatives transactions in the light of euro. However, a further key consideration is the co-ordination of the timing of all these changes and, in particular, in ensuring that individual firms are ready for the burden of the conversion weekend of 31 December 1998 to 4 January 1999. This section therefore summarises the key conclusions of the above report in terms of the timing of necessary and possible systems and back office changes. This reflects the Task Force's strong belief that the burden of the conversion weekend for derivatives should be minimised as much as possible, given the considerable changes required for some underlying cash markets.

B. Timing of Systems Changes

The following changes are discussed in further detail in the main text of the report. However, in addition, each counterparty must ensure that they check individually for further adjustments that might be required (e.g., application of new rates).

Conversion Weekend Changes

- Ensuring that systems are in place for new trading in euro (see detailed list Section V.2.A above)
- Putting in place settlement instructions and nostro arrangements for new euro trading
- Ensuring that front office and risk management systems treat legacy transactions in an appropriate euro basis alongside new euro deals (*Not strictly necessary for the conversion*

weekend, but it is anticipated that nearly all firms will make this change then)

- Changing from national currency to euro prices sources, where appropriate
- Switching ECU payment and reset advices to euro and sending out appropriate side audit letters
- In the case of a bond option (or option on a bond future), equity derivative or foreign exchange derivative action may be required if exercise takes place immediately after the conversion weekend. See below for circumstances and summary of required changes
- In the case of significant renominalisation of a bond during the conversion weekend, nominal amounts for bond options will also have to be adjusted during the conversion weekend and reconfirmed at that time
- "In"/"out" barrier options will need to change on the conversion weekend and then adjusted and reconfirmed

Transition Period Changes

- In the case of reconventioning, strike prices on bond options should be adjusted and reconfirmed within five days of the reconventioning
- In the case of significant renominalisation, nominal amounts for bond options need to be adjusted and reconfirmed at that time
- In the case of physical settlement of bond options and rounding problems due to minimum lots, cash adjustments need to be made at the time of settlement
- In the case of out country share options, strike prices need to be converted to euro in line with the underlying futures market, i.e. at the time of switch of currency of trading to euro. Side audit letters should be sent at this time
- In the case of out country indices, strike prices need to be converted and adjustments may be needed to account for euro creep in accordance with the underlying futures market

Changes by Mutual Agreement

- Changing legacy currency nostro and settlement instructions to euro[85]
- Redenomination of nominal/notional amounts, payment advices, rates of legacy currency transactions into euro

[85] See main text for discussion of what "mutual agreement" means exactly in this context.

GLOSSARY

GLOSSARY

This glossary covers some (but not all) of the terms used in the attached guidance paper. References in *italics* within a definition means that these terms are defined elsewhere in the glossary.

Article 109l(4) Regulation
Formally, a yet to be adopted (at the time of publication) Council Regulation on the Introduction of the Euro, more commonly known as the Article 109l(4) Regulation for the article of the Maastricht Treaty under which it is to be adopted. This only applies directly to "in" countries, and can therefore only be voted on by these countries, so it cannot be formally adopted until these are known. However, the contents of the regulation are fixed and deal with, inter alia, the legal characteristics of the *euro* and particular legal issues arising during the *transition period*, including the "*no compulsion, no prohibition*" principle and the exceptions to that principle. Published in the C Series of the Official Journal on 2.8.97. See Annex A & Section III.1.

Article 235 Regulation
Formally, Council Regulation 1103/97 of 17 June 1997 on Certain Provisions Relating to the Introduction of the Euro. This applies directly to all EU member states and addresses, inter alia, continuity of contracts, the one-to-one conversion of the ECU to the *euro* and rounding. See Annex A.

ACI
Association Cambiste Internationale – One of the sponsors of *Euribor*

BBA
British Bankers' Association – The sponsor of *Euro Libor*

Cross-Transaction Netting
A form of payment netting available as an option to counterparties under Section 2(c) of the *ISDA Master Agreement*, whereby payments due in the same currency on the same day (irrespective of the transaction under which they are made) are made on a net basis.

EBF
European Banking Federation (also known as the FBE: Federation Bancaire de l'Union Europeenne) – One of the sponsors of *Euribor*

ECB
European Central Bank based in Frankfurt.

ECU
European Currency Unit, a currency basket comprising specified amounts of the currencies of twelve member states.

EMI
European Monetary Institute, the predecessor of the *ECB*

ESCB
European System of Central Banks

EUR
The currency code of the euro.

Euro
The name of the new single currency. The decimal subdenominations of the euro will be called *euro cents*.

Euro cents
The decimal subdenominations of the *euro*.

Euro Euribor
The euro-area money market price source for the euro to be sponsored principally by the *ACI* and *EBF*. This will be the domestic price source for the euro, covering dealing from banks of all "in" countries and a selection of international banks.

Euro Libor
The London money market price source for *euro* to be sponsored by the *BBA*. As the UK will not participate in the first wave of EMU, this will be an offshore rate.

ISDA
International Swaps and Derivatives Association, Inc

ISDA Master Agreement
The standard contract for swaps and other privately negotiated derivatives transactions sponsored by *ISDA*

Joint Statement on Market Conventions
Recommended market conventions for the euro bond, money and forex markets proposed by *ISDA* and a number of other trade associations. The joint statement was published on 16 July and subsequently received the support of the *EMI* and endorsement of the European Commission.

NCU
National Currency Unit (e.g., the national non-decimal subdenominations of the euro)

"No compulsion, no prohibition"
During the *transition period* a basic principle applies: no party may be compelled to use the *euro* rather than any existing *NCU*, but nor should any party be prohibited from using the *euro*. This principle will be enshrined in law as part of the *Article 109l(4) Regulation*, in Article 8(1) – covering no compulsion – and Article 8(2) – covering no prohibition. However, the regulation goes on to list important exceptions to the "no compulsion, no prohibition rule". In particular, commercial banks are compelled to offer currency conversion facilities for payments in certain circumstances (Article 8(3)) and *bond redenomination* may be undertaken (Article 8(4)).

Payment Advice
In the broadest sense, any communication to another party concerning a payment arrangement. While payment advices may be sent to correspondent banks to advise on the beneficiary of a payment, it is important to note that payment advices are also sent directly between counterparties (MT362 messages) advising the settlement amount under derivatives transactions.

Reconventioning
The process of changing the market conventions governing a financial instrument (such as day count or business days) in the course of *redenomination.*

Redenomination
In the broadest sense, redenomination means changing the nominal value (in the case of a bond) or the notional value (in the case of a derivative) of a financial instrument from the existing national currency unit into *euro*. However, it is preferable to consider the types of redenomination: *simple redenomination* or currency conversion, *renominalisation* and *reconventioning*. Only redenomination of bonds is permitted as an exception to the *"No compulsion, no prohibition"* principle during the *transition period* under Article 8(4) of the *Article 235 Regulation.* Other forms of redenomination require national legislation or are governed by the terms of the bond. Article 14 of that regulation effectively redenominates all financial instruments at the end of the *transition period* without requiring further action by contracting parties.

Renominalisation
The process of rounding the nominal value of a *redenominated* bond as part of the process of *redenomination.* The level of rounding chosen depends on the exact method of redenomination: for example rounding may be to the *euro* or *euro cent* level.

Simple Redenomination
Basically, the process of multiplying an *NCU* nominal or notional amount by the relevant conversion factor, without rounding (i.e. no *renominalisation*), as part of the process of *redenomination*. Also known as currency conversion.

Single-Transaction Netting
A form of payment netting provided for under Section 2(c) of the *ISDA Master Agreement*, whereby amounts due in the same currency on the same day under a single transaction are netted against each other so that only a single net payment is made. (See also *Cross-Transaction Netting*)

Stage 3 of EMU
The period during which the euro exists as the single currency of the participating member states.

TARGET
Trans-European Automated Real-time Gross settlement Express Transfer system: the "interlinking" system which links national real-time gross settlement payment systems of all EU member states and in addition to processing payments will be used to effect monetary policy operations.

Transition Period
Defined by Article 1 of the *Article 109l(4) Regulation* as "the period beginning on 1 January 1999 and ending on 31 December 2001." Essentially, this is the period during which the *euro* becomes a legal currency (with *NCUs* simply considered non-decimal denominations of the euro), but when the *"no compulsion, no prohibition"* principle applies as a general rule. See Articles 5-9 of the *Article 109l(4) Regulation* for the legal framework governing the transition period.

XEU
The currency code for the *ECU*.

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REFERENCES

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EMI:
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European Parliament:
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ANNEXES

EC REGULATIONS

I

(*Acts whose publication is obligatory*)

COUNCIL REGULATION (EC) No 1103/97 of 17 June 1997

on certain provisions relating to the introduction of the euro

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commissions[(1)],

Having regard to the opinion of the European Parliament[(2)],

Having regard to the opinion of the European Monetary Institute[(3)],

(1) Whereas, at its meeting held in Madrid on 15 and 16 December 1995, the European Council confirmed that the third stage of Economic and Monetary Union will start on 1 January 1999 as laid down in Article 109j (4) of the Treaty; whereas the Member States which will adopt the euro as the single currency in accordance with the Treaty will be defined for the purposes of this Regulation as the 'participating Member States';

(2) Whereas, at the meeting of the European Council in Madrid, the decision was taken that the term 'ECU' used by the Treaty to refer to the European currency unit is a generic term; whereas the Governments of the fifteen Member States have achieved the common agreement that this decision is the agreed and definitive interpretation of the relevant Treaty provisions; whereas the name given to the European currency shall be the 'euro'; whereas the euro as the currency of the participating Member States will be divided into one hundred sub-units with the name 'cent'; whereas the European Council furthermore considered that the name of the single currency must be the same in all the official languages of the European Union, taking into account the existence of different alphabets;

(3) Whereas a Regulation on the introduction of the euro will be adopted by the Council on the basis of the third sentence of Article 1091 (4) of the Treaty as soon as the participating Member States are known in order to define the legal framework of the euro; whereas the Council, when acting at the starting date of the third stage in accordance with the first sentence of Article 1091 (4) of the Treaty, shall adopt the irrevocably fixed conversion rates;

(4) Whereas it is necessary, in the course of the operation of the common market and for the changeover to the single currency, to provide legal certainty for citizens and firms in all Member States on certain provisions relating to the introduction of the euro well before the entry into the third stage; whereas this legal certainty at an early stage will allow preparations by citizens and firms to proceed under good conditions;

(5) Whereas the third sentence of Article 1091 (4) of the Treaty, which allows the Council, acting with the unanimity of participating Member States, to take other measures necessary for the rapid introduction of the single currency is available as a legal basis only when it has been confirmed, in accordance with Article 109j (4) of the Treaty, which Member States fulfil the necessary conditions for the adoption of a single currency; whereas it is therefore necessary to have recourse to Article 235 of the Treaty as a legal basis for those provisions where there is an urgent need for legal certainty; whereas therefore this Regulation and the aforesaid Regulation on the introduction of the euro will together provide the legal framework for the euro, the principles of which legal framework were agreed by the European Council in Madrid; whereas the introduction of the euro concerns day-to-day operations of the whole population in participating Member States; whereas measures other than those in this Regulation and in the Regulation which will be adopted under the third sentence of Article 1091 (4) of the Treaty should be examined to ensure a balanced changeover, in particular for consumers;

(6) Whereas the ECU as referred to in Article 109g of the Treaty and as defined in Council Regulation (EC) No 3320/94 of 22 December 1994 on the consolidation of the existing Community legislation on the definition of the ECU following the entry into force of the Treaty on European Union[(1)] will cease to be defined as a basket of component currencies on 1 January 1999 and the euro will

(1) OJ No C 369, 7.12. 1996, p.8.

(2) OJ No C 380, 16.12. 1996 p.49.

(3) Opinion delivered on 29 November 1996.

(1) OJ No L 350, 31. 12. 1994, p. 27.

become a currency in its own right; whereas the decision of the Council regarding the adoption of the conversion rates shall not in itself modify the external value of the ECU; whereas this means that one ECU in its composition as a basket of component currencies will become one euro; whereas Regulation (EC) No 3320/94 therefore becomes obsolete and should be repealed; whereas for references in legal instruments to the ECU, parties shall be presumed to have agreed to refer to the ECU as referred to in Article 109g of the Treaty and as defined in the aforesaid Regulation; whereas such presumption should be rebuttable taking into account the intentions of the parties;

(7) Whereas it is a generally accepted principle of law that the continuity of contracts and other legal instrument is not affected by the introduction of a new currency; whereas the principle of Freedom of contract has to be respected; whereas the principle of continuity should be compatible with anything which parties might have agreed with reference to the introduction of the euro; whereas, in order to reinforce legal certainty and clarity, it is appropriate explicitly to confirm that the principle of continuity of contracts and other legal instruments shall apply between the former national currencies and the euro and between the ECU as referred to in Article l09g of the Treaty and as defined in Regulation (EC) No 3320/94 and the euro; whereas this implies, in particular, that in the case of fixed interest rate instruments the introduction of the euro does not alter the nominal interest rate payable by the debtor; whereas the provisions on continuity can fulfil their objective to provide legal certainty and transparency to economic agents, in particular for consumers, only if they enter into force as soon as possible;

(8) Whereas the introduction of the euro constitutes a change in the monetary law of each participating Member State, whereas the recognition of the monetary law of a State is universally accepted principle; whereas the explicit confirmation of the principle of continuity should lead to the recognition of continuity of contracts and other legal instruments in the jurisdictions of third countries;

(9) Whereas the term ‘contract’ used for the definition of legal instruments is meant to include all types of contracts, irrespective of the way in which they are concluded;

(l0) Whereas the Council, when acting in accordance with the first sentence of Article 1091 (4) of the Treaty, shall define the conversion rates of the euro in terms of each of the national currencies of the participating Member States; whereas these conversion rates should be used for any conversion between the euro and the national currency units or between the national currency units; whereas for any conversion between notional currency units, a fixed algorithm should define the result; whereas the use of inverse rates for conversion would imply rounding of rates and could result in significant inaccuracies, notably if large amounts are involved;

(11) Whereas the introduction of the euro requires the rounding of monetary amounts; whereas an early indication of rules for rounding is necessary in the course of the operation of the common market and to allow a timely preparation and a smooth transition to Economic and Monetary Union; whereas these rules do not affect any rounding practice, convention or national provisions providing a higher degree of accuracy for intermediate computation;

(12) Whereas, in order to achieve a high degree of accuracy in conversion operations, the conversion rates should be defined with six significant figures; whereas a rate with six significant figures means a rate which, counted from the left and starting by the first non-zero figure, has six figures.

HAS ADOPTED THIS REGULATION:

Article 1

For the purpose of this Regulation:

- ‘legal instruments’ shall mean legislative and statutory provisions, acts at administration, judicial decisions, contracts, unilateral legal acts, payment instruments other than banknotes and coins, and other instruments with legal effect,

- ‘participating Member States’ shall mean those Member States which adopt the single currency in accordance with the Treaty,

- ‘conversation rates’ shall mean the irrevocably fixed conversion rates which the Council adopts in accordance with the first sentence of Article 1091(4) of the Treaty,

- ‘national currency units’ shall mean the units of the currencies of participating Member States, as those units are defined on the day before the start of the third state of Economic and Monetary Union,

- ‘euro unit’ shall mean the units of the single currency as defined in the Regulation on the introduction of the euro which will enter into force at the starting date of the third stage of Economic and Monetary Union.

Article 2

1. Every reference in a legal instrument to the ECU, as referred to in Article 109g of the Treaty and as defined in Regulation (EC) No 3320/94, shall be replaced by a reference to the euro at a rate of one euro to one ECU. References in a legal instrument to the ECU without such a definition shall be presumed, such presumption being rebuttable taking into account the intentions of the parties, to be references to the ECU as referred to in Article 109g of the Treaty and as defined in Regulation (EC) No 3320/94.

2. Regulation (EC) No. 3320/94 is hereby repealed.

3. This Article shall apply as from 1 January 1999 in accordance with the decision pursuant to Article 109j (4) of the Treaty.

Article 3

The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument. This provision is subject to anything which parties may have agreed.

Article 4

1. The conversion rates shall be adopted as one euro expressed in terms of each of the national currencies of the participating Member States. They shall be adopted with six significant figures.

2. The conversion rates shall not be rounded or truncated when making conversions.

3. The conversion rates shall be used for conversions either way between the euro unit and the national currency units. Inverse rates derived from the conversion rates shall not be used.

4. Monetary amounts to be converted from one national currency unit to another shall first be converted into a monetary amount expressed in the euro unit, which amount may be rounded to not less than three decimals and shall then be converted into the other national currency unit. No alternative method of calculation may be used unless it produces the same results.

Article 5

Monetary amounts to be paid or accounted for when a rounding takes place after a conversion into the euro unit pursuant to Article 4 shall be rounded up or down to the nearest cent. Monetary amounts to be paid or accounted for which are converted into a national currency unit shall be rounded up or down to the nearest sub-unit or in the absence of a sub-unit to the nearest unit, or according to national law or practice to a multiple or fraction of the sub-unit or unit of the national currency unit. If the application of the conversion rate gives a result which is exactly half-way, the sum shall be rounded up.

Article 6

This Regulation shall enter into force on the day following that of its publication in the *Official Journal of the European Communities.*

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Luxembourg, 17 June 1997.

For the Council

The President

A. JORRITSMA-LEBBINK

ANNEX

Draft

COUNCIL REGULATION (EC) No .../97
of....
on the introduction of the euro

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 109] (4), third sentence thereof,

Having regard to the proposal from the Commissions[1],

Having regard to the opinion of the European Central Bank[2],

Having regard to the opinion of the European Parliament[3],

1. Whereas this Regulation defines monetary law provisions of the Member States which have adopted the euro; whereas provisions on continuity of contracts, the replacement of references to the ecu in legal instruments by references to the euro and rounding have already been laid down in Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro[4]; whereas the introduction of the euro concerns day-to-day operations of the whole population in participating Member States; whereas measures other than those in this Regulation and in Regulation (EC) No 1103/97 should be examined to ensure a balanced changeover, in particular for consumers;

2. Whereas, at the meeting of the European Council in Madrid on 15 and 16 December 1995, the decision was taken that the term ‘ecu’ used by the Treaty to refer to the European currency unit is generic term; whereas the Governments of the fifteen Member States have reached the common agreement that this decision is the agreed and definitive interpretation of the relevant Treaty provisions; whereas the name given to the European currency shall be the ‘euro’; whereas the euro as the currency of the participating Member States shall be divided into one hundred sub-units with the name 'cent'; whereas the definition of the name 'cent' does not prevent the use of variants of this term in common usage in the Member States; whereas the European Council furthermore considered that the name of the single currency must be the same in all the official languages of the European Union, taking into account the existence of different alphabets;

3. Whereas the Council when acting in accordance with the third sentence of Article 1091 (4) of the Treaty shall take the measures necessary for the rapid introduction of the euro other than the adoption of the conversion rates;

4. Whereas whenever under Article 109k (2) of the Treaty a Member State becomes a participating Member State, the council shall according to Article 1091 (5) of the Treaty take the other measures necessary for the rapid introduction of the euro as the single currency of this Member State;

5. Whereas according to the first sentence of Article 1091 (4) of the Treaty the Council shall at the starting date of the third stage adopt the conversion rates at which the currencies of the participating Member States shall be irrevocably fixed at which irrevocably fixed rate the euro shall be substituted for these currencies;

6. Whereas given the absence of exchange rate risk either between the euro unit and the national currency units or between these national currency units, legislative provisions should be interpreted accordingly;

7. Whereas the term 'contract' used for the definition of legal instruments is meant to include all types of contracts, irrespective of the way in which they are concluded;

8. Whereas in order to prepare a smooth changeover to the euro a transitional period is needed between the substitution of the euro for the currencies of the participating Member States and the introduction of euro banknotes and coins; whereas during this period the national currency units will be defined as sub-divisions of the euro; whereas thereby a legal equivalence is established between the euro unit and the national currency units;

9. Whereas in accordance with Article 109g of the Treaty and with Regulation (EC) No 1103/97, the euro will replace the ecu as from 1 January 1999 as the unit of account of the institutions of the European Communities; whereas the euro should also be the unit of account of the European Central Bank (ECB) and of the central banks of

(1) OJ No C 369, 7.12. 1996, p. 10

(2) Opinion delivered on ... (not yet published in the Official Journal).

