

## **The financial system and major operational disruption**

### **Response by the Council of Mortgage Lenders**

#### **to HM Treasury's Consultation Paper Cm 5751**

1. The Council of Mortgage Lenders (CML) is the representative trade association for the mortgage industry. Our 144 members comprise banks, building societies, insurance companies and other specialist residential mortgage lenders, which together represent around 98% of the assets of the mortgage market. We welcome the opportunity to respond to the Treasury's consultation paper on the financial system and major operational disruption (MOD).

### **Summary**

It is entirely appropriate that HMT Treasury should consider how prepared the financial system might be for MOD at any time. However, we are struck by the following aspects of the consultation:

- The clear evidence from New York post 9/11 was that mutual co-operation by firms was key to the swift recovery of systems and services. We believe that the financial services in the UK would respond in a similar way and would prefer to exercise forbearance and common sense rather than seek to take refuge in legal exemptions and get-out clauses.
- The consultation is almost entirely lacking in any information, other than post 9/11 reports, on what other financial centres and countries have done to address this problem.
- Despite repeated statements that the primary responsibility should lie with the financial sector, the consultation seems to assume that "legislation" is capable of providing solutions at short notice to problems which may not be predictable. Yet very few specific options and proposals for how legislation could provide solutions are put forward.
- We think there is a real danger that non-specific legislative powers, if taken, could paralyse the immediate industry response to MOD as firms await decisions and instructions from Government departments which could – conceivably – themselves have suffered major disruption. Emergency powers, once enacted, would need to be formally suspended: this could hamper the speedy recovery of systems and services if everyone had to wait to move at the speed of the slowest.
- We are sure that the paper is drafted with the best intentions, but believe that much more research and detailed consultation with the industry would be needed before legislative powers could be contemplated as a realistic option.
- **In conclusion: we believe that the greatest emphasis should be placed on advance planning by the industry, and that it is neither necessary nor desirable for the Government to take additional powers to intervene.**

Our responses to the specific issues raised are set out below.

**Question 3a: Do you have any general comments about the types of market-based approaches to promoting order in the financial system during major operational disruption?**

We agree that the main responsibility for recovery following MOD rests with the private sector. Given the unpredictable nature of MOD, market co-operation would seem to be the most likely response to whatever emergencies arise. There may be scope for contracts to provide for the possibility of and response to MOD and firms may need to be encouraged to consider whether this would be appropriate to their type of business.

**Question 3b: 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?**

It would be appropriate for regulatory and supervisory authorities to establish whether firms have adequate emergency plans for dealing with MOD. Paragraph 3.10 acknowledges the difficulty of providing for all contingencies but firms should be encouraged to think about worst-case scenarios and how they could protect themselves.

**Question 3c: 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 examples of market co-operation post 9/11 underline our view that voluntary mutual co-operation is probably the most likely and effective response to MOD. Authorities can assist by emphasising their support for (and perhaps expectation of) firms helping each other in the face of MOD. There is a danger that if procedures and plans become too formalised, firms may hesitate to help each other, whilst waiting for an “official” response.

**Question 4a: 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?**

**Question 4b: 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?**

**Question 4c: 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?**

These three questions pre-suppose that “new legislation” would be capable of delivering real benefits. However, as already stated, no disaster plans can foresee all contingencies and real delays could result if firms stood by waiting for Government departments to decide how to react, rather than concentrating their efforts on responding themselves.

Legislation should only be contemplated if it is certain of delivering benefits. At this stage, such an outcome is by no means clear. Much more discussion and consultation is needed with the financial services industry and its regulators before any decision are taken. The consultation paper almost seems to suggest an approach of “legislate first, decide what to do

later.” The worst outcome would be for ill-conceived and vague legislation to be rushed through, only to be proved ineffective in a real crisis.

The UK cannot be alone in considering what action to take in response to the threat of MOD. The consultation paper quotes various reports issued post 9/11 but refers only in passing to “statutory financial sector powers” which exist “in some other G10 countries”. Much more research should be done to establish what precautions have been deemed necessary or prudent elsewhere. How have other major financial centres reacted – Frankfurt, for example? What about countries such as Japan which have for years faced the threat of earthquakes and other natural disasters? How did Mexico City respond to the earthquakes it suffered some years ago? What other lessons have been learned around the world? Surely much more needs to be considered than the response to 9/11 before legislation is contemplated.

