

## THE FINANCIAL SYSTEM AND MAJOR OPERATIONAL DISRUPTION

### SPECIFIC RESPONSES

This document follows the form of the Consultation Paper, responding, where appropriate, to the questions and issues raised.

*Q3a: Do you have any general comments about types of market-based approaches to promoting order in the financial system during major operational disruption?*

Ordinarily we would expect market counter-parties to work together to resolve the effects of major operational disruption.

Generally, the existing *force majeure* provisions in contracts tend to be framed in quite wide and general terms and are probably not sufficiently specific and detailed to deal with these types of situations. The terms of these provisions could be reviewed with a view to enhancing their “sophistication”.

Contractual provisions will only cater for specific arrangements and their application could be disruptive if different types of provisions were to apply to different but “related” arrangements. It may be important to try and ensure a *degree* of consistency across the markets in the use of these provisions (for instance, by the framing of some generally accepted principles). However, it may be difficult to ensure that these provisions are comprehensive and will cover every type of eventuality.

*Q3b: Is there more that could usefully be done by the private sector to strengthen the contingency provisions in contracts and other legal instruments? Is there a role for the authorities in assisting with this?*

A recent example of cross-bank consensus was observed in the UK following a major CREST outage that resulted in significant long/ short balances being left by Settlement Banks at the BoE. As the BoE does not pay interest on long balances, and generally short balances are penalised, given the extreme nature of conditions, the BoE and Settlement Banks agreed through MMLG and APACS that the Repo Rate be used. Use of this rate in future extreme circumstances has now become an agreed practice by the MMLG.

Conversely to the above successful resolution of a major UK settlement system failure, at the introduction of Euro there were considerable problems about whether and where funds had been delivered. This led to large numbers of long-running disputed interest claims for failed/-misdirected payments as the banking world struggled to agree on common procedures and resolutions.

We would prefer the market to resolve these issues itself. The authorities could assist by creating a framework that allowed for dispute resolution where unusual circumstances required parties to operate outside their normal contracts, or to reinforce decisions taken in good faith by the market.

It is important that the scope and content of force majeure provisions are carefully reviewed by the private sector with a view to making any adjustments to existing contracts (where this is considered necessary) and also ensuring that contracts entered into in the future include suitably detailed and comprehensive provisions. It may be necessary to ensure some degree of consistency across sectors in the use of these types of provisions.

It may be possible for the authorities either to legislate on aspects of *force majeure* provisions or at least to issue guidance on their use and content.

*Q3c: Is there more that could usefully be done by the private sector to strengthen market co-operation? Is there a role for the authorities in assisting with this?*

The introduction of additional Rules and requirements, guidance notes etc. by industry bodies/ infrastructure providers will have the benefit of laying a framework for recovery. These however, should maintain an element of flexibility and take into account all the affected parties requirements. For example, rules that would be appropriate for the larger financial institutions may not support the requirements of smaller organisations.

We believe that the Bank of England and possibly the FSA could have a role in the co-ordination of industry wide contingency testing.

Relevant trade associations also have a useful role to play in efforts to strengthen market co-operation.

It is also essential that the Government is aware of initiatives being taken by the private sector (whether in planning for an operational disaster or during the course of a disaster) and those who should be contacted in the private sector, who will have the necessary expertise and authority to make decisions for the private sector. This will assist the Government in deciding on the approach to be adopted (whether this should be purely market based, whether it should be legislative or a combination of the two) and also in formulating any detailed proposals following a major operational disruption. The regulatory authorities should also be consulted.

*Q4a: In principle, would it be useful to have new legislation to help promote order in the financial system in the face of major operational disruption?*

In principle, yes. There is currently a possibility that measures taken by individual systems providers could lead to litigation. It makes sense therefore to have a legal framework in which the measures could be taken and/or to have a legal framework within which such disputes can be settled quickly. However, the type of “approach” to be adopted, the circumstances in which this legislation would apply, its scope and content will all require detailed consideration to ensure that the objectives can be satisfactorily achieved without the existence of this legislation exacerbating disruption and uncertainty.

