



BRITISH BANKERS' ASSOCIATION

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The British Bankers' Association (BBA) is pleased to respond to the Treasury's recent consultation paper, Cm 5751, about possible statutory powers to promote order in the financial system in the event of operational disruption caused by a catastrophic event.

The BBA represent over 250 banks from all over the world. Our larger members provide a full range of banking services; all are active in the wholesale financial markets in the City of London and many are active in the retail financial services arena too.

We believe it is entirely appropriate for HM Treasury to consider the need for legislation to supplement private sector initiatives – the financial services industry is a key contributor to the UK economy and an important node in many cross-border financing and hedging activities

However we are not convinced that the case for legislative powers of the type described in the consultation paper has yet been made. Private sector initiatives are best placed to cope with the impact of a catastrophic event on the financial sector. Existing market based approaches, which operate in close collaboration with the authorities, would not necessarily be helped by new legislation of the type contemplated.

We have reached this view based on our concerns about a number of different areas, which we have listed below;

What problem would legislation solve?

The green paper rightly observes that the financial system is an interlinking network of *operational networks* – largely people and technology – and *financial networks* - the contractual framework and infrastructure payment, settlement and clearing systems that make the value transfer associated with transactions happen.

Individual components – be it a payment system, exchange or clearing house - should have in place proper rulebooks and procedures to enable them to cope with a catastrophic event, by modifying their *modus-operandii* subject to the proper governance process, involving Boards and Executives in any decision to the fullest extent possible. The power to rectify any current shortcomings in individual components therefore lies fully in the hands of the private sector.

We envisage that any problems would emerge at the points where different critical infrastructure components touch, interrupting instruction flows in the value transfer chain. It is possible that knock-on effects of a breakdown in communication between

one critical component and another have not been fully identified. Whilst legislation might (fortuitously) act as quick fix to such problems when they emerged, the better approach is to perform a gap analysis to identify points of weakness, with a view to strengthening them in advance of them being put to the test. This analysis should be undertaken by the authorities and private sector, working in close co-operation. We recommend that the Bank of England, which has responsibility for systemic stability, should take the lead in co-ordinating this gap analysis, which banks are committed to participating in fully. A similar approach to that taken by the Bank of England for its excellent work on preparing for the introduction of the euro and for Y2K should be taken.

The output of this work could then inform any decision to introduce new legislation. It is impossible to envisage that a thorough survey of operational and financial system connectivity could be completed in a few months. Plans for legislation should therefore at the very least be delayed, if not dispensed with altogether, whilst this important gap analysis is completed.

Importance of a rapid response

Disaster recovery experts emphasise the importance of prompt – probably within two hours - action in response to a disruptive event.

Following the 11 September attacks in the United States, market participants in the UK have placed renewed emphasis on collaboration. A number of groups, including the Bank of England's operations sub-group, which is a subcommittee of the Foreign Exchange Joint Standing Committee, have come together to review the current status of Business Continuity practice. They recognise that in the aftermath of a catastrophic event they would be important interlocutors for the Tri-party Committee, providing information up the chain of command on operational capability and disseminating downwards the Triparty Committee's recommendations to other market participants.

Our concern, which is also reflected in the consultative paper, is that the implementation of market based solutions could be delayed in anticipation that legislative measures might be introduced, which could subsequently over-ride or reverse early initiatives.

Given that the mooted legislative responses would not be deployed in all situations (as it is virtually impossible to scope all the circumstances in which they might be called upon) we believe the possibility (or not) of their activation could muddy the waters and lead to unnecessary delay whilst the market waited to see if powers of suspension or direction were actually triggered.

We are not convinced that Government would always find it easy to make that assessment within the all-important first two hours. Market based responses therefore could be detrimentally delayed, as participants awaited a government decision. In reality this decision (to trigger or not) might not actually be conclusively articulated, as government would probably never want to rule out the eventual activation of its powers as the situation developed.

The introduction of legislative powers could therefore increase, rather than decrease, uncertainty in the markets at a time when participants might already be extremely nervous. This would not facilitate the resolution of problems caused by a widely ranging disruptive event.

The international dimension

The UK financial system is much more interconnected than that in New York.

Settlement of many financial transactions takes place on an irrevocable basis in a real time gross settlement/Delivery versus Payment environment. The payment leg of the transaction may happen for instance in the UK (perhaps under English law), whereas the other delivery leg might occur in a Central Securities Depository, perhaps under Belgium law. Any suspensory powers invoked in the UK would not suspend performance in other jurisdictions. This might result in events of default clauses being triggered. Legislative powers might build more risk – particularly liquidity risk - into the financial system, both here and abroad.

Similar concerns arise in the securities markets where a series of transactions are used to lay off exposures in for instance, the derivatives markets. Depending on the governing laws chosen for the contracts, or the location of the clearing house involved in the trade, it is very possible to envisage a situation where legislative powers invoked in the UK could break a chain of otherwise offsetting transactions, again introducing more risk.

