

The financial system and major operational disruption

February 2003



HM TREASURY

Cm 5751



HM TREASURY

The financial system and major operational disruption

February 2003

Presented to Parliament by
the Financial Secretary to the Treasury
by Command of Her Majesty

© Crown copyright 2003

Published with the permission of HM Treasury on behalf of the Controller of Her Majesty's Stationery Office.

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Any enquiries relating to the copyright in this document should be sent to:

HMSO
Licensing Division
St Clements House
2-16 Colegate
Norwich
NR3 1BQ

Fax: 01603 723000

E-mail: licensing@cabinet-office.x.gsi.gov.uk

HM Treasury contacts

Responses or comments on this document should be sent to:

The Financial System and Major Operational Disruption
FSM team
Room 4 / 16
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4664

Fax: 020 7451 7524

E-mail: FSMOD@hm-treasury.gov.uk

For further information on the Treasury and its work, contact:

Public Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4574

E-mail: public.enquiries@hm-treasury.gov.uk

You can also find HM Treasury on the internet:

www.hm-treasury.gov.uk

CONTENTS

	Page
Foreword by the Financial Secretary to the Treasury	1
E Executive Summary	3
1 Introduction	5
2 Context	9
3 Current Approaches	15
4 New Legislation?	21
5 A Framework for the Powers	27
6 Suspension of Obligations	31
7 Direction of Infrastructure	39
Annexes	
A The Banking and Financial Dealings Act 1971	45
B Draft Regulatory Impact Assessment	49
C Collected Questions	59

FOREWORD BY THE FINANCIAL SECRETARY TO THE TREASURY

The 11 September attacks on the United States caused terrible loss of life and physical damage. They also showed the problems that physical disruption on such a scale brings for the financial system – as exemplified by the four-day closure of the New York Stock Exchange.

Financial services play a vital role in the UK economy. This makes it particularly important to be sure that we have good arrangements to maintain the financial system's resilience during major operational disruption. While the main responsibility lies with the financial sector itself, HM Treasury, the Bank of England and the Financial Services Authority are working together, and with the private sector, to help strengthen resilience.

This consultation asks if new statutory powers should be sought to assist in promoting order in the financial system in extreme circumstances of operational disruption. The Government is seeking views on whether such legislation would be justified by the nature and scale of the threat. The consultation also requests comments about additional ways in which the financial authorities could usefully assist the private sector's work in making financial markets more resilient.

We look forward to hearing your views.

A handwritten signature in black ink, appearing to read 'Ruth Kelly', is centered on the page.

Ruth Kelly MP
HM Treasury

The financial authorities believe that the private sector itself has the main responsibility for promoting order in the financial system in the face of major operational disruption – for example by market co-operation to address problems. Could private sector approaches usefully be strengthened further?

If so, can the Treasury, Bank of England and Financial Services Authority help with this?

Would it be helpful for the Government to seek legislative powers to supplement private sector action?

If so, what powers?

E.1 The 11 September 2001 terror attacks on the US showed that operational disruption could affect many financial institutions at once. Apart from terrorism, major operational disruption might also result from natural disasters (e.g. storms) or from information technology problems (e.g. bugs, viruses). This consultation asks whether new legislation, further development of market-based approaches, or both, could assist in promoting order in the financial system in the face of major operational disruption.

E.2 The proposed Civil Contingencies Bill would be the vehicle for any legislation that the Government considered appropriate following this consultation.

E.3 Major operational disruption raises important issues for the financial system. Operational networks (e.g. physical and telecoms infrastructure) underlie all the workings of the financial system (e.g. through financial markets, payment systems). So the effects of major operational disruption need to be dealt with quickly in order to protect the financial system.

E.4 The private sector and the financial authorities (HM Treasury, the Bank of England and the Financial Services Authority) have been working to improve the system's resilience to major operational disruption.

E.5 Market-based approaches to promoting order in the financial system include:

- contractual contingency planning ensuring that financial contracts and other legal instruments can cater for major operational disruption; and
- market co-operation to resolve difficulties, on a bilateral or multilateral basis.

E.6 The authorities believe that the main responsibility for responding to major operational disruption's effects on the financial system can only realistically rest with the private sector. **This consultation asks if more could usefully be done by the private sector to strengthen market-based approaches, and if there is a role for the authorities in assisting this.**

E.7 The authorities' toolkit for handling major operational disruption currently includes:

- information collection and dissemination;
- persuasion;
- the Bank of England's central banking functions;
- the Financial Services Authority's regulatory tools;
- statutory powers (of limited use) in the Banking and Financial Dealings Act 1971.

E.8 In some extreme circumstances, new legislation might help to promote order in the financial system more effectively than market-based approaches:

- by providing a breathing space to identify and address operational problems and their financial effects; and
- in some exceptional cases, enabling intervention, for example, to define market rules.

E.9 Possible disadvantages of new legislation include that:

- it might create uncertainty about how the authorities might use their powers during operational disruption;
- it might lead private sector institutions to undertake less comprehensive planning than they otherwise would;
- use of the legislation might have distributional effects that would be adverse to some, and unhelpful knock-on effects.

E.10 These possible disadvantages – and the primacy of the private sector role – lead the Government to believe that any new legislation should only be used in extreme situations (and never in a purely financial crisis) and only with support from the private sector (subject to the practical difficulties of taking urgent soundings during major operational disruption).

E.11 This document's core question is **whether, in principle, it would be useful to have new legislation to help promote order in the financial system in the face of major operational disruption?**

E.12 To make potential new legislation workable, its powers would need to be exercised by secondary legislation or an administrative direction made in a flexible fashion during the disruption. Accountability would be important.

E.13 Two powers suggested are:

- a power to suspend certain financial obligations – providing a breathing space; and
- a power to direct financial 'infrastructure' (such as exchanges, clearing houses, settlement systems and payment systems) – providing a means of intervention (but only in formal markets and systems at the heart of the financial system).

E.14 If major operational disruption occurred, use of such powers would by no means be automatic. The authorities would consider if there were particular circumstances that called for their use. The authorities would consider in what particular ways the powers might best be used and whether the benefits to the financial system and wider economy would exceed the costs. In considering this, they would take quick soundings from the private sector (subject to the practical difficulties of doing this during major operational disruption). The authorities would also have to, in particular, consider the costs and benefits for retail customers of the financial services industry.

E.15 **This consultation asks if the suspension and direction powers could be useful and for respondents' views on whether they, or other powers, should be sought.**

E.16 In deciding whether to seek new legislation, the Government will consider the implications for the financial system and the wider economy, including for retail financial services customers such as individuals and small business.

INTRODUCTION

This chapter outlines the consultation.

It explains that the proposed Civil Contingencies Bill would be the vehicle for any legislation that the Government considered appropriate following this consultation.

It describes the structure of this document.

It notes that some respondents may wish to respond to many or all of the questions, but points out the key broad questions others may wish to focus on.

It sets out where to send responses (with a preference for an emailed Word document) and how to ask questions about the consultation.

THE CONSULTATION

1.1 This consultation is about helping the financial system cope with the effects of major operational disruption. Such disruption might be physical – e.g. a terrorist attack, or a storm – or affect information technology – e.g. a computer bug or virus.

1.2 The consultation asks how best to promote order in the financial system in such a situation. Private sector, market-based, approaches will have the main role. In particular this consultation asks whether new legislation might play some part in supporting the markets' own response and whether the authorities might assist further in the development of market-based approaches.

1.3 Once the consultation has concluded and responses have been considered, the Government will decide whether it is appropriate to seek new legislation. The financial authorities – the Treasury, Bank of England and the Financial Services Authority – will also consider the views expressed on possible strengthening of market-based approaches and if the authorities¹ can usefully further assist with such strengthening.

LEGISLATION

1.4 If the Government decides that new legislation is appropriate, it would be introduced in the proposed Civil Contingencies Bill. This Bill would deliver a single framework for dealing with all forms of disruptive challenge to modern society, including those arising from terrorist attack. The new framework will enhance the UK's capability to plan and prepare for, deal with and recover and learn from disruptive challenges at national, regional and local levels. The Government will publish proposals during this Parliamentary session with a view to introducing the Civil Contingencies Bill as soon as Parliamentary time allows.

1.5 The period of two months set for this consultation is to enable the Government to consider views in advance of the publication of the Civil Contingencies Bill proposals. The publication of these proposals will provide a further opportunity for comments to be made before the Bill is introduced in Parliament.

THE DOCUMENT

1.6 This document aims to help the reader in considering the circumstances of major operational disruption, how financial markets and other parts of the financial system would need to respond, and the ways in which the authorities might be able to assist.

¹ Throughout this document, "the authorities" denotes the financial authorities – HM Treasury, the Bank of England and the Financial Services Authority.

1.7 In Chapter 2, it sets out the context, outlining the issues that major operational disruption raises for the financial system. In Chapter 3, it looks at the existing approaches available – market-based approaches, and actions by the authorities. Chapter 3 also asks if an extension of market-based approaches would be useful.

1.8 Chapter 4 considers the question of whether new legislation might help promote order in the financial system during major operational disruption. It outlines how legislation might address risks and some possible disadvantages of legislation. It sets out constraints the Government believes should restrict use of any new legislation. It outlines two possible powers that new legislation might provide.

1.9 Chapter 5 looks at how new legislation might work. Chapters 6 and 7 cover the two possible powers, respectively to suspend certain financial dealings and to direct financial ‘infrastructure’.

1.10 Annex A provides some information on an existing piece of legislation, the Banking and Financial Dealings Act 1971, explaining why it is not particularly well-suited to addressing issues raised by major operational disruption. Annex B is a tentative Regulatory Impact Assessment of the market-based versus the legislative options. Annex C lists all the questions asked in the consultation document.

RESPONDING

1.11 Some respondents may wish to answer all or most of the questions. Others may wish to concentrate on the broad questions – for example, those set out in Box 1.1.

Box 1.1 The key broad questions addressed in this document

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?

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?

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?

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?

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?

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

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

Question numbers refer to the chapter in which they are asked.

I.12 Responses to this consultation should be sent:

- (preferably) by email and Word document to FSMOD@hm-treasury.gov.uk.
- by post to
The Financial System and Major Operational Disruption
FSM team
Room 4/16
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Or

- by fax to 020 7451 7524.

Responses should be received by Friday 25 April 2003 at the latest.

I.13 Responses, or a summary of responses, may be published. Any responses, or parts of a response, which you would not wish published should be clearly marked as confidential.

I.14 Questions on the consultation can be:

- (preferably) emailed to FSMOD@hm-treasury.gov.uk.
- phoned to FSM team on 020 7270 4664.

Or

- sent to the above postal or fax addresses.

This chapter outlines the challenge raised for the financial system by the 11 September 2001 terror attacks on the US. 11 September showed that operational disruption could affect many financial institutions at once.

Major operational disruption raises important issues for the financial system because:

- operational networks (e.g. physical and telecoms infrastructure) underlie all networks of financial dealings (e.g. markets, payment systems);
- so the effects of major operational disruption need to be dealt with quickly in order to protect the financial system.

The private sector and financial authorities (HM Treasury, the Bank of England and the Financial Services Authority) have been working to improve the system's resilience to major operational disruption.

This consultation is about how best to promote order in the financial system during major operational disruption.

THE CHALLENGE

Operational disruption 2.1 The financial sector, like any other, can be faced with operational disruption arising, for example, from physical disaster or from difficulties with information technology.

11 September 2.2 The 11 September 2001 terror attacks on New York caused terrible loss of life and destruction. The resulting major operational disruption affected a number of big financial institutions at once. The magnitude of the disruption, and the range of institutions affected, were beyond anything previously anticipated. It became clear that the financial sector needed to plan for operational disruption on a much bigger scale than had previously been contemplated.

2.3 Since 11 September 2001, the financial sector – and the public authorities that oversee it – have been taking forward work to improve the financial system's resilience to operational disruption. This consultation document is one part of that work.

2.4 Box 2.1, quoting from a discussion paper by the Federal Reserve and other US authorities¹, describes some of the effects of 11 September on the US financial system.

¹ Summary of "Lessons Learned" and Implications for Business Continuity – Discussion note prepared by staffs of the Federal Reserve, the New York State Banking Department, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission. 2002. Available at <http://federalreserve.gov/boarddocs/staffreports/200202/DiscussionNote.pdf>

Box 2.1 11 September 2001 – effects on the financial system (I)

From a discussion paper prepared by the Federal Reserve and other US authorities (see footnote to paragraph 2.4).