(3) Opinion delivered on ... (not yet published in the Official Journal).

(4) OJ No L 162, 19. 6. 1997, p. 1.

the participating Member States; whereas, in line with the Madrid conclusions, monetary policy operations will be carried out in the euro unit by the European System of Central Banks (ESCB); whereas this does not prevent national central banks from keeping accounts in their national currency unit during the transitional period, in particular for their staff and for public administrations;

10. Whereas each participating Member State may allow the full use of the euro unit in its territory during the transitional period;

11. Whereas during the transitional period contracts, national laws and other legal instruments can be drawn up validly in the euro unit or in the national currency unit; whereas during this period, nothing in this Regulation should affect the validity of any reference to a national currency unit in any legal instrument;

12. Whereas, unless agreed otherwise, economic agents have to respect the denomination of a legal instrument in the performance of all acts to be carried out under that instrument;

13. Whereas the euro unit and the national currency units are units of the same currency; whereas it should be ensured that payments inside a participating Member State by crediting an account can be made either in the euro unit or the respective national currency unit; whereas the provisions on payments by crediting an account should also apply to those cross-border payments which are denominated in the euro unit or the national currency unit of the account of the creditor; whereas it is necessary to ensure the smooth functioning of payment systems by laying down provisions dealing with the crediting of accounts by payment instruments credited through those systems; whereas the provisions on payments by crediting an account should not imply that financial intermediaries are obliged to make available either other payment facilities or products denominated in any particular unit of the euro; whereas the provisions on payments by crediting an account do not prohibit financial intermediaries from coordinating the introduction of payment facilities denominated in the euro unit which rely on a common technical infrastructure during the transitional period;

14. Whereas in accordance with the conclusions reached by the European council at its meeting held in Madrid, new tradeable public debt will be issued in the euro unit by the participating Member States as from 1 January 1999; whereas it is desirable to allow issuers of debt to redenominate outstanding debt in the euro unit; whereas the provisions on redenomination should be such that they can also be applied in the jurisdictions of third countries; whereas issuers should be enabled to redenominate outstanding debt if the debt is denominated in the national currency unit of a Member State which has redenominated part or all of the outstanding debt of its general government; whereas these provisions do not address the introduction of additional measures to amend the terms of outstanding debt to alter, among other things, the nominal amount of outstanding debt, these being matters subject to relevant national law; whereas it is desirable to allow Member States to take appropriate measures for changing the unit of account of the operating procedures of organized markets;

15. Whereas further action at the Community level may also be necessary to clarify the effect of the introduction of the euro on the application of existing provisions of Community law, in particular concerning netting, set-off and techniques of similar effect;

16. Whereas any obligation to use the euro unit can only be imposed on the basis of Community legislation; whereas in transactions with the public sector participating Member States may allow the use of the euro unit; whereas in accordance with the reference scenario decided by the European Council at its meeting held in Madrid, the Community legislation laying down the time frame for the generalization of the use of the euro unit might leave some freedom to individual Member States;

17. Whereas in accordance with Article 105a of the Treaty the council may adopt measures to harmonize the denominations and technical specifications of all coins;

18. Whereas banknotes and coins need adequate protection against counterfeiting;

19. Whereas banknotes and coins denominated in the national currency units lose their status of legal tender at the latest six months after the end of the transitional period; whereas imitations on payments in notes and coins, established by Member States for public reasons, are not incompatible with the status of legal tender of euro banknotes and coins, provided that other lawful means for the settlement of monetary debts are available;

20. Whereas as from the end of the transitional period references in legal instruments existing at the end of the transitional period will have to be read as references to the euro unit according to the respective conversion rates; whereas a physical redenomination of existing legal instruments is therefore not necessary to achieve this result; whereas the rounding rules defined in Regulation (EC) No 1103/97 shall also apply to the conversions to be made at the end of the transitional period or after the transitional period; whereas for reasons of clarity it may be desirable that the physical redenomination will take place as soon as appropriate;

21. Whereas paragraph 2 of Protocol No 11 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland stipulates

that, *inter alia*, paragraph 5 of that Protocol shall have effect if the United Kingdom notifies the Council that is does not intend to move to the third stage; whereas the United Kingdom gave notice to the Council on 16 October 1996 that it does not intend to move to the third stage; whereas paragraph 5 stipulates that, *inter alia*, Article 109l (4) of the Treaty shall not apply to the United Kingdom;

22. Whereas Denmark, referring to paragraph 1 of Protocol No 12 on certain provisions relating to Denmark has notified, in the context of the Edinburgh decision of 12 December 1992, that it will not participate in the third stage; whereas, therefore, in accordance with paragraph 2 of the said Protocol, all articles and provisions of the Treaty and the Statute of the ESCB referring to a derogation shall be applicable to Denmark;

23. Whereas, in accordance with Article 1091 (4) of the Treaty, the single currency will be introduced only in the Member States without a derogation;

24. Whereas this Regulation, therefore, shall be applicable pursuant to Article 189 of the Treaty, subject to Protocols No 11 and No 12 and Article 109k (1),

HAS ADOPTED THIS REGULATION:

PART I

DEFINITIONS

Article 1

For the purpose of this Regulation:

- ‘participating Member States’ shall mean (Countries A, B ..),
- ‘legal instruments’ shall mean legislative and statutory provisions, acts of administration, judicial decisions, contracts, unilateral legal acts, payment instruments other than bank-notes and coins, and other instruments with legal effect,
- ‘conversion rate’ shall mean the irrevocably fixed conversion rate adopted for the currency of each participating Member State by the Council according to the first sentence of Article 109l (4) of the Treaty,
- ‘euro unit’ shall mean the currency unit as referred to in the second sentence of Article 2,
- ‘national currency units’ shall mean the units of the currencies of participating Member States, as those units are defined on the day before the start of the third stage of Economic and Monetary Union,
- ‘transitional period’ shall mean the period beginning on 1 January 1999 and ending on 31 December 2001,
- ‘redenominate’ shall mean changing the unit in which the amount of outstanding debt is stated from a national currency unit to the euro unit, as defined in Article 2, but which does not have through the act of redenomination the effect of altering any other term of the debt, this being a matter subject to relevant national law.

PART II

SUBSTITUTION OF THE EURO FOR THE CURRENCIES OF THE PARTICIPATING MEMBER STATES

Article 2

As from 1 January 1999 the currency of the participating Member States shall be the euro. The currency unit shall be one euro. One euro shall be divided into one hundred cents.

Article 3

The euro shall be substituted for the currency of each participating Member State at the conversion rate.

Article 4

The euro shall be the unit of account of the European Central Bank (ECB) and of the central banks of the participating Member States.

PART III

TRANSITIONAL PROVISIONS

Article 5

Articles 6, 7, 8 and 9 shall apply during the transitional period.

Article 6

1. The euro shall also be divided into the national currency units according to the conversion rates. Any subdivision thereof shall be maintained. Subject to the provisions of this Regulation the monetary law of the participating Member States shall continue to apply.

2. Where in a legal instrument reference is made to a national currency unit, this reference shall be as valid as if reference were made to the euro unit according to the conversion rates.

Article 7

The substitution of the euro for the currency of each participating Member State shall not in itself have the effect of altering the denomined of legal instruments in existence on the date of substitution.

Article 8

1. Acts to be performed under legal instruments stipulating the use of or denomination in a national currency unit shall be performed in that national currency unit. Acts to be performed under legal instruments stipulating the use of or denominated in the euro unit shall be performed in that unit.

2. The provisions of paragraph 1 are subject to anything which parties may have agreed.

3. Notwithstanding the provisions of paragraph 1, any amount denominated either in the euro unit or in the national currency unit of a given participating Member State and payable within that Member State by crediting an account of the creditor, can be paid by the debtor either in the euro unit or in that national currency unit. The amount shall be credited to the account of the creditor in the denomination of his account, which any conversion being effected at the conversion rates.

4. Notwithstanding the provisions of paragraph 1, each participating Member State may take measures which may be necessary in order to:

- redenominate in the euro unit outstanding debt issued by that Member State's general government, as defined in the European System of Integrated Accounts, denominated in its national currency unit and issued under its own law. If a Member State has taken such a measure, issuers may redenominate in the euro unit debt denominated in that Member State's national currency unit unless redenomination is expressly excluded by the terms of the contract; this provision shall apply to debt issued by the general government of a Member State as well as to bonds and other forms of securitized debt negotiable in the capital markets, and to money market instruments, issued by other debtors,
- enable the change of the unit of account of their operating procedures from a national currency unit to the euro unit by:

    (a) markets for the regular exchange, clearing and settlement of any instrument listed in section B of the Annex to Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field[(1)] and of commodities; and

    (b) systems for the regular exchange, clearing and settlement of payments.

5. Provisions other than those of paragraph 4 imposing the use of the euro unit may only be adopted by the participating Member States in accordance with any time-frame laid down by Community legislation.

6. National legal provisions of participating Member States which permit or impose netting, set-off or techniques with similar effects shall apply to monetary obligations, irrespective of their currency denomination, if that denomination is in the euro unit or in a national currency unit, with any conversion being effected at the conversion rates.

Article 9

Banknotes and coins denominated in a national currency unit shall retain their status as legal tender within their territorial limits as of the day before the entry into force of this Regulation.

PART IV

EURO BANKNOTES AND COINS

Article 10

On... (*), the ECB and the central banks of the participating Member States shall put into circulation banknotes denominated in euros. Without prejudice to Article 15, these banknotes denominated in euros shall be the only banknotes which have the status of legal tender in all these Member States.

Article 11

On... (*), the participating Member States shall issue coins denominated in euros or in cents and complying with the denominations and technical specifications which the Council may lay down in accordance with the second sentence of Article 105a (2) of the Treaty. Without prejudice to Article 15, these coins shall be the only coins which have the status of legal tender in all these Member States. Except for the issuing authority and for those persons specifically designated by the national legislation of the issuing Member State, no party shall be obliged to accept more than fifty coins in any single payment.

Article 12

Participating Member States shall ensure adequate sanctions against counterfeiting and falsification of euro banknotes and coins.

(1) OJ No L 141, 11. 6. 1993, p. 27. Directive as amended by Directive 95/26/EC of the European Parliament and of the Council (OJ No L 168, 18. 7. 1995, p. 7).

(*) A precise date to be decided, in accordance with the Madrid scenario, when this Regulation is adopted.

PART V

FINAL PROVISIONS

Article 13

Articles 14, 15 and 16 shall apply as from the end of the transitional period.

Article 14

Where in legal instruments existing at the end of the transitional period reference is made to the national currency units, these references shall be read as references to the euro unit according to the respective conversion rates. The rounding rules laid down in Regulation (EC) No 1103/97 shall apply.

Article 15

1. Banknotes and coins denominated in a national currency unit as referred to in Article 6(1) shall remain legal tender within their territorial limits until six months after the end of the transitional period at the latest; this period may be shortened by national law.

2. Each participating Member State may, for a period of up to six months after the end of the transitional period, lay down rules for the use of the banknotes and coins denominated in its national currency unit as referred to in Article 6(1) and take any measures necessary to facilitate their withdrawal.

Article 16

In accordance with the laws or practices of participating Member States, the respective issuers of banknotes and coins shall continue to accept, against euros at the conversion rate, the banknotes and coins previously issued by them.

PART VI

ENTRY INTO FORCE

Article 17

This Regulation shall enter into force on 1 January 1999.

This Regulation shall be binding in its entirety and directly applicable in all Member States, in accordance with the Treaty, subject to Protocols No 11 and No 12 and Article 109k (1).

Done at Brussels, . . .

For the Council
The President
. . .

The legal framework for the use of the euro
Questions and answers on the euro regulations

Directorate General II
Economic and Financial Affairs

BRUSSELS, 13 NOVEMBER 1997
11/487/97-EN - FINAL

As from 1 January 1999, the competence for monetary policy, exchange rate policy and currency law for the Member States which adopt the single currency will be transferred to the Community level.

The monetary policy of the euro area will be defined and implemented by the European System of Central Banks (Article 105 of the Treaty). The exchange rate policy will be determined by the council, with the ESCB and the Commission being involved according to the provisions of Article 109 of the Treaty.

The legal framework for the introduction and the use of the euro is essentially laid down in two Council regulations:

- draft Council Regulation on the introduction of the euro[1] and
- Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro[2].

Council Regulation 1103/97, which is based on Article 235 of the Treaty, entered into force on 20 June 1997. The Council Regulation on the introduction of the euro will, given the voting rules foreseen in Article 109 1 (4) of the Treaty, only be adopted in 1998 once the participating Member States are known.

The draft Council Regulation on the introduction of the euro provides that the euro will be the currency of the participating Member States as from 1 January 1999. On that date, the national currencies of the participating Member States will be replaced by the euro.

One euro will be divided into one hundred cent. During a transitional period running from 1.1.1999 to the end of 2001, the euro will also be divided into national currency units according to the conversion rates. During this period, economic agents are free to use the euro unit, but will not be obliged to do so: this is the "no compulsion / no prohibition" principle.

On 31 December 2001, the national currency units, as sub-divisions of the euro, cease to exist. References to the national currency units in legal instruments still existing at the end of the transitional period have to be read as references to the euro unit, according to the conversion rates. However, banknotes and coins denominated in the national currency units may still keep, for a period of up to six months, their status of legal tender. Member States may shorten this period.

Council Regulation (EC) No 1103/97 includes provisions on the replacement of references to the ECU by references to the euro, the continuity of legal instruments and the specification and the use of the conversion rates, including rounding.

Questions and answers on the euro regulations

In a limited number of articles, the two Council regulations lay down rules for a great variety of currency uses. Since the legal framework for the euro has been laid down, a number of questions on their applicability to specific cases have been put forward to the Commission services by citizens, companies and business associations. To most of these questions, answers can be found in the euro regulations themselves. In some cases, answers depend on national law, e.g. tax and accounting laws or law of obligation.

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1 The draft regulation has been published as an annex to a resolution of the council in O.J. No C 236 of 2.8.1997

2 O.J. No L 162 of 19.6.1997

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

The Commission services will continue to study the legal questions raised in the course of the introduction of the euro and will, if appropriate, publish a further version of this document.

Payments in the transitional period

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

Article 8 (3) of the draft Council Regulation on the introduction of the euro provides that amounts denominated in the euro unit or a national currency unit and payable within that Member State by crediting an account can be paid by the debtor either in the euro unit or in that national currency unit. Paragraph 3 thereby establishes an important derogation from Article 8 (1) which stipulates that all legal acts (including payments) have to be carried out in the denomination of the underlying legal instrument. It allows the debtor to make payments in a denomination other than the one in which his obligation is expressed, provided of course that he has the necessary payment facility and that his creditor accepts to be paid by that means of payment.

An obligation to convert, if necessary, is de lege imposed on the institution receiving a payment. It is by virtue of Article 8 (3), second sentence, obliged to convert, if necessary, the incoming payment into the denomination of the account of the creditor. At the same time, the receiving bank does not need the authorisation of the account holder to make that conversion. Article 8 (3), second sentence is not explicitly addressed to banks, including national central banks; however, they will in practice be concerned almost exclusively. Article 8 (3) thereby ensures fungibility between the euro unit and the national currency units for payments by crediting an account.

A separate question is whether Article 8 (3) imposes an obligation on institutions to initiate payments from an account denominated in a national currency unit when clients write the order form in the euro unit and vice versa. Although banks are not obliged to do so by virtue of the euro regulation, most banks will certainly provide this service. This will help to avoid rounding inaccuracies which might arise in the case of multiple conversions (see question 4).

Likewise, banks will not be legally obliged to offer accounts in the euro unit during the transitional period.

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

Article 8 (3) of the draft Council Regulation on the introduction of the euro applies not only to domestic payments, but also to certain categories of cross-border payments. The term "payable within that Member State" should not be misunderstood to limit this provision to payments where both the account of the debtor and of the creditor are held in the same Member State.

Recital (13) of the regulation confirms that the provisions on payments by crediting an account also apply to those cross-border payments which are denominated in the euro unit or the national currency unit of the account of the creditor, provided that in the latter case the account of the creditor is denominated in the national currency unit of the Member State where the account is located.

Take a contract which foresees the payment of a certain amount in BEF to an account in Belgium, denominated in BEF; in this case the debtor may pay either in BEF or in the euro unit independently of where his account is located. A payment of BEF to a BEF account in France would not on the contrary be covered by this provision. The idea behind this limitation is that the receiving bank should only be obliged to make the necessary conversions between the euro unit and the national currency unit of the Member State where the bank account is located. A French bank would therefore be obliged to make the necessary conversions between the FRF and the euro but not between the euro and the BEF. For this type of payment existing banking practice would continue to apply, i.e. the bank would either convert under a general mandate or hold the amount in the original currency unit in a sub account pending instructions of the client.

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

Payments into and within non-EU countries are not covered by the draft Council Regulation on the introduction of the euro.

Payments from such countries are on the contrary covered as soon as the payment arrives at an account located in a participating Member State, provided the payment is denominated in the euro unit or in the national currency unit of the Member State where the account of the creditor is located. In this sense, a contract stipulating a payment to be made in DM to an account located in Germany would fall under Article 8 (3), first sentence even if the debtor is located in New York and initiates the payment from there in euro. The conversion obligation from euro to DM would of course lie only with the German bank.

The application of Article 8 (3) is dependent only on the location where the crediting of the account takes place. It is independent of the nationality or residence status of the creditor or debtor and also independent of the contractual law which underlies the payment.

4. How to handle rounding inaccuracies which arise in payments?

In many cases, monetary obligations expressed in national currency units will be converted into the euro unit and at a later stage of the payment process, back into the national currency unit or vice versa. Due to rounding effects, this double conversion may in some cases result in a difference between the initial and the final amount.

