

RESPONSE FROM CRESTCo TO HMT CONSULTATION ON THE FINANCIAL SYSTEM AND MAJOR OPERATIONAL DISRUPTION

- 1 This paper is the response from CRESTCo to HMT's consultation paper on the financial system and major operational disruption. It concentrates on those aspects of the consultation that particularly affect CREST's role in relation to securities settlement, rather than more general questions about the operation of the financial system.
- 2 CRESTCo, as operator of CREST, the central settlement system for UK and Irish securities, takes extremely seriously its role in the financial infrastructure. We have business continuity plans in place to give a high degree of assurance of being able to continue to deliver our service in a range of different eventualities. These plans are regularly tested and reviewed. However, we are conscious of the limitations on what we can achieve on our own and that in the event of major operational disruption there would be a necessity for concerted action across the financial system, including financial institutions as well as infrastructure providers. We therefore welcome the stimulus to discussion of these questions and possible courses of action.
- 3 In the event of major operational disruption, it goes without saying that CRESTCo would naturally co-operate to the best of its ability with the authorities and other market infrastructure providers to manage the crisis in an orderly way. A co-ordinated, voluntary approach by the private sector and market infrastructure providers is, in our view, the preferred way of resolving major disruption, provided circumstances allow it to work. An approach along these

lines has the advantage of being flexible and responsive to market needs and can be implemented quickly.

- 4 There are, however, circumstances in which a co-ordinated, voluntary approach may not be possible. In the confusion following a major disaster there may be differing views on the right course of action, at a time when a decisive response is vital. There may also be circumstances where firms are prevented from taking the appropriate course of action by legal constraints, either under contract or under legislation, whose application is no longer appropriate in a crisis. We therefore support consideration being given to the implementation of legislation that could be used in an emergency. We agree in principle with the conclusion in the paper that the powers under any such legislation should be used only in extreme situations and only to support the approach being followed by the market. We recognise, however, that there may be circumstances where the market does not have a consensus on the best approach and it may therefore be necessary for the authorities to impose one.
- 5 The consultation paper proposes two possible types of legislation: a power of suspending obligations and a power to issue directions. We believe that both of these powers may have a potentially useful role to play and therefore comment on practical aspects of their use.

Suspension Power

- 6 Given the difficulty of anticipating the circumstances in which a suspension power might be required, we are in favour of defining its maximum scope quite widely to provide flexibility if it ever needs to be invoked. In particular, we note that securities markets generally operate as an integrated whole, extending beyond the UK. Transactions in one part of the securities market are often linked to those in another part and sometimes to simultaneous cash transactions settled in separate settlement systems. For example, settlement of a retail purchase by an individual investor may depend on the delivery of stock as a result of a

transaction between two wholesale intermediaries. It could therefore be very disruptive to apply a suspension power to some parts of the market but not to others. At least in the securities markets, we believe that any suspension power should apply to both legs of the transaction – ie, both securities and cash – and to all participants to a transaction – ie, both corporates and individuals.

- 7 There are some practical aspects to the implementation of a suspension power. Suppose one or more major financial institutions lost all their operational capability as the result of an incident. Legislation might give them the power to suspend their obligations during the disruption. However, they would almost certainly have transactions that were already in the CREST system ready for settlement. These transactions would proceed to settlement unless the affected firms intervened to stop them, but they would be unable to do so, given that they had lost their operational capability. To be effective, therefore, a suspension power might also need to be combined with a power of direction conferring on the operator of a settlement or payment system the ability to intervene to stop transactions from settling on behalf of participants who were unable to do so themselves. Depending on the scope of the power, the operator of the system might need to be able to suspend transactions selectively, rather than simply disabling a participant and blocking all its activity. (This point is also related to the ability to over-ride some aspects of legislation: see paragraph 10 below.)

Power of Direction

- 8 In the event of a major operational disruption affecting the financial system, CRESTCo would invariably seek to work co-operatively with the authorities and other market infrastructure providers to achieve an orderly resolution of the crisis. We believe that it is unlikely that a power of direction would be required to force CREST to undertake actions against its will. However, there could be circumstances where CRESTCo felt constrained from acting in the best interests of the market by uncertainty over the legality of the actions it would be required to take or concern over liabilities it might incur by doing so. A power of

direction that resolved any legal uncertainties and removed the risk of liability would therefore be helpful in facilitating a quick and effective response.

- 9 CREST (and other market infrastructures) are complex, automated systems. There are technical constraints on what they can and cannot do at short notice. It is therefore imperative that if a power of direction were to be exercised this should be done on the basis of consultation with the relevant market infrastructures not only on what course of action was desirable, but, almost more importantly, on what course of action was realistically possible. Otherwise, it is possible that a power of direction as exercised by the relevant authority would have unintended and potentially significant consequences.
- 10 Some of the actions required by a power of direction might require changes to the rules or terms and conditions of the CREST system. If legislation introduced a power of direction, CRESTCo would need to give itself the ability to make emergency changes to its rules or terms and conditions at short notice in response to a power of direction. In addition, however, CREST faces constraints from legislation, in particular, the Uncertificated Securities Regulations. To be effective, a power of direction should be able to override some provisions of the regulations if this was necessary for continued operation of the system. Possible examples include: the requirement that CREST can act only on instructions received over accredited networks (which might need to be suspended to facilitate alternative means of communication if the accredited networks were unavailable or to allow participants to use terminals in the CREST offices to manage their settlement); the requirement to maintain the register of UK securities and notify the registrars; and the requirement to operate an interface for deposits or withdrawals of securities in certificated form.
- 11 An additional complexity in the case of CREST is that a single technical system acts as settlement platform not only for the UK, but also for the Irish and some other markets. There are serious complications arising out of competing jurisdictions if a direction issued under UK law interfered with the settlement of

transactions effected under Irish law. To some extent CREST can treat different nationalities of security separately within the system (for example, it is possible to remain open for settlement of Irish securities on a day that is a bank holiday in the UK but not in Ireland). However, there is no easy way of identifying groups of securities subject to the same jurisdiction. CREST also operates links to other settlement systems abroad (DTCC in the US, Euroclear Bank in Belgium, SIS in Switzerland and through them to other European markets). A direction issued in the UK might not prevent or achieve settlement of cross-border transactions governed by a different country's law. In addition, even if a suspension or direction might result in the suspension of a cross-border settlement of securities, a corresponding payment might not be affected. We therefore think that the UK authorities would need to liaise with foreign authorities, in particular those in the major financial centres, with a view to co-ordinating any proposed exercise of such powers.

- 12 This question of possible conflict of jurisdictions is likely to become more acute in the coming years, as settlement of transactions in UK securities becomes consolidated on a single platform operated by Euroclear, along with other European securities.
- 13 Finally, we believe that the power to issue directions should embrace institutions providing services that are the equivalent of market infrastructure, even if they do not fall within the categories identified in the paper (for example, Bank One in relation to its role as settlement system for money market instruments).