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The Financial Services Bill:

the Financial Policy Committee's macro-prudential tools

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the Financial Policy Committee's macro-prudential tools

Presented to Parliament by the
Financial Secretary to the Treasury
by Command of Her Majesty

September 2012

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Foreword

The events of the last financial crisis revealed the inadequacy of the "Tripartite" system of regulation. There was a lack of clear lines of responsibility, an over-reliance on "tick box" regulation, and not enough exercise of sound regulatory judgement. The failings of this system contributed to the greatest financial crisis in living memory, with repercussions that are still felt across the world. The reforms that the Government are implementing through the Financial Services Bill show that we have learned the lessons of the crisis and are acting accordingly.

In particular, the crisis revealed the need for macro-prudential regulation. Even if individual firms are believed to be sound, when their activities are considered in aggregate, risks to the whole system can emerge. Under the "Tripartite" system of regulation no authority had responsibility for, or the means of, addressing this type of risk. The Financial Services Bill provides for the establishment of the Financial Policy Committee (FPC) within the Bank of England, which will be charged with identifying, monitoring and addressing risks to the financial system as a whole. The Committee will address systemic risks using powers given to it by Parliament to make recommendations and directions.

The UK is not alone in moving to incorporate macro-prudential regulation into its regulation of the financial system; there is a strong international consensus that macro-prudential policies must supplement existing microprudential frameworks. The European Systemic Risk Board (ESRB) in the European Union and the Financial Stability Oversight Council (FSOC) in the United States are just two prominent examples of this international shift.

I believe that a strong, stable and secure financial services sector is vital for the UK. It is clear that instability in the financial sector can have a devastating impact on the health and growth of the wider economy. As the UK's macro-prudential authority, the FPC will have to strike a balance by taking action where necessary to protect the economy by safeguarding financial stability at the same time as ensuring that the capacity of the financial services sector to contribute to the growth of the UK economy is not unduly compromised. Recognising the importance of striking this balance, the Financial Services Bill has been amended to provide the FPC with a secondary objective to support the Government's economic objectives. To reflect the expanded responsibilities of the Bank of England, its governance arrangements will be strengthened by the creation of a new Oversight Committee with the power to commission and publish internal and external reviews of the Bank's effectiveness, including the work of the FPC.

In advance of the Financial Services Bill becoming law, we have established an interim FPC to undertake, as far as possible, the work of the statutory body. The interim FPC has made a number of recommendations to market participants and the Financial Services Authority with the aim of enhancing financial stability. I also asked the interim FPC to evaluate and recommend potential macro-prudential tools that the statutory FPC could be given powers to direct the regulators to implement. I received these recommendations in March 2012, and this document sets out our proposals for the FPC's initial toolkit.

The Government remains committed to appropriate public and Parliamentary scrutiny of the FPC's macro-prudential tools. This document contributes to such scrutiny. The feedback to this consultation will be vital in shaping the statutory instrument that goes before Parliament.

George Osborne
Chancellor of the Exchequer:

18 September 2012

1 Introduction

1.1 The Government has embarked on an ambitious programme of reform to tackle the legacy of the financial crisis that started in 2007.

1.2 The Financial Services Bill, which is currently undergoing scrutiny in Parliament, will fundamentally reshape the UK's financial services regulation by abolishing the failed "Tripartite" structure and providing for three new bodies:

- the Financial Policy Committee (FPC);
- the Prudential Regulation Authority (PRA); and
- the Financial Conduct Authority (FCA).

1.3 The creation of the FPC as a strong, macro-prudential authority within the Bank of England (the Bank) will address a key gap in the previous system of regulation. Even when firms are considered stable on an individual basis, the aggregate behaviour of firms can seriously damage the stability of the financial system. It will be the responsibility of the FPC to oversee the system as a whole, identify potential risks to its stability and take concerted action to address them.

