

24 April 2003

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Room 4/16
HM Treasury
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Dear Dan

RESPONSE TO THE HM TREASURY CONSULTATION PAPER ON 'THE FINANCIAL SYSTEM AND MAJOR OPERATIONAL DISRUPTION.'

Firstly, can I thank you, and members of your team, for their presentations at both the Foreign Exchange Joint Standing Committee (FX JSC) Operations subgroup, and its contingency working group formed specifically to consider its response to the HM Treasury consultation paper (CM5751).

Members of the Foreign Exchange Joint Standing Committee, and its Operations subgroup have approved this response to the consultation paper.¹ Members of these Committees, whether individually, or through trade associations, may also have answered separately or are proposing to answer separately.

Before responding, I thought it might be helpful to place the importance of the London foreign exchange market in a global context. Using the April 2001 BIS Triennial Survey data, London accounts for 31% of the global foreign exchange market – the largest global foreign exchange centre. In terms of the currencies traded², sterling transactions only account for 24% of the London market, against 92% for the US dollar and 41% for the euro.

The members of the FX JSC, and its Operations subgroup, account for roughly two-thirds of foreign exchange turnover in London, and can be assumed to represent a significant majority of the foreign exchange trading, by value, that occurs here.

Moving onto the response itself, the Committee strongly welcomes the publication of the HMT consultation draft, firstly because it raises the profile of the issue of contingency planning, secondly because it outlines the current legislative tools available (which many members were not fully conversant with), and finally, probably most importantly, because it recognises the primacy of private sector responses in disaster recovery situations.

This response aims to answer the key questions as outlined on p.6 (Box 1.1) of your consultation draft, as well as three ancillary questions you raise. However before doing this, I think it would be helpful to summarise the broad view of the Committee.

¹ Although the Bank of England and the Financial Services Authority are represented on these groups, the private sector members of the groups have formulated the response.

² Each currency trade consists of two legs and thus the aggregate sums to 200%, not 100% in the BIS data.

The Committee sought to distinguish between localised and more widespread disaster situations. In the latter case, where market based resolutions of problems are not possible, an official response could prove helpful. The New York Foreign Exchange Committee has formalised the following text, which is a useful guide:

Within the scope of currently available technology, firms can prepare for highly robust recovery in a short window of time for concentrated regional disruptions such as a single metropolitan area, for example. However, a catastrophic event would likely imply significant damage to infrastructure and communication systems far beyond a single metropolitan area.

In a *concentrated* based scenario, such as September 11th, private sector responses should be expected to be sufficient to ensure the continued operation of the foreign exchange (and indeed most other) markets. In this type of event a legislative approach might be sub-optimal. The Committee felt that the current proposals, as drafted, were problematic because:

- They could inhibit private sector responses.
- The international impact of their introduction had not been fully addressed.
- The global nature of the foreign exchange market is such that trading could continue elsewhere. Suspending trading in the UK could lead to legal consequences in other jurisdictions, especially if some banks were able to continue to trade and to settle, even if only on a bilateral basis.
- For *catastrophic* events, where legislation might be needed, the proposed suspensive and directional powers may not be the correct vehicles to address the problems generated by the crisis.
- The timetable is also of concern – members asked if the consultation is being rushed to fit in with a legislative agenda, rather than allowing sufficient time for discussion and to consider the impact of the change.
- The paper could also make more reference to the importance of persuasion (p.19 point 3.18) in the authorities' toolkits.
- As a general principle, the Committee felt that providing sterling (and the other currencies) can be transferred between accounts, most banks would aim to move to an alternate centre and continue to operate.

I think one of the most difficult aspects of applying the suspensive power would be the timing and identification of relevant foreign exchange trades.

CLS is currently settling foreign exchange trades with an average value in February 2003 of \$618bn. Of these trades 10% involve sterling (20% if expressed in a form equivalent to the BIS data discussed earlier). I will discuss CLS later but here I would like to stress the importance of CLS related FX business involving sterling being outside the scope of any suspension power as CLS already has the capability within its system and under its Rules both to suspend sterling settlement for a period and to roll-over sterling settlement obligations to the next day should it be deemed appropriate in a crisis scenario.

However, non-CLS foreign exchange trades are more problematic. Let us assume that only those foreign exchange trades involving sterling are affected by the legislation – although this is not clear from the proposals. It would be possible for a bank to pay to its counterparty say Japanese yen earlier in the day, for the suspensive powers to be enacted, and for the counterparty to refuse to pay the sterling leg to the bank. This could lead to large, unexpected credit exposures. The anticipation of this scenario could see foreign exchange market participants refusing to settle any foreign exchange trades until the situation was clarified, leading to a significant impact on a global level before any legislation was applied.

In summary, I can see the case for some form of legislation, to augment the authorities' toolkit, but I am not necessarily convinced that the proposals, as drafted, are the correct approach.

1. *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?*

The Committee believes there is scope to standardise the terms within ‘force majeure’ clauses.