Different algorithms have been developed to ensure that in domestic payment systems no rounding inaccuracies arise because of double conversion inside the banking system. If, however, the client himself converts before giving a payment order to his bank, (minor) rounding inaccuracies may arise, even if he has properly applied the conversion and rounding rules. In any event the risk of not discharging a debt stays with the debtor. He has to make sure that his creditor receives the amount which was agreed upon. Article 8 (3) of the draft Council Regulation on the introduction of the euro does not provide for the discharging of a debt in case of rounding inaccuracies. It is only when the creditor does not have an account denominated in the unit in which his claim is denominated that he has to accept any discrepancy caused by the necessary rounding (by his own bank) according to Article 5 of Council Regulation (EC) No 1103/97.

Nevertheless, the two euro regulations do not prevent Member States from passing legislation which further specifies under which conditions a debt is discharged.

Banks may wish to advise their clients not to make conversions during the transitional period on their own, but rather to leave these to the banking sector. If a debtor is obliged to pay 10000 ITL from an account denominated in the euro unit, he should fill in the order form in ITL, provided of course that his bank provides him with this facility. If banks were to make necessary conversions for outgoing payments free of charge, this would give an incentive to account holders to initiate payments in the unit referred to in the underlying legal instrument.

5. Are banks allowed to charge for conversions between the euro unit and the national currency units?

The euro regulations do not explicitly address the issue of conversion fees. The Commission services are examining whether conversion charges are compatible with the euro regulations and other EU law and whether any further legislative or non-legislative action is necessary in order to protect the interests of consumers.

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

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

Article 8 (4) enables Member States only to take measures which allow systems to change over. Member States are not allowed to impose this changeover on existing payment systems.

7. How should conversions between third currencies and national currency units be made?

Theoretically, conversions between a national currency unit and a third currency could be made directly according to the exchange rate which is applicable or which is specifically agreed by the parties.

As it is unlikely that quotations between the national currency units and third currencies will still be available after the entry into the third stage, conversions between national currency units and third currencies will have to be carried out by means of the conversion rate between the national currency unit and the euro unit and the exchange rate between the euro unit and the third currency. For the implied conversion between the national currency unit and the euro unit, the provisions of Articles 4 and 5 of the Council Regulation (EC) No 1103/97 would have to be applied.

It is useful to distinguish two cases: a conversion from a national currency unit to a third currency and the inverse transaction. Take first the example of a conversion from USD to NLG. The USD amount would first be converted into a euro amount by application of a USD/EUR exchange rate. The intermediate euro amount would then be converted into a NLG amount by using the conversion rate. It is only to this last operation that the rounding rules as laid down in Article 5 of Council Regulation (EC) No 1103/97 are applicable.

Article 5 is not applicable in the case of a conversion from NLG into USD. A NLG amount would first have to be converted into the euro unit by applying the conversion rate. The intermediate euro amount resulting from this operation would not have to be rounded to the nearest cent because this amount is not “to be paid or accounted for”. The intermediate euro amount would then be converted into a USD amount by using the EUR/USD exchange rate. This final step of calculating the USD amount is not covered by the Council regulation.

8. Can bilateral rates be used for conversions between the national currency units?

Article 4 (4) of Council Regulation (EC) No 1103/97 prescribes an algorithm for conversions between the national currency units. According to this provision, monetary amounts to be converted from one national currency unit into another shall first be converted into a monetary amount expressed in the euro unit, which amount may be rounded to not less than three decimals and shall then be converted into the other national currency unit. Alternative methods of calculation are permitted if they produce the same results as the algorithm described. The use of bilateral rates is therefore permitted provided that these rates always lead to the same result as the conversion via the euro unit.

The final result of a conversion using the algorithm might differ slightly (a fraction of a unit or sub-unit) depending on whether 3 or more decimals are used for the intermediate calculation in the euro unit. Assume a conversion rate 1 EUR = 6.45 FRF and 1 EUR = 1.90 DEM. A conversion of 100 DEM via the euro unit to FRF, using 3 decimals for the intermediate calculation (52.632 euros) would give an amount of 339.48 FRF. A conversion using 7 decimals (52.6315789) for the intermediate calculation would give an amount of 339.47 FRF.

In order to comply with Article 4 (4), the bilateral rate which is used instead of the conversion algorithm has to produce one of these results possible under the conversion algorithm. It might in fact be difficult to compute a bilateral rate which always leads to the same result as the prescribed algorithm. It might be, depending on the conversion rates adopted on 1 January 1999, that even a bilateral rate with a high number of significant figures, say 15 decimals, produces in some cases a different result than that from the application of the prescribed algorithm. In this case the legal risk stays with the person who has used the bilateral rate instead of the algorithm. The likelihood of such differences increases of course with the amounts which are to be converted.

The two euro regulations do not prohibit the display of cross rates for information purposes, e.g. to make it easier for clients to make an “approximate” conversion on their own. Nevertheless, it should be made clear in these cases that these cross rates are displayed for information only and that the application of these rates does not necessarily result in the correct counter-value of an amount expressed in a national currency unit when converted into another national currency unit.

Means of payment

9. Can a debt in the euro unit be settled through payment by notes and coins in a national currency unit?

According to Article 9 of the draft Council Regulation on the introduction of the euro, banknotes and coins denominated in national currency units retain their legal tender status during the transitional period (and possibly, up to a maximum of six months beyond). Euro notes and coins will not yet be available until around the end of this period. All cash payments will therefore have to be made in national currency units. Notwithstanding Article 8 (1), a creditor must therefore also accept these notes and coins for the settlement of debt denominated in the euro unit.

Depending on national provisions on payments by legal tender, which according to Article 6 (1) are still applicable during the transitional period, it might be that in case of a contract excluding cash payment, the creditor does not have to accept settlement in legal tender. The setting up of a contract in the euro unit may not without further evidence be interpreted as a contract where non-cash payment has been implicitly agreed.

10. Are retailers obliged to accept cheques denominated in the euro unit during the transitional period?

In general, a shopkeeper is not obliged to accept any cheque at all; a retailer can decide to accept only cash payments. If a retailer does accept cheques, he may for instance limit acceptance to a certain type of cheque or to cheques from known customers or to certain minimum or maximum amounts.

If, during the transitional period, a retailer has made clear to his customers that he is prepared to transact only in the national currency unit, he is entitled by virtue of Article 8 (1) of the draft Council Regulation on the introduction of the euro to refuse a cheque written in the euro unit for the sole reason that the cheque is not written in the national currency unit, even if he generally accepts cheques for payment.

11. Are cheques covered by the provisions of Article 8 (3) of the draft Council Regulation on the introduction of the euro?

Cheques are in principle covered by Article 8 (3). Nevertheless, Article 8 (3) does not confer a unilateral right on a debtor to settle a debt expressed in the national currency unit through payment with a cheque denominated in the euro unit or vice versa, because acts preliminary to a payment i.e. the writing and handing over of a cheque are not covered by this provision.

A retailer who has entered into a contract in a national currency unit is therefore not obliged to accept from the debtor a cheque denominated in the euro unit, even if he had previously agreed to accept payment by cheque.

However, Article 8 (3), second sentence is of relevance for the relationship between the person who has received a cheque and his bank. If, for example, a retailer accepts a cheque written in the euro unit even though his account is denominated in a national currency unit, then the crediting of his account will trigger the obligation to convert laid down in Article 8 (3) and his bank will be obliged to convert the proceeds of the (euro unit denominated) cheque into the unit of his account (i.e. the national currency unit). In practice it is therefore likely that many retailers will also accept cheques written in the euro unit.

12. Are debit instruments covered by Article 8 (3) of the draft Council Regulation on the introduction of the euro?

Like cheques, other debit instruments, e.g. direct debits are covered by Article 8 (3) once the payment has been "originated" by the creditor, i.e. when the creditor has given the cheque or debit instrument to his financial institution. If, for example, enterprise A is entitled to debit the account of client B which is held with another bank, the bank of A which is receiving the payment is obliged to convert the incoming payment into the denomination of the account of A.

13. Are card payments covered by Article 8 (3)?

Payments by payment cards are within the scope of Article 8 (3) as far as the crediting of an account is concerned. Nevertheless, this provision is of limited relevance for credit card systems because major credit card systems already provide today "conversion facilities" enabling the card holder/retailer to be debited/credited in the denomination of his account.

Article 8 (3), first sentence in particular is of limited value for card payments. In the case of a card payment, the creditor (shopkeeper) can ensure that the payment is initiated in the denomination he wants. If the shop operates in, say, the national currency unit, because it only has the technical facilities to do so, the shopkeeper would write the amount in this unit. It will in the end depend on the agreement between the shopkeeper and his bank or credit card company in which unit he can process transactions. In any event the unit chosen will also be the unit agreed by shopkeeper and client.

The second sentence of Article 8 (3) is relevant, but will normally reflect the existing relationship between the shopkeeper and his bank which will have to convert, if necessary, the payment made by the credit card company to the account of the shopkeeper.

14. What happens to cheques without a denomination?

During the transitional period there will be cheques in circulation written in the euro unit as well as in national currency units. In cases where no denomination is indicated on the cheque, banks are entitled to do whatever is appropriate, for example to send the cheque back. In some Member States these cheques might not be valid according to relevant national laws.

Credit institutions in some Member States are planning to issue cheque-books containing special visual indicators which will help to avoid confusion.

Continuity of contracts

15. Does the introduction of the euro affect the continuity of contracts which are governed by the law of third countries?

The application of the principle of “lex monetae” or the “state theory of money”, which is a universally accepted principle of law, should ensure the continuity of existing contracts also in third countries’ jurisdictions. As set out by F.A. Mann (“The Legal Aspect of Money”, 5th ed.), it is the law of the currency (“lex monetae”) that determines how in case of a currency alteration, sums expressed in the former currency are to be converted into the new one. The underlying assumption is that money as a legal construction is subject to the power of the State. It is held that each State exercises its sovereign power over its own currency, and that no State can legislate to affect another country's currency. From this it follows that it must be the law of the currency which determines what is money and what nominal value is attributed to it.

Applied to the introduction of the euro this means that in non-EU jurisdictions which respect the principle of “lex monetae”, references in contracts set up in the currency of a participating Member State will be interpreted with reference to European law, which is directly applicable in each of the participating Member States. To ensure the recurrent links[3] between the euro and the national currencies, the Council Regulation on the introduction of the euro stipulates in Article 3 that “the euro shall be substituted for the currency of each participating Member State at the conversion rate”. Moreover, Article 3 of the Council Regulation (EC) No 1103/97 confirms the principle of continuity of contracts and other legal instruments.

European Commission contacts with third countries' governments and market participants have shown that the principle of “lex monetae” or the “state theory of money” is indeed followed in the main financial centres of the world.

One should also bear in mind that for competitive reasons these jurisdictions have themselves an interest in recognising the euro and the continuity of contracts and will take any steps, if necessary, to further increase legal certainty. Legislation to confirm the continuity of contracts in the context of EMU has been adopted in the States of New York and Illinois.

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3 The “recurrent link” between a currency and its predecessor defines the value of a currency unit of a new currency in terms of the number of units of the former currency.

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

The legal framework for the euro does not expressly address the issue of the disappearance or replacement of reference rates like interest rates or securities prices. This is because of the diversity of existing reference rates. They are often defined by private entities making it difficult to provide a single legislative solution for the replacement of these rates.

Nevertheless, it appears that contracts including reference rates will not be discontinued because of the introduction of the euro. Many contracts include a fall-back clause which designates a substitute for the original reference rate. Moreover, it can be expected that parties will agree on the replacement of a reference rate to execute the contract. For most reference rates close substitutes will be available.

In fact, the disappearance of reference rates is not a new feature but has happened in the past, for instance in the course of the deregulation of capital markets in the European Union. If parties were not able to agree on the replacement of a reference rate, courts have in general tried to ensure the execution of the contract by taking a new reference rate which was economically as close as possible to the old one.

Furthermore the entities, be they public or private, which provide a reference rate also have an interest in providing an appropriate substitute. The Commission has urged price sponsors and subsequently screen providers to announce quickly their plans regarding the publication of existing national rates[4]. Governmental authorities, central banks and trade associations can be expected to provide assistance in this area.

Work is under way, led by some financial associations, to establish a methodology for the calculation of a European reference rate. In some Member States, public authorities envisage designating by law the reference rates which have to be substituted for reference rates which are disappearing.

17. May "force majeure clauses" be triggered through the introduction of the euro?

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

Indeed, EMU does not make the performance of a contract impossible. The EC Treaty and the draft Council Regulation on the introduction of the euro (Article 3) provide for the "recurrent link" between the national currency units and the euro and thereby ensure that obligations expressed in the former national currencies can be settled in euro.

Moreover, EMU was hardly an unforeseeable event at the time when most existing contracts were agreed. Nor does the introduction of the euro constitute a severe disruption of circumstances. The entry into monetary union on 1 January 1999 is the completion of a long process of economic convergence and technical preparation. The idea to introduce a single currency dates back to the end of the 60s. The principle of continuity of contracts is confirmed by Article 3 of Council Regulation (EC) No 1103/97.

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

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

Increased cost clauses in contracts typically allow the lender to pass on increased costs associated with the loan. It depends on the wording of these clauses and on the particular circumstances which might happen in the course of the introduction of the euro if such clauses might be triggered.

Increased cost clauses, which refer to changes in liquidity, reserve or similar legal requirements, will not be triggered by the introduction of the euro in itself and the implied change of the legal framework. If, on the other hand,

4 "The impact of the introduction of the euro on capital markets", DG II, Economic and Financial Affairs, Euro Papers, No 3, July 1997

regulatory changes were to occur after the introduction of the euro, the increased costs of refinancing thereby implied could, depending on the terms of the contract, be passed on to the borrower.

The same reasoning applies to rights given to the borrower to unilaterally terminate a contract when interest rates have fallen significantly.

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

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

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

Moreover, the original purpose of the contract, i.e. to avoid a loss or to make a profit by reference to comparative currency values, remains unchanged. Any balancing payment to be made by one of the parties is necessary to ensure that the hedge is effective at the level it was intended by the parties. Parties may not therefore argue that the purpose of the contract is frustrated only because of the introduction of the euro and the irrevocable fixing of the conversion rates.

20. Can Member States take measures which provide exemptions from the continuity of contracts?

Council Regulation (EC) No 1103/97 confirms the continuity of legal instruments after the introduction of the euro. It follows in its Article 3 the political agreement reached by the European Council at Madrid, where the continuity of contracts was explicitly confirmed.

National measures, e.g. in the area of consumer protection, would have to respect the provisions of this Council regulation which has entered into force on 20 June 1997 and which is binding and directly applicable in all Member States. Measures which would confer a unilateral right on one party to alter or terminate an existing contract only because of the introduction of the euro would not be compatible with the confirmation of continuity included in EC law.

21. Is there a need to adapt international agreements which refer to national currencies of participating Member States or to the ECU?

The Community as well as the Member States have concluded numerous international agreements which include references to national currencies or to the ECU. The principle of “lex monetae” which is applicable to contracts under private law also holds for international agreements. Since jurisdictions of third countries will recognise the euro as the successor to the respective national currency, references in agreements to a currency of a participating Member State have to be interpreted with reference to European monetary law which is directly applicable in each of the participating Member States.

A similar reasoning applies to references to the ECU as defined in Community law. According to Article 109 1 (4) of the Treaty and Article 2 of Council Regulation (EC) No 1103/97, references to the ECU will be replaced by references to the euro at a rate of 1:1.

It follows that any renegotiation of international agreements for the sole purpose of modifying the monetary unit - whether referring to national currencies or to the ECU – is not necessary. Nor is it necessary to change the respective currency references physically since such references will be read as references to the euro.

No compulsion - no prohibition

22. Can Member States restrict the use of the euro unit in contractual relationships?

By virtue of Articles 2 and 3 of the Council Regulation on the introduction of the euro, the euro is introduced as the single currency of the participating Member States and substituted for the national currencies. It is the very introduction of the euro and the euro unit as one of its expressions that allows the use of this monetary unit in contractual relationships between private economic agents as well as between such agents and public authorities.

National legislation cannot interfere with the liberty of contract in this respect. This is confirmed by Article 8 (2) which stipulates that the provisions of Article 8 (1) are subject to anything which parties may have agreed. This implies, even if a Member State has laid down in national legislation that certain types of contracts have to be made in the national currency unit (legislation which would theoretically be covered by the provision of Article 8 (1)), parties would have the possibility by virtue of Article 8 (2) to deviate from this.

This does not prevent Member States from requiring that acts which might be linked to certain contracts and which are governed by statutory obligations are carried out in the national currency unit. Member States might, for example, insist that certain contracts are registered (e.g. in land registers) in the national currency unit.

23. Can the "no compulsion principle" be restricted through private agreements?

Article 8 (2) of the draft Council Regulation on the introduction of the euro leaves to parties to a contract the possibility to deviate from the general rule contained in Article 8 (1), which is that parties have to respect the denomination of a legal instrument for all acts performed under such instruments.

This option is not only available for agreements between two parties, but also for agreements among a greater number of legal or natural persons; e.g. the statute of a company or collective agreements. Adaptations to these statutes have to be made according to the rules foreseen in the statute or by national law. These normal decision-making procedures also apply with respect to the change of the denomination of share capital to the euro unit, provided national law allows share capital during the transitional period to be denominated in the euro unit. The fact that such a decision, which might be taken by a majority of share-holders, imposes an obligation to use the euro unit on a minority is covered by the exception foreseen in Article 8 (2) of the regulation. Redenomination will in any event be of very limited practical importance for a single share-holder, for whom it will be more important in which unit the shares are quoted in the markets.

24. What are "acts to be performed under legal instruments" in the sense of Article 8 (1) of the draft Council Regulation on the introduction of the euro?

The term "acts to be performed under legal instruments" is not defined in the regulation itself. Only the term "legal instruments" is defined as legislative and statutory provisions, acts of administration, judicial decisions, contracts, unilateral legal acts, payment instruments other than banknotes and coins, and other instruments with legal effect.

The acts in the sense of Article 8 (1) comprise not only everything which produces a legal effect, but all kinds of acts which have to be performed under any legal instrument: offers, payments, invoices, requests for payments and other notifications which are made under contractional relationships. Therefore an enterprise which has a long running service contract which was set up before 1 January 1999 in the national currency of a participating Member State would be obliged to continue to send invoices and other notifications in the respective national currency unit, except in the case that the client has agreed to accept statements in the euro unit. The enterprise would of course be free to send an invoice displaying prices and sums to be paid in the national currency unit and the euro unit.

The term "acts to be performed" also includes all kinds of acts which are governed by statutory obligations, including, for example, the submission of tax declarations, the publication of accounts or the registration of legal instruments. This implies that if a national law stipulates the use of the national currency unit for certain transactions with the public sector, citizens and enterprises have to respect this denomination and do not have the choice of using the euro unit.

25. What is the legal status of a national currency unit of a given Member State in another Member State during the transitional period?

By virtue of Article 6 of the Council Regulation on the introduction of the euro, the euro will during the transitional period be divided into the national currency units according to the conversion rates. The application of this article is not restricted in temtorial terms. Therefore each national currency unit has the status of a unit of the euro in all participating Member States.

A geographical restriction does however apply to notes and coins expressed in a given national currency unit. According to Article 9, the status of legal tender of such notes and coins is restricted to the territorial limits as of the day before the entry into the third stage.

