

THE FINANCIAL SYSTEM AND MAJOR OPERATIONAL DISRUPTION

SUMMARY

The Royal Bank of Scotland Group welcomes the opportunity provided by the Government to respond to the proposals contained in HM Treasury's recent Consultation Paper 'The financial system and major operational disruption'. While we have some concerns over the adoption of legislation in this area we consider that, properly formulated, it could provide some useful benefits. Our support for such legislation is based on three basic assumptions:

1. We would not wish to see any such legislation reducing the considerable flexibility that the current private sector arrangements allow.
2. New legislation would therefore only be required to cover extremes of operational disruption and should be restricted to areas where private sector action/contingency arrangements could not reasonably be expected to effectively deal with the situation.
3. It is fundamental therefore to define as carefully as is possible the circumstances under which the powers would be used.

We would also note that we believe it to be important that the output from this consultation is consistent with the FSA proposals on operational risk systems and controls, as recently set out in the policy statement for Consultation Paper 142. The FSA propose to publish 'near-final' rules in late 2003 and any inconsistency between this text and the Treasury proposals are likely to present significant problems for firms.

Our more detailed comments and concerns that expand on the points above are noted below.

KEY THEMES

Having reviewed the Consultation Paper we have categorised our comments and concerns into three main areas, as follows:

1. The ability of legislation to respond as quickly and as flexibly as a major disruption requires. This includes recognition of the primary role of the private sector in responding to major operational disruption.
2. The criteria that need to be satisfied for the process within which this legislation to be invoked.
3. The need for very clear definition as to the circumstances under which such legislation might be invoked.

The ability of legislation to respond as quickly and as flexibly as a major disruption requires. This includes recognition of the primary role of the private sector in responding to major operational disruption.

Existing legislation such as the Banking & Financial Dealings Act 1971 provides the authorities with scope to call a bank holiday and to prohibit certain transactions. However, as

the Consultation Paper itself notes these powers are relatively rigid and we would suggest they do not offer sufficient flexibility given the type of major disruption that the proposed legislation is aiming to address. Hence more focused legislation may be helpful in this regard. In the first instance, we would expect that such legislation would support actions taken by the private sector to ensure orderly markets. We believe that such legislation would be best focussed on reducing the possibility of litigation and at providing a legal framework for settling any disputes arising from actions taken in good faith – usually at short notice – by the private sector to support the system. Given the interrelationship of many of the settlement systems it will become increasingly important to have a legal framework for dealing with contagion: the impact of a problem with one system or in one area causing problems in another.

It is important to recognise that the private sector has made considerable progress in planning for civil disruption and we believe that it remains the primary responsibility of private sector to put in place a co-ordinated approach to business resilience and recovery. (For example, as part of the preparations made for Y2K there was significant effort to exercise recovery strategies and plans at an industry level.) We recognise however that there is scope to build on this type of co-ordinated approach. Further work could usefully include considering the impacts of various scenarios and attempting to mitigate these in advance with appropriate recovery strategies and arrangements. Bodies such as CHAPS, APACS, the Bank of England and the FSA could provide a key focal point for such activity. This would enable the majority of possible disruptions to be planned for and the severity of the consequences mitigated with far more foresight and clarity than could ever be achieved during a crisis.

When considering the introduction of legislation in this area we believe it is vital to recognise the international dimension of the payments and settlements markets and the complex interrelationships and dependencies that arise. Action taken within the UK alone is unlikely to be sufficient to deal with all the consequences of such a disaster. Also, London is a major financial centre and it is important to consider and assess the impact that the introduction of any legislation may have on its competitive position. Major operational disruptions are likely to have cross-border impacts and the co-operation of market participants, regulators and industry bodies is key to ensuring successful recovery.

It is also essential that the Government only implement measures under these powers in conjunction with key players within the private sector, as the intricacies and impact of any intervention is unlikely to be fully understood by Government alone.

The criteria that need to be satisfied for the process within which this legislation to be invoked. Associated with this is the need for very clear definition as to the circumstances under which such legislation might be invoked

There needs to be clarity concerning the scope of the powers available under the primary legislation and a clear definition of what constitutes major operational disruption and criteria for the invocation of these powers. The consultation paper appears to favour the granting of over-arching powers to Government in primary legislation, with secondary legislation being effected during a crisis.

It would be expected that the Government's powers should be exercised in "conjunction with" the private sector and the regulatory authorities. The persons with the authority to make

the legislation must have appropriate technical expertise, skills and experience or should consult those with this knowledge.

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

The need for very clear definitions as to the circumstances under which such secondary legislation might be invoked and the roles and responsibilities of market participants and regulatory authorities.

The Consultation Paper notes that such legislation will never be used in a purely financial crisis. However, it may not be clear when a crisis is purely financial. There may be severe operational crises that flow from a financial crisis that need to be dealt with despite being “related” to a financial crisis. For example, a financial crisis in one part of the world could create significant operational disruption in international (and UK) financial markets. Would such an instance be classified as a purely financial crisis or as partly operational and partly financial?

Further, the Consultation Paper notes that legislation will only be used in *extreme* circumstances resulting from *major* operational disruption. It will be necessary to identify the types of situations classified as “extreme” and cases where “major” disruption has occurred. It will be important to have a degree of certainty in the market about how the authorities might use their additional powers and it must be clear when these powers will be invoked. The private sector and the regulatory authorities should also be involved in any decision as to whether secondary legislation needs to be passed and, if so, the scope and content of this legislation.

To prevent uncertainty, it is fundamentally important that the terms used, as highlighted above, are defined as closely as possible.

Lack of clarity could result in market-based solutions being delayed in anticipation of legislative measures being introduced that could over-ride them.

This clarity extends to the need to establish a framework in advance so that, in a disaster, it is immediately clear who should be consulted and who has authority to represent and make decisions for the private sector. As already indicated, it is essential that the private sector is involved in any such decisions.

This leads to another aspect of Government assistance: a key area of support to the private sector by the authorities is provision of liquidity to the system when major operational failure(s) lock up liquidity within a part or parts of the system. Private sector initiatives to date include the introduction of net settlements and support measures that would assist in the failure of a single institution through the provision of a liquidity pool that would enable orderly completion of settlements in the immediate period following a failure. Whilst the private sector can also extend credit lines, for example, to counter-parties who are waiting to receive payments, it is only the relevant Central Bank that can provide additional liquidity to

the system as a whole. Further it is only the regulators who can agree to temporary waivers of such things as credit lines (under LE exposure). We accept that private sector firms should maintain prudent liquidity policies but they cannot on their own hold sufficient liquidity to accommodate major operational failures. Clarification of the actions that the authorities would take would assist with individual firms contingency planning and could actually strengthen the individual firms' liquidity policies by making it clear what they have to do to obtain support from the authorities in the event of a systemic crisis. Again, recognising the likely cross-border impacts of any major operational disruption we would expect that Central Banks would be operate in a co-ordinated manner to help secure market stability and recovery.