- It is possible that such clauses could be linked into any legislative approach that the UK Government adopts; that is they would become operational during a time of market distress, but then be superseded by any legislative action.
- It was also felt that practical experiences, such as revisions to Non Deliverable Forward contract (a type of foreign exchange contract where the net present value is settled in US dollars, rather than gross) clauses following events in Argentina and Venezuela, could provide useful ‘sign posts’ for this work. Overall some members felt that the crafting of standardised ‘force majeure’ clauses could reduce the need for a legislative approach.
- In addition to the work that the consultation paper notes has been undertaken by ISDA, the New York Foreign Exchange Committee had also carried out work in this area. Further information on their work can be found at <http://www.newyorkfed.org/fxc/fmag1299.html>.

2. *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?*

It was noted that significant progress had already been made by the authorities following the events of September 11th 2001 – for example the creation of the Financial Sector Continuity website, and the formation of the FX JSC Operations sub-group. However there was a risk that there may be a lack of ‘clarity’ with respect to the authorities role. In the 1987 ‘hurricane’ crisis the Bank of England was the only ‘voice’ for the authorities. Now there is a risk that the authorities’ – the FSA, HMT and the Bank – response could become disjointed and less focused.

On the markets side, it was noted that there was a risk of a ‘silo’ approach developing – a failure for different market liaison groups to consult with each other. To that end, it was suggested that the authorities could facilitate a forum to enable representatives from appropriate market liaison groups to meet, to formalise contacts, and exchange ideas. For example the Operations subgroup has already made contact with a similar group operated by ISDA. *This would also address the third bullet point on point 3.15 of your consultation paper.*

- Such contacts could be useful where a set of circumstances could be defined as an ‘emergency’ for one market, but not in other markets.
- It was noted that some thought needed to be given to scenarios where equipment and employees were in separate locations, but the transport infrastructure was not operational. This is something where market bodies could take the lead.

In summary the group concluded that more ongoing, consistent communication between market liaison groups in the City is needed.

3. *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?*

As a general point the Committee felt that legislation could be useful in exceptional circumstances where the private sector was clearly unable to cope. However there should be a presumption against invoking any statutory response. Irrespective of the type and location of the disaster, so long as private sector responses were capable of resolving the problems faced, they should be left alone to do so.

- However there was an argument that in the most extreme, catastrophic cases, where market participants were unable to communicate with each other, that some form of legislation would help to resolve a crisis situation. Referring to the commentary from the New York Foreign Exchange Committee again - *However, a catastrophic event would likely imply significant damage to*

infrastructure and communication systems far beyond a single metropolitan area. In this extreme situation, some form of legislative response could prove helpful – disaster recovery plans should be robust enough to cover most contingencies; but there is an extreme they cannot be expected to cater for.

- However it was unclear that whether, in such a *catastrophic* disaster scenario, having legislation ready in advance of the event would be beneficial – some members wondered if a bespoke response to a crisis formulated immediately after the event, would be of more use?
- In this *catastrophic* situation, the type of response envisaged by the group would be a bank holiday. Maybe the ability for the UK government to call a same-day bank holiday would be an appropriate power? It is important, however, that such a bank holiday declaration is made in advance of or after the CLS settlement period, and that no sterling payments to CLS Bank or “already-settled” CLS transactions involving sterling could be unwound.

The Committee highlighted the following issues with the proposals:

- Would the market respond more quickly to a crisis than, say an official response? For example information could be gathered by the FX JSC and then passed through the Tripartite Committee to HM Government. It might need time to consider the options available and could want further information from the private sector? This could introduce delay and uncertainty into the disaster recovery process.
- Some banks may use global responses as part of their disaster recovery planning – e.g. with a global trading book, banks could simply move their business to Europe or New York. For example one bank’s experience of September 11 was that the global infrastructure was sufficiently robust – their operations simply moved to London, which ran 24 hours a day. Looking at a disaster situation in a purely UK focus may not capture these responses.
- However while this approach was feasible for the major banks with global operations, smaller banks may not have this global infrastructure, and hence could welcome the suspensive powers.
- There needed to be some clarity as to exactly what activity was being suspended – was it continued foreign exchange execution and trading or was it solely settlement? Take for example an FX option – would it be possible to agree an exercise price, but not take delivery of the underlying, or would both execution and settlement be delayed?
- The type of transactions to be ‘suspended’ would need to be precisely defined as well – e.g. only those FX transactions involving sterling if for example the sterling payments system was not operational. This could pose definitional problems, and might lead to uncertainty in the FX market – was transaction X covered by the legislation or not?
- The consequential impact is also unclear. While suspensive legislation could affect foreign exchange transactions, what about derivatives contracts, whose pricing depended on these underlying markets? In the case of those derivatives which required the physical delivery of the currency, would these be captured?
- One member noted that it was possible for an institution, which was unable to communicate in a localised ‘disaster’, might end up relying upon a market-based solution to which it had not contributed. Would the use of suspensive legislation be preferable in this scenario? Or would it be content to ‘trust’ the actions of its peer group? Hence the importance of market liaison groups agreeing generic responses in advance of a disaster situation.
- The management of the suspension was important – the group expressed a preference for an industry-based solution. However the use of legislation might create clarity, but only after the suspension had been announced – prior to this it would create uncertainty. (Which instruments? How long will the suspension last? Will the power be used or not?)
- In addition the danger with the legislative regime was that it might create a reactive regime – seeking to respond to events – rather than some of the current industry approaches where planning was taking place in advance of them. And there was a limit, in the extreme, as to how much you

could spend on contingency planning – e.g. should all settlement areas be equipped with expensive satellite phones?

