EUROPEAN MONETARY INSTITUTE

OPINION OF THE EUROPEAN MONETARY INSTITUTE

on a consultation from the Dutch Ministry of Finance under Article 109f (6) of the Treaty establishing the European Community and Article 5.3 of the Statute of the EMI on a draft law containing an amendment to the Bankruptcy Act and the Act on the supervision of credit institutions 1992 with a view to the smooth functioning of payment systems and securities settlement systems (the "draft law")

CON/97/11

1. The present opinion was requested by the Dutch Ministry of Finance, which submitted the above draft law and an explanatory memorandum of 26 October 1996 to the EMI for consultation.

2. The EMI is competent to deal with this request for consultation under Council Decision 93/717/EC, Article 1.1, fourth and fifth indents, as the draft law concerns payments systems and securities settlement systems as well as the stability of the financial markets and institutions.

3. The draft law is intended to amend the operation of the so-called zero hour rule (as laid down in the Dutch Bankruptcy Act and the Act on the supervision of credit institutions 1992) for participants in those payment systems and securities settlement systems which have been designated by the Dutch Minister of Finance. The zero hour rule (a general rule under Dutch bankruptcy law) implies, inter alia, that insolvencies of such participants have retro-active effect to 0:00 hour on the day of the declaration of insolvency. The liquidator may reclaim funds transfers which have been executed after that time. The zero hour rule is generally considered to be a threat to the smooth and efficient functioning of payment systems and securities settlement systems (which was already signalled in the G10 Report on Interbank Netting Schemes of November 1990) and the draft law therefore provides that vis-à-vis such systems, transfer orders issued by a participant and executed during the day of its insolvency cannot be annulled by its liquidating authority. However, it would appear that under the draft law, the liquidating authority would nevertheless be able to reclaim the payments and securities (or rather the "amount of the value of that which was the subject of the order" in the terminology of the draft law) from the participant having received such transfer order in a payments system or securities settlement system "outside of the system", and without leading to an unwinding of the settlement process "within the system". In this manner, the Dutch authorities attempt to accommodate the above concern with regard to their current zero hour rule and at the same time seem to anticipate the adoption of the EU Directive on settlement finality (the "draft Directive"), which is

presently in the process of being adopted by the EU Council and the European Parliament and which contains provisions on the retro-active effects of insolvency proceedings. Against this background, it is therefore necessary to consider the practical effects of the draft law and to assess whether they are indeed beneficial or otherwise appropriate. This issue will be addressed in this opinion from various perspectives. As explained further in the paragraphs below, the EMI feels that the draft law is too restrictive both from a legal point of view as well as from a payment and securities settlement systems point of view. The legal perspective will be dealt with in paragraph 4, the systems' perspective in paragraph 5. For reasons of brevity and for the purpose of this opinion, payment systems and securities settlement systems will collectively be referred to as "systems", the amount of any payments and securities will be referred to as "funds", whilst transfer orders for payments and securities will be collectively referred to as "transfer orders". "Receiving participant" will mean a participant in a system, either directly or indirectly, who first receives the funds and any subsequent participant, if any, in that or any other system which receives the funds.

4. The EMI feels that the draft law is too restrictive from a legal point of view. If the EMI understands the draft law correctly, a liquidator would be able to reclaim funds from the receiving participant in a system, irrespective of whether he is the final beneficiary of the transfer order or only an intermediary. This application of the zero-hour rule outside of the system seems to give the receiving participant only conditional finality for funds received during the day of the opening of insolvency proceedings, whereas such a participant should actually be in the position to rely on the definitive character of the funds transfer, particularly in view of its other operations (see point 5 below). This right of the liquidator is based on the fact that the "zero-hour rule" will remain applicable "outside the system", which would allow to challenge all funds transfers on the day of the opening of insolvency proceedings for the sole reason that they have been made between 0:00 hour and the opening of the insolvency proceedings on that day in infringement of the retro-active dispossession of the insolvent party. This ignores the fact that the receiving participant may only be an intermediary instructed to forward funds to other parties. The avoidance of systemic risks requires that finality and irrevocability of transfer orders should not only apply to the original transfer order, but also to any other subsequent transfer orders which are issued as a means of carrying out or pursuant to the first transfer order, and to any funds transfers made thereunder. This means that, where a participant in a system enters transfer orders into a system and forwards funds to other parties, such funds transfers should not retro-actively be affected by an insolvency of the originator of the transfer. To the extent that the draft law appears to provide a liquidator with the possibility to reclaim funds from the receiving participant in a system which have already been transferred to a subsequent beneficiary, this would raise numerous legal uncertainties, particularly in a cross-border context. For example, should the receiving participant delay the execution of a funds transfer until the

moment that certainty exists with regard to the finality of this transfer (i.e. the next day?). This would obstruct the smooth and efficient functioning of systems and contradict the very aims which RTGS systems attempt to achieve. Should the receiving participant retain a right vis-à-vis a subsequent receiving participants to revoke any transfer order? This is difficult to construe from a legal point of view and, again, contradicts the smooth and efficient functioning of systems. Or should the receiving participant bear any losses resulting from a successful claim for restitution itself? This is unreasonable, particularly if the receiving participant is only the channel through which funds are transferred to other beneficiaries. In addition to these observations of a legal nature, it would also be unlikely that the draft Directive intends to allow for a continued, but delayed, application of the zero-hour rule as envisaged in the draft Dutch law, particularly since Article 7 of the draft Directive on the non-retroactive effect of insolvency proceedings seems to be specifically included with a view to the abolition of the zero-hour rule. In this connection, the EMI recalls that in other countries a zero-hour rule either has never existed or has recently been abolished (at least for all participants in their respective systems).

