

The Financial System and Major Operational Disruption

Summary of Responses

Introduction

1. On 25 February 2003, HM Treasury published a consultation paper, "*The Financial System and Major Operational Disruption*". The paper asks if there is anything that the authorities can usefully do to supplement private sector responses to the threat of major operational disruption (MOD).
2. The consultation exercise closed on 25 April 2003. A total of 36 responses were received (four were marked confidential). This document summarises the responses.

Market Cooperation and Contractual Contingency Provisions

3. Respondents agreed with the Green Paper that the main responsibility for civil contingency planning in the financial services industry rests with the private sector. However, many argued that more could be done to strengthen market cooperation and contingency provisions in contracts.
4. In terms of market co-operation, the following points were made :
 - a. There is always more that can be done. Market co-operation is best achieved through accepted market practice or rule changes. Industry fora such as LIBA and the Exchange's Market Rules Advisory Group are useful for driving behaviour changes, agreeing new processes and increasing cooperation;
 - b. There are a number of cross-industry bodies designed to co-ordinate the response to any major disruption of the financial system. These allow for sufficient consultation and it is difficult to see how the

authorities could strengthen this approach without imposing an additional level of bureaucracy;

- c. The private sector should continue to strengthen market co-operation; the authorities can assist by providing background information on how they would co-ordinate the work of the infrastructure;
- d. The role of the authorities should be limited and subject to the overarching principle of intervening only where and insofar as this is likely to be necessary and helpful;
- e. The authorities could assist by creating a framework that allowed for dispute resolution where unusual circumstances required parties to operate outside their normal contracts, or to reinforce decisions taken in good faith by the market;
- f. There is a risk of a silo approach developing – a failure of different market liaison groups to consult with each other. The authorities should facilitate a forum to enable representatives from appropriate market liaison groups to meet to formalise contacts and exchange ideas;
- g. There needs to be an official coordinating body for the financial services sector to act as the general overseer of the initiatives being undertaken, established by the financial authorities (some respondents thought that the Bank of England was the appropriate body to lead this work). The body might include the various trade associations and market participants, including the exchanges and settlement systems;
- h. There is a need, assisted by the authorities, to establish effective communication protocols to enable market participants to obtain and share reliable information;

- i. In the event of a major disruption, the regulator could act as a central communication hub;
 - j. All market participants should evaluate and strengthen their internal company business continuity and disaster recovery plans and regularly test them;
 - k. The authorities can help to arbitrate and develop industry best practice standards and assist by encouraging and leading market practice changes;
 - l. The location and robustness of contingency sites should come under closer review; and
 - m. Cross market testing should be undertaken at regular intervals.
5. As for contractual contingency provisions, the following proposals were made:
- a. More needs to be done to encourage the use of standard clauses either through trade associations or through the promulgation of standard wording;
 - b. The terms of existing force majeure provisions in contracts should be reviewed in order to ensure that they properly cover major operational disruption. Consistency in the nature of these provisions should be ensured, for example, by the framing of some generally accepted principles;
 - c. The authorities could encourage an international dimension to this work; and

- d. It may be possible for the authorities either to legislate on aspects of force majeure provisions or at least to issue guidance on their use and content.

Legislation

- 6. On the whole, respondents preferred a coordinated, voluntary approach to MOD by the private sector and market infrastructure providers. Concerns regarding new legislative powers were based on the following:
 - a. Lack of clarity about the circumstances that would trigger the exercise of the powers (in other words, what would constitute major operational disruption?);
 - b. The unforeseen nature of the problems that arise after a major disruption;
 - c. The international nature of the UK financial system. For example, the situation of a contract to be entered into between a German and Spanish firm on a UK RIE's trading system, which is novated into a contract with a UK clearing house and settled in both Euroclear Brussels and Swiss SIS. Many respondents argued that these international considerations and cross border issues need to be more fully explored before any legislation is proposed;
 - d. The possibility that the legislative powers might create moral hazard. A market-based approach maintains strong incentives to invest in contingency plans, that will enable them to continue to operate under a wide range of conditions. Legislation may have the unintended consequence of creating a "moral hazard" because of the perception by firms that they will not have any relative advantage in being able to maintain operations even if other firms are disabled;

- e. If the UK were to press ahead, this might trigger other states to take parallel but inconsistent approaches to addressing these issues in a way which might be unhelpful and fragmented. Even if other governments were to follow the UK legislative model proposed, that model may not be well adapted to local requirements or may, in a crisis, be exercised in a way which is less sensitive to market requirements;
 - f. The little time afforded by the timetable for the Civil Contingencies Bill for further evaluation and discussion;
 - g. The possibility that the powers might delay a response to MOD; and
 - h. That the above concerns would undermine London's competitive advantage in the financial services sector.
7. In terms of the specific legislative proposals, there was more support for the suspension power than the direction power. In principle, several respondents appreciated the possible advantage of the breathing space that might be afforded by a suspension power. However concerns remained, in particular:
- a. The possible adverse affect on the global settlement of foreign exchange transactions; and
 - b. The possible knock on effects on contracts under English law between counterparties outside the UK. Suspension could result in a technical event of default due to a failure to perform which would then trigger cross-default clauses in contracts not governed by English law.
8. As for the direction power concerns included:

- a. Again, the possible adverse affect on the global settlement of foreign exchange transactions;
- b. The need to keep markets open in order to maintain confidence, rather than directing their closure; and
- c. The possible resistance of quasi infrastructure to being directed to do things which might be counter to the responses they had already deployed.

Conclusion

- 9. Regardless of whether respondents supported or rejected the proposals, the large majority suggested that more time was needed to consider the complex legal and policy implications of the legislative proposals.
- 10. Matters which respondents thought required further research included the following:
 - a. The powers currently at the disposal of the authorities;
 - b. The measures in place in other major financial centres;
 - c. The circumstances in which the legislation would apply and its scope and content;
 - d. The impact of the proposed new powers on cross border trading, clearing and settlement;
 - e. Ways of avoiding uncertainty in respect of the exercise of the powers;
 - f. The feasibility of declaring same-day bank holidays or “non-business days” (the Hong Kong approach to addressing typhoon risk through declaration of non-business days was cited by one respondent); and

- g. How to make it easier for firms to move management or other functions or personnel from one jurisdiction to another (firms in the US responded to 11 September by transferring some functions to the UK).

Responses received from:

1. London Stock Exchange
2. London International Financial Futures Exchange
3. International Petroleum Exchange
4. London Metal Exchange
5. Virt-x
6. Baltic Exchange
7. CRESTCo
8. Corporation of London
9. London Clearing House
10. Law Society
11. CLS
12. Association of Payment And Clearing Services
13. Federation of European Stock Exchanges
14. British Bankers' Association
15. London Investment Banking Association
16. International Swaps and Derivatives Association
17. The Bond Markets Association
18. Council of Mortgage Lenders
19. International Securities Market Association
20. Investment Management Association
21. Futures and Options Association
22. Association of Corporate Treasurers
23. Bank of England's Foreign Exchange Joint Standing Committee
24. Lloyds TSB

25. ABN AMRO

26. LINK

27. Royal Bank of Scotland

28. ING Bank

29. JP Morgan

30. State Street

31. Morgan Stanley

32. Freshfields