1.4 Alongside the FPC, the PRA will be created as an operationally independent subsidiary of the Bank, responsible for supervising the micro-prudential soundness of individual firms. This will fulfil the coalition agreement to bring responsibility for macro-prudential and micro-prudential regulation together within the Bank.

1.5 As a result of the combined remit of the Financial Services Authority (FSA), participants in financial services and markets – particularly ordinary consumers of retail products – did not always get the degree of regulatory focus or the protection they may have expected or required. Prudential and conduct of business regulation have different end goals and require different approaches, regulatory cultures, skills and experience.

1.6 The creation of the FCA as a dedicated standalone conduct regulator will therefore allow for more a more focused, tougher approach to the regulation of conduct in financial services and a more proactive approach to promoting better consumer outcomes and ensuring market integrity.

The FPC's powers

1.7 The Government is committed to ensuring that the FPC is given appropriate powers to do its job effectively. One of the main failures of the "Tripartite" system was that the Bank was responsible for financial stability, but it did not have the necessary tools to achieve it.

1.8 The FPC's macro-prudential powers are designed to allow the FPC to mitigate risks to systemic stability, for example by influencing the behaviour of firms or placing requirements on them. The Financial Services Bill will provide the FPC with two primary tools: powers of recommendation and powers of direction.

1.9 The FPC will have the power to make recommendations to the regulators (which can be made on a comply-or-explain basis), to the Treasury, within the Bank and to other relevant persons.

1.10 In practice, the Government expects the FPC's broad and flexible powers to make recommendations to be the primary means by which the FPC will address the risks it identifies in many circumstances. However, in some circumstances it will be appropriate for the FPC to direct the regulators to take action. Therefore, in addition to recommendation powers, the legislation will also provide the FPC with a direction-making power over the PRA and FCA.

1.11 When it identifies a systemic risk, the FPC will need to decide whether action is necessary, and which of its levers would be most effective and appropriate to mitigate that risk. In making this decision, the FPC will need to consider a number of factors, including the nature and severity of the risk, the suitability of its existing direction-making powers to address that risk, the urgency of the situation and the complexity of the intervention.

1.12 Given the significant statutory force of the direction power, the Government recognises the importance of ensuring that the macro-prudential tools that are subject to the FPC's direction-making powers are well-designed, proportionate and subject to sufficient safeguards. The Government also considers that Parliament should have a clear role in determining the scope of the power of direction available to the FPC.

1.13 For these reasons, the FPC's direction-making power will be restricted to specific tools set out by the Treasury in secondary legislation under the Bank of England Act 1998 (as amended by the Financial Services Bill).

1.14 The Government is committed to ensuring that potential macro-prudential tools that are covered by the FPC's direction-making power (the "directive tools") are subject to thorough and robust analysis and evaluation. The Government asked the interim Financial Policy Committee (interim FPC) to help undertake this task, which involved a public consultation in December 2011 on the discussion paper entitled *Instruments of Macroprudential Policy*.[1] In March 2012, the interim FPC made recommendations to the Treasury on which tools it believed should be included in the FPC's initial macro-prudential toolkit. The interim FPC's recommendations and analysis have informed the proposals set out in this consultation document.

1.15 The Government recognises that macro-prudential policy is a relatively new area and expects the FPC's directive tools to adapt and evolve over time as the international debate and academic literature on this subject develops and empirical experience becomes more widely available. The scope of existing tools may need to be adjusted over time in order to mitigate leakages or regulatory arbitrage. Tools may be added to or removed from the toolkit as the shape of EU and wider international regulation becomes clearer. The interim FPC have already highlighted additional tools that the FPC may recommend become part of its toolkit in future.

This document and next steps

1.16 This consultation document sets out the Government's proposals for the macro-prudential tools that will initially be subject to the FPC's direction-making powers and asks for comments and responses on those proposals. Chapter 6 contains a draft of the statutory instrument that will establish the FPC's toolkit and Annex C includes a draft of the impact assessment that will accompany it.