26. What is the legal status of national currency units after the end of the transitional period?

From the end of the transitional period, national currency units cease to be sub-divisions of the euro. Banknotes and coins denominated in the former national currency units may, according to Article 15 of the draft Council Regulation on the introduction of the euro, keep their legal tender status until six months after the end of the transitional period at the latest.

References to national currency units in legal instruments which were already existing on 31.12.2001 will according to Article 14, have to be read as references to the euro unit according to the conversion rates.

Contracts in national currency units which are set up after the end of the transitional period are not covered by the provisions of Article 14. References to national currency units in these contracts are therefore references to units which are no longer legally defined. In case of litigation it can nevertheless be assumed that courts will examine the intentions of the parties and consequently enforce performance of such a contract by applying the official conversion rates. To avoid legal uncertainty, new contracts should no longer be set up in national currency units after the end of the transitional period.

<u>ECU - euro</u>

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

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

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

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

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

It can be expected that those ECU contracts under third countries' jurisdictions which include no clear reference to the official ECU will equally be converted to the euro at a rate of 1:1; in case of litigation a judge will probably refer to European law which establishes a presumption that all references to the ECU are references to the official ECU.

In fact, although not being a lawful currency, financial markets have always treated the ECU as being very similar to a currency, which might therefore benefit from the application of “lex monetae”.

Redenomination of debt and rounding rules

29. When will contracts existing on 1 January 1999 which are set up in national currencies be redenominated in the euro unit?

The euro will be substituted for the national currencies of the participating Member States as from 1 January 1999. However, these former national currencies will for a transitional period of three years continue to exist as sub-divisions of the euro (Article 6 of the draft Council Regulation on the introduction of the euro). References in legal instruments to national currency units will during this period be references to the euro as the single currency, but in a particular denomination. A contract set up in 1998 imposing the payment of 1000 BEF will after 1 January 1999 become an obligation to pay the equivalent amount in euros but denominated in BEF, i.e. 1000 BEF.

It is only at the end of the transitional period (31.12.2001), when the national currency units lose their legal status, that all existing legal instruments are redenominated at one stroke. According to Article 14, references to national currency units in instruments which existed on 31.12.2001 will from thereon be read as references to the euro unit according to the conversion rates.

For certain kinds of debt instruments, Article 8 (4) under certain conditions gives a unilateral right to issuers to impose redenomination before the end of the transitional period.

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

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

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

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

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

The term “redenominate” is defined in a narrow sense. According to Article 1 it only means changing the unit in which the amount of outstanding debt is stated from a national currency unit to the euro unit, as defined in Article 2. This means that redenomination in itself only consists of the division of amounts expressed in a national currency [unity] by the conversion rate. The question of rounding arises only when the resulting amounts expressed in the euro unit are to be paid or accounted for (see question 32). The narrow definition for the term “redenominate” was the basis for choosing the currency denomination as the criterion for allocating the right of triggering the process of redenomination.

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

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

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

31. What are the consequences of the redenomination for the investor?

The change of the denomination means a change of the unit in which the debt is expressed. This debt will be a euro debt, no longer expressed in a national currency unit but in the euro unit. According to Article 8 (1) of the draft Council Regulation on the introduction of the euro, acts under this debt contract will therefore have to be carried out in the euro unit. This concerns payments, notifications, requests for payments, etc.

In practice the difference for investors will be rather limited. Investors holding accounts in a national currency unit will continue to receive their payments (interest and principal) in the national currency unit with the financial institutions making the necessary conversions (see Article 8 (3)).

Issuers will have to make known their decision to redenominate. The form which this information is required to take is not specified in the Regulation but is determined by the law applicable to the contract. Member States whose law is applicable may either decide to define for the particular case of redenomination which form the information to investors shall take, or Member States may refrain from initiating any national legislative measures dealing with the redenomination of outstanding debt. In this case, an issuer making use of Article 8 (4) would have to inform investors of his decision according to national law already in place.

32. Do bonds and shares after redenomination have to be rounded to the nearest cent?

Article 5 of the Council Regulation (EC) No 1103/97 applies to “monetary amounts to be paid or accounted for when a rounding takes place after a conversion into the euro unit”. The term conversion also covers the redenomination of outstanding debt or of share capital.

Article 14 of the draft Council Regulation on the introduction of the euro explicitly confirms that the rounding rules laid down in Council Regulation (EC) No 1103/97 apply to the redenomination of existing legal instruments which will take place at the end of the transitional period. A redenomination which takes place beforehand, either under Article 8 (4) (for debt instruments) or because of an agreement by the parties concerned (for share capital), will have to follow the same regime. In this context it is important to recall that redenomination only means changing the unit in which the amount of outstanding debt is stated from a national currency unit to the euro unit. It does not cover the renominalisation of bonds.

The phrase “when a rounding takes place” used in Article 5 of Council Regulation (EC) No 1103/97 implies that rounding to the nearest cent must not necessarily take place after a conversion. It only has to take place when an amount is paid or accounted for. For the redenomination of bonds, this means that in a first logical step, the nominal value of a bond after redenomination would be its face value (expressed in national currency units) divided by the conversion rate. This value will be an unrounded amount expressed in the euro unit.

A rounding to the nearest cent will only have to take place when it comes to the payment or the redemption of the bond or the accounting of the bond at the individual or holdings level.

It depends on the provisions of the underlying agreement or national law whether the rounding to the nearest cent has to take place for each minimum nominal amount (this would arguably be the case if the debtor has an obligation to pay bond by bond) or for the aggregated amount of bonds held by each investor (if the obligation to pay concerns the aggregated amount).

Remaining minor rounding inaccuracies at the issuer's level might nevertheless oblige an issuer to realise profits or losses in his accounting because of the rounding. The regulation does not address how such inaccuracies can be reconciled in the context of redenomination. If necessary, national legislation may take account of such discrepancies.
Such remaining rounding inaccuracies should not be considered as being a change to the economic value of a monetary obligation or claim and will not give rise to particular rights or obligations for any party. This also means that changes in the nominal share capital which are only due to the application of the rounding rules for conversions at the end of the transitional period should not require any approval either from shareholders or from public authorities.

33. Can Member States take measures to facilitate agreements to redenominate share capital?

The draft Council Regulation on the introduction of the euro does not foresee special provisions for the redenomination of share capital in the transitional period. Article 8 (4) of the draft Council Regulation on the introduction of the euro does not apply to share capital.

This means that redenomination of share capital cannot under the regulation be imposed upon a shareholder by the company unilaterally. However, Article 8 (1) does not override existing provisions for cases where numerous parties must arrive at a common decision and where the procedures therefore provide for majority voting. These procedures are covered by Article 8 (2) and are applicable also to decisions on redenomination, which may imply that redenomination is imposed on a minority of shareholders.

Member States wishing to facilitate the process of redenomination have to respect Article 8[s] (1) and 8 (5) of the draft Council Regulation on the introduction of the euro. The borderline between measures which are compatible with Article 8 (1) and 8 (5) is where facilitation turns into compulsion. One might argue that national measures changing the majorities necessary at shareholder meetings to decide on redenomination are compatible with EC law, whilst measures that profoundly change the decision-making procedure, e.g. a transfer of the decision-making power on redenomination from the shareholders to the executive board, which is not approved by the shareholders, would be incompatible with the draft Council Regulation on the introduction of the euro.

Member States could take legislative measures to allow the use of Non Par Value shares. This would be compatible with the draft regulation and would considerably facilitate the changeover.

34. Can Member States adopt complementary legislation or other measures on rounding rules?

The rounding rules of Council Regulation (EC) No 1103/97 are designed to ensure a high degree of accuracy when making conversions. The regulation allows further national legislation in two areas:

1. Article 5 of the regulation points to national law or practices when it comes to the rounding of amounts converted from the euro unit into a national currency unit. National law can specify to which multiple of a sub-unit or unit of the national currency unit such an amount shall be rounded.

2. Moreover, Recital (11) of the same regulation points to rounding practices, conventions or national provisions providing a higher degree of accuracy for intermediate computations. The scope of the term “intermediate computations” has to be read as including all steps which are necessary in order to compute the amount of a monetary obligation.

Member States would therefore be free to take measures to resolve the problem of rounding discrepancies which may arise when sums or products are converted.

One important source of potential rounding discrepancies is the fact that different methods are applied for the conversion of sums. The sum of the converted individual amounts may be different from the amount obtained by converting the sum of the amounts in the original denomination. These rounding discrepancies may reach a significant magnitude in cases where single items are converted which are of equal value.

This discrepancy might lead to confusion in accounting or in the settlement of debts, e.g. when a supplier of a lot of goods uses a different way of calculating the total value of the lot than the buyer. Different solutions to ensure consistency have already been developed at national levels. In France, a working group consisting of representatives of the public as well as the private sector has suggested converting only final results wherever possible and not the single monetary amounts of the individual items. In Germany, banking associations have announced that they will always convert the individual monetary amounts and not the sums.

Both approaches are compatible with the rounding rules laid down in the euro regulations. Recommendations by Member States' governments or by associations can play a useful role to provide clarity.

35. Are Member States allowed to deviate from the general rule that monetary amounts have to be rounded up when the application of the conversion rate gives a result which is halfway?

Article 5 of Council Regulation (EC) No 1103/97 stipulates that in cases where a conversion between a national currency unit and the euro unit leads to a result which is exactly half way, the sum shall be rounded up. An amount of, say, 100.445 EUR or 45.675 FRF would have to be rounded to 100.45 EUR or 45.68 FRF respectively.

The reference in Article 5 to “national law and practice” relates only to the definition of the unit or sub-unit of the national currency unit to which amounts have to be rounded after a conversion from the euro unit to a national currency unit. It does not extend to the question of whether these half way results have to be rounded up or down. Member States are therefore not allowed to deviate from the rounding-up rule.

Effects on Community legislation

36. How will references to monetary amounts in Community legislation be treated?

The rules contained in the two euro regulations on the redenomination of legal instruments (in particular Article 2 of Council Regulation (EC) No 1103/97 and Article 14 of the draft Council Regulation on the introduction of the euro) apply to Community legislation as they do to national legislation, private contracts, and other legal instruments.

Most monetary amounts in EC legislation are expressed in ECU. From 1 January 1999 all references to the ECU will be replaced by references to the euro at a rate of 1: 1.

All references to amounts expressed in a specific national currency of a participating Member State (e.g. 1000 ITL) will have to be read as references to the euro unit according to the respective conversion rate as from the end of the transitional period, i.e. 31 December 2001. During the transitional period, these references have to be read as references to the euro as the single currency but expressed in the denomination of the respective national currency unit. According to Article 8 (1) of the draft Council Regulation on the introduction of the euro, this implies that obligations expressed, e.g. in ITL, will during the transitional period have to be honoured in ITL.

37. How are references to “national currencies” to be interpreted?

In a number of regulations or directives one can find references to “national currencies” without further specification. A typical clause might read “... a threshold of 1000 ECU. The equivalent in national currency shall be obtained ...”.

During the transitional period a reference to a national currency has to be read as a reference to the currency euro. This reference does not in itself refer to any particular unit of the euro (neither euro unit nor national currency unit). Nevertheless, according to Article 7 of the Council Regulation on the introduction of the euro, the substitution of national currencies by the euro does not in itself have the effect of altering the denomination of legal instruments (including national laws) existing at the date of substitution.

Amounts expressed in national currency units will therefore continue to be the relevant amounts under EC law for the parties concerned (Member States, enterprises, citizens ...) during the transitional period.

38. Are clauses which foresee a conversion between the euro and the national currencies in the transitional period still applicable?

In some directives, where a conversion between the ECU and the national currencies is foreseen, no specific algorithm is defined for making these conversions. In these cases the reference amounts expressed in ECU (euro) will after 1 January 1999 continue to apply directly and no specific steps are required at Community level. Member

States will therefore be obliged to maintain amounts in their national currency unit which are at all times in excess of the thresholds or below the ceilings defined in Community legislation.

Other Community directives contain particular clauses for the conversion of ECU amounts into the respective national currencies. Typically such clauses provide a reference date (or formula) for converting ECU amounts into national currency, often allowing for some degree of "legislative rounding" by national authorities (e.g. up to 10% of the amount) in order to arrive at suitable amounts expressed in national currency. In addition, some directives include clauses which ensure periodic revisions of the conversions into national currencies without the need for further legislative actions.

The amounts resulting from the conversion under simple "fixed date clauses", i.e. clauses which require conversion of an ECU amount at a historical exchange rate (e.g. fixing a threshold at 1000 ECU to be converted into national currencies at the exchange rate of 1 January 1994) and which do not include a revision clause, will continue to be applicable after I January 1999. Consequently there will be no need to change the corresponding amounts in national legislation, which are expressed in the respective national currency units. For the sake of legislative coherence, these clauses should be amended with effect at the latest from the end of the transitional period. The Commission may put forward proposals to this effect.

In other cases, directives contain "revision clauses", i.e. clauses which foresee a timetable and a mechanism for conversion into national currencies. If the revision date falls on or after 1 January 1999, the irrevocably fixed conversion rates will have to be applied for the conversion of ECU (euro) amounts into the respective national currency unit as of the revision date. Given that the euro will be the currency of participating Member States, formulae which describe how to convert ECU (euro) amounts into national currencies will have become pointless for the participating Member States. For such conversions it will not be possible to deviate from the irrevocably fixed conversion rates.

A second question which arises is whether the participating Member States can continue during the transitional period to make use of "rounding clauses" which are provided for in some directives. Given that the objective of the rounding clauses, namely to facilitate the national legislator's task by ensuring convenient amounts expressed in national currency units, is still valid, these clauses remain applicable. After the end of the transitional period, when national currency units cease to exist as sub-units of the euro, the ECU (euro) amounts apply directly. Neither conversion mechanisms nor rounding clauses will be applicable any more. Member States will therefore have to make sure that the necessary steps to ensure compliance with the Community law are taken before the end of the transitional period.

It should be noted that the reasoning set out above applies only to participating Member States. For non-participating Member States, the clauses will continue to apply as before.

NY Legislation on Continuity of Contract General Obligations Law

TITLE 16. CONTINUITY OF CONTRACT

§ 5-1601. Definitions

As used in this title the following terms shall have the following meanings:

1. "Euro" shall mean the currency of participating member states of the European Union that adopt a single currency in accordance with the treaty on European Union signed February seventh, nineteen hundred ninety-two.

2. "Introduction of the euro" shall mean and include the implementation from time to time of economic and monetary union in member states of the European Union in accordance with the treaty on European Union signed February seventh, nineteen hundred ninety-two.

3. "ECU" or "European Currency Unit" shall mean the currency basket that is from time to time used as the unit of account of the European Community as defined in European Council Regulation No. 3320/94. When the euro first becomes the monetary unit of participating member states of the European Union, references to the ECU in a contract, security or instrument that also refers to such definition of the ECU shall be replaced by references to the euro at a rate of one euro to one ECU. References to the ECU in a contract, security or instrument without such a definition of the ECU shall be presumed, unless either demonstrated or proven to the contrary by the intention of the parties, to be references to the currency basket that is from time to time used as the unit of account of the European Community.
(Added L.1997, c. 311, § 1, eff. July 29, 1997.)

Practice Commentaries

By Richard A. Givens

Former Regional Director, Federal Trade Commission

TRANSLATION OF INDIVIDUAL NATIONAL CURRENCIES TO PROPOSED EUROPEAN CURRENCY

Chapter 311 of the Laws of 1997 adding GBL §§ 5-1601 to 1604 makes it easier for those dealing with individual European currencies to accept the proposed European currency. This provision is a positive step toward furthering world-wide commerce. Other changes in currency must, of course, be accommodated by creditors in any event; §§ 5-1601-1604 assist in establishing predictable implementation, at least until Congress or an appropriate federal agencies establishes nation-wide means of dealing with such changes in currency. Should that occur, it would be in the interest of those in New York as well as elsewhere to adopt the federal approach in whatever form is adopted at the federal level.

In the meantime, the worthwhile New York measures making the extension of transactions more reliable is likely to also encourage attention to other transactions in foreign currency. Utilizing multiple currencies in major transactions may at times be beneficial from the viewpoint of interest rates and other aspects. This is worth mentioning because at times dealing in foreign currency is clearly permitted in New York and the United States and not covered by controls under the Commodity Exchange Act. *Dunn* v. CFTC, 117 S.Ct. 913, 137 L.Ed.2d 93 (1997). For further references, see R. Givens, Manual of Federal Practice § 7.101 (4th ed. 1992 and supplement 1997).

§5-1602. Continuity of contract

1. (a) If a subject or medium of payment of a contract, security or instrument is a currency that has been substituted or replaced by the euro, the euro will be a commercially reasonable substitute and substantial equivalent that may be either: (i) used in determining the value of such currency; or (ii) tendered, in each case at the conversion rate specified in, and otherwise calculated in accordance with, the regulations adopted by the council of the European Union.

(b) If a subject or medium of payment of a contract, security or instrument is the ECU, the euro will be a commercially reasonable substitute and substantial equivalent that may be either: (i) used in determining the value of the ECU; or (ii) tendered, in each case at the conversion rate specified in, and otherwise calculated in accordance with, the regulations adopted by the Council of the European Union.

(c) Performance of any of the obligations described in paragraph (a) or (b) of this subdivision may be made in the currency or currencies originally designated in such contract, security or instrument (so long as such currency or currencies remain legal tender) or in euro, but not in any other currency, whether or not such other currency (i) has been substituted or replaced by the euro or (ii) is a currency that is considered a denomination of the euro and has a fixed conversion rate with respect to the euro.

2. None of: (a) the introduction of the euro; (b) the tendering of euros in connection with any obligation in compliance with paragraph (a) or (b) of subdivision one of this section; (c) the determining of the value of any obligation in compliance with paragraph (a) or (b) of subdivision one of this section; or (d) the calculating or determining of the subject or medium of payment of a contract, security or instrument with reference to interest rate or other basis has been substituted or replaced due to the introduction of the euro and that is a commercially reasonable substitute and substantial equivalent, shall either have the effect of discharging or excusing performance under any contract, security or instrument, or give a party the right to unilaterally alter or terminate any contract, security or instrument.

(Added L.1997, c. 311, § 1, eff. July 29, 1997.)

§5-1603. Effect of agreements

The provisions of this title shall not alter or impair and shall be subject to any agreements between parties with specific reference to or agreement regarding the introduction of the euro.
(Added L.1997, c. 311, § 1, eff. July 29, 1997.)

§5-1064. Application

1. Notwithstanding the uniform commercial code or any other law of this state, this title shall apply to all contracts, securities and instruments, including contracts with respect to commercial transactions, and shall not be deemed to be displaced by any other law of this state.

2. In circumstances of currency alteration, other than the introduction of the euro, the provisions of this title shall not be interpreted as creating any negative inference or negative presumption regarding the validity or enforceability of contracts, securities or instruments denominated in whole or in part in a currency affected by such alteration.
(Added L.1997, c. 311, § 1, eff. July 29, 1997.)

