

ANNEX 1

Terms of reference

1 The Task Force's terms of reference were¹:

"To make recommendations on the need for and possible form of a legislative response to the threat of major operational disruption in the UK financial services sector, with particular regard to:

- the appropriateness and effectiveness of existing statutory powers, including the Banking and Financial Dealings Act 1971;
- the *force majeure* and other provisions included in private contracts;
- the need for new or amended powers;
- the suitability of the proposed suspension and direction powers set out in the consultation document; and
- the non-legislative measures already put in place by the authorities for dealing with major operational disruption.

"In fulfilling these terms of reference, the Task Force will take account of the responses to the consultation paper, 'The Financial System and Major Operational Disruption', the work already being undertaken by the authorities and the legislative, regulatory and other measures in place in other jurisdictions."

2 The Task Force was composed of representatives from the three financial authorities, the chairmen of the three working groups established to consider contracts, infrastructures and statutory powers and a senior lawyer who was also the chairman of the Financial Markets Law Committee's Emergency Powers Legislation Working Group:

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| Sir Andrew Large | Chairman | Bank of England |
| Alastair Clark | | Bank of England |
| Michael Foot | | Financial Services Authority |
| James Sassoon | | HM Treasury |
| William Blair QC | Regulatory & Statutory Powers Working Group | 3 Verulam Buildings |
| Keith Clark | Contracts Working Group | Morgan Stanley |
| Mark Harding | Infrastructures Working Group | Barclays Bank |
| Bill Tudor John | | Lehman Brothers & FMLC |
| William Lea | Task Force Secretary | Bank of England |

Also attending

| | |
|------------------|------------------------------|
| Paul Mills | HM Treasury |
| John Trundle | Bank of England |
| Andrew Whittaker | Financial Services Authority |

¹ HM Treasury, *The financial system and major operational disruption*, Press Notice 75/03 19 June 2005.

ANNEX 2

Background on the study

Introduction

1 In June 2003, the Government asked Sir Andrew Large, a Deputy Governor of the Bank of England, to establish the Task Force and examine the possible need for new or amended statutory powers to deal with the threat of major operational disruption. The Task Force was asked to examine the issues arising from the consultation, produce an interim report by November 2003 and make final recommendations by February 2004. In the event, with the active support of many from the financial services sector, the Task Force was able to produce this final report over a shorter timetable.

2 The Task Force established three Working Groups to help with its work and to provide additional expertise to deal with the wide range of complex issues raised during the consultation process. These were:

- the Contracts Working Group;
- the Infrastructures Working Group; and
- the Regulatory and Statutory Powers Working Group.

3 The Task Force was composed of representatives from the three financial authorities (Bank of England, Financial Services Authority and HM Treasury), the three chairmen of the Working Groups and a senior lawyer who was also the chairman of the Financial Markets Law Committee's Emergency Powers Legislation Working Group¹.

4 The Financial Markets Law Committee (FMLC) had been invited by HM Treasury to respond to its Green Paper and it decided to conduct an analytical exercise — a 'gap analysis' — to identify whether and, if so, where there were gaps in existing legal provisions to deal with major operational disruption. The Committee established a working group to take this exercise forward and it worked in parallel with the Task Force and has published its own report². Its findings — as they

emerged — were used by the Task Force's Working Groups in preparation of their own reports³.

5 The collaboration between the FMLC and the Task Force has been extremely helpful in addressing a wide range of complex legal issues in a short time frame. For example, the Task Force's Working Groups benefited from having members who were also involved in the FMLC's work. The FMLC report focuses on the adequacy or otherwise of existing statutory powers, while this report takes the matter a stage further by considering whether new statutory powers would be desirable and what else might be done to respond to the threat of major operational disruption.

The Green Paper

6 The Green Paper, *The financial system and major operational disruption*, published in February 2003, sought views on whether new statutory powers were needed to assist in promoting order in the financial system in circumstances of operational disruption⁴.

7 The paper emphasised that the main responsibility for responding to major operational disruption must rest with the private sector. It also explored, however, the potential role of the financial authorities in strengthening market-based approaches. In particular it suggested that new or amended legislation might help to promote order in the financial system by providing a breathing space to identify and address problems and, in exceptional circumstances, enabling intervention, for example, to define market rules. Two specific powers were suggested:

- 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).

¹ See Annex 1.

² Financial Markets Law Committee *Issue 56: Emergency Powers Legislation* December 2003

³ See Annexes 4,5,6.