1.17 The Government is committed to ensuring that both the public and Parliament are given ample opportunity to scrutinise and examine the proposals set out in this document. The final statutory instrument is expected to be laid in draft before Parliament shortly after the Financial Services Bill receives Royal Assent. The order containing the directive tools will then need to be approved by resolution of both Houses of Parliament, via the affirmative procedure.

[1] *Instruments of Macroprudential Policy*, Bank of England, December 2011.

2 Macro-prudential regulation

What is macro-prudential policy?

2.1 Macro-prudential policy is not, as some have claimed, an invention of the financial crisis. The Bank for International Settlements (BIS) Quarterly Review for March 2010 cites the first international usage of the term "macroprudential" as occurring during a meeting of the Cooke Committee in 1979.[1] In 2000, the head of the BIS Sir Andrew Crockett stated that "in order to build most productively on past achievements in the pursuit of financial stability, we should strive for a better marriage between the micro-prudential and macro-prudential dimensions of the task", arguing that financial supervisors should "consolidate a shift in perspective that is already taking place, complementing the micro-prudential perspective with increased awareness of, and attention to, the macro-prudential facet".[2]

2.2 In 2003, the BIS published a working paper by Claudio Borio titled "Towards a macroprudential framework for financial supervision and regulation?"[3] which described the purpose of macro-prudential regulation as limiting " ... the risk of episodes of financial distress with significant losses in terms of the real output for the economy as a whole" as opposed to micro-prudential regulation, whose purpose is to "limit the risk of episodes of financial distress at individual institutions, regardless of their impact on the overall economy."

2.3 Macro-prudential policy therefore supplements micro-prudential regulation, which focuses on individual firms, by identifying, monitoring and addressing risks to the financial system as a whole – known as "systemic risks". In the recent financial crisis, firms that were considered sound on an individual basis were put at risk by stresses in other institutions and the aggregate behaviour of financial market participants.

2.4 Systemic risks stem from many sources, but experience and academic research – including BIS's 2003 paper – tend to distinguish two main types of systemic risks: those that are related to the time dimension – also known as cyclical risks – and those that are cross-sectional or structural. This distinction has now become a cornerstone of macro-prudential theory and practice.

2.5 As the Government set out in consultation documents leading up to this Bill, cyclical or "time series" risks are related to over-exuberance in the upturn of the economic cycle being exacerbated by systematic under-pricing of risk, leading to asset bubbles, stretched balance sheets and other unsustainable expansionary trends. When the bubble bursts, this effect is switched around, with generalised pessimism leading the financial sector to over-price risk and be reluctant to lend, which can slow the economy's recovery. This underlines the importance of containing the upswing.

2.6 Cross-sectional or "structural" risks are related to connections between firms, the distribution of risk within the sector and structural factors, such as information asymmetries. These risks exacerbate both the upswing and the severity of the downswing.

[1] *The term "macroprudential": origins and evolution,* Piet Clement, BIS Quarterly Review, March 2010. The Cooke Committee was the precursor of the current Basel Committee on Banking Supervision.

[2] *Marrying the micro- and macro-prudential dimensions of financial stability*, Sir Andrew Crockett, BIS Eleventh International Conference of Banking Supervisors, September 2000.

[3] *Towards a macroprudential framework for financial supervision and regulation?,* Claudio Borio, BIS Working Papers, No 128.

2.7 Box 2.A discusses systemic risks in more detail.

Box 2.A: Types of systemic risks

Systemic risks stem from many sources but recent experience and academic research has focused particularly on three aspects, set out below. These types of risks can, however, be closely interrelated.