“During the week of September 11, the widespread destruction of physical infrastructure supporting financial institutions in and around the World Trade Center and extensive telecommunications breakdowns throughout the region caused dislocations in financial markets. U.S. equity markets were closed for four days and most bond trading, including Government securities trading, halted for two days. There were significant disruptions in the clearing and settlement mechanisms for Government securities, repurchase agreements, and commercial paper. Although the core payments systems continued to work well, operational failures and telecommunications breakdowns among major financial institutions led to significant liquidity bottlenecks for several days. During this period, the Federal Reserve and other major payment systems remained open well past their normal closing times to accommodate institutions that were attempting to send funds or waiting to receive funds from other institutions. A number of institutions borrowed from the central bank discount window in substantial amounts to obtain sufficient liquidity to continue meeting their obligations. Other institutions and their customers built up high cash balances or held on to Government securities positions for precautionary reasons, exacerbating market liquidity imbalances. Some institutions could not ascertain their own financial positions or those of their customers for several days. Various prudential regulatory requirements were relaxed in the face of credit and liquidity disruptions and unreconciled transactions that caused significant, though temporary, balance sheet distortions across a wide range of institutions. Some transactions were lost and had to be reconstructed, a laborious and inexact process. Vaults containing physical certificates were destroyed and records identifying these certificates were not always readily available. At the same time, the extraordinary levels of cooperation by market participants in the aftermath of the September 11 events helped overcome limitations within the scope of firms’ business continuity planning. Some firms were accommodated by other organizations (including competitors) in the New York City area in finding office space for staff. Customers and counterparties helped re-create transaction records that were lost. Institutions extended credit to customers and counterparties hampered by liquidity shortfalls despite the inherent uncertainty and lack of reliable information in the marketplace about their current financial condition. Large numbers of people inside and outside the financial industry worked long hours to restore communications links that had failed.”

Features of the financial system

2.5 In considering the potential impact of major operational disruption, there are several features of the financial system that are particularly relevant². The most important point is that the financial system is a set of interlinking networks:

- **operational networks.** The financial system is built upon operational networks. These include financial institutions’ offices and computer facilities, and the telecommunications links that connect them together. The system’s operations also rely on the institutions’ staff being able to do their work;

and

- **financial networks.** The operational networks underlie financial networks. The financial system resembles a web of dealings that link financial institutions together and with their customers in the wider economy. To a great degree the links in the system are underpinned by legal instruments such as contracts, securities and rulebooks. There are numerous, and

² Aside from highlighting issues relevant for major operational disruption, these features also provide justification for much of the public authorities’ role in the financial system, including financial regulation.

interlinking, financial networks within the system as a whole. Most of these are markets of one form or another³. Some of the networks are rather formal – for example: a stock exchange; a payment system. These tend to have formal rulebooks and an explicit list of members. Others networks are more *ad hoc*. They lack such a strong central structure. Examples of such networks include the foreign exchange market and the various markets in ‘over the counter’ derivatives. However, even these more *ad hoc* networks tend to evolve conventions and practices that give them a degree of consistency.

2.6 Box 2.2 outlines briefly these interdependencies on 11 September, including difficulties affecting institutions outside New York through telecoms and settlement failures.

Box 2.2 11 September 2001 – effects on the financial system (2)

From the discussion paper quoted in Box 2.1.

“...the events of September 11 graphically demonstrated the interdependence among financial system participants, wherever located. While organizations located outside the New York City area were affected to a much lesser degree than were those within it, many felt the effects of the disaster. Most lost connectivity to banks, broker-dealers and other organizations in lower Manhattan, which impeded their ability to conduct business and determine whether transactions had been completed as expected. Some customers were affected by actions of institutions with which they did not even do business, when funds or securities could not be delivered due to operational problems at other institutions.”

2.7 There are important aspects of these networks which mean that the effects of major operational disruption need to be dealt with quickly. These include:

- **time sensitivity.** The financial markets move large values of assets around very quickly. The assets to settle one transaction are obtained from the settlement of another. The web-like structure of the system means that in some conditions phenomena in one part of the system can be felt more widely very quickly;
- **the importance of information.** The financial system is highly dependent on information. In a crisis, the normal mechanisms through which information⁴ is generated and made available to market participants could break down. If information asymmetries between participants are too extreme, this may reduce order in the financial system. During major operational disruption, financial institutions would also wish to know how normal arrangements have been disrupted, and what alternative practices are being adopted;
- **significant ‘externalities’.** Decisions made by financial institutions can have unusually wide consequences for other financial institutions. Because the institutions are linked together in numerous financial networks, problems at one institution can cause problems for others. These problems can also spread to the wider economy via the effects on financial institutions’ customers. Decisions made by an individual financial institution may therefore have significant consequences **external** to that institution. An institution may not have the right information or incentives to assess these decisions fully with regard to those externalities.

³ Important networks which do not resemble markets include payment, settlement and clearing systems.

⁴ The types of relevant information vary from market to market. Some examples include: quotation of prices by market makers, news on the availability of willing buyers, details of previous trades, up-to-date background information on investments.

COPING WITH MAJOR OPERATIONAL DISRUPTION

2.8 To help set the scene for later chapters, this section reviews the implications of major operational disruption in terms of the features of the financial system described in paragraph 2.5 above. It outlines the roles of the private sector and the authorities in such circumstances, noting the primacy of the private sector role.

2.9 The features of the financial system identified above have the following implications during major operational disruption:

- **operational networks.** These may be directly affected by the disruption. 11 September highlighted the importance of institutions having resilient operations and good contingency plans, and of taking account of the possibility that many other institutions might be affected at the same time;
- **financial networks.** Operational disruption can have direct financial consequences – for example as trades fail to settle, payments cannot be made, or new (perhaps risk-reducing) trades cannot be struck. Financial networks may not function as expected and may need to adapt to the new operational circumstances. Because one part of the financial system links to another, the financial consequences may spread beyond the direct impact of operational disruption and...
- **...time sensitivity** means that this could happen very quickly;
- **the importance of information.** During major operational disruption, new information would very quickly be required in order to evaluate the changed circumstances. However, the conditions would hinder its acquisition and assimilation. Information about the basic operation of institutions and markets would be much more important than usual;
- **significant externalities.** Handling major operational disruption is likely to require significant decision-making by financial institutions in a very short time with unusually incomplete information. Because of the network features of the financial system, co-operation has a vital role to play in coping with disruption. Externalities will therefore tend to loom larger than usual during such disruption.

The private sector role **2.10** The primary responsibility for preparing for, and dealing with, operational disruption rests with the financial sector itself. Because of the nature of financial sector business, before 11 September 2001 many firms had already put a relatively high emphasis on resilience and good business continuity planning. The attack on the World Trade Center increased the importance of this yet further. It also demonstrated that physical disruption can occur on a large scale not previously envisaged or planned for.

The public authorities **2.11** HM Treasury, the Bank of England, and the Financial Services Authority are the public authorities that oversee the UK financial system. Following 11 September 2001, they have worked with the financial sector to improve the system's resilience against major operational disruption and, in particular, a terrorist attack. The authorities' work on resilience after 11 September is part of the Government's wider work to improve UK resilience⁵.

⁵ See <http://www.ukresilience.info/> for more information.

2.12 The authorities' work on resilience occurs within their joint arrangements for maintaining financial stability in the UK. A joint HM Treasury, the Bank of England and the Financial Services Authority Standing Committee on UK financial stability plays the focal role in these arrangements⁶. Through the Committee – and their many, more informal, contacts – the authorities have built common analysis and understanding of financial stability issues.

2.13 The authorities are undertaking a range of activities to improve resilience in advance of possible disruption, and to ensure an appropriate response should disruption occur. Their website at www.financialsectorcontinuity.gov.uk provides some further information on particular aspects of this work.

2.14 Should major operational disruption occur, Standing Committee would provide the basis for the authorities' joint work to address the consequences for the financial system. The financial authorities have been working together closely to ensure that a robust framework exists to support this function. The framework provides for tasks, such as information-gathering, that would need to be carried out quickly but could be impeded by the attack's physical effects. It also provides for the possibility that one or more of the authorities might be severely affected by an incident and would be unable to function effectively, either initially or for a more prolonged period. Contingency plans have been put in place to ensure that if this occurs, the necessary decisions can be taken as quickly as possible, informed by the best data available.

**Promoting order
in the financial
system**

2.15 This consultation looks at how best to promote order⁷ in the financial system in the face of major operational disruption. This involves addressing the financial network consequences of major operational disruption, having regard to aspects of the system such as time sensitivity, the importance of information and externalities, and also to the need to focus on the restoration of operational networks. The Government believes that, while the financial authorities have a role, the main responsibility for such extensive and detailed work can only rest with the private sector. The next chapter looks at such private sector, market-based, approaches and then the current toolkit the authorities can use to help.

⁶ A Memorandum of Understanding (MoU) on financial stability describes the respective roles of HM Treasury, the Bank of England and the Financial Services Authority, and how they work together. The MoU can be found via http://www.financialsectorcontinuity.gov.uk/home/default.asp?expand=1&open=uk_fin_auth/

⁷ Examples of lack of order might include: failure of underlying operational networks, uncertainty about how a market or other financial network should function during operational disruption, lack of availability of information used for price formation in normal conditions or poor price formation. Order in the financial system is *not* however inconsistent with major price changes reflecting changed circumstances.

This chapter outlines the approaches currently available to both the private and public sectors to deal with major operational disruption in the UK's financial markets.

The main responsibility can only realistically rest with the private sector. *Market-based approaches* include:

- contractual contingency planning ensuring that financial contracts and other legal instruments can cater for major operational disruption; and
- market co-operation to resolve difficulties, on a bilateral or multilateral basis.

The authorities believe it is important to maximise use of market-based approaches. The chapter asks if more could usefully be done by the private sector to strengthen these, and if there is a role for the authorities in assisting.

The *authorities' existing toolkit* to provide help includes:

- information collection and dissemination;
- persuasion;
- Bank of England central banking functions;
- Financial Services Authority regulatory actions;
- statutory powers (of limited use) in the Banking and Financial Dealings Act 1971.

INTRODUCTION

Financial and operational networks

3.1 As outlined in the previous chapter, the financial system is made of various and interlocking networks of financial dealings. Examples include: stock exchanges; clearing houses; payment systems; the banking system; foreign exchange markets; and derivatives markets. Because operational networks underlie these financial networks, major operational disruption can have financial consequences. This consultation aims to identify the best approaches to promoting order in the financial system during major operational disruption.

Possible approaches

3.2 This chapter looks at the approaches available under current arrangements. There are two sorts of approach to promoting order in the financial system during major operational disruption:

- a **market-based approach** in which the private sector addresses problems itself. This chapter describes ways in which this may occur and asks for ideas about how the market-based approach might be taken further;
- the authorities can assist through various tools currently available to them. This chapter outlines the **authorities' existing toolkit**.

3.3 The authorities believe that the main responsibility for recovery following major operational disruption rests with the private sector. The complex and extensive networks that comprise the financial system can only be restored to normality by action from those who run them. Market-based approaches are also to be preferred because they best align responsibility for recovery with market knowledge, and with institutions' financial duties. This is consistent with the authorities' emphasis on the responsibility of financial institutions' senior management for the management of their business¹.

¹ As mandated by the Financial Services and Markets Act 2000, section 2(3)(b).

3.4 It follows that the authorities would use their toolkit to assist the private sector in restoring order to the financial system. The authorities have accordingly put in place arrangements to gather information quickly from the financial sector immediately after major operational disruption.

MARKET-BASED APPROACHES

3.5 Two sorts of market-based approach are:

- **contractual contingency planning.** Provision in contracts – or other legal instruments such as formal markets’ rulebooks – that provide for the possibility of and response to major operational disruption;
- **market co-operation.** The private sector, bilaterally or multilaterally, co-operates to respond to the effects of major operational disruption.

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

Contractual contingency planning **3.6** Contracts – or other legal instruments such as rulebooks – may, and do, make provision for dealing with contingencies. This can help greatly, aiding planning for a contingency, and assisting with dealing with a contingency that occurs.

3.7 Such provisions are sometimes known as ‘*force majeure*’ clauses. Although their use is well-established, the scale and nature of the terror attacks of 11 September may suggest new roles and issues for such provisions.

3.8 A force majeure clause will apply in stated circumstances. It sometimes contains a list of certain events but may also include a sweeper up provision aimed at dealing with any other circumstance beyond the parties reasonable control which, for example, makes it impossible for obligations to be performed. In such a case, the relevant affected party would typically not be liable for breach or non-performance – instead the performance will be suspended during the operation of the event in question. There may also be a duty on one or both parties to say, use reasonable efforts to mitigate the effects in question, and/or to seek to find alternative means to perform, with ultimately, the possibility that the parties may decide to terminate the agreement on a no-fault basis.

Box 3.1 Examples of contractual contingency planning

- Post 11 September, the International Swaps and Derivatives Association, Inc. (ISDA) have included a standard ‘*force majeure*’ clause in their 2002 Master Agreement.
- Infrastructure system documentation can make provision for what should happen in the case of widespread disruption, including for example determining who would be responsible for taking the decision, who should be consulted, and what the consequential effects should be. These could include arrangements for closing, not opening, or extending the opening hours of systems and for adjusting the settlement period. For example, the London Stock Exchange rules specify that the Exchange may postpone or extend a settlement period for all transactions or for transactions in specified securities effected on a given day, indefinitely or for a specified period.

3.9 Contractual contingency planning has the great advantage that it provides a readily-available means for handling operational disruption, agreed in advance by the parties. This not only assists in resolving contractual issues when disruption occurs, but increases certainty in advance of disruption which may well also help wider contingency planning.

3.10 A potential weakness of contractual contingency planning is that it may be difficult to provide for all contingencies appropriately.

