

***VI MEETING OF LEGAL ADVISERS OF CEMLA
CENTRAL BANKS***

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Legal aspects of financial contracts of central banks

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Legal framework for monetary policy management - central
bank regulation for monetary purposes and legal protection
from risks



Introduction

- MP structure + legal environment varies from country to country. No single solution for central banks (CBs)
- Presentation overview
 - Legal / Regulatory framework for monetary policy (MP)
 - Legal safeguard + protection mechanisms
 - International dimension + recent legislative initiatives
 - Legal risk management issues
- Focus = Bank of England (BoE) MP framework + operations

Legal + regulatory framework

- BoE - big picture
 - Acts: 1694 / 1946 / 1998
 - Core Purposes
 - Memorandum of Understanding 1997 (BoE / HMT / FSA)
 - MP aims + objectives [BoE May 2002 paper]
- High level legal features of BoE MP operations
 - 1998 Act
 - no specific statutory / regulatory framework within which BoE MP operations conducted
 - general principles of English law apply
 - English law + financial markets
 - EC impact

Legal + regulatory framework

- MP instruments
 - general issues for central banks (CBs) eg: direct controls (eg limits) v indirect instruments (eg open market operations ‘OMOs’)
 - what is appropriate depends on local factors
- BoE documentation / process
 - OMOs / typically two week repurchase agreement (‘repo’)
 - BoE ‘Money Market Operations Master Sale and Purchase Agreement’ + BoE Operational Notice (latest versions 15 Sept 03)
 - no reserve requirements
 - Liquidity Withdrawal Legal Agreement
 - deposit facility

Legal + regulatory framework

- Counterparties

- issues typically confronting CBs (eg all or some banks? / banks and others? / does congregation achieve MP objectives? / functional criteria? / uniform criteria for different instruments?)
- BoE approach [May 2002 paper] (objectives / general stance = ready to deal with wide range of financial institutions subject to specified functional criteria)

- Eligible assets

- issues typically confronting CBs (eg broad v narrow range / how add / who determines / dematerialised etc?)
- BoE: eligible assets repo + eligible assets outright. Details in BoE Operational Notice 15 Sept 03

Legal + regulatory framework

- Broader legal / regulatory environment eg
 - London-based market committees (Money Markets Liaison Group / Stock Lending and Repo Committee)
 - Codes eg industry-produced Gilt Repo Best Practice
 - Financial Markets Law Committee: legal certainty in wholesale financial markets
 - legal expertise
 - FSA regulation

Legal protection

- Overall aim = achieve MP objectives
- Agreement + secure legal environment key BUT only part of overall mechanisms eg
 - sound counterparties (CPs)
 - adequate pool of high quality collateral
 - secure supporting infrastructure
- Focus on legal safeguards + protections eg
 - well-drafted Agreement
 - secure transaction (repo)
 - collateral + margin
 - default provisions incl close-out netting

Legal protection

- Agreement - basic objectives / features eg
 - protect CB if counterparty (CP) defaults
 - establishes legal nature of transaction (eg repo)
 - provides certainty as to rights + obligations (eg substitution / margin / income provisions / status of CP)
 - determines who bears what risk
 - sets out basic mechanics (who does what when?)
 - standard provisions (eg single + entire agreement / amendments / governing law + jurisdiction etc)
- Legal nature of repo
 - aim / essential elements
 - risk of re-characterisation? - position under Eng / different laws
 - repo v pledge

Legal protection

- Collateral + margin maintenance
 - initial 'collateral' = repo'd securities
 - margin
 - top-up
 - default provisions
 - legal issues (eg are provisions relating to initial collateral / margin / top-up enforceable in relevant jurisdictions?)

Legal protection

- Default provisions
 - various provisions in Agreement aim to protect CB against insolvency / default of CP
 - warranties + representations
 - events of default (insolvency events + others - widely drafted)
 - automatic / optional events of default (need right balance)
 - remedies
- Close-out netting
 - default / insolvency of CP = event of default
 - delivery + payment obligations of both parties are accelerated
 - resulting sums owed by each party aggregated + set off against sums owed to it. Single net sum
 - English law netting regime one of strongest in world

Legal protection

- What type of Agreement?
 - Depends on various factors eg legal environment / objectives
 - Standard documents eg TBMA/ISMA Global Master Repurchase Agreement 2000
 - Advantages of market standard documentation
 - But special considerations of CBs - ‘off the peg’ v bespoke
 - BoE documentation (eg events of default / margining / jurisdiction)

International

- International dimension
 - multi-jurisdictional issues faced by CBs in MP context (eg foreign CPs / eligible assets with foreign element)
 - contracts / security needs to work in all relevant jurisdictions (eg local formalities / choice of governing law /close-out netting / insolvency etc)
 - insolvency differences
- Recent initiatives
 - European Union initiatives (Settlement Finality Directive (SFD) / Winding-up Directive / Collateral Directive) - nature of Directives
 - Other eg Hague Convention + UNIDROIT

International

- Settlement Finality Directive (98/26/EC)
 - protection against insolvency proceedings opened against participant in designated payment or settlement system; or against counterparty of CB where collateral security provided as part of CB's operations
- Winding-up Directive (2001/24/EC)
 - winding-up / reorganisation measures against EU credit institutions fall to 'home' Member State with certain exceptions (eg netting + repo agreements = governing law and book entry securities = PRIMA)

International

- Collateral Directive (2002/47/EC)
- Application
 - ‘financial collateral arrangements’ (eg repo + pledge)
 - ‘financial collateral’ (ie cash + financial instruments)
 - specified parties to arrangement (eg CBs, financial institutions)
- Effects
 - ensures collateral recognised + enforceable across EU
 - minimises formalities
 - removes major obstacles to cross-border use of collateral
 - assists in creating clear legal framework

Legal risk management

- How CBs encounter 'legal risk' (LR) in MP context
 - institution specific LR
 - broader based LR
- LR = risk that CB's actual legal position not what it thinks it is
- LR management not mean not incurring any LR - rather that CB aware of risks + manages accordingly

Legal risk management

- Possible processes / techniques / environment eg
 - identify LRs
 - recognise special features of LR
 - ensure internal coordination
 - formalise LR management process
 - use well-drafted legal documentation
 - appropriate remedies
 - advice from all relevant jurisdictions
 - exercise rights / remedies when appropriate
 - promote secure legal framework