Cross-sectional risks related to structural features of financial markets:

- information problems: poor information can lead to institutions making damaging decisions. For example, in the last crisis, there was little information available about the distribution of sub-prime mortgages and associated securities. This led to unwillingness to lend due to uncertainties regarding counterparty risk;
- externalities: individual agents sometimes make decisions that have unexpected or unforeseen consequences when considered in aggregate. For example, weakening asset prices can trigger "firesales" of distressed assets, which can lead to further declines in asset prices;
- market illiquidity: illiquidity in markets can exacerbate volatility during periods of stress as thin markets can augment the impact of relatively small trades;
- contagion: vulnerabilities can spread between sectors. This risk can be amplified by poor information or the complexity of financial intermediation increasing the interconnectedness of the financial sector;
- systemically important financial institutions: institutions which are so important that the failure of even a single institution can place the whole system at risk, and
- inadequate market infrastructure: financial markets rely on safe, reliable and efficient payment, clearing and settlement systems. Failure in any of these systems may lead to market disruption.

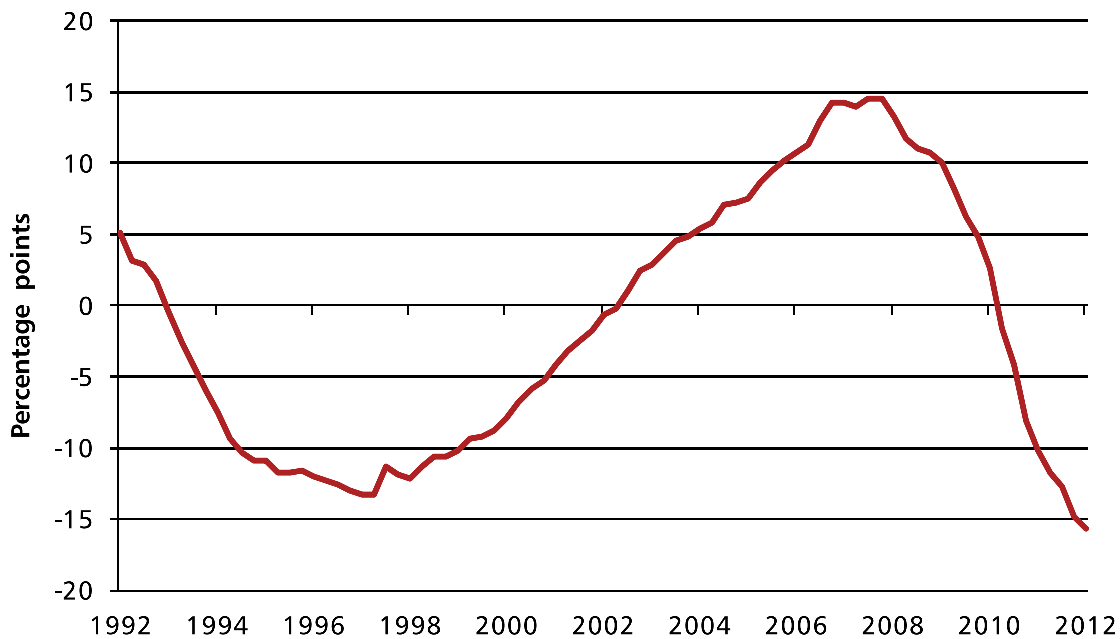
Cross-sectional risks related to the distribution of risk within the financial sector: where a risk is concentrated in a small number of firms or markets or an activity is dominated by a few firms this is more likely to create problems than when risks and services are more evenly distributed throughout the system. For example, an interbank funding market dominated by a few key players may cease to function properly if even one of those players becomes distressed.

Cyclical risks: There is a strong collective tendency for financial services firms, households and companies to underestimate risks when conditions are favourable and to overestimate them when risks materialise. This behaviour can amplify the wider economic cycle. Such pro-cyclical behaviours can manifest in many ways, but in the upturn of the cycle they particularly tend to contribute towards the build-up of unsustainable levels of leverage, debt and credit growth.