3.11 There are various common law rules² which could be invoked to resolve issues arising when the performance of obligations under a contract is rendered impossible (or radically different from what the parties originally intended when the contract was entered into) and those situations were not provided for in the contract or contemplated by the parties. However, the scope and application of these common law rules is uncertain³, and, accordingly, their application may be overridden by specific contractual provisions agreed between the parties. Where no specific contractual provision is made for *force majeure* situations, courts may tend to seek solutions to avoid injustice where obligations cannot practicably be fulfilled through no fault of the parties. However, it must be borne in mind that courts have traditionally set strict criteria for intervening to modify or discharge contractual obligations.

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?*

MARKET CO-OPERATION

3.12 The simplest form of co-operation is where the two parties to a contract agree that, in light of major operational disruption, they will adopt some approach different from that set out in their contract. For example, if one party is experiencing difficulties in fulfilling an obligation the counterparty may agree to forbear from seeking fulfilment until some later time.

3.13 Multilateral co-operation occurs when a group of participants in a financial network agree a certain approach to handling disruption. This co-operation might occur at the time of the disruption, but is likely to operate more efficiently if decisions have been taken in advance about the relevant group of decision-makers, and the basis on which decision-making would be approached and decisions promulgated.

Box 3.2 Examples of market co-operation

Market co-operation had a significant role to play in responding to 9/11. The Operations Managers Working Group of the New York Foreign Exchange Committee was instrumental in co-ordinating the response of the foreign exchange industry, for example through industry-wide conference calls, and the Bond Market Association made recommendations to extend the settlement period in the US Treasuries market. Recommendations which might be made by market committees include market closure, extension of the normal settlement period to give damaged infrastructure and back-offices a breathing space to recover, and agreements on the interest rates and compensation to be paid for delays in settling trades.

3.14 The great advantage of market co-operation is that the private sector itself resolves issues voluntarily. This put responsibility for managing disruption where it most appropriately belongs. It aligns the responsibility with general ownership and management responsibilities. It puts those with the most knowledge of a financial network in charge of resolving its difficulties.

²The general doctrine of frustration.

³E.g. the concept of “partial frustration” remains legally controversial.

3.15 Potential difficulties of market co-operation, in particular multilateral co-operation, are:

- such approaches rely on readiness to co-operate in difficult situations, including when information may be very limited. This may be undermined by uncertainty about the financial or legal consequences of decisions taken or fear of litigation by stakeholders who may be adversely affected. Individual institutions may also fail to act co-operatively if they fear that they will be disadvantaged as a result of others failing to do so;
- multilateral approaches rely additionally on identifying in advance a group of people who are representative of the participants in the relevant network with sufficient authority to take decisions and promulgate these in the reasonable expectation that other market participants will abide by them;
- different market-based initiatives may come up with different answers to the same, or related, questions.

3.16 Recognising both the great value of market co-operation and the possible practical issues to be addressed, the authorities have been working to strengthen market co-operation in the UK. More details are shown in Box 3.3.

Box 3.3 UK work on market co-operation after 11 September

The UK authorities have been working to ensure that suitable market groups exist in the UK to assume a co-ordination role. In the case of the exchange-traded markets (e.g. equities on the London Stock Exchange), the exchange itself would take primary responsibility for deciding how to respond, in association with its supervisor, the Financial Services Authority. The Markets and Exchanges Regulatory Liaison Information Network (MERLIN) – which acts as the forum for the recognised exchanges, their associated clearing houses (e.g. the London Clearing House) and settlement systems (e.g. CREST) – and their supervisors, to discuss issues of common interest, has established a contingency sub-group to further co-operation on practical issues.

In the case of the over-the-counter markets (sterling money markets and foreign exchange) market committees have a particularly important role to play, as there is no central body with the power to direct these markets, and therefore the only way to ensure a co-ordinated approach is through informal agreements. In the UK the Sterling Money Market Liaison Group (MMLG), chaired by the Bank of England, has assumed a co-ordination role for the sterling money markets and *inter alia* has considered at what rate unintended overdrafts and credit balances (arising from unsettled trades) should be charged or remunerated. The committee has recommended use of the Bank's official repo rate, which has the advantages of neutrality, of being known to all in the market, and hence of giving rapid certainty and transparency. The Foreign Exchange Joint Standing Committee, also chaired by the Bank, has created an operations sub-group to focus specifically on technical operational issues within the foreign exchange and international money markets, including contingency planning. There have also been private sector initiatives such as the Securities Industry Business Continuity Management Group (SIBCMG) – established by the major securities firms to consider best practice.

3.17 Possible ways of considering whether co-operation might usefully be strengthened include:

- identifying groups of knowledge and authority to tease out relevant issues;
- deciding on issues that can usefully be resolved in advance of disruption;

- identifying groups (quite likely the same groups as in the first point above) with sufficient authority to promulgate decisions in advance of, and during, disruption;
- seeking industry-wide agreement on the broad approach to decision-making during major operational disruption, and on the need to abide by decisions taken;
- working out the practicalities of communication between that group, and with the financial network more widely, during disruption;
- noting what issues are unlikely to be resolvable by market co-operation and how they might be addressed.

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 AUTHORITIES' EXISTING TOOLKIT

3.18 Following major operational disruption, the authorities' tools would include:

- collection and dissemination of information – e.g. to reassure or to aid recovery;
- persuasion by encouraging particular private sector parties to take a particular course of action;
- persuasion by making general announcements – for example, on market conventions;
- the central banking functions of the Bank of England, for example the provision of liquidity to the market and the settling of payments;
- regulatory action by the Financial Services Authority – non-application of certain rules; variation of permissions; use of powers to, for example, impose requirements about how a firm conducts its business⁴; direction of recognised bodies to take certain corrective actions if they do not comply with their Recognition Requirements⁵;
- statutory powers under the Banking and Financial Dealings Act 1971. The 1971 Act allows bank holidays to be called and provides for certain other potential measures, including the prevention of a variety of financial dealings. The 1971 Act is considered further in Annex A. The conclusion is that the Act is of limited use in responding to major operational disruption, not least because it was not designed for that purpose. (Bank holiday powers are used to declare public holidays. This consultation does **not** suggest any changes in respect of public holidays).

3.19 These tools can be very effective in responding to a crisis. Box 3.4 on the 1987 hurricane describes an occasion when the authorities, in co-operation with the markets, dealt with major operational disruption.

⁴The Financial Services and Markets Act 2000, section 45.

⁵The Financial Services and Markets Act 2000, section 296. A list of Recognised Investment Exchanges and Recognised Clearing Houses can be found at <http://www.fsa.gov.uk/register/servlet/uk.gov.fsa.register.exchange.ExchangeMain>

Box 3.4 The 1987 Hurricane

During the “hurricane” on the night of 15-16 October 1987, London suffered severe physical disruption to travel services and widespread power and telecommunications failures. As a result of this dislocation, it became apparent that normal banking operations were impossible and, in particular, the final settlement of payments due to be cleared on that day could not take place. The Bank of England made a statement on the morning of 16 October expressing the view that conditions in the City made clearing settlements impossible that day and suggesting postponement until the next working day. These arrangements were subsequently confirmed by the clearing banks. The Bank co-ordinated the publication of informal guidance on how to treat delayed settlements, including the interest rate to be paid. No formal order was made under the 1971 Act.

3.20 However, the authorities’ toolkit may in some instances be limited by the lack of legal powers designed to deal with major operational disruption. For example, the power to direct recognised bodies is for the purpose of bringing about their compliance with the Recognition Requirements. It is not clear that this would encompass actions needed to respond to major operational disruption, unless that disruption was causing or likely to cause a recognised body to fail to meet the Recognition Requirements.

THE AUTHORITIES’ TOOLKIT IN OTHER COUNTRIES

United States 3.21 The authorities in United States had at their disposal on 11 September a toolkit that in some ways is more extensive than that currently available to the authorities in the UK, including powers to call suspensions of trading and to call bank holidays.

3.22 The suspension powers were not used in response to 11 September. The Federal Reserve Bank of New York worked with the New York State government in developing their declaration that gave New York banks the option (but not the requirement) to close that day.

3.23 In their post-11 September work, the US authorities have focused on market-based approaches.

Other countries 3.24 Statutory financial sector powers of this kind also exist in some other G10 countries⁶. However, we are not aware of any moves to develop further legal powers to respond to operational disruption. We understand that the Finnish government has sought to strengthen their powers relating to the financial markets in the light of 11 September. The Finnish powers are considerably more wide-ranging than those discussed in this document.

⁶The G10 countries are: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

New legislation might supplement current approaches by allowing the authorities to help promote order in the financial system:

- providing a breathing space to identify and address operational problems and their financial effects;
- in some exceptional cases, intervening, for example, to close markets and systems.

This document's core question is whether such legislation might in principle be useful.

Possible disadvantages of new legislation include that:

- it might create uncertainty about how the authorities might use their powers during a major operational disruption;
- it might lead private sector institutions to undertake less comprehensive planning than they otherwise would;
- use of the legislation might have adverse effects for some, and unhelpful knock-on effects.

These possible disadvantages – and the primacy of the private sector role – lead the Government to believe that any new legislation should only be used in extreme situations (and never in a purely financial crisis) and only with support from the private sector (subject to the practical difficulties of taking urgent soundings during major operational disruption).

The chapter concludes by asking what specific powers might be sought via new legislation, giving examples of powers to suspend financial obligations and direct financial infrastructure.

INTRODUCTION

4.1 This chapter explores the general arguments for and against new legislation. It sets out how new legislation might address the risks of major operational disruption. It considers the possible disadvantages of legislation. It then suggests two possible new legislative powers which are discussed further in Chapters 5-7.

4.2 Underlying this discussion of the possible role of legislation is the assumption that such legislation would consist of:

- primary legislation, which would not have any direct effect, but only provide a framework for...
- ...specific measures that would be put in place quickly by secondary legislation or other means during the major operational disruption.

More details on this are set out in Chapter 5.

HOW NEW LEGISLATION MIGHT ADDRESS RISKS

4.3 Chapter 2 set out some features of the financial system relevant to thinking about major operational disruption. Chapter 3 outlined the currently available approaches, noting some difficulties (such as the possibility that contracts may not be able to anticipate responses to emergencies sufficiently, the potential difficulties in establishing and delivering market co-operation, and the lack of specific legal powers to respond to major operational disruption). This section aims to pull out how new legislation might go beyond currently available approaches in addressing risks arising from the features of the financial system.

A breathing space **4.4** During major operational disruption, financial institutions might be faced by pressing financial obligations and uncertainty about how financial networks should function. The time sensitive nature of many of these networks suggests that in some circumstances it might be useful for institutions, and their customers, to have a breathing space in which to focus upon restoration of operations, resolve uncertainties (for example about the functioning of markets) and perhaps contain financial problems. Such a breathing space could involve delaying certain legal obligations associated with contracts and other legal instruments used in certain financial networks.

4.5 A breathing space would enable infrastructure providers and participants in financial markets to address the underlying operational problems without being preoccupied with the immediate financial consequences of these. As well as allowing market participants to address their own problems, it might also provide time for a proper assessment to be undertaken of broader market conditions and the condition of counterparties. It is possible that such powers, judiciously used, could also contain the potential systemic consequences of any significant disruption.

4.6 Similar breathing spaces might be created by market co-operation (the authorities' preference). However the potential difficulties with market co-operation noted in paragraph 3.15 mean that there could, in some circumstances, be a role for the authorities in providing such a breathing space in a more co-ordinated and more definite fashion. Externalities that might arise from a poor outcome, with significant costs within or beyond the financial system, could justify this role.

Intervention **4.7** New powers might also, in some exceptional cases, be able to promote order in the financial system by intervening, for example, to define market rules to attempt to manage and contain operational and financial problems. Such intervention would generally not be appropriate. However, it could be useful in circumstances where external costs might be significant and in which co-operative market solutions are not available or would take too long to develop.

Discussion **4.8** The signs – from reactions in New York to 11 September (see Boxes 2.1 and 3.2) and from the subsequent work of financial institutions in the UK (see Box 3.3) – are that there would be a very strong tendency to market co-operation. This could avoid or address some of the risks set out above. Action by the authorities using their existing toolbox, including informal persuasion, could also help address the risks.

4.9 However the pressures on the system could be greater than on 11 September, in particular if:

- operational disruption affected the financial system to a greater degree than on 11 September; or
- the underlying financial outlook was already more difficult before the disruption occurred.

4.10 These would be extreme conditions, but it is responsible to consider their implications carefully. The Government therefore believes it is right to raise the issue of whether new legislation could provide a useful extra tool for dealing with major operational disruption.

POSSIBLE DISADVANTAGES AND LIMITATIONS OF NEW LEGISLATION

Disadvantages 4.11 Some possible disadvantages of new legislation include that its existence might lead to:

- **uncertainty about how the authorities might use their powers during operational disruption.** Such uncertainty could be unsettling. Were it to prove a significant negative factor it might to some degree alter perceptions about the UK as a financial centre;
- private sector inaction because of increased **moral hazard**. The existence of legislation might lead private sector institutions to undertake less comprehensive planning than they otherwise would.

4.12 Disadvantages of using new legislation might include:

- **distributional effects, that might be adverse for some.** A power would only be used if the authorities considered that the net overall effect would be beneficial. However their use might involve costs to some parties;
- the potential for **knock-on effects** through the financial system being hard to anticipate or contain.