Our main concern about legislation is that it could be restrictive: emergency powers that can be imposed have to be lifted again – and the time taken to do this could hamper firms’ mutual efforts to get systems up and running again in the shortest possible time.

**Question 5a: 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?**

The worst outcome would be that the financial services sector could be paralysed - waiting for Government departments to make their minds up what to do and how – rather than getting on with the job of disaster recovery. Precious time could be wasted, when disaster plans should have been drawn up (and preferably tested) long in advance. It is helpful that paragraph 4.16 states that emergency powers should “only be used with support from the private sector” - but again, time could be wasted trying to contact and consult with the private sector, distracting it from the immediate task of restoring systems and services. There certainly would not be time for secondary legislation to be considered and enacted – responses would need to be immediate.

**Question 5b: Should primary legislation include further conditions for use of its powers (beyond the basis for use being major operational disruption and not purely a financial crisis)? If so, what?**

As stated above, we do not believe that legislation should be introduced at all unless its purpose, provisions and effectiveness had been thoroughly researched and established.

**Question 5c: 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?**

This question merely illustrates one of the problems: emergency powers once enacted cannot be implemented selectively. They also have to be formally lifted when they are no longer needed. This could hamper firms’ ability to get certain sectors of their systems and services back to normal as quickly as possible.

**Question 5d: If the powers were adopted, do you agree they should affect actions in the UK (rather than actions governed by UK law)?**

This illustrates another practical problem which could arise simply because a legislative solution is imposed rather than a common-sense, mutually co-operative one.-

**Question 5e: If the Government seeks new legislation, should it allow the use of powers following major operational disruption affecting a non-UK major financial centre?**

How can new legislation even be contemplated without first consulting other major financial centres and establishing what plans they may have?

**Question 6a: Which wholesale market obligations should be included in a suspension power's maximum scope? Please draw attention to any particular issues that might arise (eg regarding proprietary rights).**

**Question 6b: Should retail obligations be included in a suspension power's maximum scope?**

**Question 6c: If a distinction should be made between retail and wholesale obligations, how should the line be drawn?**

**Question 6d: Which insurance contracts, if any, should be included in a suspension power's maximum scope?**

**Question 6e: Are there any other types of obligations suitable for inclusion in a suspension power's maximum scope?**

**Question 6f: 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?**

**Question 6g: 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?**

**Question 6h: Should a suspension power only be able to affect obligations which could not be fulfilled as a result of the disruption?**

**Question 6i: Are there any other restrictions that should apply to how a suspension power could be used?**

**Question 6j: Have you any comments about consequential effects of a suspension power?**

**Question 6k: After a suspension period should obligations return immediately, as soon as practically possible, or is some other approach preferable?**

**Question 6l: Do you support the idea of a suspension power, subject to the constraints of paragraph 6.28?**

These 12 questions all pre-suppose that a suspension power would be an appropriate response. For the reasons already rehearsed – inflexibility and speed of response being the main ones – we do not agree with this supposition.

**Question 7a: Should recognised bodies be within the maximum scope of a direction power?**

**Question 7b: Should payment systems be within the maximum scope of the direction power? If so, which?**

**Question 7c: 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?**

**Question 7d: 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?**

**Question 7e: Have you any comments about consequential effects of a direction power?**

**Question 7f: Do you support the idea of a direction power, subject to the constraints of paragraph 7.29?**

These six questions all pre-suppose that a direction power is an appropriate response. As with a suspension power, we do not believe that the case has been made for this option. Paragraph 7.25 acknowledges that “there could be wide and significant consequential effects of using a direction power.” So why create the problem in the first place – unless the Government is very sure that the power is capable of delivering more benefits than disadvantages?

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

The act is clearly an inappropriate vehicle for dealing with MOD. The idea that a serious Government response to MOD could be the declaration of a public holiday is, quite frankly, farcical. The powers in Section 2 of the Act could result in an unnecessarily inflexible response: paragraph A10 notes that “the emphasis is very strongly on prohibition” – which is likely to be unhelpful to rather than supportive of firms’ efforts to recover.

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

The benefits of continuing as at present, while encouraging regulatory authorities to discuss disaster planning with their regulated firms, is likely to deliver the most effective response to MOD. No case has been made for the Government to take new powers to intervene, and no legislation should be contemplated without much more evidence that such legislation could be effective.