ACI - THE FINANCIAL MARKET ASSOCIATION
BANKING FEDERATION OF THE EU
CEDEL BANK
EUROPEAN ASSOCIATION OF COOPERATIVE BANKS
EUROPEAN FEDERATION OF FINANCIAL ANALYSTS' SOCIETIES
EUROPEAN MORTGAGE FEDERATION
EUROPEAN SAVINGS BANKS GROUP
INTERNATIONAL PAYING AGENTS ASSOCIATION
INTERNATIONAL PRIMARY MARKET ASSOCIATION
INTERNATIONAL SECURITIES MARKET ASSOCIATION
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION
MORGAN GUARANTY AS OPERATOR OF THE EUROCLEAR SYSTEM (EUROCLEAR)

JOINT STATEMENT ON MARKET CONVENTIONS FOR THE EURO

Economic and Monetary Union presents a number of technical challenges for the international and new domestic (i.e. euro-zone) financial markets. One of these is the need for market participants to prepare for the market conventions that will apply to trading and settlement of the euro money, bond and foreign exchange markets. However, market conventions currently vary across the European Union and there is as yet no agreed set of common conventions for the new single currency. The above named organisations are therefore publishing this joint statement recommending harmonised market conventions for the euro.

Support for Harmonisation

In our views, harmonisation of euro market conventions is desirable, as it would promote liquidity and transparency in the new markets and prevent confusion and disputes for euro trading and settlement. Also, firms and settlement facilities face uncertainty in their systems requirements while this question is left open. We therefore publish the attached bond market, money market and foreign exchange market conventions for the euro with the aim that they establish standards for market practice for the new single currency. We note that parties to a financial contract may always specify their own terms, including day count or other conventions. However, we believe that the attached provide a basis for standard practice, which we strongly recommend to our members and to both public and private issuers of securities. We note that government issuers in particular have an important role to play in achieving harmonisation, by ensuring the use of common standards for euro-denominated benchmark government bond issues.

Treatment of Legacy and Redenominated Instruments

While harmonisation has strong benefits for new euro-denominated instruments, applying new, harmonised, conventions to existing "legacy" instruments – including bonds that redenominate into euro – – presents considerable complications. In light of the legal obstacles associated with revising existing agreed conventions and the dangers of hedging mismatches, if underlying and derivative instruments do not all switch to the new conventions, we conclude that existing conventions should be retained for legacy instruments.

Timing

We propose that the attached agreed standards be adopted for financial instruments entered into after the start of stage three of Economic and Monetary Union on 1 January 1999. We also note that new issues before that date of instruments designed to redenominate into euro should also adopt these standards.

CONVENTIONS FOR THE EURO MONEY MARKETS

Day Count Basis

We recommend the adoption of an **actual/360 basis.**

We note that this is common practice in EU money markets and has been proposed by the European Monetary Institute as the basis for repo instruments used for open market intervention. This convention would apply to wholesale financial activity; we do not recommend a standard retail market convention.

Settlement Basis

We recommend the adoption of a **spot/two day standard.**

We note that this is the prevalent practice for inter-bank offer rate settlement for most EU currencies.

Fixing Period for Derivatives Contracts

We recommend the adoption of a **two day rate fixing convention** for derivatives contracts.

Most EU currencies currently provide for a two day period between the fixing of a new floating rate and the date when these new rates become effective (ie. when the contract actually becomes "reset" to the new rates for the purposes of calculating payments). We believe that this practice should continue and that it would be impractical to shorten this cycle in the near term.

Business Days

We recommend that **TARGET operating days form the basis for euro business days.**

As a practical matter, we believe that the convention for euro business days and TARGET operating days should be identical, to ensure the availability of euro payments arrangements throughout *all* EMU area countries on a day identified as a euro business day. In order to facilitate financial activity throughout the EMU area, we recommend that the number of non euro business days be kept to a minimum and possibly be limited to 1 January and 25 December.

We note that this approach has implications for the operating days of commercial and investment banks and other financial market participants in the EMU area and may raise questions concerning national legislation governing bank holidays. It would, for example, mean that institutions unable to make payments specified for a euro business day due to observance of a national holiday would be liable to pay interest for the period of delay.

Finally, we should note that parties to an instrument may well decide to agree to use national business day conventions for the euro, due to the likely absence of full payment services on euro business days in all EMU participant member states (at least in the short term) or if the use of national business days are more convenient for transactions with domestic counterparties.

CONVENTIONS FOR THE EURO BOND MARKETS

Day Count Basis

We recommend adoption of an **actual/actual basis.**

> While many EU markets currently use a 30/360 methodology, in volume terms act/act or act/365 is probably most prevalent in the EU, as it is the convention for French, British and Italian markets. Also, we note that this standard is used in the US and Japanese government bond markets. We note that this is a more exact basis than other methods and presents fewer calculation problems than a 30/360 basis, which largely developed due to systems calculation limitations which have since been overcome.

Quotation Basis

We recommend adoption of **decimals**, rather than fractions, **for bond quotation.**

> Quotations in decimals provide for a more accurate and precise methodology of yield calculation, will unify price quotation for government and corporate debt, as well as being easier for screen displays.

Business Days

We recommend that **TARGET operating days form the basis for euro business days.**

> Please refer to the commentary above on euro business days in money markets.

Coupon Frequency

We **do not recommend a standardised practice** in this area.

> In our view, there are strong arguments for the use of either a semi-annual or annual payment basis as the standard for euro coupon frequency. Semi-annual coupons reduce the credit exposure of investors to issuers and on swaps linked to bonds. They are also attractive to institutional investors seeking regular income. In volume terms, it is the standard most widely used globally, employed in the US, Japan, UK and Italy. On the other hand, annual coupons are used by most EU countries, involve lower administrative costs and are attractive to some issuers and investors.
>
> The competing merits of both payment bases, combined with a desire to allow flexibility to respond to issuer and investor preferences, leads us to conclude that in this particular area the case for harmonisation is less compelling. While the individual organisations have made recommendations in this area, the group does not recommend a standardised practice for coupon frequency.

Settlement Dates

We recommend that the standard settlement date for internationally traded cross-border transactions for the euro remain on a **T plus 3 business day cycle.**

> While we note that special value dates may be agreed between buyer and seller, we feel that the current T plus 3 day cycle currently in force should be retained for the euro. However, with the soon to be introduced real time gross settlement systems and the ever-increasing desire to reduce settlement risk, we believe that a move to ever shortening settlement cycles is inevitable.

Nevertheless, we feel that it would be inappropriate to introduce such a change at the current time, due to other significant system changes posed by the introduction of the euro.

CONVENTIONS FOR THE EURO FOREIGN EXCHANGE MARKETS

Settlement Timing

We recommend the adoption of a **spot convention.**

International markets should move to a spot convention for settlement of foreign exchange transactions of the euro and interest accrual should then begin on the second day after the deal has been struck.

Foreign Exchange Quotation

We recommend the adoption of the **rule of 'certain for uncertain'.**

In our view, the methodology for the quotation of foreign exchange rates should follow the rule of 'certain for uncertain' (i.e. 1 euro = x foreign currency). It may not be appropriate to harmonise domestic retail market conventions. This should be left to subsidiarity.

Reference Rate

We recommend that the **ECB (or its national central banks) should be responsible for the publication of a daily reference rate.**

There would be advantages in having one authoritative closing reference rate, produced at an appropriate time each day and published through a well known and established medium (e.g. a major screen based service).

16 July 1997

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

EMU AND PRICE SOURCES: MARKET PREFERENCES AND LEGAL ISSUES

Introduction

ISDA's 11 June discussion paper on EMU and price sources asked members and other market participants to provide details of their favoured approach to the changeover of price sources in the light of EMU and to consider any associated legal issues. This paper now reports on the results of this consultation exercise and explains how ISDA intends to address some of the legal issues raised by the changeover process.

We would emphasise that this analysis has been conducted solely in the context of the impact of disappearing or changing price sources on transactions entered into under the ISDA Master Agreement. The impact of EMU on price sources also has important implications for many other types of financial transaction, including bond agreements and loans. We would strongly urge market participants and their representative associations to give careful thought to the impact of the changeover for these markets. We would note that it is rarely appropriate to consider the impact of EMU on a derivatives transaction in isolation, as there will frequently be linked hedges or underlying instruments in the cash markets. ISDA stands ready to work with relevant market bodies to seek parallel changes in the underlying and derivatives markets.

Market Preferences Concerning the Changeover Process

Continuing National Currency Quotation or Roll-Over to Euro Quotation: Early in its work on this subject, members of ISDA's EMU Market Practice Task Force expressed a strong preference that national currency price sources “roll over” to euro quotation, such as euro EURIBOR, immediately upon the start of EMU. This was due to anticipation of the swift movement of wholesale financial market activity into euro, the legal equivalence between the euro and participating national currencies, and the development of an EMU zone-wide integrated euro money market following establishment of common interest rate policy and co-ordinated open market intervention by the ECB.

While many ISDA members and market participants still appear to favour this approach, it is clear that the legal uncertainties of any roll over process and the exact nature of any successor rate have led a number of firms to doubt the feasibility of this approach (and have prompted some price sponsors to decide that they need to keep sponsoring local price sources.) It appears that the uncertainties relate less to the changeover from national currency rates to the euro than to the roll over from local financial centre rates to an EMU zone-wide euro rate (eg EURIBOR). Even assuming that EURIBOR is a rate that commands wide market support and is representative of actual market activity, the changeover from a local rate (one that reflects average funding costs of banks in a single financial centre) to an EMU area-wide rate (one that reflects the average funding cost of a much larger number of banks throughout the EMU area) could pose legal difficulties in some jurisdictions.

ISDA members have also expressed concern that if the changeover process is uncertain or unclear, then resort to the potentially cumbersome and expensive route of using reference banks may be necessary (see below). Thus, generally, members have expressed a strong belief that ISDA should take an active role to ensure the smooth continuance of existing contracts and to ensure that the potential legal difficulties associated with the changeover of reference rates are fully recognised and addressed well in advance on the start of EMU.

ISDA's role as a representative market association is to respond to member needs as best as possible in the light of any legal constraints. The preference of many members to roll over to euro rates and the potential legal uncertainties surrounding this process have therefore led us to conclude that we should develop appropriate legal mechanisms to enable counterparties to achieve this result, should they both agree to do so. Our proposals in this regard are explained in further detail below.

Method of Screen Changeover: We also asked our members and other market participants to explain how they would prefer any successor rates to be displayed on screen pages. It appears that members would prefer new successor rates to be displayed on the same page as old national currency rates, replacing these old rates, rather than a cross-reference from the old rate page to the new rate page. We understand that this is also the preferred technical approach of most screen service providers.

Legal Issues Posed by the Effect of EMU on Price Sources

The effect of EMU on price sources raises a number of legal issues. It is, however, first of all important to emphasise that the changeover of price sources should, in and of itself, not affect the continuity of transactions entered under ISDA Master Agreements: the article 235 euro regulation recently adopted by the EU, recently enacted New York State legislation and ISDA's own contractual provision on continuity of contracts (where included in relevant documentation) all ensure that the advent of the single currency is not grounds for one party unilaterally abrogating transactions entered into under the ISDA Master Agreement.

Instead, at issue is the appropriate price source to employ following EMU for these contracts that continue. As explained in our 11 June paper, under the 1991 ISDA Definitions, typically incorporated into confirmations of interest rate and currency transactions under the ISDA Master Agreement, reference is first of all made to a relevant screen page for a national currency rate, then to any designated successor page (so long as it is comparable) and then to the use of reference banks. Thus, in the case of a confirmation incorporating the ISDA Definitions, even if a rate source disappears or there are doubts about the comparability of a designated successor rate, the use of reference banks as a fall back would ensure that a rate may, in fact, still be calculated.

However, market participants have made it clear that they would prefer to avoid employing the reference bank fall-back provisions, as this may be somewhat cumbersome to operate where resort to reference banks is being made concurrently by a great many market participants. This therefore raises the question as to whether, before relying on the fall-back provision, a duly designated successor rate would be applied to existing transactions governed by the ISDA Definitions.

This is first and foremost a matter for individual counterparties to consider for themselves. ISDA would note that the answer to this question could vary from jurisdiction to jurisdiction. In this respect, we would note that the key consideration would be the intentions of the parties as construed in accordance with the governing law of the contract, and not the law of the jurisdiction where the relevant price source is located. Thus, if the French law position is, say, that French Franc PIBOR could be replaced by euro EURIBOR, it is by no means assured that an English judge would share this view if the PIBOR-based contract was subject to English law.

The legal position will also depend considerably on the facts of the case. In this respect, the nature of any successor rate will be important, as will be whether the old rate is being published in any form. As noted above, we understand that in some jurisdictions the fact that a national rate calculated from national bank quotes would be replaced by an international rate calculated from the quotes of banks from various countries could lead a court to rule that a rate such a euro EURIBOR would not be a comparable successor. However, again, the position may vary from jurisdiction to jurisdiction and could also be influenced by the extent to which national rates and any EMU zone-wide euro rate in practice converge.

These considerations lead ISDA to make the general observation that it is reasonably clear that the retention of national currency rates or their replacement by national centre-based euro rates poses minimal legal uncertainties, but that the position is much less clear when a national rate is abolished and replaced by a successor rate calculated for the EMU-zone as a whole, or where an EMU-zone successor is designated for the screen but the national rate continues to be quoted elsewhere.

ISDA Proposals to Address Market Preferences and Legal Uncertainties

As can be seen from the above, market participants are likely to face one of two situations:

- National price sources are retained (either as national currency or explicitly euro rates) for the relevant financial centre;
- National prices sources disappear outright, with an EMU zone-wide price source (such as euro EURIBOR) probably designated as a successor; or
- The screen rate is replaced by an EMU zone-wide rate, but the old national rate continues to be calculated for domestic purposes

ISDA is proposing to develop legal provisions for these different possible circumstances: to allow market participants, if both parties agree, to opt to move to EMU zone-wide euro rates in the former situation and to address the legal uncertainties of the latter two situations

Providing an Option to Move From Continuing National Rates to an EMU Zone-Wide Euro Rate: As noted above, the first situation should pose minimal (if any) legal uncertainties under the ISDA Master Agreement: the national price source would continue to be employed as per the relevant screen page designated in the ISDA Definitions. Counterparties to a transaction may, however, for their own commercial reasons, still wish to switch from such a national rate to an EMU zone-wide euro rate, as evidenced by the number of ISDA members that have expressed a preference to “roll over” to euro rates (see above).

ISDA therefore proposes to develop a contractual provision which would allow counterparties to agree to switch from national price sources to any new EMU zone-wide euro rate, such as euro EURIBOR. This is simply to be provided as an option for market participants and there should in no way be any assumption in favour of roll over to a new rate. It is a commercial matter for both parties to agree that they no longer wish to use the existing rate which governs their transaction.

Minimising Legal Uncertainty Due to Disappearing National Rates: As noted above, the disappearance of national rates (either completely or just for screens, with national rates retained for domestic purposes) appears to pose greater legal uncertainties if it is intended that the designated successor should automatically be an EMU zone-wide euro rate.

ISDA is therefore proposing to develop a contractual provision which would allow counterparties to clarify that in the event of the disappearance of a national price source they intend to employ a published or displayed successor rate.

Use of Reference Banks: Where a national rate source disappears and there is no clear successor rate agreed between the parties or as a matter of general law, it would be necessary, under the ISDA Definitions, to rely on reference banks as a fall-back reference rate.

We are aware that market participants have expressed concern about the mechanics of determining reference bank quotations, especially the requirement for the calculation agent to call prime banks for quotations. This would impose a burden on market players who would be asked to respond to frequent phone requests for quotations.

We would, however, note that the need for phone quotations could be avoided. If, as expected, euro EURIBOR is launched on the basis of quotations from a range of banks in different centres, these individual underlying quotes should also be available on screen. (It is common practice for constituent quotes to be provided in addition to the average of these quotes and we would anticipate that EURIBOR will also employ this practice.) Thus, details of individual bank quotations in a range of national financial centres may be available on screen to provide a basis for calculating the reference bank fall-back rate.

Conclusion and Next Steps

ISDA believes it is important to emphasise that counterparties themselves need to consider the legal implications of changing or disappearing price sources for their outstanding contracts, in light of the relevant jurisdictions, the particular facts, and the nature of the contract in question. ISDA will however develop contractual provisions designed to address the uncertainties posed by the disappearance of national rate sources and their replacement by an EMU zone-wide rate source and, also, to provide an option to move to such a rate source even where the relevant national rate continues. Consideration will also be given to identifying ways in which ISDA can facilitate the adoption of the appropriate provisions by the parties in their existing ISDA Masters. Also, separately, we will revise the ISDA Definitions to provide market participants with the option to employ any new post-EMU rate sources for new contracts, as is our existing practice for national rates.

International Swaps and Derivatives Association
19 August 1997

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

UPDATED REPORT ON DEVELOPMENTS BY PRICE SPONSORS

I. Introduction

ISDA has for some time expressed concern regarding the need to ensure a smooth changeover process for price sources in light of the significant volume of outstanding transactions referring to these sources and the legal and systems issues raised by the transition. ISDA's initial consultative paper[1] highlighted the need for national price source sponsors to declare their euro strategies and requested euro rate sponsors to announce details of their plans for an EMU-zone euro fixing.

ISDA is happy to report that significant progress has been made since our last progress report on this subject[2]. In particular, we are grateful to the BBA and Euribor sponsors for announcing their official plans of a euro rate fixing. ISDA also very much appreciates the support provided by the EMI in clarifying the position of national central banks in regard to current national price sources. In September, the EMI published a very helpful overview[3] of the responses of national central banks to the request for information on price sources.

However, in spite of this progress, in some countries, as described below, concern remains as to the precise intentions of national price source sponsors.

II. Remaining Questions

There has been significant progress in clarifying the impact of EMU on existing price sources. In nearly all countries, current price sponsors have made an official announcement or have told ISDA that they have made a decision in principle which will be confirmed within a matter of weeks. Part III.4. of this paper describes the position and each country and annex A summarises the position in tabular form.

However, in a couple of countries, it is even at this late date still unclear whether the domestic rate will be maintained or will disappear. The rate sources where the position is still uncertain are;

- Italian Lira RIBOR; Price Sponsor: ABI
- Portuguese Escudo LISBOR; Price Sponsor: Portuguese banks

ISDA urges that decisions in these countries be made as soon as possible.

In addition to clarifying whether or not a price source will continue or not, it is important to establish whether an official successor rate will be designated. This is also an area where the

1 ISDA - 11 June 1997: Effect of EMU on Price Sources

2 See also: ISDA - 19 August 1997: I. Report on Developments by Price Sponsors - II. EMU and Price Sources: Market Preferences and Legal Issues

3 EMI - 5 September 1997: Response of National Central Banks to the Request for Information by EU-wide Banking and Financial Associations on Price Sources in Stage Three of EMU

position has become much clearer since our last report: as the attached overview shows nearly all price sponsors that have reported their existing rate will be discontinued have confirmed the name of the successor rate. However, (in addition to RIBOR and LISBOR) the position concerning a designated successor is still not clear regarding Dutch Guilder AIBOR.

