BANK OF ENGLAND
LONDON EC2R 8AH

26 June 2013

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear George,

In my role as Chairman of the Financial Policy Committee, I attach the FPC's formal response to the remit and recommendations that you set out in your letter and attachment of 30 April.

With all best wishes.

Yours ever

FINANCIAL POLICY COMMITTEE RESPONSE TO HM TREASURY'S "REMIT AND RECOMMENDATIONS FOR THE FINANCIAL POLICY COMMITTEE"

On 30 April, the Chancellor set out a series of recommendations to the Financial Policy Committee (FPC) under sections 9E(1) and 9E(2) of the Bank of England Act 1998 (as amended by the Financial Services Act 2012) (the Act). The Committee discussed these recommendations at its policy meeting on 18 June 2013. This document sets out the Committee's response, in accordance with section 9E(3) of the Act. The response is organised around the sub-headings of the HM Treasury document, with additional issues raised in the Chancellor's covering letter covered in the final section.

A. The Government's economic policy

The Financial Policy Committee notes the Government's economic policy, including its objectives for growth and employment.

B. Matters that the Financial Policy Committee should regard as relevant to the Bank's financial stability objective, and the responsibility of the Committee in relation to the achievement of that objective

The Committee acknowledges the matters that HM Treasury recommends the Committee to regard as relevant to the Bank's financial stability objective. The Committee welcomes the clarification that the purpose of preserving stability is to contribute to avoiding serious interruptions in the vital functions which the financial system as a whole performs in our economy: notably, the provision of payment and settlement services, intermediating between savers and borrowers, and insuring against risk. These vital functions are recognised in the Bank's current Financial Stability Strategy.

Of the various types of issues raised, the Committee monitors and considers risks to stability arising from developments in financial markets and its regular briefing includes intelligence gathered from market participants. It also considers risks to stability from conduct issues, where it is briefed by staff from the Financial Conduct Authority (FCA).

One of the Committee's powers is to make recommendations to the Prudential Regulation Authority (PRA) and FCA. The Committee recognises that this role entails making recommendations on general policies and approaches rather than on actions specific to individual firms. The Committee will be briefed on the position of individual firms by the PRA and FCA when relevant to financial stability, as will be the case given the United Kingdom's currently concentrated banking system. The Committee recognises that it could, where appropriate, use its recommendation powers to steer general policies towards types of firms or risks, including the PRA's strategic approach to large systemically important firms, and will do so where appropriate.

C. The responsibility of the Financial Policy Committee in relation to support for the Government's economic policy, and matters to which the Committee should have regard in exercising its functions

<u>i. Recommendations as to the interaction between the Financial Policy Committee's objectives</u>

Under section 9C of the Act, the Committee is to exercise its functions with a view to contributing to the achievement of the Bank's financial stability objective and, subject to that, supporting the Government's economic policy, including its objectives for growth and employment. In addition, the FPC is not required or authorised to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.

In most circumstances, the Committee's primary and secondary objectives will be complementary. Recent experience demonstrates all too well that financial stability is a precondition for sustainable economic growth; a stable and resilient financial system should help to facilitate an efficient flow of funds within the economy and an effective allocation of savings to investment.

The Committee recognises, however, that there may be trade-offs between the objectives on occasions. In such circumstances, it will manage and communicate those trade-offs transparently and consistently, having regard to the proportionality and, where appropriate and practicable, costs and benefits of its actions in the context of its primary and secondary objectives. More broadly, the Committee will set out how its actions contribute to its objectives, including its judgement as to the balance of risks to those objectives and how those risks have evolved and are expected to evolve.

<u>ii. Recommendations as to the interaction between monetary policy and macroprudential policy</u>

Monetary policy and macroprudential policy objectives are, in general, complementary. A resilient financial system is a vital precondition for price stability and helps to ensure changes in monetary policy are transmitted to the economy effectively and predictably; price stability contributes to fostering a stable financial system, by removing the distortions caused by varying inflation expectations.

The actions of the FPC can have implications for the objectives of the Monetary Policy Committee (MPC) and *vice versa*. Where the FPC's actions have an effect on the path of aggregate demand in the short run, the MPC may sometimes both be able and choose to mitigate those effects, consistent with its inflation target. In the current environment, with the extraordinary degree of monetary policy stimulus around the world, the FPC is monitoring whether excessive risk might be accumulating in parts of the financial system. And, with the conventional instrument of monetary policy constrained by the lower bound to interest rates, the FPC's actions may be particularly relevant to the level of aggregate demand, the way the financial system transmits changes in monetary policy to the economy and, therefore, for the MPC's objectives. That makes close liaison between the FPC and the MPC especially important at the current juncture.