- Was there an assumption in the proposal that existing market based approaches were not able to cope as well as they could do? One member noted that no ‘gap’ analysis had been carried out.

4. *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?*

Some of the pertinent points to answer this question have been covered in the sections above. In essence the key risks were that legislation could inhibit private sector responses, and that it could have unanticipated effects on existing transactions. In terms of the constraints that should be applied:

- The powers should be seen as an absolute last resort and there should be a presumption that that the powers would not be used.
- There was a need for a system of controls, of checks and balances.
- It was unclear as to how any powers would be implemented? Should some kind of ‘state of emergency’ be declared first?
- The trigger points for implementing the legislation need to be clearly stated.
- It was also noted that in the consultation draft (para. 5.13, second bullet) there is reference to the ‘*option...[for] the requirement for support from the private sector [to use the powers.]*’ Although this was something that the Committee strongly supported, it was unclear as to how this would be formalised – which bodies would be consulted and how? And how would the government show that the market had assented to the use of these powers *ex post*?

5. *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?*

The Committee did not feel it was suitably qualified to comment in depth on this question. However, during discussions, it was agreed that the ability to call a ‘same-day’ bank holiday would be a useful tool in the authorities’ ‘armory.’ A temporary suspension of health and safety legislation might also be advantageous, although it was not specified which aspects of this should be covered. It was also noted that the Government could enforce, in a practical manner, the closure of parts of the infrastructure, by cordoning off buildings etc, leading to some members wondering if legislation were needed. In such a scenario, the ‘doctrine of frustration’ would most likely apply.

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

The consensus view was that there were only a few limited and extreme scenarios in which the use of some form of suspensive power would be appropriate. However this did not mean that the proposed suspensive legislation was the correct response. For example, as already discussed, the ability to call a same-day bank holiday might be a more useful tool in a *catastrophic* situation (see CLS related comment under third bullet of section 3). If the situation were so bad as to prohibit private sector responses, then discretionary suspensions of obligations would not be an appropriate response.

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

The group was much less supportive for the use of directional powers. Of particular concern was the possible use of the legislation and its impact on CLS. Only four CLS members are subject to UK legal

jurisdiction; one of these, it was noted, operated its CLS operations from the Indian subcontinent. The types of questions asked by the Committee were:

- Could the infrastructure, such as CLS, cope with directional legislation?
- Would directional legislation conflict with CLS's existing contingency planning, which had to be robust on a global level?

Other questions

8. *6b – Should retail obligations be included in a suspensions power's maximum scope?*

It is unclear as to whether banks would be able to distinguish between the two categories? Retail is defined as 'small, medium sized businesses or personal customers' in the paper. In the foreign exchange market these 'retail' customers would be presumed to be 'professionals' and thus raise fewer issues than with, for example, the suspension of standing orders. Given the criteria by which 'retail' would be defined would be arbitrary, it would be extremely difficult for banks to distinguish between the retail and non-retail foreign exchange transactions (or at least require a great deal of work to do so, again during a time of market distress). Therefore attempting to differentiate between the two, in the foreign exchange market, would hinder banks' responses to the disaster situation, and so all foreign exchange transactions (other than those made by private individuals through *bureau de change*), if the legislation were introduced, should be captured.

9. *5d – If the powers were adopted, do you agree that they should affect actions in the UK (rather than actions governed by UK law)?*

5e – If the Government seeks new legislation, should it allow the use of powers following major operational disruption affecting a non-UK major financial sector?

It is unclear, given the international nature of the London foreign exchange market, which foreign exchange trades should be captured? Should the powers extend to those FX trades (and I have already discussed the problems in defining this on page 4) which do not involve sterling? Imagine a UK bank trades £100mn of Cable (sterling-US dollar) with a US bank.

- Would the suspensive legislation affect both legs of the trade or only the sterling leg?
- Can UK legislation cover actions in the United States – the transfer of the US dollars from the UK's banks nostro agent to the other? And what is the legal impact of seeking to delay settlement?
- What about CLS with its net (i.e. smaller) pay-ins? Assuming the trade settles through CLS, where multilateral netting takes place, because the funding requirements are much smaller compared to gross settlement, is there the same need to suspend obligations?
- What would the impact be on bilateral contractual settlement (i.e. netting?)
- What if transactions were undertaken under New York law, but occurred in the UK. Should these transactions be captured?
- And how should the 'location' of transactions through electronic trading systems be defined?

With very best regards.

Yours sincerely