Finally, in nearly all countries it is unclear whether the successor rate will be displayed on the same screen page as the existing price source or whether the screen page of the discontinued rate will simply refer to the successor page. Only in regard to current BBA Libor rates and Belgium national rates, have these details been clarified (see below). All other price sponsors still need to formally announce their plans which also have to be confirmed with the relevant screen service providers. It is important that this is done as quickly as possible.

III. Status Report

The overview below shows the details of the changeover plans which have been received to date.

1. EMI and Overnight Rates

ISDA is very grateful for the support received by the EMI and national central banks in addressing this issue. As noted above[4], the EMI has encouraged the market to provide further information on the intentions of screen service providers and this has been helpful in focusing the attention of price sponsors on the need to decide on their euro strategy and publicise those results.

Also, in July, ISDA, along with the Association Cambiste International (ACI) and the Federation Bancaire de 1’Union Europeenne (FBE), wrote to the EMI and requested that consideration be given to ESCB sponsorship of an effective overnight euro rate (i.e. a weighted average of actual transactions). We are grateful that the EMI council has agreed that the ESCB will assist in the calculation of this rate.

The panel for the effective overnight euro rate (EONIA) is likely to be structured in line with the Euribor panel and calculated in a manner similar to the French Franc TMP rate. However, more issues are being discussed within a technical working group of the EMI and results will likely be published in due course.

2. Euro LIBOR

The British Bankers’ Association (BBA) has confirmed its intention[5] to provide a euro rate following monetary union in Europe. ISDA very much appreciates the BBA’s early release of its final plans. The timely publication of these has assisted the market in recognising what information is actually needed to start preparations for a smooth changeover to the euro.

Specifically, the BBA announced that Euro Libor will replace XEU Libor from 1 January 1999 and that the fixing of euro BBA LIBOR will take place at 11:00 am London time. Rates will be quoted each day the Target system is open[6] and interest calculation will be based on act/360. During the transition period, the BBA will continue to fix settlement rates for national currencies for which LIBOR is currently calculated, on the basis that they are identical to the rate being quoted for euro LIBOR. These official announcements have clearly been very helpful and ISDA

[4] See Introduction

[5] BBA - 13 October 1997: BBA launched Euro-Denominated Settlement Rate

[6] EMI - 16 September 1997: Second Progress Report on the Target Project

urges other national price source sponsors to follow suit, by releasing similarly detailed information.

3. EURIBOR

Plans to publish euro EURIBOR have also advanced significantly and ISDA very much welcomes the publication of detailed information yesterday[7]. In July, the ACI and FBE formally announced their intentions to sponsor a euro Interbank Offered Rate and ISDA had subsequently expressed the urgent need for more details on the technical parameters, in order to allow market participants to prepare for the use of EURIBOR.

ISDA very much welcomes the market-oriented approach that has been adopted in yesterday's ACI/FBE statement, which places the emphasis on quick movement from a quota oriented panel to one comprised of banks active in the euro market and administered by an independent advisory panel. In summary, the euro panel will operate as follows:

- It will initially be composed of up to 58 banks based on national quotas and up to 6 international (non-EU) banks
- It will be revised after a start-up phase of one year, based on actual euro money, repo and derivatives trading activity by banks operating in the euro area
- It will be open to non-EU banks and non-EMU participant countries, so long as they are active in the euro area.
- Quotations will be posted at 11:00 am Brussels time on an act/360, 2 day fixing basis.

ISDA is grateful for the significant progress made in short time in deciding these arrangements.

4. National Price Sources[8]

Austria: The EMI has been informed that the Austrian Schilling VIBOR fixing will not be discontinued.

Belgium: ISDA has been officially notified that the Belgian Banks will cease to provide Belgian Francs BIBOR rates and that EURIBOR has been officially designated as the successor. Furthermore, the current national rate screen page will continue to show a national rate reflecting a converted Euribor rate. As EURIBOR will fix on an act/360 basis, the conversion will entail modifying the rate to reflect an act/365 day count.

Denmark: The EMI has been informed that the Danish Krone fixing will not be discontinued. As Denmark will not participate in the third stage of EMU, no changes to CIBOR are anticipated.

Finland: ISDA has been officially notified by the Suomen Pankkiyhdistys (Finnish Bankers' Association) that they will assume responsibility for Finnish Markka HELIBOR fixing after the Bank of Finland will cease quoting HELIBOR rates at the beginning of the third stage of EMU. National legislation will be introduced to ensure the changeover to this new rate.

France: ISDA has been officially notified that the Association Francaise de Banques (AFB) has decided in principle to cease quoting French Franc PIBOR rates and that EURIBOR

[7] ACI/FBE - 15 December 1997: Euribor: The new money market reference rate for the euro

[8] See attached Grid

will be designated as the official successor. It is expected that the Executive Committee of the AFB will confirm this decision in mid-January.

Concerning short-term French rates, ISDA has been officially informed by the Banque de France that these rates will cease to be published and that EONIA (and variants of EONIA) will be their officially designated successor.

Germany**:** ISDA has been officially notified by the Zentraler Kreditausschuss (ZKA - German Banking Association) that EURIBOR will be officially designated as the successor to current national FIBOR rates. It has not yet been officially decided whether a DEM FIBOR rate will continue to be quoted in all instances after the introduction of the euro. However, it is expected that FIBOR will be discontinued and that this will be officially confirmed by the end of December. In addition, Germany is currently in the process of drafting legislation which is intended to confirm the planned changeover to Euribor.

Greece**:** ISDA has been officially notified that no decisions have yet been made in regard to the national rate fixing of ATHIBOR for the Greek Drachma, but that further information should become available early next year. As Greece is not expected to participate in EMU, this lack of information is not a cause for concern.

Ireland**:** ISDA has been officially notified by the Central Bank of Ireland that the sponsor of DIBOR -the Dublin Markets Committee- has agreed that with effect from entry into EMU, DIBOR will be replaced by EURIBOR as the standard for the Dublin market.

Italy**:** No information has been received from the italian Banking Association (ABI) concerning the intended plans for RIBOR.

Luxembourg**:** While the ISDA Definitions provide for a reference to a LUXIBOR Luxembourg franc fixing, this is in fact not posted.

Netherlands**:** The EMI has been informed that the national central banks will cease to quote Dutch Guilder AIBOR rates. However, it is important to receive confirmation on whether there will be an officially designated successor and whether this will be EURIBOR.

Portugal**:** No details of the position regarding Portuguese Escudo LISBOR rates have been received by end November.

Spain**:** The EMI has been informed that the Spanish Peseta MIBOR rates will not be discontinued.

Sweden**:** ISDA has received informal indications that the Swedish Krona STIBOR Rates will continue to be quoted after the introduction of the euro. As Sweden will not participate in the third stage of EMU, no changes are anticipated.

United Kingdom**:** ISDA has been officially notified by the BBA that the national currency rates of all currently posted countries will continue to be published during the transition period, although the rates of the counties participating in EMU will be the same as the euro LIBOR rate. As the UK will not participate in the third stage of EMU, no changes to GBP LIBOR are anticipated.

5. ISDA Price Sources

ISDA itself sponsors a number of rates which will be affected by the introduction of the euro. As clarified in our previous publication[9], many of these fixings currently replicate rates posted by other price sponsors. The respective euro strategy of the underlying price sponsor will thus carry over to the ISDA rates. In regard to ISDA's directly sponsored London-based rates ISDA intends, as announced in August, to continue publishing those rates by replicating the corresponding BBA LIBOR rates.

IV. Legal Position

As described in our previous update[10], the changeover of price sources in light of EMU will force market participants to consider the legal implications these changes may have on their contracts. ISDA aims to assist the market by focusing on the impact of disappearing or changing price sources of transactions entered into under the ISDA Master Agreement. Other types of financial transactions, which may also be affected, will have to be considered separately.

Following clarification that the start of stage three will not affect the continuity of contracts[11], the discussion in ISDA's EMU Market Practice and EMU Documentation Task Forces has focused on the need for market participants to deal with any planned changes to price sources. The specific legal issues raised by this process are set out in our paper of 19 August on this subject.

Since publication of the July paper ISDA's EMU Documentation Task Force has been working on devising contractual provisions to facilitate the possibility of amending existing Master Agreements and clarifying contracting parties' intentions in this area. One of the provisions under discussion aims to allow parties to elect a euro rate source to be used in place of a current national rate source; another provision aims to specify particular fall-backs in the event of the relevant information vendor ceasing to display a rate.

Separately, ISDA will revise the current Definitions to include any new post-EMU rate sources. ISDA is also considering the practical problem of amending large numbers of existing contracts and contemplating the use of a protocol arrangement to facilitate this. ISDA members interested in these activities should ensure they are represented on the EMU Documentation Task Force.

We should also note that since we published our August paper, a number of members have considered legislation to address the legal uncertainties concerning the changeover of price sources. However, such legislation would of course only apply to local law contracts and may be further limited by referring only to local rates. As there is no consensus about a comprehensive legislative solution covering all relevant jurisdictions and price sources (and it is by no means clear that one would be desirable given the potential adverse implications for freedom of contract), we are continuing to work on our contractual provisions.

[9] ISDA - 19 August 1997: I. Report on Developments by Price Sponsors

[10] ISDA - 19 August 1997: II. EMU and Price Sources: Market Preferences and Legal Issues

[11] As a result of the Article 235 euro regulation, recent New York and Illinois State legislation and ISDA's own contractual provision of continuity of contracts (where included in relevant documentation)

V. Conclusion

ISDA is very grateful for the considerable progress that has been made in clarifying the impact of the euro on existing price sources. The position is now only uncertain in a few isolated cases and, once price sponsors address questions regarding screen display, market participants will have a much clearer basis on which to make necessary contractual and systems preparations for EMU.

International Swaps and Derivatives Association
- 16 December 1997

[redacted]

OVERVIEW OF PRICE SPONSOR'S INTENTIONS **Annex F**

ISDA - April 1998

Currency	Price Source	Displayed on	Sponsor	Will Source Continue Unchanged? Yes	No	Designated Successor	Original Page to Display	Comments
ATS	ATS-VIBOR-VIBO	Reuters-VIBO	Reuters	X		None	Same	See endnote
BEF	BEF-BIBOR-ISDB	Reuters-ISDB	ISDA		X	Euribor	Converted Euribor rate	Replicates local sponsor - ABB
	BEF-BIBOR-BEFIXING	Reuters-BEFIXING	ABB		X	Euribor	Converted Euribor rate	
	BEF-BIBOR-Telerate	Telerate 29200	ABB		X	Euribor	Converted Euribor rate	
DKK	DKK-CIBOR-DKNH	Reuters-DKNH	Central Bank	X		None	Same	Denmark will not participate in third stage of EMU
DEM	DEM-LIBOR-ISDA	Reuters-ISDA	ISDA		X	euro Libor	euro Libor rate	Replicates local sponsor - BBA
	DEM-LIBOR-BBA	Telerate 3750 Reuters-FRBD	BBA		X	euro Libor	euro Libor rate	
	DEM-FIBOR-ISDB	Reuters-ISDB	ISDA		X	Euribor	Not yet decided	Replicates local sponsor - ZKA
	DEM-FIBOR-FIBO-OLD	Reuters-FIBO	GBA/ZKA		X	Euribor	Not yet decided	
	DEM-FIBOR-FIBO	Reuters-FIBO	GBA/ZKA		X	Euribor	Not yet decided	
	DEM-FIBOR-FIBP	Reuters-FIBP	GBA/ZKA		X	Euribor	Not yet decided	
	DEM-FIBOR-GBA	Telerate-22000	GBA/ZKA		X	Euribor	Not yet decided	

OVERVIEW OF PRICE SPONSOR'S INTENTIONS

ISDA - April 1998

Annex F

Currency	Price Source	Displayed on	Sponsor	Will Source Continue Unchanged?		Designated Successor	Original Page to Display	Comments
				Yes	No			
NLG	NLG-AIBOR-ISDB	Reuters-ISDB	ISDA		X	Not yet decided	Not yet decided	
	NLG-AIBOR-AIBO-DOM	Reuters-AIBO	Central Bank		X	Not yet decided	Not yet decided	Successor expected to be Euribor
	NLG-AIBOR-AIBO-EURO	Reuters-AIBO	Central Bank		X	Not yet decided	Not yet decided	Successor expected to be Euribor
	NLG-LIBOR-BBA	Telerate 3740 Reuters-FRBG	BBA		X	euro Libor	euro Libor rate	
XEU	XEU-LIBOR-ISDA	Reuters-ISDA	ISDA		X	euro Libor	euro Libor rate	Replicates local sponsor - BBA
	XEU-LIBOR-BBA	Telerate-3750 Reuters-FRBE	BBA		X	euro Libor	euro Libor rate	
	XEU-PIBOR-ISDB	Reuters-ISDB	ISDA		X	Euribor	Not yet decided	Replicates local sponsor - AFB
	XEU-PIBOR-AFB	Telerate-20041	AFB		X	Euribor	Not yet decided	
FIM	FIM-HELIBOR-SPFB	Reuters-SPFB	Bank of Finland		X	FIM-HELIBOR-FINBA	To be announced	Legislation to ensure changeover
	FIM-HELIBOR-FINBA	Reuters-FINBA	Finnish Bankers' Association	X		None	Same	See endnote
FRF	FRF-PIBOR-ISDB	Reuters-ISDB	ISDA		X	Euribor	Not yet decided	Replicates local sponsor - AFB
	FRF-PIBOR-AFB	Telerate-20041	AFB		X	Euribor	Not yet decided	
	FRF-PIBOR-PIBO	Reuters-PIBO	AFB		X	Euribor	Not yet decided	

[redacted]

OVERVIEW OF PRICE SPONSOR'S INTENTIONS

ISDA - April 1998

Annex F

Currency	Price Source	Displayed on	Sponsor	Will Source Continue Unchanged? Yes	No	Designated Successor	Original Page to Display	Comments
FRF	FRF-LIBOR-BBA	Telerate-3740 Reuters-FRBF	BBA		X	euro Libor	Euro Libor rate	
	FRF-TAG-CDC	Reuters-AFBP	AFB		X	EONIA based	Not yet decided	
	FRF-TAG-CDC-COMPOUND	Reuters-CDCD/ BDFB	AFB		X	EONIA based	Not yet decided	
	FRF-TAM-CDC	Reuters-CDCD	CDC		X	EONIA based	Not yet decided	
	FRF-T4M-CDC-COMPOUND	Reuters-CDCD	AFB		X	EONIA based	Not yet decided	
	FRF-T4M-CDC	Reuters-CDCM/ BDFB or CDCD	AFB		X	EONIA based	Not yet decided	
	FRF-TMP-CDC-AVERAGE	Reuters CDCD/BDFB	Banque de France		X	EONIA based	Not yet decided	
GRD	ATHIBOR	Reuters-ATHIBOR	Hellenic Bank Association	X		None	Same	Greece will not participate in third stage of EMU
IEP	IEP-DIBOR-DIBO	Reuters-DIBO	Dublin Markets Committee		X	Euribor	Not yet decided	
ITL	ITL-RIBOR	Reuters-ITFX	ABI-ATIC	Not yet decided		Not yet decided	Not yet decided	
	ITL-LIBOR-BBA	Telerate-3740	BBA		X	euro Libor	euro Libor rate	
	ITL-LIBOR-ILIR	Reuters-ILIR	ISDA		X	euro Libor	euro Libor rate	Replicates local sponsor - BBA
LUF	LUF-LUXIBOR-ISDB	Reuters-ISDB	ISDA	Not applicable				No rate actually published

Annex F

OVERVIEW OF PRICE SPONSOR'S INTENTIONS

ISDA - April 1998

Currency	Price Source	Displayed on	Sponsor	Will Source Continue Unchanged?		Designated Successor	Original Page to Display	Comments
				Yes	No			
PTE	PTE-LISBOR-LBOA	Reuters-LBOA	Reuters	X		None	Same	Different day counts might apply Also, see endnote
	PTE-LIBOR-BBA	Telerate-3770 Reuters-FRBH	BBA		X	euro Libor	euro Libor rate	
ESP	ESP-LIBOR-BBA	Telerate-3740 Reuters-FRBG	BBA		X	euro Libor	euro Libor rate	
	ESP-MIBOR-BANDE	Reuters-BANDE	Banca de Espana	X		None	Same	Different day counts might apply Also, see endnote
GBP	GBP-LIBOR-ISDA	Reuters-ISDA	ISDA	X		None	Same	Replicates local sponsor - BBA
	GBP-LIBOR-BBA	Telerate-3750	BBA	X		None	Same	UK will not participate in third stage of EMU
SEK	SEK-STIBOR	Reuters-SIDE Reuters-SIOR	Nordic Data Management	X		None	Same	Sweden will not participate in third stage of EMU

Endnote: For "in" countries where rates remain unchanged (e.g. existing panels continue to be used), it should be remembered that the national currency will nevertheless become a non-decimal subdenomination of the euro. Also, please note that these issues are considered on the basis that all countries will participate in EMU, unless otherwise specified

This overview aims to reflect the current decisions of various price sponsors, but should not be taken as definitive. ISDA will periodically update this overview on its web site: www.isda.org

[redacted]

EURO LIBOR

Statement by the British Bankers' Association

Definition

BBA LIBOR is the offered interest rate quoted by major banks in London for placing deposits with other banks at 11.00 a.m. London time. For each currency, rates are fixed for maturities of one week and each month from 1 month to twelve months inclusive. Sixteen banks selected by the BBA on the basis of market activity and perceived market reputation are surveyed for their view of what the market rate is. The highest four and lowest four replies are disregarded and the remainder averaged. All the reference bank inputs are published on-screen to ensure transparency.

Euro BBA LIBOR

BBA LIBOR is the primary benchmark for short term interest rates globally. The announcement of European Union plans for a single currency means a corresponding transition from national currency and ECU LIBOR to the euro BBA LIBOR. How this will happen is detailed here:

BBA LIBOR for European Currencies:

	Now		From 1 January 1999	
XEU	Act/360 Spot	EUR		Act/360 Spot
DEM	Act/360 Spot	DEM	= EUR*	Act/360 Spot
FRF	Act/360 Spot	FRF	= EUR*	Act/360 Spot
NLG	Act/360 Spot	NLG	= EUR*	Act/360 Spot
ITL	Act/360 Spot	ITL	= EUR*	Act/360 Spot
PTE	Act/365 Spot	PTE	= EUR*	Act/360 Spot
ESP	Act/360 Spot	ESP	= EUR*	Act/360 Spot
GBP	Act/365 Same Day	GBP		Act/365 Same Day

*Assuming these are then national currency units of the euro

Technical details

How the BBA intends to provide a LIBOR fixing for the euro and replace the LIBOR fixings for the ECU and participating national currencies.

1. In the event that the euro comes into existence and replaces the ECU, the BBA will cease to fix LIBOR for the ECU and replace it immediately with a LIBOR fixing for the euro[1].

2. Euro LIBOR will be fixed as a ‘spot’ currency i.e. on the basis of two euro days value[2].

3. The day-count basis for calculating interest accrual for euro LIBOR will be the actual number of days elapsed divided by 360.

3. Euro LIBOR will be fixed on the basis of quotes from the London offices of sixteen major banks active in the euro market[3] at 11.00am London time on all London or euro business days[4].