2.8 Macro-prudential policy is therefore designed to improve the overall resilience of the financial system by addressing all types of systemic risks – including both cyclical and cross-sectional risks. Taking cyclical risks as an example, macro-prudential regulation would seek to identify and address risks caused by the aggregate behaviour of firms, for example unsustainable increases in the availability of credit or debt during the up-turn of the cycle.

2.9 As demonstrated by charts 2.A and 2.B this pro-cyclical effect helped fuel the rapid growth in lending that preceded the onset of the recent financial crisis.

Chart 2.A: UK credit-to-GDP gap



Source: Bank of England

Why is macro-prudential regulation necessary?

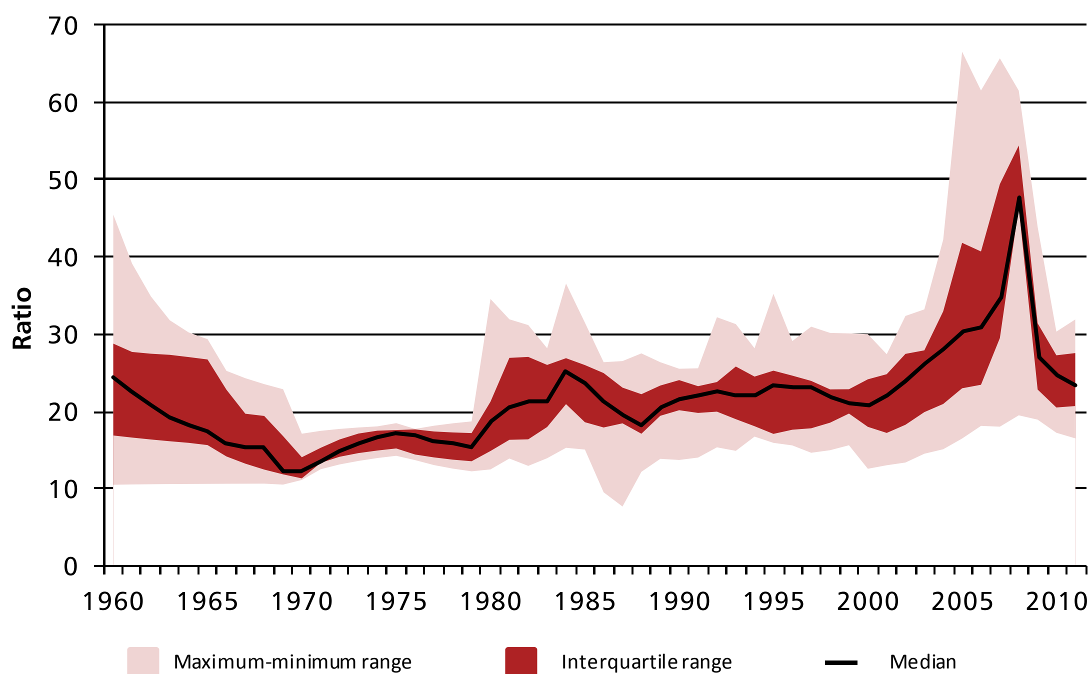
2.10 Financial crises can be global events with far-reaching consequences. Their impact on growth, employment and the public finances can be devastating. During the last crisis, the UK's public finances were placed under great strain as the previous Government had to inject funds into a number of UK banks to avoid their collapse. There was also huge damage to the economy as lenders became overly cautious and asset prices fell rapidly. The impacts of this crisis are still being felt today. In March 2010, the Chairman of the Office for Budget Responsibility (OBR) stated following the publication of the *Economic and fiscal outlook (EFO)*:

> "Our forecasts for the level of potential output over the forecast horizon are broadly in line with those of the OECD and the IMF and slightly more optimistic than those of the European Commission. They all imply a permanent loss of potential relative to the pre-crisis trend. It is this apparent permanent loss of potential that helps explain the structural deterioration in the public finances that has accompanied the financial crisis and the recession, and the consequent need for fiscal consolidation."[4]