⁴ Cm 5751 available at http://www.hm-treasury.gov.uk/consultations_and_legislation/major_operational_disruption/consult_operationaldis_index.cfm

Responses to the Green Paper

8 HM Treasury received 36 responses to the Green Paper and these agreed that the main responsibility for civil contingency planning in the financial services industry rested with the private sector⁵. On the whole, respondents favoured measures to ensure a co-ordinated, voluntary approach by the private sector and market infrastructure providers. HM Treasury's summary of responses highlighted a number of concerns that were raised regarding statutory powers⁶:

- lack of clarity about the circumstances that would trigger the exercise of the powers (in other words, what would constitute major operational disruption?);
- the unforeseen nature of the problems that arise after a major disruption;
- the international nature of the UK financial system... Many respondents argued that these international considerations and cross-border issues need to be more fully explored before any legislation is proposed;
- 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 [market participants] 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;
- 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;
- the little time afforded by the timetable for the Civil Contingencies Bill for further evaluation and discussion;
- the possibility that the powers might delay a response to MOD; and

- that the above concerns would undermine London's competitive advantage in the financial services sector.

9 HM Treasury identified a number of specific issues that respondents believed needed more detailed research, including⁷:

- the effectiveness of the powers currently at the disposal of the authorities;
- the measures in place in other major financial centres;
- the circumstances in which the legislation would apply and its scope and content;
- the impact of the proposed new powers on cross-border trading, clearing and settlement;
- ways of avoiding uncertainty in respect of the exercise of the powers;
- 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); and
- 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).

Definition of major operational disruption

10 The Green Paper did not contain a definition of major operational disruption *per se*. Instead, it referred to operational disruption in the context of the 11 September 2001 terror attacks on the US and suggesting that such disruption “might be physical — eg a terrorist attack, or a storm — or affect information technology — eg a computer bug or virus”.

11 The Task Force considered a number of questions surrounding the definition of major operational disruption:

- how large an impact would there need to be for it to be classed as major operational disruption?;
- would the incident have to be of domestic rather than international origin?; and
- would the incident have to be due to operational disruption rather than a financial shock?

⁵ See summary of responses at: http://www.hm-treasury.gov.uk/media//83FEB/fsmod_resp_sum_03_2.pdf

⁶ Ibid paragraph 6.

⁷ Ibid paragraph 10.

How large an impact?

12 The Green Paper envisaged that an event constituting major operational disruption would need to threaten the stability of the UK financial system. The Task Force believed that this was a sensible general criterion — “major operational disruption” should imply the potential to have an impact on financial stability; and it is this threat to financial stability which would justify public intervention. Such impact might arise either as a:

- **systemic effect:** this would be the situation where the inability of a market participant or an infrastructure to meet its obligations results in the inability of other market participants to meet their obligations as they fall due. Such a failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the financial system as a whole; or as a
- **system-wide effect:** this would be the situation, falling short of a systemic effect, where the failure of a market infrastructure, or a market participant, nevertheless causes widespread disruption because it is widely used and there are no ready alternative means for transactions to be completed.

13 It was clear to the Task Force that an event that was so significant as to have systemic impacts should definitely be classed as major operational disruption. However, it was not immediately apparent that all events with a system-wide impact should automatically be considered the same way. For example, should a scenario where a co-ordinated attack resulted in the disruption in all payments processed through the retail payment system, BACS, which processes direct credits such as salary payments, standing orders and direct debits, be classed as major operational disruption?

14 In this context, the Task Force considered the values being processed through different infrastructures and the potential exposures that resulted⁸:

- CHAPS Sterling: daily value of payments £217 billion.
- CHAPS Euro: daily value of payments €118 billion.
- BACS: daily value of payments £10.3 billion.
- Debit cards & credit cards: daily values of £430 million and £410 million respectively.

- LINK (ATM network): daily withdrawals of £287 million.
- LCH: figures are more difficult to calculate but the notional value cleared annually is €220 trillion which could potentially be equated to around €1 trillion per day.
- CREST: daily average value of sterling stock moved £608 billion.

These figures clearly demonstrate at least one or two order of magnitude differences between wholesale and retail values.

15 Individual firms, as well as infrastructures, can play a significant role in particular markets. For example, an analysis of payments through CHAPS recently published by the Bank demonstrated that two settlement banks were each involved (either as an originator or recipient) in 50% of all CHAPS payments (by value)⁹. Similar figures are found in other markets, for example, the importance of Bank of New York and JP Morgan Chase as global custodians for US government securities was clearly apparent in the aftermath of 11 September 2001.