4. The BBA, after consultation with market participants, will decide which sixteen banks should compose the euro LIBOR panel during the third quarter of 1998. As with existing LIBOR panels, the sixteen banks will comprise a panel which in the view of the BBA is broadly representative of the market’s liquidity at the time. Only banks present in London will be eligible to participate in the euro LIBOR panel. To the extent that foreign banks as well as domestic [euro] banks are active participants in cash transactions in the new market, these will be included in the pool from which the panel is drawn.

5. Settlement rates for national currencies for which LIBOR is currently calculated and which participate in the euro (with the exception of the ECU) will continue to be fixed after 1 January 1999 and until value for 31 December 2001, on the basis that they are identical to the rates being quoted for the euro in London. There will not be separate panels for the national currency rates. All participating national currency rates will be quoted on a 360-day basis.

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[1] The ECU LIBOR fixings on the last two London Business days of 1998 will be for settlement in euro (at the rate of 1:1) on the first two euro business days of 1999.

[2] A cash (same-day settlement) euro fixing will also be provided if there is sufficient market demand. The panel for this fixing may not be the same as that for the spot fixing.

[3] The euro LIBOR panel will not necessarily consist of the same banks as the current ECU LIBOR panel.

[4] The BBA expects that euro business days will be on those which the interlinking element of the TARGET system is open. This will be each weekday except Christmas Day and New Year’s Day on which at least two participating member states’ RTGS payment systems are open. It also expects that London banks will trade on each euro business day. In the event that there is a day when London is open but TARGET is not, there will be a euro LIBOR fixing that day but the one two days earlier will be for settlement the following day.

EURIBOR

Statement by the Banking Federation of the EU

The European banks consider that the introduction of the single currency makes it necessary to establish a new interbank reference rate - the "Euro Interbank offered rate", "EURIBOR", within the Economic and Monetary Union (EMU). The Euribor, which will be published with effect from 4 January 1999, will be the rate at which euro interbank term deposits will be offered by one prime bank to another prime bank; it will be published at 11.00 a.m. Brussels time. A group of experts was set up by the Banking Federation and the Financial Markets Association (ACI), together with the European Savings Bank Group and the European Association of Cooperative Banks, in order to draw up a code of conduct.

After having announced in July 1997 that Euribor would be published, the European banks reached agreement on the panel of banks from countries participating in EMU. If all the Member States were to participate in EMU from the outset, the number of banks would be 58. Since such will not be the case, the real figure will be lower. The banking community in each Member State was invited to communicate, by the end of 1997, the name of the banks from their respective countries which will take part in the start-up Euribor panel. The composition of this panel will be periodically reviewed after an initial one year period, taking into account the money market and related derivative activity of the reference banks in the euro zone.

In addition, 6 banks from countries outside the European Union (international banks), active at a global level in interbank euro transactions and with at least one office in the euro zone (subsidiary or branch) will be invited to be part of the panel and will be selected no later than June 1998. Since certain EU countries will not take part in EMU on 1 January 1999, these countries will not use the number of places allocated to their banks on the above-mentioned panel of 58 banks. On the other hand, the number of international banks may be increased from 6 to 10, enabling certain banks from these countries to participate in the panel on the same basis as the international banks.

The code of conduct, fixing the rules applicable to Euribor and the reference banks, was finalised and approved on 15 December 1997 by all the members of the European organisations having participated in its preparation. This code of conduct includes rules covering amongst other things:

- the criteria used to determine which banks may belong to the panel of reference banks;
- the obligations of the banks which contribute to the fixing of Euribor;
- the tasks and the composition of the Steering Committee, which will be responsible for overseeing Euribor.

The code of conduct also contains three annexes: a table fixing for a one-year start-up period the quota of reference banks per country, for the countries which will take part in EMU from the outset; the rules applicable to the 6 international banks of third countries which will participate in the panel, as well as the 4 banks (maximum) from the EU countries not amongst the first wave of euro participants and, finally, rules on the rotation system of banks, whereby the banking communities of small countries may nominate more banks than the number sets out under their national quota. It is intended that this rotation system will gradually disappear after a year.

Finally, Dow Jones Markets Ltd. was selected as screen service provider. They will be responsible for computing and publishing Euribor. A test-run will be organised with the reference banks during 1998, using the US Dollar as the operational currency. These reference banks are chosen on the basis of their volumes on interbank money-market transactions in the EMU-zone. Only very large banks of prime standing will be accepted in the panel. Therefore Euribor will be a market-driven rate created within the EMU-zone and will be able to compete with any other reference rate in the world.

EONIA

Joint Statement compiled by the EMI

ACI - THE FINANCIAL MARKETS ASSOCIATION
BANKING FEDERATION OF THE EUROPEAN UNION
EUROPEAN COMMITTEE OF OPTIONS AND FUTURES EXCHANGES
EUROPEAN ASSOCIATION OF COOPERATIVE BANKS
EUROPEAN FEDERATION OF BUILDING SOCIETIES
EUROPEAN FEDERATION OF FINANCIAL ANALYSTS' SOCIETIES
EUROPEAN MORTGAGE FEDERATION
EUROPEAN SAVINGS BANKS GROUP
FEDERATION OF EUROPEAN STOCK EXCHANGES
INTERNATIONAL PRIMARY MARKET ASSOCIATION
INTERNATIONAL SECURITIES MARKET ASSOCIATION
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

JOINT STATEMENT ON SOME TECHNICAL FEATURES OF THE EFFECTIVE OVERNIGHT REFERENCE RATE IN EURO (THE "EONIA")

The EU banking and financial associations as signatories of the present joint statement support the following method for the computation and publication of an effective overnight reference rate for the euro area. The method has been agreed with the EMI which has informed the banking and financial associations that the ESCB will take up the computational aspects related to the reference rate.

The features of the effective overnight reference rate for the euro area are set out hereafter:

1. the reference rate will be referred to as the EONIA (Euro OverNight Index Average);
2. the panel of declaring banks will be the same as for the EURIBOR, so that only the most active banks located in the euro area will be represented in the panel and also that a geographical diversity of banks in the panel will be maintained;
3. the EONIA will be computed as a weighted average of all (without exceptions) overnight unsecured lending transactions in the interbank market, initiated within the euro area by the declaring panel banks. It will be expressed with two (2) decimals;

4. all specified transactions initiated during the business day shall be reported by banks in the panel in aggregate, i.e. the sum of all lending transactions carried out before the closing of RTGS systems at 6.00 p.m.;
5. each panel bank shall on a daily basis and no later than 6.30 p.m. ECB time report the total volume of unsecured lending transactions that day and the average lending rate for these transactions to the relevant entity of the ESCB;
6. the amount of lending transactions shall be reported by panel banks as the rounded amount to the nearest EURO 1 000 000, and the individual average rates shall be reported with two (2) decimals;
7. the ECB will aim at making the computed rate available for the publication body as soon as possible so that the EONIA normally will be published at the latest at the opening of TARGET the following day;
8. the EONIA will be published by "Euribor FBE association internationale sans but lucratif" and "Euribor ACI association internationale sans but lucratif" under the neutral logo of "EONIA";
9. rounding shall be carried out following established rounding rules in the market. For the average interest rate, the third decimal being 1 – 4 shall be rounded downwards and the third decimal being 5 – 9 shall be rounded upwards. For the total lending amount ending with EURO 000 001 – 499 999, the amount shall be rounded downwards to the nearest multiple of EURO 1 000 000 and for amounts ending with EURO 500 000 - 999 999, it shall be rounded upwards to the nearest multiple of EURO 1 000 000; and
10. the ESCB will undertake control measures to assess the quality of the EONIA and may report to the Steering Committee on the performance of individual panels banks.

With respect to the type of transactions to be covered for the computation of EONIA the signatories of the present joint agreement agree to cover only unsecured lending transactions. Repurchase transactions have also been considered to be included, as such transactions represent a significant part of the activity in overnight market. However, as secured financing transactions based on repos may be difficult to distinguish from other transactions of similar structure but entered into for a different purpose, such as securities lending transactions, it was viewed preferable to exclude all such secured transactions from the computation at this stage, in order not to introduce a source of instability in the EONIA. In addition, it was concluded that the homogeneity with other interbank rates e.g. EURIBOR rates, would best be achieved by basing the EONIA on only unsecured lending transactions. Nevertheless, due to the growing importance of repos, experts from banking associations agreed that a collection of information on repurchase transactions for analytical and other purposes will be studied.

EUROPEAN COMMISSION

Brouhns Report

MONETARY COMMITTEE
– secretariat –

Brussels, 5 April 1998
MC/II/89/98 EN final

Debt redenomination and Market conventions in Stage 3 of EMU

I

National plans for redenomination of outstanding debt

Table 1 : Basic plans for Central Governments national currency debt

	Does the Member State intend to redenominate its outstanding debt?	Are particular issues to be redenominated ?	At which date will outstanding debt be legally redenominated ?
Belgium	Yes	Dematerialised debt	2 January 1999)
Denmark	no participation in stage 3	/	/
Germany	yes	tradable debt in bonds	1 January 1999
France	yes	tradable debt	first w.e of 1999**
Italy	yes	tradable debt	1 January 1999
Austria	yes	liquid issues in bonds selected in consent with banks	1 January 1999
Netherlands	yes	tradable bonds	1 January 1999
*United Kingdom**	yes[1]	all sterling denominated gilts	at entry in stage 3
Finland	yes	all dematerialised bonds and bills	1 January 1999
*Sweden**	yes	all dematerialised debt	at entry in stage 3
Spain	yes	tradable debt	first w.e of 1999**
Portugal	yes	tradable debt (except bonds maturing before 31/12/1999)	1 January 1999
Luxembourg	yes	only dematerialised bonds	first w.e of 1999**
Ireland	yes	tradable debt	1 January 1999
*Greece**	yes	tradable debt	at entry in stage 3

*all answers related to these countries are subject to their entry in Stage 3 of EMU.
** in these countries, the legal date of redenomination remains to be decided.

[1] Just intention, as the United Kingdom has taken no formal decision about redenomination (bills and bonds) after UK entry in Stage 3

Table 2 : Method of redenomination

	At what level will the redenomination[2] be made ?	Will the nominal value of the redenominated bond be expressed in whole euro or in cents ?
Belgium	individual holdings	cents
Denmark	/	/
Germany	individual holdings	cents
France	individual holdings	whole euro
Italy	bond level (on the basis of minimum issuing amount)	cents
Austria	bond level (on the basis of each face value)	cents
Netherlands	individual holdings	whole euro
United Kingdom	individual holdings	cents
Finland	individual holdings	cents
Sweden	probably bond level	cents
Spain	individual holdings	cents
Portugal	individual holdings	cents
Luxembourg	Individual holdings	cents
Ireland	Individual holdings	cents
Greece	individual holdings	cents

[2] **DEFINITIONS**

- ***Individual holding*** is a set of bonds from the same issue held by an entity. The holder can be an individual investor or a financial intermediary hoding bonds on its own account or on a nominee basis.
- ***Face value*** is the value for a bond or a bill (or other security) as expressed on the certificate or instrument. Unless there is a default, securities are redeemed at maturity at face value. Face value is also referred to as nominal value or par value. *This corresponds to the Austrian case.*
- ***Minimum issuing amount*** is the minimum face value available in a particular issue. For example, if a particular government issues two groups of bonds, one with a nominal value of 100 and the other 500, then the minimum issuing amount would be 100. *This corresponds to the Italian case.*

Table 3 : Technical modalities

	Will cashing out be employed ?	Will the nominal value of the redenominated bonds be adjusted (i.e. renominalisation) ?[3]
Belgium	no	no
Denmark	/	/
Germany	no	yes
France	yes	yes
Italy	no	yes
Austria	no	yes
Netherlands	possible[4]	yes
United Kingdom	no	no
Finland	no	yes
Sweden	no	yes
Spain	no	no[5]
Portugal	no	yes
Luxembourg	no	no
Ireland	no	no
Greece	no	yes

[3] In addition to rounding

[4] There are two possibilities : either the nominal amount converted into euros will be rounded down to the nearest euro, in which case cashing out will take place, or this amount will be rounded up. In the latter case the banks or brokers will have to make a gift (of less than one euro) to their clients.

[5] Face values of unit securities will be substituted for face values of individual holdings

Table 4 : Legal issues

	Will redenomination require national legislation or executive decision?	What is the state of the legislation?	Will the redenomin. debt be considered as new security ?
Belgium	yes	draft law (should be adopted by mid-98)	no
Denmark	/	/	/
Germany	yes	draft law (should be adopted in the coming months)	no
France	yes	draft law (should be adopted by mid-98)	no
Italy	yes	yes (law n°433 of 17/12/97)[6]	no
Austria	yes	draft law (should be adopted by mid-98)	no
Netherlands	yes	draft law (should be adopted in autumn)	no
United Kingdom	yes	not yet addressed	no
Finland	yes	draft texts (should be adopted in spring/autumn)	no
Sweden	yes (Government decision)	not yet addressed	probably no
Spain	yes	draft law (should be adopted in the coming months)	no
Portugal	yes	draft law (should be adopted by mid-98)	no
Luxembourg	yes	yes	no
Ireland	yes	draft law (should be adopted by end July)	no
Greece	yes	in preparation	no

[6] Delegates to the Government powers to issue specific decrees (should be adopted by April 98)

Table 5 : The debt of other public authorities

	Is it planned to make redenomination obligatory ?	Is there an obligation to use the method of the Central Gov. ?	Will this type of debt be addressed by national legislation ?
Belgium	no	yes	yes
Denmark	not applicable	/	/
Germany	no	yes in some aspects	yes
France	no	yes	yes
Italy	no	yes	yes
Austria	no	no*	yes
Netherlands	no	yes	yes
United Kingdom	probably no	under study	/
Finland	no	no	yes
Sweden	probably no	under study	/
Spain	no	no[7]	yes[8]
Portugal	no	probably yes	yes
Luxembourg	no relevant	/	/
Ireland	no	no*	yes
Greece	under study	under study	/

* In these countries, when issuers decide to use the Government method of redenomination (terms and conditions), they shall have the authority of law to do so unilaterally.

[7] Except in the case of regional governments'debt registered at the Book-entry system, for which there will be an obligation to use the Central Gov. method.

[8] The national law covering all the legal issues concerning the transition to the euro will include a general authorization to other public authorities to redenominate their debt.

Table 6 : The debt of other issuers

	Is it planned to make redenomination obligatory?	**Will the redenomination of the debt of other issuers be addressed by legislation ?**	**Will there be prescribed methods ?**
Belgium	no	yes	no*
Denmark	not applicable	/	/
Germany	no	yes	yes, in some aspects
France	no	yes	yes
Italy	no	yes	no*
Austria	no	yes	no*
Netherlands	no	yes	yes
United Kingdom	no	under study	no
Finland	no	yes	no
Sweden	no	under study	under study
Spain	no	under study	no
Portugal	no	yes	no*
Luxembourg	no	no	no
Ireland	no	yes	no*
Greece	under study	under study	under study

* In these countries, when issuers decide to use the Government method of redenomination (terms and conditions), they shall have the authority of law to do so unilaterally.

II

Scope of redenomination

. Table nº 7 : Central government debt debt denominated in national currency: Scope of redenomination
. Table nº 8 : Debt denominated in EU foreign currency: % of Government debt
. Table nº 9 : Central Government debt denominated In EU foreign currencies: Modalities of redenomination

Table 7 : Central Government debt denominated in national currency[9] Scope of redenomination

	Tradable national currency debt/national currency debt [10]	Redenominated tradable national currency debt /tradable national currency debt[11]	Non tradable national currency debt/national currency debt	Redenominated non tradable national currency debt / Non tradable national currency debt
Belgium	95,6%	81,3%	4,4%	0%
Denmark	100%	no redenomination	0%	no redenomin.
Germany	86%	97%	14%	0%
France	89%	100%	11%	not yet decided
Italy	88%	100%	12%	0%
Austria	73,5%	34%	26,5%	0%
Netherlands	91%	95%	9%	0%
United Kingdom	79%	99%	21%	0%
Finland	95%	77%	5%	0%
Sweden	96%	96%	4%	30%
Spain	94%	100%	6%	0%
Portugal	72,5%	86,2%	27,5%	0%
Luxembourg	100%	89,9%	0%	0%
Ireland	83%	100%	17%	0%
Greece	80%	100%	20%	0%

[9] Excluding the debt denominated in ECU.

[10] Tradable national currency debt (long, medium, and short term)/national currency debt

[11] Tradable national currency debt redenominated (long, medium, and short term)/total tradable national currency debt

Table 8 : Central Government debt denominated in EU foreign currencies [12]

	Debt denominated in EU foreign currency/ total debt[13]	Tradable debt denominated in EU foreign currency/total debt denominated in EU foreign currency
Belgium	3,2%	88,1%
Denmark	7,6%	91%
Germany	0%	0%
France	0%	0%
Italy	0,8%	85%
Austria	10,8%	93%
Netherlands	0%	0%
United Kingdom	0%	0%
Finland	19%	100%
Sweden	9,1%	95%
Spain	4,7%	92%
Portugal	15,1%	93,6%
Luxembourg	0%	0%
Ireland	11%	49%
Greece	6%	90%

[12] Excluding the debt in ECU

[13] In gross figures (before currency swaps)

Table 9 : Central Government debt denominated in EU foreign currencies : modalities of redenomination

	Will there be unilateral redenomination by use of Art. 8.4 of the euro Regulation ?	**At which date will the redenomination occur ?**
Belgium	yes	as soon as possible*
Denmark	no plan	/
Germany	no EU foreign debt	/
France	no EU foreign debt	/
Italy	yes	as soon as possible*
Austria	no (in principle)	/
Netherlands	no EU foreign debt	/
United Kingdom	no EU foreign debt	/
Finland	not yet decided	/
Sweden	not yet decided	/
Spain	yes	as soon as possible*
Portugal	yes	as soon as possible*
Luxembourg	no EU foreign debt	/
Ireland	not yet decided	/
Greece	yes	as soon as possible*

* In these countries, the redenomination of the EU currency debt by use of Article 8(4) of the euro Regulation, will occur when the concerned Member State has taken measures which may be necessary to redenominate its own debt.

III

Technical specificities

. Table nº10 : The clearing and cash settlement systems
. Table nº 11 : ISIN codes

Table 10 : The clearing and cash settlement systems

	Is it possible to use decimals in the clearing systems ?	**Will it be possible in Stage 3 ?**	**Is it possible to use decimals in the cash systems?**	**Will it be possible in Stage 3 ?**
Belgium	no	yes	no	yes
Denmark	no (but under study)	no participation	yes	no participation
Germany	yes	yes	yes	yes
France	yes[14]	yes	yes	yes
Italy	no	yes	no	yes
Austria	yes	yes	yes	yes
Netherlands	no	no	yes	yes
United Kingdom	yes	yes	yes	yes
Finland	yes	yes	yes	yes
Sweden	yes	yes	yes	yes
Spain	no	yes (probably before the end of 1999)	no	yes
Portugal	yes	yes	yes	yes
Luxembourg	yes	yes	yes	yes
Ireland	yes	yes	yes	yes
Greece	yes	yes	yes	yes

[14] Except for money market debt instruments, until the beginning of 1999.