2.11 The benefits of macro-prudential regulation accrue by reducing the likelihood of a crisis occurring in any given year, which will mean that financial crises should occur less often. Macro-prudential regulation involves the identification, monitoring and mitigation of systemic risks before they can crystallise, preventing those risks from triggering instability in the financial sector. Financial crises often cause significant output losses and can have permanent or highly persistent impacts on the growth potential of the economy. The Government believes that counter-cyclical macro-prudential policy should also reduce the severity of crises by mitigating the effects of unsustainable behaviours during the boom and can potentially help to moderate the impact of crises once losses materialise. Building resilience during the upswing should increase the loss absorbing capacity of firms and help them maintain credit supply in the downturn instead of deleveraging.

[4] *Briefing on the Economic and fiscal outlook,* Robert Chote, Office for Budget Responsibility, March 2012.

Chart 2.B: UK banks' leverage



Source: Published accounts and Bank of England calculations

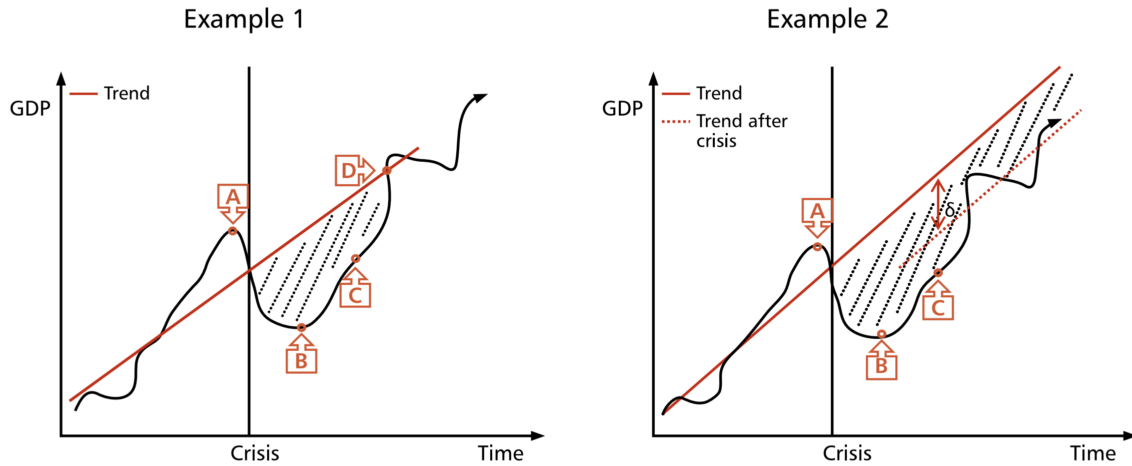
2.12 In this way, excessive volatility in output can be avoided or reduced. The overall effect would be to smooth the supply of credit relative to a financial system more vulnerable to crisis. Smoothing the supply of credit over the cycle should help support the growth of the economy through lower risk premiums, lower precautionary saving and less uncertainty for prospective investment decisions.

2.13 The damage caused by financial crises can be particularly pernicious and persistent. If financial crises are assumed to have permanent "scarring" effects on growth, the potential benefits of macro-prudential regulation can be even more significant as in these circumstances output is permanently lower than it otherwise would have been. This concept can be seen in Chart 2.C below. In Example 1, there is no permanent impact on growth and output returns to its pre-crisis level before resuming to grow at trend meaning that there are no ongoing output costs. In Example 2, there is a permanent impact on growth and although growth returns to its pre-crisis trend growth rate, it does so from a lower starting point. This implies an ongoing output cost as output is lower than it would have otherwise been if not for the financial crisis. This point is illustrated in Chart 2.D which shows the OBR's forecast for potential output and its estimate of the pre-crisis trend. The OBR's EFO March 2012 states:

> "Our latest estimates for 2011 imply a potential output loss of around 8 per cent against a continuation of a pre-crisis trend. This shortfall widens to around 11 per cent by 2016 as potential growth remains below the pre-recession average ..."[5]

[5] *Economic and fiscal outlook,* Chapter 3 Economic Outlook, Office for Budget Responsibility, March 2012.