The primacy of English law

English law is widely used in financial contracts around the world, even where none of the parties to, or legs of, the transaction have a locus in the UK. Indeed the wide utilisation of English law is one of the pillars on which the City's leading position in the wholesale foreign exchange, money and capital markets is built.

It may be that for instance the New Zealand subsidiary of a Japanese bank is dealing with the Singaporean subsidiary of a German securities house in an Australian dollar denominated securities contract, under English law. All legs to this transaction could be properly settled prior to the opening of the London markets and would thus be unaffected by a disruption event of the type contemplated in the green paper. Transactions should only be caught by disruption legislation if one or more obligations under the contract are affected by a disruption in the UK. Whilst the paper acknowledges that the legislative powers suggested could be limited in their scope to actions taking place in the UK, this may be difficult in practice to implement.

We believe that, as a result, users of English contracts may re-consider their choice of law if such uncertainty is introduced. This would definitely weaken the position of London as an international financial centre and be could be of detriment to both the global reputational standing of the UK financial system as well as to the UK economy and the international law firms that operate here.

Setting an inappropriate precedent

UK legislation is well regarded in the global financial services community and is often in the vanguard as it responds to emerging issues in finance through the creation of new law.

Oftentimes principles developed in Parliament, and through secondary legislation and administrative directions, are adopted with little modification in other countries. Even where this is not the case, UK laws can be highly influential as other jurisdictions decide on their approach to topics which can have a similar theme.

Introducing legislation into Parliament now could result in other countries reacting in a similar fashion and replicating it in their jurisdictions, before the need for it has not been comprehensively established as a result of a thorough gap analysis.

The cross-border interconnectedness of the financial system suggests that if a legislative response is required it should be highly co-ordinated with the other major financial centres with which the UK interacts. It is not clear to us the extent to which other countries are considering legislation of the type contemplated in the green paper.

We recommend that HM Treasury actively discusses with its counterparts in other countries the extent to which they are considering such legislation in order that, if need be, a harmonised set of principles is established internationally. Not to do so would risk cross-border discontinuity at a time of stress. This could in itself be de-stabilising.

Liquidity is key

The experience of 9/11 in New York emphasised that in times of extreme stress access to liquidity is key to confidence in the ability of the global financial system to cope. Central banks in the US, mainland Europe and the UK all worked together to ensure that financial institutions had sufficient access to funding in order to complete their transactions. No amount of legislation could shape the critically important response of central banks to a crisis, emphasising again the importance of co-ordinated action by governments and central banks, as a result of scenario planning undertaken on an international scale.

Whilst the gap analysis is being undertaken in the UK, the Bank of England could be simultaneously working with other central banks to review the impact of a catastrophic event in one country on the liquidity needs of the global financial system.

Should the parliamentary timetable drive the introduction of new legislation?

Pragmatically HM Treasury is considering new powers as it has the opportunity to table them in the White Paper on the Civil Contingencies Bill, expected to be introduced into Parliament in the early summer.

The ramifications of introduction of suspensory or directive powers may be very wide ranging and could have unintended consequences. They should not be introduced too

quickly. The industry has not had the time to identify what these might be and their possible impact.

We re-iterate that it is right and proper for Government, with industry, to be examining this issue but fear that the short timetable could result in the introduction of legislation in haste. Our view is that rushed legislation can in certain circumstances be worse than no legislation at all. The Dangerous Dogs Act is text book example which bites on only a discrete, identifiable threat. Financial services legislation is far more all pervasive and there are likely to be many, as yet un-envisagible, ramifications of such an initiative. Legislation, if any is required at all, should only be introduced after due consideration and full consultation with industry.

What can be done already?

We believe that Government already has very broad powers to pass new legislation in a crisis under the Emergency Powers Act and Banking and Financial Dealings Act. A useful and straight forward modification to this legislation might be to amend the power to declare a bank holiday so that this process can be speeded up without recourse to the Sovereign. We believe the same powers could be used to ensure that, as key components of the national infrastructure operational and financial networks, payment, clearing and settlement systems have appropriate prioritised access to data and voice communication systems, power and transport for key employees.

What could be included in the Civil Contingencies Bill?

Whilst we do not believe major powers should be included in the upcoming Civil Contingencies Bill, there are minor issues that could be addressed.

One relates to the Data Protection Act's prevention of the construction, by trade associations such as the BBA, of databases of key individual within member banks.