Limitations 4.13 Limitations of new legislation might include:

- **difficulties of using the power** in practice. Would the authorities be able to respond quickly and flexibly enough?
- **the international nature of the financial system.** The UK financial system's strong international links might also limit new legislation's effects. The UK financial system cannot be insulated from that in the rest of the world;
- **human rights** as embodied in the Human Rights Act 1998 and the European Convention on Human Rights.

Discussion 4.14 These possible disadvantages figure in discussions below, and in later chapters on potential new legislation. Some of the issues associated with disadvantages have a more positive side. Beneficial new legislation might strengthen perceptions of the UK as a place to do business. Reversing the moral hazard point, it might be possible to use legislation to sharpen, rather than blunt, incentives for the private sector.

GENERAL CONSTRAINTS ON THE USE OF NEW LEGISLATION

4.15 The possible disadvantages lead the Government to believe that any new legislation should be used only in limited circumstances. Their existence would not imply that they would necessarily be called into use in any particular circumstance of major operational disruption. The judgement the authorities would need to make would be that a specific use of the powers would bring greater benefits than costs. The authorities' Standing Committee arrangements – described in paragraphs 2.12 and 2.14) – would play a vital role in reaching such a judgement. Provided it was possible during major operational disruption, rapid discussions with the private sector that suggested the benefits outweighed the costs would clearly be of assistance in making that positive judgement.

4.16 The possible disadvantages – and the primacy of the private sector role in responding to major operational disruption – lead the Government to conclude that the powers should:

- **never be used in a purely financial crisis.** The considerations applying in purely financial crises are very different to those obtaining in a case of major operational disruption. In particular, legislation aiming to address operational disruption would be attempting to assist the financial system's resumption of business, whereas the issues raised by a purely financial crisis are not so readily separable from that business. The existence of primary legislation that could be used in a purely financial crisis could therefore more easily raise questions about ability to rely on transactions executed in, or with parties from, the UK;
- **only be used in extreme situations** resulting from major operational disruption;
- **only be used with support from the private sector** – subject to the practical difficulties of taking urgent soundings during major operational disruption. Unless such difficulties prevented it, it would be important for the authorities to listen to the private sector's views in order to ensure that their actions were based on a good understanding of the situation and commanded support. However, it should be recognised that the authorities might have to balance different views from the private sector in reaching their decision.

CORE QUESTION

4.17 Chapter 3 discussed:

- market-based approaches, asking also if they could usefully be strengthened; and
- the authorities' existing toolbox for dealing with major operational disruption.

4.18 This chapter has surveyed:

- how new legislation might address risks; and
- the possible disadvantages and limitations of new legislation.

It set out some constraints on the use of any new legislation that the Government considers important.

4.19 The Government would be grateful for views on the benefits of new legislation to enable the authorities help promote order in the financial system in the face of major operational disruption. In particular, might it be useful to have such powers available in case they could supplement a market-based approach (as it is or could be developed) and the authorities' existing toolbox? The issues would seem to be:

- whether new legislation could be of use in some circumstances of major operational disruption? and
- whether the possible disadvantages of having new legislation outweigh this consideration?

4.20 The Government will consider the implications of seeking legislation for the financial system and the wider economy, including for retail financial services customers such as individuals and small business.

4.21 Before answering the next questions readers may find it helpful to consider the more specific ideas set out in the remainder of this document.

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?*

POSSIBLE NEW LEGISLATIVE PROVISIONS

4.22 This section considers what specific sorts of new legislation might address the risks outlined above, bearing in mind the possible disadvantages of new legislation.

A suspension power **4.23** The possibility of providing a breathing space through legislation suggests a power to suspend financial obligations. As discussed in more detail in Chapter 6, such a power could allow the authorities to suspend temporarily obligations arising from certain financial system contracts. This could provide directly for a breathing space, but would not prevent two parties who wanted to fulfil obligations from doing so.

A direction power **4.24** A power to more directly intervene would be very wide-ranging if it were exercisable in respect of any contract in the financial system. However, as noted in paragraph 2.5, some financial networks are more formal in character than others. These networks – stockmarkets and clearing, settlement and payment systems – play a role of ‘infrastructure’ – financial infrastructure – for the financial system. They have more formal rules than other networks. Because of the strong multilateral nature of these networks, collective action will be particularly important in order to address problems. Also, it is reasonable to suppose that their central positions in the financial system mean that the externalities arising from their decisions during major operational disruption have the potential to be large. These considerations suggest a possible power for the authorities to direct financial infrastructure to take certain actions – this is discussed in more detail in Chapter 7.

4.25 There is a question of whether it could be useful for a direction power to be applicable to functions of financial institutions which resemble financial infrastructure to some degree¹.

But not a prohibition power **4.26** Another possible type of legislation would provide a power to *prohibit* transactions. Whereas the suspension power would allow transactions to be suspended for a period, this type of power would *prohibit* them being undertaken for a period. The Banking and Financial Dealings Act 1971 provides some prohibitive powers (see Annex A for more details). However, a prohibition power goes considerably beyond providing a breathing space or intervening in formal markets and other infrastructure systems. It might hinder the restoration of financial networks rather than the reverse. A prohibition power does not therefore seem particularly well-suited to promoting order during major operational disruption, and is not considered further in this document.

4.27 The direction power has a prohibitive element. However, it would be limited to more formal financial networks. These have a strong element of common rules, so it is plausible that their restoration would need a common approach even if this does not suit all individual institutions. The direction power would not, however, prohibit the performance of similar transactions away from the formal financial network (for example, off-exchange deals).

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?*

¹ For example: alternative trading systems, major custodians, general clearing members of the London Clearing House and settlement members of CHAPS.

To make potential new legislation workable, its powers would need to be exercised by secondary legislation or other means in a flexible fashion during the disruption. Accountability would be important.

The powers might be exercised by Treasury Ministers. Establishing a fallback method of using the powers might well be useful to allow for disruption affecting the authorities themselves.

The chapter asks what conditions – beyond the existence of major operational disruption – might be required before the powers could be exercised.

The powers might be defined to apply to actions that take place in the UK (rather than actions governed by UK law).

The chapter asks if new legislation should allow the use of powers following major operational disruption affecting a *non-UK* major financial centre.

The Government would be concerned to ensure that the powers were used only to the extent which appeared necessary to deal with major operational disruption, and that full account was taken at that stage of the UK's obligations regarding human rights.

5.1 This chapter briefly looks at issues raised by the possible limitations of new powers summarised in Box 5.1 below (and originally set out in paragraph 4.13). These considerations relate to the overall framework for the powers and apply to both the suspension and the direction power.

Box 5.1 Possible limitations of legislation

- Difficulties of using the power in practice.
- The international nature of the financial system.
- Human rights legislation.

5.2 Flexibility is the key to overcoming difficulties of using the power in practice. Flexibility calls for accountability, and this is also considered in the first section below.

FLEXIBILITY AND ACCOUNTABILITY

Accountability 5.3 Any use of the powers would, of course, attract significant interest. The authorities would inevitably be held to account via Parliament and the media for their actions. However, it would be important to include more specific accountability mechanisms to safeguard use of the powers.

Flexibility 5.4 New legislation would have to be flexible in order to overcome difficulties that may arise in using the power in practice:

- the unpredictability of the form and consequences of major disruption suggests that it would not be possible to anticipate the exact circumstances in which any legislation would be used;
- over the medium term, very specific primary legislation could very likely be superseded by financial market developments;
- the operational disruption could affect the authorities themselves.

5.5 The Standing Committee arrangements noted in paragraphs 2.12 and 2.14 above would assist in ensuring sufficient flexibility existing in practical and organisational terms. The legislation itself would also need to reflect the importance of flexibility.

Secondary legislation/administrative direction

5.6 That implies a legislative approach (sketched in paragraph 4.2) in which the primary legislation would not have a direct effect, but would provide a framework for secondary legislation or administrative directions made quickly during the major operational disruption. The secondary legislation or administrative directions would activate the powers and specify how they were used.

Procedure

5.7 The power to make the secondary legislation or administrative directions might be exercised either:

- by a Treasury Minister¹; or
- by the Financial Services Authority (FSA), in the case of regulated institutions, and by the Bank of England, in the case of payment systems.

The former seems preferable. It would appear more appropriate, in particular in terms of accountability, for the Government to exercise the powers. It is also possible that the powers would have effects cutting across the division of responsibility between the FSA and the Bank suggested in the second point above. Keeping exercise of the powers united would assist consistency and avoid boundary questions in such instances.

5.8 However, the need for resilience during major operational disruption would very strongly suggest that a fallback approach would be needed. If the first route for making the secondary legislation or administrative directions were impractical, alternatives could then be pursued. Possible fallbacks might include exercise of powers by:

- Treasury officials;
- the Financial Services Authority and/or the Bank of England;
- non-Treasury Government ministers acting on advice from Treasury officials, the FSA and/or the Bank of England.

5.9 Because of the time constraints, it would not be practicable to require the secondary legislation or administrative directions to be laid before Parliament for it to take effect. Instead it would appear appropriate for the secondary legislation or administrative directions to be laid before Parliament after being made. (This approach was adopted for certain powers in the Banking and Financial Dealings Act 1971.) This would provide the formal mechanism for scrutiny by Parliament and accountability for the use of the powers.

5.10 Because the operational situation and its financial consequences might well evolve, it should be possible to modify the secondary legislation/administrative direction by further secondary legislation/administrative direction. This modification should not be retrospective, not least because that would undermine the certainty that use of the powers would intend to create.

Publicising the legislation

5.11 The powers would only have practical effect if their use was communicated. The authorities would therefore publicise use as widely and quickly as possible. The Government would consider the utility of a statutory obligation to publicise use of the powers, but considerations of flexibility mean there would need to be discretion about how this should occur.

¹ The more usual method of making Treasury secondary legislation is for the legislation to be approved by the Lords Commissioners of the Treasury. This requires the two Lords Commissioners to be located and is not likely to be consistent with speedy exercise of the powers, especially during Parliamentary recess or at weekends.

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?*

Conditions for exercising powers **5.12** The powers would only be usable in a case of major operational disruption, and never in a purely financial crisis. This would be specified in the primary legislation. Subject to the requirement of flexibility, it might be possible to promote accountability by including further conditions for the exercise of powers in the primary legislation.

5.13 Options for further conditions might include setting out in the primary legislation:

- further specification of the extreme circumstances required for the power to be used;
- the requirement for support from the private sector – although any formal requirement would have to carefully recognise the severe difficulties there might be in taking soundings – especially wide soundings – quickly during major operational disruption;
- an objective, or objectives, for the use of the powers. The simplest kind of objective would be to allow the authorities to use the power only if they believed it was in the public interest to do so. The drawback with more complex objectives is that they may imply that in some circumstances the authorities could not use the power even if it were in the public interest to do so.

5.14 A balance would need to be struck between enhancing accountability and reducing flexibility.

Question 5b *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?*

Time period **5.15** The nature and intention of legislation clearly implies that use of the powers should have only temporary effect. The specific period or periods to which a particular use of the powers applied would be set out in the secondary legislation/administrative direction. Would there be any benefit in a maximum time period being specified in the primary legislation? Could that be done without either compromising flexibility or being so long that it was meaningless? One option would be for a maximum time period for each individual piece of secondary legislation/administrative direction, but to allow it to be renewed or amended as many times as is necessary.

5.16 In practice, the length of time for which powers would be applied would depend on the duration of the operational disruption and its effects on the functioning of the financial system. The authorities would, subject to the difficulties of taking soundings during disruption, maintain touch with the private sector when deciding time periods and their renewal.

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?*

Preparation for use of the powers **5.17** To ensure that the powers were usable in practice, the authorities would also consider in advance the possible ways in which they might use them. The exact circumstances could not be anticipated fully, but prior preparation would assist in making a quick response during major operational disruption.

THE INTERNATIONAL NATURE OF THE FINANCIAL SYSTEM

Where these powers will apply **5.18** The UK financial markets have a strong international component. There are many cross-border transactions starting or ending in the UK. Foreign financial institutions and companies operate in the UK. Contracts and assets referring to actions in the UK may be governed by foreign laws. Conversely actions abroad may be governed by UK law. This raises the question of which financial dealings would be affected by the powers – those under UK law, or those which took place in the UK?

5.19 Given the nature of the problem these powers would be intended to address, it would appear that they would better affect actions that took place in the UK, whether governed under UK or foreign law. It would be the location of the actions – not whether they were governed in contractual or proprietary terms under a UK or a foreign law – that would matter. They would not therefore affect UK law transactions that did not involve persons or actions in the UK.

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

5.20 A particular issue arises for the suspension power, in respect of financial obligations falling to be performed in the UK, but which are governed by foreign law. This is considered further in paragraph 6.17.

The international dimension **5.21** Because of the cross-border nature of many financial transactions, and the international nature of much of the UK financial sector, UK authorities would as necessary (subject to the practical difficulties of taking urgent soundings during major operational disruption) discuss use of the powers with foreign financial authorities.

Major operational disruption outside the UK **5.22** Because of its international character, the UK financial system could be affected by major operational disruption in major financial centres abroad. New legislation could allow for the powers to be used in such circumstances, as well as in circumstances of major operational disruption directly affecting the UK.