5. The EMI notes that the above analysis is indicative of a more general debate on the appropriate level of finality in order to avoid systemic risks for systems in particular and threats to the stability of financial markets and institutions in general. There are strong arguments in favour of beneficiary finality (except, of course, in cases of imperfections in the underlying transactions or funds transfers resulting from fraud or error as decided by courts on a case-by-case basis) for the purpose of achieving the smooth and efficient functioning of systems and the stability of the financial markets. The EMI believes that systemic risk concerns are only adequately addressed if, at least, finality (subject to the foregoing exceptions) for receiving participants is ensured.

Funds transfers between participants in the financial markets cannot be seen in isolation from each other. Such participants tend to operate on the basic assumption that funds transfers, when due and indeed made, are irrevocable, final and cannot successfully be challenged whether through court proceedings or otherwise and they anticipate these consequences in their transactions with other parties. Thus, the continued exposure of a receiving participant to the originator of a transfer order after the purported settlement of that transfer order, as a result of the delayed application of the zero-hour rule, could still lead to a domino effect causing systemic risk and instability of financial markets and institutions.

The above argument applies even more strongly in an environment where market participants are global players, where credit institutions participate in different systems operating in different time zones and where links between such systems are established. In this connection, the magnitude of the transactions involved is also important. Whereas, for individual transactions, or specific types of transactions, risks such as market risk, replacement risk or operational risks are relevant, such risks are multiplied for systems due to the fact that the full amount of the funds transferred is at stake.[1]

The above considerations were, inter alia, a reason for EU central banks to urge the implementation of Real-Time Gross Settlement systems (RTGS systems), on the basis that these systems, at least from a technical point of view, can guarantee intra-day finality of individual transfers as they occur. Thus, RTGS systems provide a tool for banks to manage credit and liquidity risks inherent in their banking business; but this tool is of course only effective if funds transfers are also final from a legal point of view. As far as the TARGET system is concerned, which the EU central banks have been developing over the past few years, this system is designed on the basic assumption of intra-day finality. If such finality cannot be achieved due to legal obstacles in a Member State, this may have implications for all participants in the system and for all credit institutions incorporated in that Member State. The latter may face difficulties if they wish to participate in or connect to RTGS systems on a remote basis or through branches abroad. Furthermore, the NCB in a Member State with such legal obstacles may have to guarantee that TARGET payments channelled through it to receiving participants in other Member States are indeed final, irrespective of the legal situation in the Member State concerned. This would suggest that the draft law does not achieve one of its most important aims: the removal of legal obstacles for the participation of Dutch credit institutions in RTGS systems outside the Netherlands.

Furthermore, the absence of finality in systems may make it difficult to implement mechanisms such as payment-versus-payment and delivery-versus-payment or to build bridges between systems. This is an obstacle to attempts to make financial markets as efficient and sound as possible.

For the reasons set out above, the EMI regrets that, although the explanatory memorandum to the draft law acknowledges many of the above considerations, the draft law itself nevertheless takes such a restrictive stance towards finality. This is from the EMI's point of view also particularly important as the smooth and efficient functioning of payment systems is indispensable for the achievement of the ESCB's objectives in Stage Three and, in particular, the implementation and execution of the single monetary policy.

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[1] For example, the scale of potential problems can be demonstrated by reference to the daily turnover in the FX market alone, which was estimated in April 1995 at 1.26 trillion USD and where daily settlement flows are likely to amount, in aggregate, to a multiple of this figure. See a report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries on settlement risk in foreign exchange transactions which was published by the Bank for International Settlements in March 1996.

6. In summary, the EMI is of the opinion that the draft law is too restrictive. Firstly, it does not seem to protect transfer orders issued to, and funds transfers made by, the receiving participant. This means that the draft law does not sufficiently accommodate the need to avoid systemic risks. Secondly, the draft law appears to run contrary to an increasing trend in the financial markets to achieve receiving participant or even beneficiary finality (except for cases of imperfections in underlying transactions or funds transfers resulting from fraud or error) for the purpose of achieving the smooth and efficient functioning of systems as well as the stability of financial markets and institutions. The EMI therefore recommends to the Dutch legislative authorities to reconsider the draft law in the light of the above considerations.

7. The EMI has no objections to this opinion being made public.

11 November 1997