We envisage a secure, password accessible section of the BBA member website, activated only in the event of a catastrophic event impacting the London market. By collecting data on key contact points within members banks and disseminating them in the aftermath of a catastrophic event, it is hoped that communication would be facilitated, enabling the financial community to work together to return rapidly to full operational capacity. The database would also have a bulletin board to disseminate information quickly and securely. Disappointingly we have been prevented from establishing such a database due to Data Protection Act constraints, requiring all contact points - perhaps up to 1,000 - to individually give their permission for their name and details to be so held. An easier solution would be for their employing firm to be able to give such permission where data would only be used in this secure context.

A second issue which could be addressed, and which would have wider applicability outside the financial services sector, would be the introduction of anti-abuse type wording to prevent undue enrichment in the event of the wide range of scenarios contemplated by the Civil Contingencies Bill.

Summary

In summary we believe that:

- industry and the authorities should work together, under the leadership of the Bank of England, on a gap analysis to identify and solve points of weakness that could only be solved by legislation;
- a communication *modus operandii* should be developed between the Triparty Committee and the market, involving where appropriate trade associations, to facilitate information flows up and down the chain of command;
- the case for powers of suspension or direction has not yet been made but could be validated by a gap analysis;
- co-operative private sector initiatives are best placed to cope with the impact of a catastrophic event on the financial sector, because of their ability to respond quickly, which could be impeded were legislation introduced;
- the cross-border interconnectedness of the UK financial services infrastructure complicates the introduction of powers which may or may not be triggered, increasing uncertainty;
- over hastily introduced legislation could have un-intended consequences and also be introduced in other jurisdictions perpetuating it, despite shortcomings which might subsequently emerge; and
- central banks should ensure that means of communication and their own contingency plans are in place to ensure that they can supply liquidity to the financial system in a co-ordinated fashion.

Responses to key broad questions raised in the Green Paper

- 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?*

Typically English law contracts contain key provisions relating to Force Majeure and Business Day Conventions, which could be relevant in a catastrophic event. If a force majeure clause is triggered a waiting period applies which has the effect of deferring performance until the force majeure no longer applies or until the end of the waiting period. There is no market wide force majeure definition. Different definitions are used in different standard documents, probably because of the different approaches to the same problem employed by different drafters, rather than because of a deliberate assessment of the precise needs of the industry sub-segment using the standard documentation.

It would be beneficial if an analysis of the different shades of force majeure clauses were undertaken, if only to highlight specific differences. With this knowledge market practitioners could determine whether the development of a pan-industry standard force majeure clause would be beneficial - as we believe it could be.

Similar work could be undertaken looking at how Business Days are differently defined in representative standard documentation and the impact of the declaration of a non-business day.

- 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?*

Many market initiatives have come together post 9/11 and have emphasised the need for effective communication up and down the chain of command. We understand that the authorities have identified a few dozen key firms with which they would communicate in the event of a crisis. The financial services community in London is many times larger than this. A clear communication strategy must be developed by the Triparty Committee, involving trade associations, so this wider community's need for accurate information in the event of a crisis can be satisfied.

In this way market participants, who in our view are best placed to deal with market disruption, would have ready access to timely, accurate information about the authorities' plans and be better able to input themselves into the development of these plans.

- 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?*

Private sector responses are best placed to cope with the immediate aftermath of a catastrophic event and experience has shown that competitive behaviour is temporarily suspended and replaced by co-operation, in order to solve problems. In general we do not believe the case has yet been made warranting new legislation. It may be, however, that the results of the gap analysis would highlight specific areas and circumstances in which legislation would be beneficial. Were this the case targeted legislation could be crafted to meet the special needs rather than relying on the current, generic proposals which may have unintended consequences.

- *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?*

We have already identified some of the disadvantages and limitations of the proposed new legislation; unintended consequences, cross border impacts, moral hazard, the delaying of market initiatives and the introduction of more not less certainty. Until a fuller risk analysis has been performed we are not in a position to recommend legislative measures that could mitigate them.

- *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?*

Our initial feeling is that the proposed powers of suspension and direction may be too sweeping and that the time it would take for the authorities to decide to trigger such powers could delay and confuse private sector initiatives. The ability to call a bank holiday on the day of actual disruption, rather than as at present on the subsequent day, might however be a useful tool in the armoury, although we have not considered this and other powers already available to authorities under existing legislation in any detail. This work could usefully be undertaken by a "legal affairs" sub group of the gap analysis work that we believe the Bank of England should orchestrate.

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

We are not in a position to contemplate the circumstances in which a suspensive power might be beneficial and while not ruling it out, would wish more work to be done to identify it as actually creating more certainty than uncertainty. Furthermore we believe that the possible knock on effects into contracts under English law between counterparties outside the UK would be problematic. For instance suspension could result in a technical event of default due to a failure to perform which would then trigger cross-default clauses in contracts not governed by English law.

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

We are more wary of a directional power, which could have effects beyond the formal markets and systems at the heart of the financial system and extend out into major participants in the markets - perhaps our larger member banks - who would not necessarily wish to be directed to do things which were counter to the responses they had already deployed.

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