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?*

HUMAN RIGHTS

5.23 The potential primary legislation would be compatible with the UK's obligations as regards human rights, in particular as embodied in the European Convention on Human Rights and the Human Rights Act 1998. The primary legislation would not contain any substantive measures, only powers enabling substantive measures to be put in place later by secondary legislation or administrative directions. Further consideration of human rights issues would be needed when any substantive measures were adopted by secondary legislation or administrative directions made under those powers. The Government would be concerned to ensure that the powers were used only to the extent which appeared necessary to deal with major operational disruption, and that full account was taken at that stage of the UK's obligations regarding human rights. In the circumstances envisaged, it is very likely that the UK would have flexibility in this area provided its responses were proportionate to the circumstances, and used only to the extent which appeared necessary to deal with major operational disruption.

6

SUSPENSION OF OBLIGATIONS

This chapter describes in more detail the possible power to suspend financial obligations and seeks views. It provides examples of how such a power might be used.

Wholesale financial market obligations might be included in the range of obligations to which such a power might be applied. Should the power also be capable of applying to retail financial obligations?

Insurance contracts might be excluded from the scope of a suspension power.

The power might be constrained only to enable suspension of all obligations relating to a contract (to avoid leaving some obligations of a contract in place when others were suspended).

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

It might be useful to provide in legislation for handling consequential effects of suspending obligations, although market approaches to addressing these effects would be preferred where available.

The chapter concludes by asking if respondents would support legislation for a suspension power.

A SUSPENSION POWER

Overview 6.1 This chapter considers a power for the authorities to suspend temporarily certain financial system obligations in the event of major operational disruption. It describes how a suspension power might be used, seeks views about key characteristics of its possible design, and concludes by asking whether such a power would be beneficial.

6.2 Earlier chapters provided a framework to assist in considering whether such a power would be beneficial. In particular, Chapter 4 looked at general issues raised by new legislation, and Chapter 5 discussed some points that could be common to this power, and to the direction power discussed elsewhere in this document.

Motivation 6.3 As set out in Chapter 4, a suspension power could provide for a breathing space following major operational disruption. It would suspend obligations but would not prevent two parties who wanted to fulfil obligations from doing so.¹

Use of a suspension power and constraints on its use 6.4 As described in Chapter 5, a suspension power would be exercised by secondary legislation or administrative direction – referred to here as a ‘suspension order’ – with appropriate procedural requirements. If a suspension power were created, the Government believes that it should never be used in a purely financial crisis; it should only be used in extreme circumstances, and only with the support of the private sector (subject to the practical difficulties of taking urgent soundings during major operational disruption). If major operational disruption occurred, use of the power would by no means be automatic. The authorities would consider if there were particular circumstances that called for its use.

¹As set out in paragraph 6.20, there are two different broad views of what a suspension power should be able to do.

Box 6.1 Examples of use of a suspension power

- A terrorist attack badly damages a number of significant players in an informal market. Others, however, are still able to operate. By suspending obligations in the market, use of the power could send a clear and *legally-underpinned* signal that settlement of market contracts could be delayed for a specified number of days. Two parties who wanted to settle, and could, would still be able to do so. However, a clear breathing space would have been created for those who were unable to settle, whether because of direct damage from the attack, or because of financial difficulties arising out of it.
- As a result of serious physical disruption, a number of financial firms are unable to make payments under derivatives contracts. This means that contractual payments cannot be made – this results in the accumulation of unexpected and largely unsecured credit exposures in some institutions and excess liquidity in others. As a result, credit limits and covenants begin to be breached and creditor firms (who are unable to meet other obligations) threaten to begin legal proceedings against those unable to pay. Use of the suspension power effectively freezes positions until payments can plausibly be resumed and heads off the possibility of litigation. During the period of the suspension, market participants can devise an appropriate basis for remuneration of contracts that are, perforce, rolled over. (If firms were able to find bilateral means of settling and were willing to do so, they would be free to do this. But debtor firms would – for a limited period – be spared the consequences of breaching time-essential contractual provisions.)
- Following disruption such as a major terrorist attack or severe weather conditions, virtually no-one can settle any transactions. Use of the suspension power recognises this legally on a consistent basis, and signals clearly the broad timetable to get up and running again. Institutions are able to focus on restoration of operational networks in preparation for resumption of normal business, with less preoccupation with short-term financial pressures.

CHARACTERISTICS OF A SUSPENSION POWER

6.5 Chapter 5 discussed some general issues that would arise in framing and using a suspension (or other) power. This chapter looks at the more specific issues raised by a suspension power.

Issues 6.6 There are some particular characteristics of such a power that would need to be defined:

- the **maximum scope** of the power. What range of financial system obligations could be suspended by use of the power? (In using the power, it would be necessary to specify from within this maximum scope which obligations, or groups of obligations were actually to be suspended);
- how the suspension order could **specify the obligations suspended**. In particular, should there only be provision to suspend obligations which the disruption made it difficult to fulfil?
- **handling the consequential effects** of the power. There could well be knock-on effects arising from a suspension of obligations. Should, and how should, the power address these?
- what would happen **after the end of a suspension**?

Responding to this chapter's questions **6.7** This chapter asks questions about these issues seeking to define the suspension power optimally. The chapter's final question is whether the Government should seek a suspension power. Even if a respondent's answer to this final question is negative, answers to earlier questions could usefully help identify the optimal form of the power or explain why a suspension power should not be sought.

DEFINING THE POWER'S MAXIMUM SCOPE

Maximum scope **6.8** Primary legislation would have to prescribe the maximum scope of obligations that could be suspended. A suspension order made at the time of the disruption would specify which obligations were suspended, from within this maximum scope. Too narrow a maximum scope would restrict the power's flexibility and usefulness. But the maximum scope should not be unnecessarily wide.

6.9 As the term maximum scope suggests, there would be no presumption that – if the suspension power were used – it would be applied across all that potential scope. In considering if the power should be used, it would be necessary to consider **how** it might be used. The scope of a particular use of the power, as with the choice about whether to use the power at all, would depend on the particular circumstances. This would clearly be an issue for the authorities' soundings with the private sector.

Defining the maximum scope **6.10** The aim of new legislation would be to help promote order in the financial system. This suggests that the power should focus upon financial system obligations. Wholesale market transactions are particularly associated with the time-sensitive network effects discussed in Chapter 2. This suggests that wholesale market transactions should be included within the maximum scope of the suspension power. Box 6.2 shows some obligations that seem clearly to fall into this category.

Box 6.2 Wholesale market obligations

Obligations within the maximum scope of the suspension power might include those associated with the following:

- Wholesale loans and deposits
- Wholesale (high-value) payments
- Wholesale foreign exchange transactions
- Derivatives contracts
- Securities and money market paper. The obligations concerned might include both those arising from such assets – e.g. bond interest payments, payment of (declared) share dividends, corporate actions – and other obligations associated with them (e.g. settlement and collateralisation obligations)
- Transfer orders (effected via payment, settlement or similar systems)
- The bullion market

(Insurance contracts may raise different issues, and are considered in paragraphs 6.15 and 6.16.)

6.11 The inclusion of obligations associated with securities as well as contracts in this list seems balanced in economic terms. For example, it could seem odd if bonds were excluded but loans included in the maximum scope. However, securities raise issues of proprietary as well as personal rights. (For example, with regard to competing ownership claims.)

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 (e.g. regarding proprietary rights).*

Retail obligations **6.12** Should retail financial obligations be included within the power's maximum scope? Retail obligations are generally less time-sensitive than wholesale obligations. For example, non-payment by a retail customer typically leads to a payment reminder. This factor might suggest exclusion of retail obligations from the power's scope. On the other hand, the suspension power could provide relief to parties who were unable to make payments, which might suggest that it would be better to avoid ruling out use of the power in respect of retail customers. In any case, the Government could only consider calling a retail suspension if the alternative of not acting was clearly likely to lead to a worse outcome for retail customers.

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

6.13 Suppose the right principle is that wholesale, but not retail, obligations should be within the maximum scope. For many of the obligations listed in Box 6.2 – loans, deposits, payments, foreign exchange and derivative contracts – this raises the question of defining the cut-off between wholesale and retail activities. Wholesale obligations might be considered to be those in which the parties were all financial institutions or major corporates. Retail obligations would be the remainder, including obligations between financial institutions on the one hand and small- or medium-sized businesses, or personal retail customers, on the other.

6.14 For securities,² it is less clear that a line could usefully be drawn dividing holders into wholesale and retail categories.

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

Insurance contracts **6.15** A category of financial obligation not considered above are those obligations arising from insurance contracts, which raise a different issue. Timing is not usually a critical element of insurance contracts. So a suspension period lasting a few days is unlikely to have much material effect on insurance contracts. But the possibility of such a suspension might raise fears that insurance liabilities arising from major operational disruption would not be honoured. Although this would be a groundless fear, it could affect willingness to insure. There might, therefore, be an argument for excluding insurance contracts from the scope of the power on the grounds that their suspension would not generally have a material effect, but that an undue disincentive to insure might arise.

6.16 The considerations may be different for some insurance contracts, such as credit insurance.

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?*

6.17 As noted in paragraph 5.20, a particular issue arises in respect of obligations which fall to be performed in the UK, but which are governed by foreign law. Consistent with the approach suggested in question 5d, it could be desirable for these obligations to be suspendable during major operational disruption. If this is desirable, that raises the question of whether or how such a suspension could be made, or how a similar effect could be achieved.

² In principle, also money market paper although there are few retail investors.

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?*

SPECIFYING THE OBLIGATIONS SUSPENDED

Contracts as a whole **6.18** It seems plausible that a contract in its entirety should be either within or outside a suspension order. A clear example of why this appears right is provided by settlement of a share purchase. It would seem inequitable if the seller's obligation to deliver a share was suspended, but the buyer's obligation to pay was not. However, there may be examples where this is not the right solution, and issues – for example, of practicality – suggest that only some obligations arising from a contract might be suspended.

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?*

Flexibility **6.19** See Box 6.3 for some examples of different ways in which a suspension order might specify the obligations to be suspended. This section considers possible restrictions on this flexibility.

Box 6.3 How an order might specify obligations suspended

For example, the order could suspend obligations arising from contracts...

- of type X;
- of type X which were affected by the operational disruption;
- of type X involving companies A, B and C;
- or even could suspend obligations arising from individually identified contracts (subject to the obvious practical limitations of making such a list).

Alternative approaches **6.20** There are two alternative broad approaches to what a suspension power should do:

Narrower approach

- a suspension order should only affect obligations **which could not be fulfilled as a result of the disruption**; and

Wider approach

- a suspension order should also be able to affect obligations which could be fulfilled.

6.21 Underlying the narrower approach is the idea that the power is to confirm that fulfilment of obligations need not take place when it is not possible – whether because of direct operational difficulties, or because of the disruption's financial consequences. A breathing space is therefore created for those more directly affected by the disruption. It would be necessary to have clear criteria for benefiting from protection from the suspension.³

6.22 Underlying the wider approach is the idea that the power is to provide a breathing space more generally. In particular, it might be appropriate to suspend obligations across a market as a whole, rather than just those parts of it most directly affected by the disruption. Preferring the wider approach could also reflect weight being given to possible problems with the narrower approach. In particular, the creation of a breathing space depends upon increasing certainty – there is a risk the narrower approach would create additional uncertainty as it was debated which obligations could benefit from the suspension. It might be hard for a party to determine if its counterparty was validly asserting protection from the suspension.

³For example, suppose an institution has reduced liquidity because of the disruption. It can still fulfil some but not all of its obligations, and so has to choose which to fulfil. Should it be able to benefit from the suspension in respect of the obligations it chooses not to fulfil?

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?*

HANDLING THE CONSEQUENTIAL EFFECTS OF THE SUSPENSION POWER

6.23 If a debtor takes advantage of a suspension to delay meeting an obligation, possible consequences of this raise questions including:

- what, if any, **consequential remuneration** should be due from the debtor to the creditor?;
- what impact should suspension have on the **exercise of contract rights**? (The obligation arising from the exercise would be suspended – but should the ability to exercise remain?);
- what should happen when prices of suspended obligations underlie **derivatives contracts**?;
- what happens if because the creditor is not paid, he cannot meet some other (not suspended) obligation – **consequential delay**?

6.24 The primary legislation might usefully enable a suspension order to make provision to deal with such consequential effects. However, consistent with views expressed in Chapter 3, it would be preferable to rely on market solutions. This suggests that, if necessary, the order might make provision, but that agreement by the parties should have priority over this.

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

AFTER THE END OF A SUSPENSION

6.25 At the end of a suspension period, the obligations suspended would return. They might return immediately. Alternatively, the legislation might require them to be fulfilled as soon as practically possible.

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

6.26 Depending on the context, there might also need to be consequential provisions to handle the transition from the suspension.

CONCLUSION

6.27 A suspension power might be a useful tool for addressing disruption. The issues would seem to be:

- whether a suspension power could be useful in some circumstances of major operational disruption; and
- whether the possible disadvantages of having such a power outweigh this consideration.

6.28 The Government believes that a suspension power might be useful in some circumstances, but would be grateful for views. The Government believes that any suspension power should be limited – it should never be used in a purely financial crisis; it should only be used in extreme circumstances, and only with the support of the markets (ascertaining this support would, of course, be subject to the practical limitations on consultation that may arise in the circumstances of major operational disruption). The Government would only use a suspension power if the overall benefits of doing so outweighed the costs. In using the power, the Government would in particular, have to consider any costs and benefits of use for retail financial services customers.