In reaching its decisions, the Committee considers the policy settings and forecasts of the MPC, as explained in its June 2013 *Financial Stability Report* (*FSR*). The Committee will continue to explain how it has regard to the stance of monetary policy and the MPC's forecasts. More generally, overlapping membership of the Committees should foster co-ordination. This is enhanced by the sharing of relevant information, briefing and analysis to all members of both Committees. For example, FPC and MPC members are free to attend the other Committee's briefing meetings. The Committees may also have joint discussions if the circumstances warrant it.

iii. Recommendation that the Financial Policy Committee have regard to risks to public funds

As recommended, the Committee considers material risks to public funds arising from its actions to support resilience, or failure to take such actions, in both the short and long run. It seeks to minimise overall risks to public funds in this context where consistent with its statutory objectives, and takes account of any such risks in formulating its actions.

Staff from the Bank, including the PRA, and the FCA brief the Committee on developments that are relevant to financial stability including, as appropriate, the position of individual financial institutions. The Bank executive will alert the FPC to any Public Funds Notices to the Chancellor unless there is an exceptional reason not to do so, in which case the Bank will notify HM Treasury that the FPC is not being informed. Where the FPC is notified, the Committee's briefing will include an assessment of the implications for systemic stability of the failure or distress of the institution in question given its circumstances.

iv. Recommendation to the Treasury on legislative changes to the regulatory perimeters

The Act provides for the Committee to make recommendations to HM Treasury relating to the boundaries between and within regulated activities and products. The Committee will receive regular briefing on the relevant risks to financial stability arising from less regulated sectors and activities from the Bank, PRA and FCA. It will also hold, at least annually, a regular dedicated discussion on the appropriate boundaries around, and within, the regulatory perimeter.

Were the Committee to make a recommendation to HM Treasury in this area, it would, as recommended, provide evidence to explain why a change to the perimeter was a necessary and proportionate response to the risks it had identified, and an explanation of why existing provisions were insufficient.

v. Accountability

The Committee is accountable to Parliament and the public. FPC members are subject to a clear code of conduct designed to preserve the Committee's reputation for integrity and independence of judgement. Members need to be, and be seen to be, independent of

Government and other influences. To promote accountability, all FPC members stand ready to give evidence to the Treasury Committee, including by giving evidence following each *FSR*. As required by the Act, the Governor will also meet with the Chancellor after each *FSR* to discuss matters relating to the stability of the UK financial system, with a public record of the meeting published within six weeks.

Consistent with its statutory objectives and functions, the Committee recognises the importance of reducing uncertainty and boosting confidence in financial markets through its actions. To that end, it will continue to develop its published indicators. But these indicators will be considered alongside a wider set of information, varying over time depending on emerging risks, including market and supervisory intelligence. And the Committee will explain its decisions and judgements in the context of both this analysis and its published indicators. Stress tests of banking sector resilience will also be a key element of the Committee's approach in the future.

The Committee agrees on the importance of clear and consistent communication, especially on decisions reached by consensus. Where a consensus cannot be reached, the results of any vote, including individual members' votes, and the balance of arguments will be set out in the Record of the meeting; and members will be free to explain their vote subsequently. In such circumstances, the Committee will ensure that its communications seek to avoid uncertainty.

Response to additional issues raised in the Chancellor's covering letter

The Chancellor raised three additional issues in his covering letter.

In the context of its response to the recommendations on accountability (section C(v) above), the Committee will, as recommended by the Chancellor, use its end-2013 *FSR* to bring out what it sees as risks to stability that it will pursue as a priority. The Committee will indicate the horizon of any relevant existing global, regional or national initiatives or where any new initiative is needed. This view will be updated over time to respond to new threats, and will be reflected in subsequent *FSR*s.

The Chancellor noted the importance of the Committee taking into account, and giving due weight to, the impact of its actions on the near-term economic recovery at this stage of the cycle. Section C(i) above sets out the Committee's general approach to its objectives. In this context, the Committee judges that the past and current recommendations to the Financial Services Authority and PRA on capital adequacy and liquidity requirements support both financial stability and growth.

In reaching policy decisions and in making recommendations to HM Treasury on its powers and toolkit, the Committee will, as recommended by the Chancellor, seek to co-operate effectively with relevant EU institutions and agencies and conform to EU processes. In some cases, the Committee will need to follow European procedures.