This could probably also be achieved by the adoption of principles by the private sector that enabled specific remedies to be implemented in the event of a crisis.

Given the complexities, intricacies and interdependencies involved in this type of situation, the Government will need to be advised and guided by the private sector in deciding what action (if any) it should take when a disaster occurs. Decisions should be based on technical knowledge, expertise and experience in the relevant field. It is therefore vital that the private sector, the regulatory authorities and the Government work together in deciding on whether any secondary legislation or administrative direction needs to be adopted and, if so, what form this should take. If at all possible, the involvement of the private sector should be enshrined in the primary legislation.

*Q4b: Have you any comments on how new legislation might address risks, the possible disadvantages and limitations of new legislation and the general constraints on the use of new legislation?*

In general:

- Legislation should add certainty, not create uncertainty.
- Legislation should not introduce risk to the marketplace, which did not exist hitherto.
- The authorities need to be able to respond quickly and decisively, having taken appropriate market soundings.
- Consenting counter-parties should not be constrained by legislation.
- Legislation should not reduce the current willingness of market participants to be flexible in their approach.
- Legislation should **support** private sector arrangements rather than seek to replace them. Generally, it would be better if the markets were left to develop their own rules and arrangements rather than the authorities seeking to deal with the situation by passing legislation.

With regard to the general constraints on the use of the proposed new legislation, it will be necessary to clarify and explain how these would operate, more fully.

The first constraint mentioned at paragraph 4.16 is that it will never be used in a purely financial crisis. It may not always be clear when a crisis is purely financial. There may be severe operational crises that flow from a financial crisis which need to be dealt with despite being “related” to a financial crisis. For example, a financial crisis in one part of the world could create significant operational disaster in international (and UK) financial markets. The boundaries of such legislation require to be very clearly defined to ensure that they can be operated in a practical manner that supports rather than hinders sound market operations.

The second restriction is that it will only be used in *extreme* circumstances resulting from *major* operational disruption. It will be necessary to identify the types of situations likely to be classified as “extreme” and cases where “major” disruption has occurred. It will be important to have a degree of certainty in the market about how the authorities might use their additional powers and it must be clear when these powers will be invoked.

As regards the private sector support, it would be important to establish a framework in advance so that, in a disaster, it is immediately clear who should be consulted and who has authority to represent and make decisions for the sector. As already indicated, it is essential that the private sector has a primary role in decisions as to whether secondary legislation/ administrative direction should be adopted, and if so, the scope and content of these.

*Q4c: If new legislation were to be sought, are the suspension and direction powers the right choices? Are there any other types of legislation that might be useful to help promote order in the financial system?*

In the circumstances outlined, the types of powers outlined appear appropriate, although as our other responses indicate we would expect such powers to be used in extremis only.

Further, it may be useful to ensure that some mechanism is put in place to deal swiftly with claims/ appeals particularly relating to the resolution of contractual disputes arising from any action taken as a consequence of the disruption.

*Q5a: Have you any comments on the possible approaches to making secondary legislation/administrative directions, including who should exercise this function, the attractiveness of potential fallback routes for making the secondary legislation/administrative directions, accountability to Parliament and modification of secondary legislation/administrative directions?*

As already mentioned above, the Government's powers should be exercised in "conjunction with" the private sector and the regulatory authorities. The regulatory authorities may also be able to separately achieve much by way of rule changes in relation to those areas falling within the scope of their respective authorities

The persons with the authority to make the legislation should have appropriate technical expertise, skills and experience or should be required to consult those with this knowledge. Whilst the primary legislation may be able to make some provision in this respect, it is doubtful whether anyone other than a Minister of the Crown would be entitled to make this secondary legislation. Accordingly, these powers should be capable of being exercised by a Treasury Minister, or failing that, non- Treasury Government Ministers.

There must also be sufficient accountability for use of these powers. Given the nature of the circumstances in which this secondary legislation etc is to be made it is accepted that prior consultation and the following of normal Parliamentary processes will have to be dispensed with. However, it is essential that any legislation made is eventually laid before Parliament to provide a formal mechanism for scrutiny and accountability for use of these powers.