16 Examining the issue from a bottom-up perspective, rather than top-down, and the usefulness of potential measures to deal with major operational disruption — such as powers of direction or suspension — then the Task Force considered that these were more applicable to wholesale markets rather than retail markets. In retail markets, most of the issues surrounding firms’ abilities to deal with operational disruption should be adequately dealt with by the significant ongoing business continuity planning work.

17 In relation to wholesale markets, it is difficult to determine *a priori* whether a particular exposure or value of payment is sufficiently large to be of systemic impact. However, from a broader perspective CHAPS is considered to be a systemically important payment system in the UK and CHAPS, CLS, CREST and LCH have all been designated under the Settlement Finality Directive (which provides for legal certainty in the event of member default). The Task Force concluded that, in terms of definitions, an operational disruption would have to have a *potentially* systemic impact in order to be classed as major operational disruption. Such a disruption might arise from an incident affecting key

⁸ Figures for April 2003 apart from debit & credit cards and LCH which are for 2002.

⁹ Bank of England Financial Stability Review June 2003 — A statistical overview of CHAPS Sterling.

market infrastructures, a number of firms or even, potentially, a single firm.

18 The Task Force decided that insurance contracts, either wholesale or retail, should not be included within the scope of its study¹⁰. Fulfilment of insurance contracts are, in the main, less time-critical than most wholesale financial market transactions with the result that detrimental cascade effects are less likely to develop quickly from the disruption of insurance payments. In addition, pay-outs from insurance contracts are less likely to interact with other parts of the financial system (with the possible exception of credit protection insurance), and so the systemic implications of disruption to insurance contracts are muted. Hence the question of whether to suspend or postpone the fulfilment of insurance contracts is not material in this context.

19 Significant issues might arise in the insurance context if major operational disruption led to the withdrawal of some aspects of insurance cover for an activity critical to protecting the physical health and well-being of the population or economic activity. Immediate withdrawal of cover is, in general, not contractually possible leaving some breathing space for other provision of cover to be sought. The Government has been involved in the Pool Re arrangements since 1993 to ensure that terrorism insurance would continue to be available following withdrawal of insurers from provision of terrorism cover for commercial property. In the case of aircraft and airport insurance in September 2001, the UK Government established a reinsurer to provide terrorist and war-related cover for the industry with the strong presumption that cover would be withdrawn once private sector providers had sufficiently re-entered the market. Government-backed cover was withdrawn in October 2002.

Domestic versus international origin

20 In examining whether major operational disruption could occur in the UK as a result of an event outside the UK, the obvious question to consider is whether the events of 11 September 2001 would at the time have been classed as such. Although the event occurred in the US, the impact was felt in the UK and there was operational disruption in UK and European markets. Given the international nature of many

markets in London and the rest of the UK, there is scope for incidents in a variety of international locations to have an impact on markets in the UK. Taking a bottom up approach, there could potentially be benefits from suspending obligations in relation to markets in the UK as a result of incidents taking place elsewhere. This raises a wider question of whether the UK could take a unilateral approach in relation to international markets, but on the narrow question, the Task Force concluded that an incident outside the UK could have a sufficient impact in the UK to be classed as major operational disruption.

Operational impact versus financial shock

21 The context for the Green Paper, as described above, was of an operational disruption arising from an incident which might lead to physical dislocation — such as a terrorist bombing or a hurricane — or one that might lead to the non-performance of IT systems — such as a virus attack or widespread loss of power. It considered that any new powers should never be used in a purely financial crisis¹¹. The Task Force also concluded that, for the purposes of its work, a purely financial crisis — such as the insolvency of a major firm — should not be classed as major operational disruption. Under the provisions of the HMT/Bank/FSA Memorandum of Understanding on financial stability there are separate, established procedures for dealing with such an issue.

Definition of major operational disruption

22 The Task Force concluded that for an incident to be classed as giving rise to “major operational disruption” the following conditions would have to be met:

- there would *potentially* have to be an impact on the financial system as a whole;
- it could affect either retail financial services or wholesale markets (although wholesale markets were, in general, more likely to be systemic);
- the incident would originate from operational disruption rather than a purely financial shock, such as a bank failure; and
- the incident could have a domestic or international origin, but the impact must have significant potential consequences for the UK financial system.

¹⁰ See paragraphs 6.15 & 6.16 of the Green Paper.

¹¹ *Ibid* paragraph 4.16.