Table 11 : ISIN codes

	Will there be new ISIN codes for redenominated Securities ?
Belgium	no
Denmark	no participation
Germany	no
France	yes*
Italy	no
Austria	no
Netherlands	yes*
United Kingdom	no
Finland	no
Sweden	no
Spain	no
Portugal	no
Luxembourg	no
Ireland	no
Greece	no

* The implementation of new ISIN codes will not have any effect on the legal status of the securities (i.e. they will not be considered as new securities).

IV

Market conventions

Tables 14, 15, 17, 1 8 reflect the intentions of the national authorities and market participants in relation to market conventions. Market participants should refer to national documents and relevant national bodies for more information.

Table 12 : Adaptation of market conventions : national plans

	What is the procedure for the modification of market conventions ?	**Are formal decisions already taken ?**
Belgium	regulation of a national authority (Min.Fin.)	yes (in some aspects)
Denmark	agreement between market participants	no (under study)
Germany	agreement between market participants	no
France	it depends on the convention	yes[15]
Italy	decision by market authorities	no
Austria	it depends on the convention	yes (in some aspects)
Netherlands	it depends on the convention	no
United Kingdom	it depends on the convention	yes (in some aspects)
Finland	it depends on the convention	no
Sweden	discussed with market participants	no
Spain	it depends on the convention	yes (in some aspects)
Portugal	it depends on the convention	yes (in some aspects)
Luxembourg	by the Minister of Budget	no
Ireland	it depends on the convention	yes (in some aspects)
Greece	it depends on the convention	no

[15] The present French conventions already correspond to the proposed harmonised conventions, except for the business days.

Table 13 : Present Conventions for bills

	day count basis	quotation basis	business days	settlement dates
Belgium	ACT/365	decimals	bank opening	T+2
Denmark	ACT/360	decimals	bank opening	T+2
Germany	ACT/360	decimals	bank opening	T+2
France	ACT/360	decimals	national business days	T+1
Italy	ACT/365	decimals	national business days	T+2
Austria	ACT/360	decimals	bank opening	T+2
Netherlands	ACT/360	decimals	bank opening	usually T+2
United Kingdom	ACT/365	fractions and decimals	national business days	T+1
Finland	ACT/365	decimals	national business days	T+2
Sweden	30/360	decimals	national business days	T+2
Spain	ACT/360	decimals	national business days	T+1 (standard)[16]
Portugal	ACT/365	decimals	national business days	T+2
Luxembourg	/[17]	/	/	/
Ireland	ACT/365	fractions	national business days	usually T+0 or T+1,
Greece	30/360	decimals	national business days	T+2

[16] any other settlement date also possible under bilateral agreement.

[17] Luxembourg has no short term debt.

Table 14 : Conventions to be used for new debt in Bills

	day count basis	quotation basis	business days	settlement dates
Belgium	ACT/360	decimals	Target operating days	T+2
Denmark[18]	ACT/360	decimals	prob. Bank opening days	T+2
Germany	ACT/360	decimals	prob. Target operating days	T+2
France	ACT/360	decimals	under study	probably T+2
Italy	ACT/360	decimals	prob. Target operating days	T+2
Austria	ACT/360	decimals	probably Target operating days	T+2 (aim : T+0 in 1999)
Netherlands	ACT/360	decimals	Target operating days	usually T+2
United Kingdom	probably ACT/360[19]	probably decimals	probably Target operating days	T+1
Finland	probably ACT/360	decimals	prob. Target operating days	T+2
Sweden	under discussion with the market	decimals	under discussion with the market	T+2
Spain	ACT/360[20]	decimals	probably Target operating. days	T+1[21] (standard)
Portugal	ACT/360	decimals	Target operating days	T+2
Luxembourg				
Ireland	ACT/360	decimals	probably Target operating days	usually T+0 or T+1
Greece	probably ACT/360	decimals	probably Target operating days	T+2

[18]These conventions will operate at the beginning of Stage 3, irrespective of Danish participation.

[19] following UK entry into EMU.

[20] The transition from ACT/ACT to ACT/360, will be discussed with Financial institutions in February 1998.

[21] Any other settlement date possible under bilateral agreement.

Table 15 : Conventions to be used for existing debt in Bills[22]

	day count basis	quotation basis	business days	settlement dates
Belgium	ACT/360	decimals	Target operating days	T+2
Denmark[23]	ACT/360	Decimals	prob. Bank opening days	T+2
Germany	ACT/360	decimals	prob. Target operating days	T+2
France	ACT/360	decimals	under study	probably T+2
Italy	ACT/365	decimals	prob. Target operating days	T+2
Austria	ACT/360	decimals	national business days	T+2
Netherlands	ACT/360	decimals	Target operating days	usually T+2
United Kingdom	ACT/360[24]	decimals	probably Target operating days	T+1
Finland	probably ACT/360	decimals	probably Target operating days	T+2
Sweden	under discussion with market	decimals	under discussion with the market	T+2
Spain	ACT/360	decimals	probably Target operating days	T+1 standard[25]
Portugal	ACT/360	decimals	Target operating days	T+2
Luxembourg	/	/	/	/
Ireland	ACT/365	fractions	probably Target operating days	usually T+0 or T+1
Greece	probably ACT/360	decimals	probably Target operating days	T+2

[22] Germany, Netherlands, the UK, and Austria do not intend to redenominate bills. Thus, for these countries, the intentions indicated correspond to the non redenominated debt in Bills.

[23] The intentions indicated correspond to non redenominated bills as Denmak will not participate in Stage 3 from 1 January 1999.

[24] following UK entry into EMU.

[25] Any other settlement date possible under bilateral agreement.

Table 16 : Present conventions for debt in bonds

	day count basis	quotation basis	business days	coupon frequency	settlement dates
Belgium	30/360	decimals	bank opening	annual	T+3
Denmark	30/360	decimals	bank opening	annual (in most cases)	T+3
Germany	30/360	decimals	bank opening	annual	T+2 (national)[26]
France	ACT/ACT	decimals	national business days	annual	T+3
Italy	30/360	decimals	national business days	semi annual	T+3
Austria	30/360	decimals (starting 1998)	bank opening	annual	T+3
Netherlands	30/360	decimal	bank opening	annual	T+3
United Kingdom	Accrued-ACT/365 Discount-ACT/ACT	fractions	national business days	semi annual	T+1
Finland	30/360	decimals	national business days	annual	T+3
Sweden	30/360	decimals	national business days	annual	T+3
Spain	ACT/365	decimals	national business days	annual	T+3 (standard)[27]
Portugal	ACT/ACT and 30/360	decimals (starting 1998)	national business days	annual and semi annual	T+3
Luxembourg	30/360	decimals	national business days	annual	T+2[28]
Ireland	ACT/365, 30/360 and ACT/ACT	decimals	national business days	annual (in most cases)	usually T+1
Greece	30/360 and ACT/365	decimals	national business days	annual	T+2

[26] T+3 for cross border operations

[27] Any other settlement date possible under bilateral agreement.

[28] For primary market (T+3 for secondary market)

Table 17 : Conventions to be used for new debt in bonds

	day count basis	quotation basis	business days[29]	coupon frequency	settlement dates
Belgium	ACT/ACT	decimals	Target op. days	annual	T+3
Denmark[30]	under discussion with the market	decimals	prob. Bank opening days	annual	T+3 (standard)
Germany	ACT/ACT	decimals	prob. Target operating days	annual	T+2 (national)[31]
France	ACT/ACT	decimals	under study	annual	T+3
Italy	ACT/ACT	decimals	prob.Target op. days	semi annual	T+3
Austria	ACT/ACT	decimals	prob. Target op. days	annual	T+3
Netherlands	ACT/ACT	decimals	Target op. days	annual	T+3
United Kingdom[32]	ACT/ACT	decimals	national business days[33]	semi annual	T+1
Finland	probably ACT/ACT	decimals	prob. Target op. days	annual	T+3
Sweden	under discussion with the market	decimals	under discussion with the market	annual	T+3
Spain	ACT/ACT	decimals	probably Target op. days	annual	T+3 (standard)[34]
Portugal	ACT/ACT	decimals	Target op. days	annual	T+3
Luxembourg	ACT/ACT	decimals	Target op. days	annual	T+2[35]
Ireland	ACT/ACT	decimals	probably Target op. days	annual	usually T+1
Greece	probably ACT/ACT	decimals	prob. Target op. days	annual	T+2

[29] Just intentions, as the legal implications are under study in most countries.

[30] These conventions will also apply to existing debt, even though Denmark will not participate in Stage 3 of EMU from January 1, 1999.

[31] T+3 for cross border operations

[32] These conventions will operate at the beginning of stage 3, irrespective of UK participation.

[33] Target operating days following UK entry in EMU.

[34] Any other settlement date possible under bilateral agreement.

[35] For primary market (T+3 for secondary market)

Table 18 : Conventions to be used for redenominated debt in bonds

	day count basis	quotation basis	business days	coupon frequency	settlement dates
Belgium	ACT/ACT*	decimals	Target op. days	annual	T+3
Denmark	not applicable	not applicable	not applicable	not applicable	not applicable
Germany	probably ACT/ACT**	decimals	prob. Target operating days	annual	T+2 (national)[36]
France	ACT/ACT	decimals	under study	annual	T+3
Italy	ACT/ACT**	decimals	prob. Target op. days	semi annual	T+3
Austria	ACT/ACT**	decimals	prob. Target op. days	annual	T+3
Netherlands	to be discussed with the market	decimals	Target op. days	annual	T+3
United Kingdom	ACT/ACT***	decimals	Target op. days	semi annual	T+1
Finland	probably ACT/ACT**	decimals	prob. Target op. days	annual	T+3
Sweden	under discussion with the market	decimals	under discussion with the market	annual	T+3
Spain	ACT/ACT	decimals	prob. Target op. days	annual	T+3 (standard)[37]
Portugal	probably ACT/ACT**	decimals	prob. Target op. days	annual and semi annual	T+3
Luxembourg	ACT/ACT	decimals	Target op. days	annual	T+2[38]
Ireland	ACT/ACT, ACT/365 and 30/360	decimals	prob. Target op. days	annual (in most cases)	usually T+1
Greece	probably ACT/ACT	decimals	prob. Target operating days	annual	T+2

* during the first week-end of 1999
** probably at the date of the payment of the first coupon
*** on 1 November 1998

[36] T+3 for cross border operations

[37] Any other settlement date possible under bilateral agreement.

[38] For primary market (T+3 for secondary market)

INLAND REVENUE

Press Release 5/98 of 21 January 1998[1]

ECONOMIC AND MONETARY UNION (EMU): TAX CONSEQUENCES

The Government proposes to introduce legislation in the next Finance Bill to deal with some technical tax issues arising out of EMU. In his speech to the Bank of England Symposium "London as an International Financial Centre for the euro" the Chancellor of the Exchequer, Gordon Brown MP, said:

"I can announce a further step that the Government is taking to help business prepare. We propose to introduce legislation in the next Finance Bill to help businesses by dealing with technical tax issues arising out of EMU. The introduction of the euro in January 1999 will have implications for some UK businesses and there are some tax obstacles which business has identified and which we propose to remove. The Inland Revenue are today issuing a Press Release setting out some proposals for change"

This Press Release

- describes some consequences for the calculation of direct taxes which will arise as a result of the start of the single currency in January 1999, despite the UK not joining on that date;
- sets out the Government's proposals for some legislation in the next Finance Bill (which might take the form of an enabling power for appropriate secondary legislation); and
- invites written comments from interested parties on these proposals, or other tax issues arising out of EMU, to be sent to the co-ordinator for EMU for the Inland Revenue

Julian Reed
Inland Revenue
Room 507
22 Kingsway
London WC2B 6NR

DETAILS

1. The Inland Revenue have been holding discussions with the Bank of England and certain representative bodies about the tax consequences of EMU. An agreed statement is attached which sets out how the Government proposes that the tax system will apply in certain circumstances.

2. When dealing with foreign currency, the corporate tax system broadly follows the accounting treatment. The Government proposes to adopt this approach when dealing with the introduction of the euro. Some technical changes are needed to achieve this result. The Government proposes to bring forward legislation to make the following changes:

[1] See web site of Inland Revenue: http//www.open.gov.uk/inrev/irhome.htm

- Under existing law a trading company can, subject to certain conditions, elect for its corporation tax liability to be computed on the basis of accounts drawn up in a foreign currency. The Government will bring forward legislation to convert automatically an existing election for a currency which joins EMU into an election for the euro.
- Bonds in currencies which join EMU may be redenominated into the euro. It is the Government's intention that a straightforward redenomination will not normally give rise to a tax charge that would not otherwise have arisen. The Government is considering what legislation will be needed to achieve this result.
- There are special rules applying, for the purposes of the legislation on foreign exchange gains and losses and financial instruments, to contracts involving two currencies ("currency contracts"). The Government proposes to introduce legislation to allow these rules to continue to apply to existing contracts if the currencies both join EMU.

SOME TAX ISSUES ARISING AS A RESULT OF ECONOMIC AND MONETARY UNION

The following is a summary of some tax issues arising as a result of EMU, whether or not the UK participates. The issues addressed are not comprehensive, but are those of immediate concern which have been raised with and agreed by the Inland Revenue.

Discussions on remaining issues continue between the Inland Revenue, the Bank of England and representatives of the following bodies: the International Swaps & Derivatives Association, the London Investment Banking Association, the British Bankers' Association, the International Primary Markets Association, the International Securities Markets Association, the Institutional Fund Managers' Association and the American Banking & Securities Association in London.

Foreign Exchange Legislation

Q. The foreign exchange legislation allows a trading company which satisfies certain conditions (an "eligible company") to adopt a currency other than sterling as its functional currency for tax purposes by making a local currency election (under sections 92-94 FA 1993 and SI 1994/3230). Will eligible companies be allowed to make a local currency election for the euro?

1.1 Yes. The euro will be allowed as the subject of a local currency election.

Q. Will an existing local currency election in respect of a participating currency effectively carry over into the euro without any action or consequence for taxpayers?

1.2 The Government proposes to introduce legislation in the next Finance Bill to ensure the continuity of a local currency election for a participating currency.

Q. Will a company which has an existing local currency election for a non-participating currency be able to re- elect for the euro following monetary union?

1.3 Yes, if it satisfies the conditions in the normal way (that is, if the euro becomes an eligible currency and the existing currency becomes ineligible).

Q. When will the revised local currency elections described at 1.2 and 1.3 above become effective?

1.4 The election for a participating currency (1.2) will switch automatically (as a result of the legislation proposed in 1.2) from that currency to the euro for the first accounting period ending after 1 January 1999 when the company in question prepares its accounts in euros.

An election for the euro which replaces an election for a non-participating currency (1.3) will only be effective from the beginning of the next accounting period after it is received. So companies must make an election before the start of the first accounting period to which they want the election to apply.

Q. The foreign exchange legislation contains the anti-avoidance legislation in sections 135-136 Finance Act 1993 which may be applied at the direction of the Board. Respectively, the sections apply where the main benefit of the asset or liability is the accrual of a loss and where the transactions are entered into otherwise than at arm's length. In cases where the conversion of assets or liabilities occurs, or the main economic purpose of the transaction has fallen away, as a result of the introduction of the euro, will the Board seek to apply these provisions?

1.5. No. Sections 135-136 Finance Act 1993 will not be invoked as a result of the introduction of the euro, provided that the Board believes that no abuse is taking place. It should also be noted that the Consultative Document on the Modernisation of Transfer Pricing Legislation proposes that under self assessment the requirement for a Board's direction would be removed, so taxpayers would have an obligation to declare when these provisions applied. If these reforms proceed, then taxpayers may rely on this statement in the preparation of their tax returns.

Q. Unrealised exchange gains on debts which are considered "long-term capital assets or liabilities" may be deferred under section 139 Finance Act 1993. If the assets or liabilities are redenominated in such a way as to appear to give rise to a different asset or liability will such gains or losses be considered realised and therefore ineligible for deferral?

1.6. The Government proposes to introduce legislation to prevent the relief in section 139 Finance Act 1993 being lost as a result of redenomination.

Q. A company may choose to hedge a foreign currency asset with a foreign currency liability or currency contract. Under Schedule 15 Finance Act 1993 and SI 1994/3227 exchange movements on an eligible liability or currency contract may, in the circumstances prescribed, be deferred eg. until the disposal of the matched asset. If such a matched asset is redenominated in such a way as to appear to give rise to a different asset will it cause the crystallisation of any deferred exchange movements on hedging liabilities or currency contracts?

1.7 It is not the Government's intention that redenomination should cause matching elections to become ineffective. Views are invited on whether legislation is needed to achieve this in practice.

Financial Instruments Legislation

Q. The financial instruments legislation provides inter alia for the taxation of "currency contracts". It contains a definition (section 150 Finance Act 1994) of "currency contract" which requires payments in different currencies. Will currency contracts involving two currencies that convert to the euro no longer be currency contracts, as only the euro will be involved?

2.1 No. The Government proposes to introduce legislation to ensure that such contracts will continue to be currency contracts for all purposes of the legislation.

Q. The financial instruments legislation provides that "qualifying payments" may be paid gross by a "qualifying company" (section 174 Finance Act 1994). Will fixed rate swaps of two currencies which convert to the euro lose this protection, becoming subject to withholding as an annuity or annual payments for tax purposes?

2.2 No. The Government's intention is that such contracts will continue to be within the financial instruments legislation provided that no abuse is taking place (eg. where a transaction is entered into immediately before conversion to exploit this relief).

Q. The financial instruments legislation prescribes the payments which may be made under a "currency contract". A contract may allow for other transfers of money or money's worth and still be a "currency contract" provided that the conditions in section 152 Finance Act 1994 are met, which broadly seek to ensure that the relative value of these transfers at the "relevant time" is small. Will conversion constitute a "relevant time" for section 152 Finance Act 1994, causing the issue of whether or not a contract is a "currency contract" to be re-considered?

2.3 No. Conversion, regardless of how it is achieved, will not be a "relevant time" for these purposes. (Council Regulation (EC) No 1103/97 under Article 235 of the Treaty provides for continuity of contract on the introduction of the euro. However conversion may also be achieved through bilateral legal agreement.)

Q. The financial instruments legislation contains anti- avoidance provisions, dealing with transfers of value, transactions not at arm's length and qualifying contracts with non-residents (sections 165-168 Finance Act 1994). If conversion to the euro causes there to be a new contract, will there be a re-consideration of sections 165-168 Finance Act 1994 potentially causing adjustments to taxable income to arise under these anti-avoidance provisions?

2.4 No. Conversion to the euro of itself will not cause anti-avoidance provisions to apply, provided the Board believes that no abuse is taking place. (The removal of the requirement for a Board's direction which is referred to in 1.5 above also applies to this legislation.)

ISDA EMU GUIDE

The International Swaps and Derivatives Association

Inside this guide. ISDA outlines the basics of the changeover to the euro for the money. forex. bond. equity and related derivatives markets and explains the legal. documentation. accounting. tax and risk management issues raised by EMU. This guide also includes key reference materials and covers the back office and systems impact of EMU.