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

6.29 See also the draft Regulatory Impact Assessment for new powers at Annex B.

This chapter sets out in more detail the possible power to direct financial infrastructure and seeks views. It provides examples of how such a power might be used.

The financial infrastructure to which such a power applied might include recognised bodies, payments systems and, perhaps, quasi-infrastructure functions of other financial institutions.

Possible actions that directions might be able to order include closing, opening and modifying rules. Directions might perhaps also themselves effect changes where appropriate (or they might only be able to require infrastructure to take actions).

This power raises questions about the consequential effects of directing infrastructure. Such a power would need to provide infrastructure with legal protection from the consequences of a direction. The power might also provide for handling other consequential effects of a direction.

The chapter concludes by asking if respondents would support legislation for a direction power.

A DIRECTION POWER

- Overview** **7.1** This chapter considers a power for the authorities to direct financial infrastructure – such as Recognised Investment Exchanges, Recognised Clearing Houses and payment systems – to take temporary actions, for example to open or close, or to modify some rule. The power could also be used to enable the infrastructure provider to take action they wished to pursue in the wider interests of the financial system, but felt unable to because of fear of legal claims being made against them.
- 7.2** The financial infrastructure stands at the heart of the most important formal networks in the financial system – the main formal markets for securities and derivatives, and the payment systems which enable the transfer of money within the system.
- 7.3** This chapter describes how a direction power might be used and seeks views about key characteristics of its possible design – including where the power might also apply to infrastructure-like functions performed by other financial institutions. It concludes by asking whether a direction power would be beneficial.
- 7.4** Earlier chapters provided a framework to assist in considering whether such a power would be beneficial. In particular, Chapter 4 looked at general issues raised by new legislation, and Chapter 5 discussed some points that could be common to this power, and to the suspension power discussed elsewhere in this document.
- 7.5** Chapter 3 recalled that the Financial Services Authority (FSA) power to direct recognised bodies is for the purpose of bringing about their compliance with the Recognition Requirements.¹ It is not clear that this would encompass actions needed to respond to major operational disruption, unless that disruption was causing or likely to cause a recognised body to fail to meet the Recognition Requirements.
- Motivation** **7.6** As set out in Chapter 4, a direction power could allow the authorities to direct financial ‘infrastructure’ – institutions (such as Recognised Investment Exchanges, Recognised Clearing Houses and payment systems) at the heart of important formal financial networks – how to behave. Depending on how the power were used, it could define a breathing space or define market rules to attempt to contain financial problems or assist planning and co-ordination of operational restoration.

¹ The Financial Services and Markets Act 2000, section 296.

Use of a direction power and constraints on its use

7.7 As described in Chapter 5, a direction power would be exercised by secondary legislation or administrative direction – referred to here as a ‘direction order’ – with appropriate procedural requirements. If a direction power were created, the Government believes that it should never be used in a purely financial crisis; it should only be used in extreme circumstances, and only with the support of the private sector (subject to the practical difficulties of taking urgent soundings during major operational disruption). If major operational disruption occurred, use of the power would by no means be automatic. The authorities would consider if there were particular circumstances that called for its use. They would need to consider carefully the views of infrastructure stakeholders – its providers and its users.

Box 7.1 Examples of use of a direction power

- **After major operational disruption, the authorities and providers of equity market infrastructure agree that, in the interests of avoiding even more disorderly markets and preventing any further loss of public confidence, equities trading, clearing and settlement should be temporarily stopped. But the exchanges and clearing houses are concerned about the prospect of legal claims from members. A direction order, telling them to stop and removing their liability, could address this risk.**
- **A terrorist attack in London leads to widespread settlement difficulties in the regulated markets. Opinions differ strongly about the best course of action for resumption of trading, settlement and clearing. After consulting, the authorities are able quickly to prescribe a clear, definitive and consistent solution via the direction power.**
- **Major operational disruption – e.g. a computer virus – occurs shortly before the end of the month, seriously affecting several banks’ system capabilities. These banks’ corporate customers can no longer push out credit instructions to employees so that many salaries cannot be paid. Directing a pause in direct debits could protect retail customers by ensuring that automatic outflows from their accounts were put on hold while salaries were also held up by the computer problems.**
- **An infrastructure provider feels obliged to – for example – suspend members or increase margining payments, even though the wider effects would be deleterious. The authorities could resolve this problem for the provider – quite possibly at the provider’s request – by using the direction power. Exercise of the power would remove legal liability from the infrastructure provider.**

CHARACTERISTICS OF A DIRECTION POWER

7.8 Chapter 5 discussed some general issues that would arise in framing and using a suspension (or other) power. This chapter looks at the more specific issues raised by a direction power.

Issues

7.9 The broad outline of a possible direction power was described above. Some particular characteristics that would need to be defined include:

- the **maximum scope** of the power. Which institutions would be defined as ‘financial infrastructure’ potentially subject to the power? (The direction order would have to specify from within this maximum scope which institutions were being directed, and how);
- **the nature of the directions** that could be ordered;
- **ensuring compliance** with a direction order; and
- **handling the consequential effects** of the power. There could well be knock-on effects arising from a direction order. Should, and how should, the power address these?

Responding to this chapter's questions **7.10** This chapter asks questions about these issues, seeking to define the direction power optimally. The chapter's final question is whether the Government should seek a direction power. Even if a respondent's answer to this final question is negative, answers to earlier questions could usefully help identify the optimal form of the power or explain why a direction power should not be sought.

DEFINING THE POWER'S MAXIMUM SCOPE

Flexibility **7.11** In order to be usable in exceptional and unusual circumstances, the power would need to be flexible. Primary legislation would define the limits of the power. Secondary legislation or an administrative direction made quickly at the time of the disruption would specify how it was to be used.

Maximum scope **7.12** The key limit that the primary legislation would have to set out would be the maximum scope of institutions that could be directed by such an order. (The order would specify the particular institutions directed and how they were being directed.) Too narrow or inflexible a maximum scope would restrict the power's usefulness. But the maximum scope should not be unnecessarily wide.

Financial infrastructure **7.13** The idea behind the power is to be able to direct financial infrastructure to take action that is in the best interests of the public. This will tend to mean the best interests of the financial system and the wider economy. Standing at the heart of formal financial networks, financial infrastructure plays a central role in the system. Decisions made by infrastructure providers will have particularly wide ramifications. This raises the question of what should be considered financial infrastructure.

Recognised bodies **7.14** The regulatory system already recognises the particular status of certain financial market institutions. The recognised bodies – Recognised Investment Exchanges and Recognised Clearing Houses² – have a special regulatory regime under the Financial Services and Markets Act 2000.³ This reflects, among other things, their particular role as providers of infrastructure services to the markets.

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

Payment systems **7.15** Payment systems are the other kind of 'infrastructure' central to the financial system. Indeed, a payment system is the most basic and fundamental kind of financial infrastructure – without the transfer of money operating effectively few parts of the financial system will work well. The biggest domestic payments systems are the electronic CHAPS high-value system and BACS high-volume system. Other high-volume systems support paper cheques and credit clearing systems, cash point systems and payment cards. The CLS Bank – a high-value system settling many wholesale foreign exchange dealings – is operationally based in the UK, although the company's management is based in New York.

7.16 The high-value systems – CHAPS and CLS Bank – raise the biggest issues for the financial system. (CHAPS is also used by retail customers.) The high-volume systems are not critical for the wholesale markets, but are very important for the wider economy, including retail consumers who use their services via banks to pay bills and receive credits. CHAPS is also used by retail financial services customers (for example, for house purchases).

7.17 The Bank of England oversees payment systems in the UK under a non-statutory regime.⁴ This legislation for major operation disruption would not alter that regime.

² A list of Recognised Investment Exchanges and Recognised Clearing Houses can be found at <http://www.fsa.gov.uk/register/servlet/uk.gov.fsa.register.exchange.ExchangeMain>

³ Part XVIII of the Act.

⁴ See <http://www.bankofengland.co.uk/financialstability/paymentsystems/oversight.htm> including a Bank paper on *Oversight of Payment Systems*, November 2000.

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

Quasi-infrastructure 7.18 As also noted in Chapter 4, it appears less appropriate for a direction power to be applicable to informal financial networks. There might, however, be a case for a direction power to be usable with respect to functions of financial institutions which resemble financial infrastructure to some degree. These might include – for example – the alternative trading systems, major custodians of securities, general clearing members of the London Clearing House and settlement members of CHAPS. These institutions – or rather these particular functions of institutions – are central to financial networks. These networks tend to be smaller or less formal than those of the financial infrastructure, or subsidiary to such networks. But the biggest are of significant importance in the financial system, and may therefore warrant inclusion in the maximum scope of a direction power. (Sometimes these are termed ‘quasi-infrastructure’.)

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?*

THE NATURE OF THE DIRECTIONS

Direction order 7.19 A piece of secondary legislation or administrative direction made at the time of the disruption – a direction order – would set out the actual directions, including saying to which parts of the financial infrastructure they applied.

Opening and closing 7.20 During major operational disruption great attention is likely to focus on whether a financial infrastructure is open or closed. A direction order could direct parts of the infrastructure to open or close for specified periods. This could assist in defining intended recovery times for the financial system more widely. A direction order should be flexible enough to treat different parts of an institution differently, if appropriate.

Moral limitations 7.21 A direction to open may raise particular issues if the institution being instructed to open is affected by physical disruption. The authorities should take into account the implications for the institutions’ employees of such a direction. It would not be acceptable for the authorities to make a statutory order that forced these employees into danger, or induced their employers to do so.

Rule changes and other actions 7.22 More widely, directions could order temporary rule changes or other actions. In some cases – those which do not require operational action from the infrastructure concerned⁵ – it might be desirable for directions actually to **effect** changes rather than to require them. Such an aspect of a power could be significant if the infrastructure’s headquarters no longer functioned.

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?*

ENSURING COMPLIANCE

7.23 Since a direction order could require an infrastructure provider to take specified action, the authorities would need to be able to ensure compliance. The authorities do not anticipate non-compliance, but clearly there would need to be proportionate sanctions available in the legislation should enforcement become necessary.

7.24 These sanctions would need to recognise the corporate responsibility of the infrastructure providers, and also appropriately recognise the personal responsibility of their officers and senior managers. But they would also need to recognise the moral limitations discussed in paragraph 7.21 above.

⁵ For example, changes relating to conventions of a regulated market.

HANDLING THE CONSEQUENTIAL EFFECTS OF THE DIRECTION POWER

7.25 There could be wide and significant consequential effects of using a direction power. These imply a need for legal protection from the consequences for the infrastructure that was directed.

7.26 Infrastructure users might find it more difficult, or impossible, to carry out legal obligations to third parties as a result of the direction. It might be appropriate for a direction order to protect the users from the legal consequences of this. This protection might also be extended to the third parties and to those who are effected by any difficulties resulting for the third parties (and so on).

7.27 Depending on the direction, there might be issues raised which were similar to the consequences of using the suspension power, set out in paragraph 6.23.

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

CONCLUSION

7.28 A direction power might be a useful tool for addressing disruption. The issues would seem to be:

- whether a direction power could be useful in some circumstances of major operational disruption; and
- whether the possible disadvantages of having such a power outweigh this consideration.

7.29 The Government believes that a direction power might be useful in some circumstances, but would be grateful for views. The Government believes that any direction power should be limited – it should never be used in a purely financial crisis; it should only be used in extreme circumstances, and only with the support of the markets (ascertaining this support would, of course, be subject to the practical limitations on consultation that may arise in the circumstances of major operational disruption). The Government would only use a direction power if the overall benefits of doing so outweighed the costs. The Government would need to consider the implications for the providers and users of the financial infrastructure it proposed to direct. In using the power, the Government would also have in particular, to consider any costs and benefits of use for retail financial services customers.

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

7.30 See also the draft Regulatory Impact Assessment for new powers at Annex B.

This annex summarises the financial sector powers currently available to the authorities under the Banking and Financial Dealings Act 1971:

- the Section 1 power to call a bank holiday; and
- the Section 2 powers to prohibit certain transactions.

The effects of these powers do not appear ideally suited to responding to major operational disruption.

The mechanics of the powers could create some difficulties in using them, in particular with appropriate speed.

The annex concludes by asking for comments on the usefulness of the 1971 Act powers in responding to major operational disruption.

THE BANKING AND FINANCIAL DEALINGS ACT 1971

A.1 As noted in Chapter 4, the Banking and Financial Dealings Act 1971 (‘the 1971 Act’) contains some powers that, at least on the face of them, might be relevant. This annex looks at the 1971 Act and considers the utility of its powers to promote order in the financial system during major operational disruption.

A.2 The 1971 Act splits into two main provisions:

- Section 1 specifies how bank holidays are called in the United Kingdom. Its relevance, therefore, goes much wider than the financial sector. This consultation does **not** suggest any changes in respect of public holidays in the UK. The issue for this consultation is whether using Section 1 to call an unplanned bank holiday could help in responding to major operational disruption;
- Section 2 provides some more specific financial sector powers. These are generally of a prohibitive nature. The issue for this consultation is whether the Section 2 powers are likely to be suitable for use in responding to major operational disruption.

