12 June 1998

The Chief Executive
All authorized institutions

Dear Sir / Madam,

**Introduction of the Euro**

Further to my letter of 3 April 1998, I am writing to draw your attention to the implications of the introduction of the Euro for authorized institutions in Hong Kong and to provide some advice in relation to the preparations for this.

**Background**

The Economic and Monetary Union ("EMU") and the Euro will come into being on 1 January 1999. On that date, the conversion rates between the Euro and the national currencies of the eleven participating countries[1] in the EMU will be irrevocably fixed and the Euro will replace the existing national currencies for the participating countries although the physical currency will not be put into circulation until 2002. For a period of three years from 1999 to 2001 ("the transitional period"), the existing participating currencies will continue to exist as "national currency units", that is as sub-denominations of the Euro.

**The "no compulsion – no prohibition" principle**

During the transitional period, the principle of "no compulsion, no prohibition" will be adopted. This rule ensures that economic agents will have the freedom to use the currency unit – the national currency unit or the Euro unit – to which they have agreed. However this principle applies more to the private sector. It is understood that the European Central Bank and the national central banks of the participating countries will operate exclusively (including issues of new marketable public debt) in Euro from the very start of

[1] These countries are France, Germany, Italy, Spain, Belgium, the Netherlands, Luxembourg, Portugal, Austria, Finland and Ireland.

EMU after 1 January 1999. For the private sector, it is also expected that economic agents may feel obliged to use the Euro before the end of the transitional period for competitive reasons. For example, it is likely that the trading and settlement in the interbank markets will be substantially conducted in the Euro rather than the national currencies as early as from 1 January 1999. It is therefore important that authorized institutions need to have the capability to deal with two different currency units for each participating country by 1 January 1999. It will be difficult for an authorized institution to avoid completely using the Euro when it is introduced.

**Impacts and Implications**

***Impact on business***

Although the impact of the changeover to the Euro on authorized institutions in Hong Kong will be less than for banks in Europe, all institutions should ascertain the impact of the Euro on their business. Generally speaking, an institution which currently provides any products or services involving any participating national currency or the ECU will be affected by the introduction of the Euro. These would typically include banking services like foreign exchange trading, treasury products, trade financing, other loans and advances, deposit taking payment and remittance services and custodian service (e.g. keeping custody of bonds denominated in the existing national currencies). As mentioned above, institutions will need to have the operational capability to accommodate the use of both the Euro and the existing national currencies during the transitional period.

Institutions will also need to examine their business processes to see whether these might be affected by the introduction of the Euro and to consider whether any revisions in these might be desirable. For example, institutions may wish to review the arrangements with correspondent banks for payment and settlement in the Euro and the existing national currencies. As the nostro accounts in different participating national currencies will essentially become nostro accounts in different sub-denominations of the Euro after the Euro is introduced, it may be more efficient from the cash management point of view to consolidate these nostro accounts. On the other hand, business relationship considerations may suggest that more than one nostro account should be maintained. Institutions should give due consideration to these factors.

***Impact on systems***

In most cases the financial information systems of an institution are built with the assumption that all transactions in a given currency take place in the same currency unit. The introduction of the Euro with the coexistence of the participating national currencies for a transitional period thus poses a range of functionality problems for the information systems of an authorized institution. These include:-

(a) institutions being faced with situations in which they receive financial information in both Euro and the national currency units (input functionality problem);

(b) institutions being required to produce financial information either in Euro or the national currency unit or in both (output functionality problem); and

(c) information systems working in the national currency unit having to communicate with systems working in Euro as it may not be possible to change all information systems over to the Euro at the same time (interface problem).

The extent to which an institution will experience these problems greatly depends on the type of information systems that it uses. To prepare an institution’s information systems for the introduction of the Euro, it is therefore important to establish in the first instance which information systems are affected by the Euro as well as the degree of impact on these systems. Compiling a systems inventory is essential to determining the scope and nature of the problems and to identifying the right priorities and strategy for preparing for the changeover. Where systems are essential for the operations of the institution (in particular those affecting customers), they need to be accorded a higher priority for modification. If the conversion of different systems will be performed at different times, it will be necessary to develop interim interfaces between those systems working with the Euro and other systems working with the existing national currencies.

In addition to the above general considerations, there is also a wide range of technical issues that need to be taken into account when modifying information systems for the Euro:-

(a) <u>conversion and rounding rules</u>

There are EU regulations describing how the conversions between the Euro and the national currency units and rounding should be performed to achieve a consistent degree of accuracy. The regulations require the conversion rates between the Euro and the national currency units to have six significant figures and not to be rounded or truncated when making conversions. 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. If an institution’s systems do not implement these rules correctly, unnecessary rounding differences may result. Institutions therefore need to adapt the software in their computer systems to take account of these rules.