Modifications to legislation and administrative directions should be made, as appropriate, throughout this period, again with the involvement of the private sector and the regulatory authorities. It is agreed that any modifications should not have retrospective effect.

The possibility of Treasury officials, the FSA and the Bank of England being able to take some action which might have a similar effect should only be contemplated in the event that these powers cannot be exercised by the Government. If any authority were to be given to the FSA or the Bank of England presumably it would have to be exercisable by them by way of implementing rules falling within the scope of their respective "jurisdictions". It is doubtful whether the regulatory authorities could issue rules which have a wide and general application across the whole industry/ all markets/ all settlement systems etc for which they may have no direct responsibilities. This could necessitate action having to be taken by more than one authority in order to achieve the desired objective.

*Q5b: Should primary legislation include further conditions for use of its powers (beyond the basis for use being major operational disruption and not a purely financial crisis)? If so, what?*

The primary legislation should include further conditions for the exercise of these powers.

This legislation should only be used in extreme circumstances.

It is fundamentally important to define or provide some explanation of what was meant by terms such as “*purely* financial crisis”, “*major* operational disruption” and “extreme circumstances”.

As regards private sector support, the primary legislation should acknowledge the significant role of the private sector in deliberations about any secondary legislation and the necessity for it to be consulted. Having an already established mechanism in place (such as a Standing Committee) to represent and provide the private sector input is more likely to lead to action being taken swiftly and to effective private sector participation in the process.

It would also be useful to include any fundamental objectives in the legislation, though it is agreed that these will probably need to be framed in wide and general terms to ensure that they do not impede action being taken, where necessary.

*Q5c: Would you support specification in the primary legislation of a maximum time period for the duration of powers? If so, how, and for what period?*

There will be a paramount need to preserve operational flexibility and the imposition of specific time limits for the duration of these powers could adversely affect this. Imposing specific time limits would be arbitrary and could have unintended consequences.

*Q5d: If the powers were adopted, do you agree they should affect actions in the UK (rather than actions governed by UK law)?*

Contracts may be governed by UK law even where they may have little (if any) connection with the UK and are being performed entirely outside the UK. It could be quite inappropriate for these types of contracts to be affected by legislation being passed to accommodate purely local conditions in the UK. Accordingly, it is agreed that the focus here should not simply be on those contracts governed by UK law.

From a practical viewpoint it would seem sensible that the powers should affect all actions to be performed in the UK but where contracts are governed by a foreign law, the detailed implications of attempting to take this action would need to be considered further. Apart from this, as a practical matter, trying to carve out and focus on those actions to be performed in the UK is likely to be a difficult exercise due to the cross border nature of many of these transactions and the international character of the financial services sector and it is very likely that the exercise of these powers could impact on obligations to be performed in other financial centres around the world. It will therefore be important for the UK authorities to

discuss the use and application of these powers with their foreign counterparts, both generally and in principle and also to inform them, in situations where these powers are to be (or have been) exercised. To fully achieve these desired objectives (and to the extent that these may not already be in place), bilateral agreements, conventions and protocols between the relevant Governments may be necessary. Apart from these agreements, in these types of circumstances it may be necessary for these foreign authorities to take certain consequential steps so as to “accommodate” any actions taken by UK authorities impacting on contracts governed by their laws.

However, focusing on whether the contract is to be performed in the UK would not, say, assist a UK based organisation, severely affected by the operational disaster in the UK, but obliged to perform contracts outside the UK (whether governed by UK law or a foreign law). To try and deal with these and other types of situations where the impact will not be limited to or where it cannot be contained within, the UK, effective mutual co-operation between the authorities of at least the major global financial centres will be essential. It is unlikely that action taken within the UK alone will be able to deal with the consequences of a major operational disaster, fully and effectively.

*Q5e: If the Government seeks new legislation, should it allow the use of powers following major operational disruption affecting a non-UK major financial centre?*

Yes. Again it is not possible to foresee the exact nature and extent of a particular problem. Further, given the international nature of the financial system and the complex interrelationships and dependencies which exist across many countries it is essential we can react to problems arising in at least the major world financial centres.