Section I A.3 The provisions on bank holidays in the 1971 Act are modelled on those that were set out in the Bank Holidays Act 1871. These provisions were specifically intended to help Victorian banks give their clerks days off. They modelled bank holidays on the common law holidays of Christmas Day and Good Friday. The main contemporary relevance of a bank holiday is, of course, that it is regarded as a public holiday.

A.4 Effects of a bank holiday are specified in subsection 1(4) of the 1971 Act:

“No person shall be compellable to make any payment or to do any act on a bank holiday under this Act which he would not be compellable to make or do on Christmas Day or Good Friday; and where a person would, apart from this subsection, be compellable to make any payment or to do any act on a bank holiday under this Act, his obligation to make the payment or to do the act shall be deemed to be complied with if he makes or does it on the next following day on which he is compellable to do it.”

A.5 The meaning of this is not completely unambiguous. It turns upon the interpretation of ‘compellable’. The use of the word ‘compellable’ strongly suggests that this is a weaker provision than a removal of obligation. Rather, it appears to mean that a person cannot be **forced** to make a payment or do an act – for example, by legal action. This interpretation would not imply that the obligation itself is removed.

A.6 It seems relatively unlikely that compelling the making of a payment or doing of an act – for example, through legal action – could take place in the immediate aftermath of major operational disruption. This suggests that the bank holiday power would be of limited use during major operational disruption, except possibly purely as a signal to the banks and markets.

A.7 The time-sensitive nature of the financial system – and the consequent need for effective action to be swift – adds difficulties in using the bank holiday power for the purpose of promoting order in the financial system during unanticipated major operational disruption. Calling a bank holiday requires a proclamation by the Monarch, and the bank holiday cannot be declared for the day of the proclamation.

Section 2 A.8 Section 2 of the 1971 Act provides the Treasury with powers which make it a criminal offence to perform various kinds of transactions to suspend various types of transaction on a compulsory basis. The powers are sketched in Box A.1 which summarises subsection 2(1) of the 1971 Act.

Box A.1 Powers in Section 2 of the 1971 Act

Section 2 provides the Treasury with eight separate powers.

No:

- **person carrying on the business of a banker; or**
- **building society**

may conduct transactions.

No person may deal in:

- **foreign currency;**
- **gold;**
- **silver bullion; or**
- **(for members of a commodity exchange) commodities futures.**

Also the section allows the Treasury to direct that:

- **no member of a stock exchange shall effect any transactions on that exchange; and**
- **the Post Office must suspend the operation of certain banking services provided by it.**

The powers are exercised by a relatively simple procedure. For the powers of the first six bullet points above, the section allows the Treasury means to specify the prohibitions more closely.

A.9 As Box A.1 suggests, the provisions are relatively inflexible and, to some extent, now appear archaic. The procedure – for a Treasury direction – is simpler than for the Section 1 power, but, once again, can take effect no earlier than the day after the day when the direction is made. It is not as flexible as the form of power envisaged in Chapter 5, and does not allow for a fallback mechanism if the Treasury is unable to exercise its power.

A.10 Moreover, as noted in Chapter 4, prohibitive powers of this kind go considerably beyond the kind of power envisaged as useful for handling major operational disruption. The emphasis is very strongly on prohibition. This seems to suggest that the Section 2 powers would also be of limited use in responding to major operational disruption.

Conclusion A.II The 1971 Act powers were not designed to deal with major operational disruption, or for modern financial markets. While difficulties in anticipating all scenarios mean that their usefulness cannot be ruled out, they generally seem likely to be of limited use.

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

This draft Regulatory Impact Assessment (RIA) is concerned primarily with assessing the balance between the benefits that the proposed new powers would provide and any costs or burdens that might be imposed.

Responses to the consultation will play a key role in deciding whether the potential benefits of the new powers outweigh the potential costs and, consequently, whether to go ahead with legislation.

This annex concludes with a request for any comments on the draft RIA.

If the Government proceeds to seek legislation a revised RIA will be published with the draft Bill.

PURPOSE, RISKS AND INTENDED EFFECT

11 September B.1 The 11 September 2001 terror attacks on the US showed that operational disruption could affect many financial institutions at once (see Box B.1 quoting from a discussion paper by the Federal Reserve and other US authorities¹). This raises significant challenges for the UK. Apart from terrorism, major operational disruption might also result from natural disasters (e.g. storms) or from information technology problems (e.g. bugs, viruses).

B.2 Major operational disruption raises important issues for the financial system because operational networks (e.g. physical and telecoms infrastructure) underlie all networks of financial dealings (e.g. markets, payment systems). The effects of major operational disruption need to be coped with quickly in order to protect the financial system, in which high values of money and other assets move very quickly.

Consultation B.3 The Government has published a consultation about how best to promote order in the financial system during major operational disruption. This draft RIA can be found as an annex to that consultation.

B.4 The 'authorities' (used in this document to mean the Treasury, Bank of England and Financial Services Authority²) believe that the main responsibility for handling major operational disruption rests with the private sector. The private sector has done significant work since 11 September to strengthen its response to major operational disruption. The authorities have also been assisting the private sector in this work.

¹ Summary of 'Lessons Learned' and Implications for Business Continuity – Discussion note prepared by staffs of the Federal Reserve, the New York State Banking Department, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission 2002. Available at <http://federalreserve.gov/boarddocs/staffreports/200202/DiscussionNote.pdf>

² FSA.

Box B.1 11 September 2001 – effects on the financial system (1)

From a discussion paper prepared by the Federal Reserve and other US authorities (see footnote to paragraph B.1).

“During the week of September 11, the widespread destruction of physical infrastructure supporting financial institutions in and around the World Trade Center and extensive telecommunications breakdowns throughout the region caused dislocations in financial markets. U.S. equity markets were closed for four days and most bond trading, including Government securities trading, halted for two days. There were significant disruptions in the clearing and settlement mechanisms for Government securities, repurchase agreements, and commercial paper. Although the core payments systems continued to work well, operational failures and telecommunications breakdowns among major financial institutions led to significant liquidity bottlenecks for several days. During this period, the Federal Reserve and other major payment systems remained open well past their normal closing times to accommodate institutions that were attempting to send funds or waiting to receive funds from other institutions. A number of institutions borrowed from the central bank discount window in substantial amounts to obtain sufficient liquidity to continue meeting their obligations. Other institutions and their customers built up high cash balances or held on to Government securities positions for precautionary reasons, exacerbating market liquidity imbalances. Some institutions could not ascertain their own financial positions or those of their customers for several days. Various prudential regulatory requirements were relaxed in the face of credit and liquidity disruptions and unreconciled transactions that caused significant, though temporary, balance sheet distortions across a wide range of institutions. Some transactions were lost and had to be reconstructed, a laborious and inexact process. Vaults containing physical certificates were destroyed and records identifying these certificates were not always readily available. At the same time, the extraordinary levels of cooperation by market participants in the aftermath of the September 11 events helped overcome limitations within the scope of firms’ business continuity planning. Some firms were accommodated by other organizations (including competitors) in the New York City area in finding office space for staff. Customers and counterparties helped re-create transaction records that were lost. Institutions extended credit to customers and counterparties hampered by liquidity shortfalls despite the inherent uncertainty and lack of reliable information in the marketplace about their current financial condition. Large numbers of people inside and outside the financial industry worked long hours to restore communications links that had failed.”

Discussion B.5 The signs – from reactions in New York to 11 September and from the subsequent work of financial institutions in the UK – are that there would be a very strong tendency to market co-operation. Action by the authorities using their existing kit of tools, including informal persuasion, could also help.

B.6 But the pressures on the financial system could be greater than on 11 September, in particular if:

- operational disruption affected the financial system to a greater degree than on 11 September; or
- the underlying financial outlook was already more difficult before the disruption occurred.

B.7 These would be extreme conditions, but it is responsible to consider their implications carefully. The Government therefore believes it is right to raise the issue of whether new legislation could provide a useful **extra tool** for dealing with major operational disruption, which might in some circumstances help promote the health of the financial system (and the wider economy) in the face of such disruption.

B.8 New legislation would **not** replace market-based approaches. The consultation asks whether new legislation might, in some circumstances, be able to help promote order in the financial system in the face of major operational disruption.

Options B.9 There are essentially three main options for Government:

- (1) continue as at present;
- (2) adopt further ways to help the private sector strengthen its approach to the problem; and
- (3) seek new legislation to be available to supplement private sector responses in some circumstances.

(2) and (3) could be pursued together.

B.10 The consultation suggests two possible legislative powers:

- a power to suspend certain financial obligations for a period following major operational disruption. The financial obligations that could be suspended would include wholesale financial market obligations. The actual obligations suspended would be determined by the authorities at the time of the disruption. However, use of the power would **not** prevent two parties who wanted to fulfil 'suspended' obligations from doing so; and
- a power to direct the UK's financial infrastructure (for example, the stockmarket, payment systems) to act in particular ways. Possible actions that directions might be able to order include closing or opening of the infrastructure or modification of its rules. Again, the actual direction would be made under the legislation at the time of the disruption.

B.11 The reasons for identifying these powers are explained in paragraph B.35 and B.36.

B.12 The powers could therefore only come into play during major operational disruption. In particular – because of the possible disadvantages of legislation, and the primacy of the private-sector role – the Government believes that such powers should only be used in extreme situations (and never in a purely financial crisis) and only with support from the private sector (subject to the practical difficulties of taking urgent soundings during major operational disruption). Use of the powers would by no means be automatic. The powers would only be used if the authorities believed that the benefits to the financial system as a whole, and to the wider economy that it serves, outweighed the costs.

COSTS AND BENEFITS

B.13 It is not possible to provide detailed quantification of possible costs and benefits of the options. The form and likelihood of major operational disruption cannot be anticipated. The effects upon the financial system are yet harder to quantify. The discussion in this section outlines the approach taken. It then aims to give a very broad idea of the scale of costs that might arise from major operational disruption, and so to illustrate the importance of making sure that the private sector and the authorities have the best available toolkits to deal with disruption affecting the financial system.

Cost-benefit of the suspension power **B.14** In analysing benefits and costs of a suspension power, it is helpful to distinguish direct and indirect effects. The direct benefits from using a suspension power would be felt by those who no longer had to fulfil suspended obligations for a certain period. These direct benefits would accrue to debtors – to those whose obligations were of the kinds suspended. The direct costs would fall, correspondingly, on the creditors who were owed these obligations. The net aggregate of these direct costs and benefits, at least in monetary terms, would be zero - the direct effect is purely distributional. The value of using the power therefore depends on indirect effects upon the health of the financial system and the wider economy, having regard also to any distributional effects.

Cost-benefit of the direction power **B.15** The benefits from using a direction power would accrue to infrastructure stakeholders who preferred the actions arising as a result of use of the authorities' power to the likely alternative in the absence of such a direction.³ The costs from use of a direction power would accrue to infrastructure stakeholders who preferred the actions that would have taken place in the absence of a direction to those which were, in fact, directed. These benefits and costs would not necessarily be equal. The cost-benefit balance therefore depends on the effects of use of the power upon the health of the financial system and the wider economy, having regard also to any distributional effects.

B.16 The discussions below on benefits and costs of the different options therefore focus upon identifying advantages and disadvantages which the different options might bring through their effects upon the health of the financial system and the wider economy, noting in particular distributional issues for small business and retail financial services customers.

Quantitative indicators **B.17** The effects of major operational disruption depend very much on the circumstances. It is only possible to give very broad quantitative estimates of the possible costs of major operational disruption, as an indicator of the importance of having the right toolkits available to respond to it.

B.18 A New York City Partnership study of the economic impact of 11 September estimated that, for the New York financial sector, “[t]he cost of business disruption, a combination of lost revenues from market closure and dislocation expenses, was about \$1.8 billion⁴], and was partially covered by insurance”.⁵ As suggested in paragraph B.6, 11 September did not result in a systemic financial crisis which could have had much greater costs.

B.19 Although 11 September showed that the risk exists, there has not been experience of a financial crisis caused by operational disruption. However, studies have been carried out to look at the costs of purely financial crises (financial crises arising from financial, rather than operational, difficulties). Hoggarth and Saporta,⁶ for example, estimate the fiscal costs of a Scandinavian banking crisis at 11% of GDP for Finland, 8% for Norway and 4% for Sweden. But they also estimate the consequential output losses of a crisis, which can be very significant, especially in developed countries (e.g. output 45% lower than trend in Finland for the period of the crisis). (For reference, UK GDP in 2001 was £988 billion.⁷) It is **not** possible to conclude that the effects of major operational disruption upon the financial system would be of anything like this order. The nature of the problems raised by major operational disruption is very different from those considered in this study.

³ In some circumstances the infrastructure provider itself could be among these benefited stakeholders, if it wished to pursue a course of action, but only felt legally safe in doing so with a direction from the authorities.

⁴ £1.2 billion at the 11 September 2001 exchange rate.

⁵ *The Economic Impact of the 11th September attacks on New York* (page 23). This is available at <http://www.nycp.org/impactstudy/study.htm>

⁶ *Costs of banking instability: some empirical evidence*, Financial Stability Review, Bank of England, June 2001.

⁷ UK money GDP at market prices – source: *Pre-Budget Report 2002*, Table A.8.