(b) dual currency displays and reports

Depending on customer requirements and business needs, information shown in certain display screens, reports, customer statements and correspondence may need to be displayed in dual currencies (the Euro and the participating national currency units) during the transitional period, taking into account practical constraints such as the limitation of space available on display screens and reports.

(c) interfaces between systems

Institutions will need to take account of the changeover arrangements of certain external systems (e.g. S.W.I.F.T., Euroclear, Cedel, and financial information vendors) which have interfaces with institutions' systems. Care also needs to be taken to avoid information systems accidentally combining amounts expressed in Euro with amounts expressed in the national currency unit (data pollution).

(d) decimals

Financial information systems that were designed to work with a national currency unit without decimals (e.g. custodian systems for bonds) will need to be modified in order to work with Euro cents (For example, the redenomination plans of many of the participating countries will require 2 decimal places for storing nominal amounts of government bonds expressed in the Euro). Expanding the field length will involve significant effort.

***Legal implications***

There are already EU Regulations which confirm that the Euro will be the single currency of the participating member states from 1 January 1999 and provide certainty for continuity of contracts denominated in ECU and the existing national currencies in EU countries.

However the situation is less clear outside the European Union. The Hong Kong SAR Government is currently considering whether it is necessary to introduce specific legislation to provide for continuity of contracts after the introduction of the Euro. Regardless of whether new legislation will be introduced, institutions should review all relevant legal instruments and contractual documents to ascertain whether they will be affected by the introduction of the Euro. Particular attention should be paid to:-

(a) longer term contracts (e.g. currency swaps involving any participating national currency) spanning beyond the transitional period ended in 2001, after which the existing national currency units will cease to exist;

(b) the disappearance of price sources and the potential application of trigger clauses in securities documentation – there may be contracts containing provisions on reference rates such as interest rates or securities prices e.g. the documentation of a floating rate note denominated in a participating national currency may refer to the interbank interest rate of that particular country in determining the coupon rate. These reference rates based on the existing national currencies may disappear after the introduction of the Euro. In this respect, it should be noted that market participants have increasingly seen the advantage of adopting a consistent approach to deal with the issue e.g. using the standard clauses prepared by the International Swaps and Derivatives Association ("ISDA"). Institutions should review the relevant contracts and seek agreements from the parties concerned to adopt the relevant market consensus or other appropriate arrangements; and

(c) contracts with reference to the ECU – the ECU will cease to exist after the introduction of the Euro. Although there is an EU Regulation which provides that references in a legal instrument to the ECU will be replaced by references to the Euro at the rate of one Euro to one ECU, institutions will need to review whether the conversion of the ECU to the Euro at a rate of 1:1 will be applicable if the contract concerned is governed by laws of jurisdictions outside the participating countries.

**Other issues**

Given that the introduction of the Euro will have an impact on different aspects of your institution, it will be important for your institution to make sure its clients and staff adequately appreciate the implications of the Euro. Early communication and understanding of clients' preparation for the changeover to the Euro and their needs in respect of Euro services will help your institution's planning and preparation. Meanwhile, raising the awareness of staff at all relevant levels, including front line, operations and IT staff, is essential to the success of preparing for the changeover.

During the conversion weekend from 1 to 3 January 1999, all outstanding transactions, customer accounts or assets denominated in ECU will need to be redenominated in Euro as the ECU will cease to exist from 1 January 1999. Government bonds of the participating countries denominated in ECU or the existing national currencies will also be redenominated in the Euro over the conversion weekend. Euroclear and Cedel, the clearing and settlement systems, will also carry out the redenomination processes during that weekend. Authorized institutions should have plans to prepare for these redenomination exercises.

The introduction of the Euro will also affect authorized institutions' prudential reporting to the HKMA. We are currently reviewing the adjustments which may be needed to the prudential returns submitted to the HKMA. Institutions will be advised of the changes in due course.

The above-mentioned issues represent only some of the more important issues that an authorized institution needs to consider when assessing the impact of the Euro and planning for the modification work. Institutions should not therefore take the advice given in this letter as exhaustive or definitive. There are still on-going developments in relation to the implementation of the Euro. Management of authorized institutions should ensure that they undertake proper assessment of all relevant developments relating to the Euro on their operations and take necessary actions to prepare for the changeover in a timely manner.

Yours faithfully,

(D T R Carse)
Deputy Chief Executive

c.c. Chairman, HKAB
Chairman, DTCA