Major operational disruption in other countries could have a major impact on the financial markets in the UK and could significantly affect the performance of contracts in the UK.

*Q6a: Which wholesale market obligations should be included in a suspension power’s maximum scope? Please draw attention to any particular issues that might arise (e.g. regarding proprietary rights).*

We believe that in most cases the market should be left to effect settlement, but if the powers were enacted then they should apply to all markets. Where settlement can be reached any legislation should not seek to prevent this.

*Q6b: Should retail obligations be included in a suspension power’s maximum scope?*

If a line had to be drawn between retail and wholesale would best be done by differentiating between the systems used. However, as a practical matter it will be difficult to draw such a line. For example CHAPS is used to settle transactions arising from actions in the money markets as well as in the retail area of house purchase. BACS is used by corporates to pay salaries but funds will be transferred into bank accounts via CHAPS to enable salary payments from the money markets. Suspending CHAPS could therefore impact on BACS. Trying to distinguish between retail obligations and wholesale obligations is unlikely to be feasible.

*Q6c: If a distinction should be made between retail and wholesale obligations, how should the line be drawn?*

See above. There is no easy way to distinguish between wholesale and retail obligations. If a distinction is to be made it would best be done by reference to types of transaction and/or the systems used.

*Q6d: Which insurance contracts, if any, should be included in a suspension power's maximum scope?*

Given the nature of insurance contracts and the fact that they tend not to be time critical, generally we do not see any necessity to include them within the maximum scope of a suspension power.

*Q6e: Are there any other types of obligations suitable for inclusion in a suspension power's maximum scope?*

Our views on this point is covered elsewhere in our response.

*Q6f: Should obligations governed by foreign law, but falling to be performed in the UK, be subject to the suspension power? How important is this? How might such an effect be achieved?*

Yes. This is important to preserve market unity and equality of treatment. Legislation if enacted, should cover all transactions denominated in Sterling and obligations performed in the UK. However, as a practical matter, it may be difficult for UK legislation to achieve this outcome, unilaterally. It may require separate arrangements/ agreements on these issues to be made between the Governments of those countries with major financial centres.

*Q6g: Should a suspension order only be able to apply to all the obligations arising from a contract? Or are there cases for which it could be preferable to suspend some obligations arising from a contract, but not others?*

Each major operational disruption is likely to be unique and depending on the circumstances, some obligations may be unaffected or it may be possible to perform certain obligations, but not others. Performance of certain obligations may be beneficial to the parties and may assist in the recovery process. Flexibility is an important consideration and so to cover a range of eventualities it should be possible for any suspension order to apply to some or all of the obligations arising from a contract.

In this context, a number of detailed issues requiring further consideration also arise, for example:

- It is unclear what the consequences for CLS might be from such arrangements.

- Complex issues arise in the area of fx, where one leg will not be denominated in Sterling. Settlement of one side of the transaction and not the other may increase market risk to such a degree as to make partial suspension untenable.

*Q6h: Should a suspension power only be able to affect obligations which could not be fulfilled as a result of the disruption?*

It is conceivable to think of circumstances in which the suspension in one area will have a significant impact on another. To restrict the suspension power only to those obligations, which could not be performed in the first instance, might create a situation in which other obligations become impossible (or at least difficult) to perform and no arrangements can be made to cover this. Accordingly, suspension powers should be capable of affecting other areas impacted by the action taken to deal with the disruption, but, in practice, the wider use of this power should be subject to tight safeguards and controls.

*Q6i: Are there any other restrictions that should apply to how a suspension power could be used?*

Suspension should simply mean that the relevant obligations are, in effect, “suspended”. The position should be frozen, the parties given an appropriate breathing space and thereafter, these obligations should resume as soon as the period of suspension ends. Apart from the “delay”, care needs to be taken to ensure that the actual obligations themselves are not affected by the use of these powers.

*Q6j: Have you any comments about consequential effects of a suspension power?*

No party should benefit, or be seen to benefit, from material undue enrichment as a result of the exercise of the suspension power.