B.20 The 11 September and Scandinavian banking crisis figures give a rough indication of the possible scale of costs of adverse effects in the financial system that might arise from major operational disruption. What these figures indicate is the broad conclusion that the costs of financial crises can be very large. Accordingly, the Government believes it is right to consider whether the private sector and authorities have the best possible toolkit to deal with problems which major operational disruption may pose for the financial system.

BENEFITS

(I) Continue as at present

B.21 The Government believes that market-based approaches, rather than action by the financial authorities, have the main roles to play in promoting order in the financial system in the face of major operational disruption. Market-based approaches include contractual contingency planning and market co-operation.

Contractual contingency planning

B.22 Parties can include terms in their contracts that assist in handling major operational disruption. Such contractual contingency planning has the great advantage that it provides a readily-available means for handling disruption, agreed in advance by the parties. This not only assists in resolving contractual issues when disruption occurs, but increases certainty in advance of disruption which may well also help wider contingency planning.

B.23 Infrastructure system documentation can make provision for what should happen in the case of widespread disruption including, for example, determining who would be responsible for taking the decision, who should be consulted, and what the consequential effects should be. These could include arrangements for closing, not opening, or extending the opening hours of systems and for adjusting the settlement period. For example, the London Stock Exchange rules specify that the Exchange may postpone or extend a settlement period for all transactions or for transactions in specified securities effected on a given day, indefinitely or for a specified period.

Market co-operation

B.24 The great advantage of market co-operation is that the private sector itself resolves issues voluntarily. This puts responsibility for managing disruption where it most appropriately belongs. It aligns the responsibility with general ownership and management responsibilities. It puts those with the most knowledge of a financial network in charge of resolving its difficulties.

B.25 Market co-operation had a significant role to play in responding to 11 September. The Operations Managers Working Group of the New York Foreign Exchange Committee was instrumental in co-ordinating the response of the foreign exchange industry, for example through industry-wide conference calls. The Bond Market Association made recommendations to extend the settlement period in the US Treasuries market. Recommendations which might be made by market committees include market closure, extension of the normal settlement period to give damaged infrastructure and back offices a breathing space to recover, and agreements on the interest rates and compensation to be paid for delays in settling trades.

Authorities' current toolkit

B.26 The tools currently available to the authorities can be effective in supplementing market-based approaches to responding to a crisis. The 1987 hurricane is a recent occasion when the authorities, in co-operation with the markets, dealt with major operational disruption.

B.27 During the hurricane on the night of 15/16 October 1987, London suffered severe physical dislocation which disrupted travel services and caused widespread powers and telecommunications failures. As a result of this dislocation, it became apparent that normal banking operations were impossible and, in particular, the final settlement of payments due to be cleared on that day could not take place. The Bank of England made a statement on the morning of 16 October expressing the view that conditions in the City made clearing settlements impossible that day and suggesting postponement until the next working day. These arrangements were subsequently confirmed by the clearing banks. The Bank co-ordinated the publication of informal guidance on how to treat delayed settlements, including the interest rate to be paid.

(2) Adopt further ways to help the private sector strengthen its approach

Market co-operation **B.28** Recognising both the great value of market co-operation and the possible practical issues to be addressed, the Bank of England and the FSA have already been working to strengthen market co-operation in the UK.

B.29 The UK authorities have been working to ensure that suitable market groups exist in the UK to assume a co-ordination role. In the case of the exchange-traded markets (e.g. equities on the London Stock Exchange), the Exchange itself would take primary responsibility for deciding how to respond, in association with its supervisor, the FSA. The Markets and Exchanges Regulatory Liaison Information Network (MERLIN), which acts as the forum for the recognised exchanges, their associated clearing houses (e.g. London Clearing House) and settlement systems (e.g. CREST), and their supervisors, to discuss issues of common interest, has established a contingency sub-group to co-operate further on practical issues.

B.30 The consultation seeks views on whether there are further ways in which the authorities could usefully help strengthen private-sector approaches.

(3) New legislation to supplement private-sector responses in some circumstances

B.31 The main responsibility for dealing with major operational disruption rests with the private sector. However, there are two possible roles that powers supported by legislation might play in the sort of extreme circumstances envisaged in paragraph B.12. These reflect potential disadvantages of a market-based approach noted in paragraph B.39, and therefore suggest that legislative powers might be able to improve the health of the financial system during major operational disruption.

Breathing space **B.32** A breathing space would enable infrastructure providers and participants in financial markets to address the underlying operational problems without being preoccupied with the immediate financial consequences of these. As well as allowing market participants to address their own problems, it might also provide time for a proper assessment to be undertaken of broader market conditions and the condition of counterparties. It is possible that such powers, judiciously used, could also contain the potential systemic consequences of any significant disruption.

⁸ Costs of actions by financial institutions which are external to those institutions (whether falling upon other financial institutions, or in the wider economy).

B.33 Such breathing space might be created by market co-operation (the authorities' preference). But the potential difficulties with market co-operation noted in paragraph B.39 below mean that there could be a role for the authorities in providing such a breathing space in a more co-ordinated and more definite fashion. This could be a role for powers under new legislation. Externalities⁸ that might arise from a poor outcome, with significant costs arising within or beyond the financial system, could justify this role.

Intervention B.34 New powers might also, in some exceptional cases, be able to promote order in the financial system by intervening, for example, to define market rules or attempt to contain financial problems. Such intervention would generally not be appropriate. However, it could be useful in circumstances where external costs might be significant and in which co-operative market solutions are not available or in which it would take too long to develop them.

A suspension power B.35 It is the possibility of providing a breathing space through legislation that suggests a power to suspend financial obligations, as outlined in the first point of paragraph B.10. This could allow financial institutions to focus on restoration without immediate pressure to settle obligations. It would provide directly for a breathing space – in particular if multilateral co-operation did not occur – but would **not** prevent two parties who wanted to fulfil obligations from doing so.

Box B.2 Examples of use of a suspension power

- **A terrorist attack badly damages a number of significant players in an informal market. Others, however, are still able to operate. By suspending obligations in the market, use of the power could send a clear and *legally-underpinned* signal that settlement of market contracts could be delayed for a specified number of days. Two parties who wanted to settle, and could, would still be able to do so. However, a clear breathing space would have been created for those who were unable to settle, whether because of direct damage from the attack, or because of financial difficulties arising out of it.**
- **Following disruption such as a major terrorist attack or severe weather conditions, virtually no-one can settle any transactions. Use of the suspension power recognises this legally on a consistent basis, and clearly signals the broad timetable to get up and running again. Institutions are able to focus on restoration of operational networks in preparation for resumption of normal business, with less preoccupation with short-term financial pressures.**

A direction power B.36 A power to intervene more directly would be very wide-ranging if it were exercisable in respect of any contract in the financial system. However, some financial networks are more formal in character than others. These networks (stockmarkets and clearing, settlement and payment systems) play a role of 'infrastructure' – financial infrastructure – for the financial system. They have more formal rules than other networks. Because of the strong multilateral nature of these networks, collective action will be particularly important in order to address problems. Also, it is reasonable to suppose that their central positions in the financial system mean that the externalities arising from their decisions during major operational disruption could be large. These considerations suggest a possible power for the authorities to direct financial infrastructure to take certain actions, as outlined in the second point of paragraph B.10.

Box B.3 Examples of use of a direction power

- A terrorist attack in London leads to widespread settlement difficulties in the regulated markets. Opinions differ strongly about the best course of action for resumption of trading, settlement and clearing. After consulting, the authorities are able quickly to prescribe a clear, definitive and consistent solution via the direction power.
- Major operational disruption – e.g. a computer virus – occurs shortly before the end of the month, seriously affecting several banks' system capabilities. These banks' corporate customers can no longer push out credit instructions to employees so that many salaries cannot be paid. Directing a pause in direct debits could protect retail customers by ensuring that automatic outflows from their accounts were put on hold while salaries were also held up by the computer problems.

COSTS**(1) Continue as at present**

B.37 There are weaknesses in the current approach that might hamper a recovery from large-scale operational disruption.

Market based approaches

B.38 A potential weakness of contractual contingency planning is that it may not be practically possible to anticipate contingencies and to provide for them appropriately.

B.39 Potential difficulties of market co-operation, in particular multilateral co-operation, are:

- such approaches rely on readiness to co-operate in difficult situations, including when information may be very limited. This may be undermined by uncertainty about the financial or legal consequences of decisions taken or fear of litigation by stakeholders who may be adversely affected. Individual institutions may also fail to act co-operatively if they fear that they will be disadvantaged as a result of others failing to do so;
- multilateral approaches rely, additionally, on identifying in advance a group of participants who are representative of the participants in the relevant network with sufficient authority to take decisions and promulgate these, in the reasonable expectation that other market participants will abide by them; and
- different market-based initiatives may come up with different answers to the same, or related, questions.

(2) Adopt further ways to help the private-sector strengthen its approach

B.40 This could reduce the potential costs of option (1). The consultation seeks ideas on this approach.

(3) New legislation to supplement private-sector responses in some circumstances

B.41 The primary legislation that would create these powers would have no effect in normal times. However, the possible disadvantages of new legislation include that its existence might lead to:

- **uncertainty about how the authorities might use their powers during major operational disruption.** Such uncertainty could be unsettling. Were it to prove a significant negative factor it might, to some degree, alter perceptions about the UK as a financial centre; and
- private-sector inaction because of increased **moral hazard**. The existence of legislation might lead private-sector institutions to undertake less-comprehensive planning than they otherwise would.

B.42 Disadvantages of using new legislation might include:

- **distributional effects, that might be adverse for some.** A power would only be used if the authorities considered that the net overall effect would be beneficial. But their use might involve costs to some parties; and
- the potential for **knock-on effects** through the financial system being hard for the authorities to anticipate or contain.

B.43 As was noted above, these possible disadvantages – and the primacy of the private-sector role – lead the Government to believe that new legislative powers should only be used in extreme situations (and never in a purely financial crisis) and only with support from the private sector (subject to the practical difficulties of taking urgent soundings during major operational disruption). The powers would only be used if the Government believed that the benefits to the financial system as a whole, and to the wider economy that it serves, outweighed the costs.

SECURING COMPLIANCE

B.44 To ascertain support for use of the powers, orders would be made, as far as possible, only **after consultation** with the private sector (subject to the practical limitations on consultation that may arise in the circumstances of major operational disruption).

B.45 The authorities would communicate, as widely and quickly as possible, the use of powers to ensure they had effect.

Suspension B.46 Compliance issues do not rise with the suspension power – the nature of the power is permissive. It enables certain parties to delay fulfilling obligations if they wish.

Direction B.47 Compliance in the case of the direction power would be secured by monitoring of the situation by the Treasury, Bank of England and Financial Services Authority. Because of the limited class of institutions to which the direction power would be applicable, it is anticipated that monitoring would be relatively straightforward. Legislation would create sanctions for non-compliance which would be set out in the draft Bill for comment, and referred to in the accompanying revised RIA.

IMPACT ON SMALL BUSINESSES

B.48 Small businesses could be affected by the financial system consequences of major operational disruption – for example, through unavailability of payment services. Having an improved toolkit to help promote order in the financial system would therefore assist small businesses.

B.49 There might also be direct effects upon small businesses. The consultation asks whether the suspension power should apply outside wholesale markets, including to financial system obligations of small businesses. The actual benefits and costs of inclusion or exclusion depend upon the circumstances of whatever disruption occurred. Inclusion would give the Government the most options in the event of disruption, whereas exclusion might be preferred because it might seem inappropriate to suspend obligations owed to or from small businesses.

B.50 Small businesses could also be affected by use of the direction power in respect of payment systems, or by the wider effects of use of the suspension power. The consultation also asks for views about the scope of the direction power – including whether it should be extended to cover high-volume payment systems most relevant for small businesses, as well as the high-value systems (which small businesses also use).

B.51 Government will consider the position of small business (and other retail consumers of financial services) before making decisions on possible new legislation. If new legislation were taken, in considering whether to use its powers the Government would, in particular, have to consider the costs and benefits of use for retail customers, including small businesses.

CONSULTATION

B.52 This RIA can also be found as an annex to a consultation on the proposed new powers, which aims to find out if the benefits of having the powers outweigh the cost.

MONITORING AND EVALUATION

B.53 Any use of the powers would, of course, attract significant interest. The authorities would inevitably be held to account via Parliament and the media for their actions. However, new legislation would include more specific accountability mechanisms to safeguard use of powers.

RECOMMENDATION

B.54 To consider whether to go ahead with legislation, and/or efforts to strengthen further market-based approaches in light of the outcome of the consultation.

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

This annex lists all the questions asked in this document.

Chapter 1's Box 1.1 picked out the key broad questions.

- Question 3a** Do you have any general comments about types of market-based approaches to promoting order in the financial system during major operational disruption?
- 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?
- 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?
- 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?
- 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?
- Question 5b** 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?
- 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?
- Question 5d** If the powers were adopted, do you agree they should affect actions in the UK (rather than actions governed by UK law)?
- 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?
- 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 (e.g. 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?
- 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?
- Question Aa** Have you any comments about the usefulness of the Banking and Financial Dealings Act 1971 powers in responding to major operational disruption?
- Question Ba** Have you any comments on this draft Regulatory Impact Assessment?

Other comments would also be welcome.