Generally, if parties are able to perform their obligations they should be required to do so, rather than being allowed to do so at their discretion, relying on a suspension power. The suspension should last only for any period for which it is actually required and no longer. Contractual rights should not be impacted long term and should be capable of being exercised as soon as the suspension is lifted.

As far as possible market solutions should be allowed to deal with the impact of any suspension power. Trying to legislate so widely is likely to interfere unnecessarily in markets and contractual relations between parties. Adopting this course is likely to have a ripple effect and it might be difficult to determine at what point intervention should cease.

*Q6k: After a suspension period should obligations return immediately, as soon as practically possible, or is some other approach preferable?*

Ensuring market certainty is essential and the position needs to be clearly communicated to the industry. It is also important that normal rules and standards begin to apply and that usual trading conditions begin to operate without delay. To assist in ensuring certainty, it would be

preferable to arrange for the obligations to resume as soon as practically possible once the suspension ends.

*Q6l: Do you support the idea of a suspension power, subject to the constraints of paragraph 6.28?*

Generally, it is agreed that a suspension power may be beneficial in certain circumstances, providing its operation and application is controlled. As referred to above in the responses to Qs4b and 5b, it is essential that detailed consideration be given to what constraints will be required and how these will be applied.

*Q7a: Should recognised bodies be within the maximum scope of a direction power?*

After consultation and agreement, it would seem appropriate for recognised bodies to fall within the *maximum* scope of a direction power given the critical role they play in UK financial markets, which could help facilitate recovery from a major operational disruption.

*Q7b: Should payment systems be within the maximum scope of the direction power? If so, which?*

It would seem appropriate for payments systems to fall within the maximum scope of a direction order for similar reasons to those given in response to Q7a. Systems which should be included are CHAPS, BACS, CLS Bank, SWIFT.

There is a need for CLS itself to have rules to deal with a major disruption in a major financial centre as any unilateral action in UK could create international issues that would require to be resolved within CLS.

*Q7c: Should functions of institutions that are similar to the functions of recognised bodies and payment systems be within the maximum scope of a direction power?*

We would expect coverage of recognized bodies and payment system functions generally to be sufficient.

*Q7d: What actions should directions to infrastructure be able to order? Should directions themselves effect changes, where appropriate, or only be able to require infrastructure to take actions?*

Key actions include the following although it is stressed we would look for such actions to be taken in line with agreement by the market(s):

- Open / shut systems, extend / amend cut-offs.
- Provide liquidity support.
- Ease regulatory requirements.

If the infrastructure's headquarters are functioning, the directions should be implemented via the infrastructure, rather than the directions themselves directly effecting changes.

*Q7e: Have you any comments about consequential effects of a direction power?*

We would note that the cessation of settlement merely delays rather than cancels the event. It may be useful for the primary legislation to enable a direction power to provide for certain consequential effects of implementing the direction. However, care should be taken to try and achieve the intended objectives without interfering with obligations more than is absolutely necessary, in the circumstances. The more specific consequential action is taken by the authorities, the further the impact of the original action is likely to be felt and the more difficult it will be to draw a line.

The direction power should at least generally outline the circumstances in which any "wider powers" might be exercised.

*Q7f: Do you support the idea of a direction power, subject to the constraints of paragraph 7.29?*

Yes, after suitable consultation with the private sector. It is important to note that any constraints to which direction powers will be subject will need to be carefully considered.

*QAa: Have you any comments about the usefulness of the Banking and Financial Dealings Act 1971 powers in responding to major operational disruption?*

This legislation is not specifically designed to cope with disruption of payment systems and we accept that relying on the provisions of the Banking and Financial Dealings Act 1971 is unlikely to be adequate to deal with situations of "extreme financial disruption" effectively. It is a blunt instrument that seems inappropriate to use in response to the immediacy of the market disruptions currently being envisaged. Any new proposals should be such that they can be tailored to meet the needs of the particular situation.

*Qba: Have you any comments on this draft Regulatory Impact Assessment?*

No comments at present.