Chart 2.C: Measuring the cost of crises

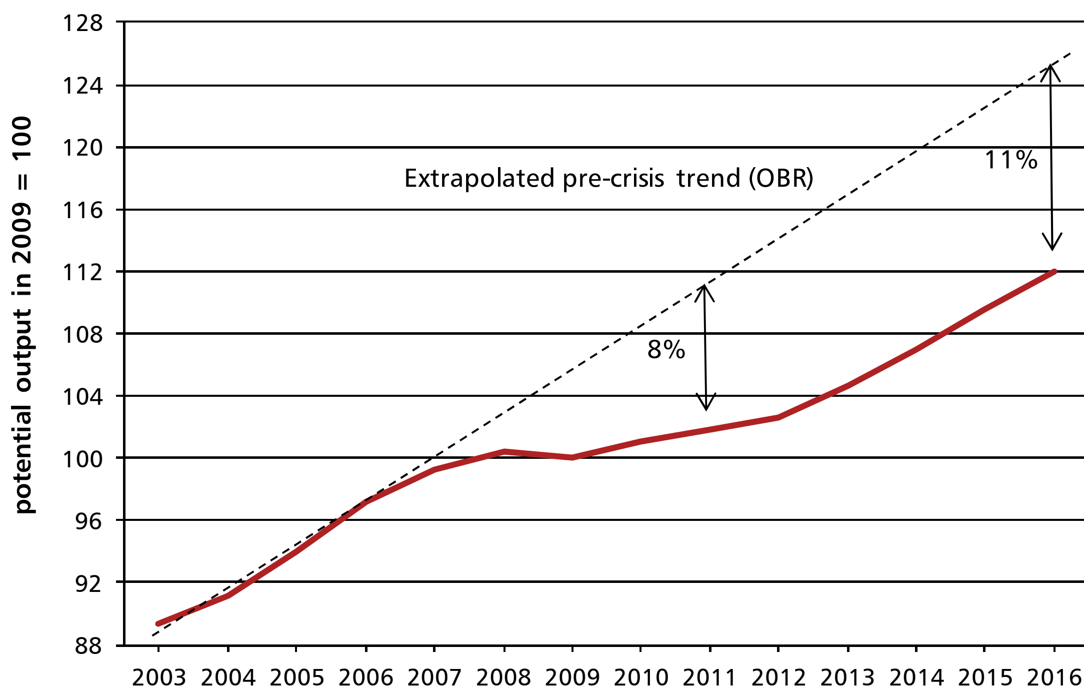


Point A: pre-crisis peak. Point B: post-crisis trough. Point C: GDP growth equals trend GDP growth for the first time after the crisis. Point D: the level of GDP returns to the pre-crisis level.

Source: Basel Committee on Banking Supervision paper An assessment of the long-term economic impact of stronger capital and liquidity requirements

2.14 This means that the costs of financial crises can be huge and long-lasting. Macro-prudential policy aims to avoid or reduce the costs of financial crises whether temporary or permanent, which should accrue significant benefits in the form of avoided damage to output. This may involve making recommendations or imposing additional requirements onto financial institutions in order to enhance their resilience or discourage particular behaviours, but the costs of these actions should be considerably outweighed by the damage to output avoided, even if the probability of a crisis occurring is reduced by a small margin.

Chart 2.D: Projection of potential output



Source: Office for Budget Responsibility

The international macro-prudential programme of reform

2.15 Given the clear benefits of effective macro-prudential policy, it is no surprise that there is an international consensus that macro-prudential regulation should be incorporated into financial regulatory systems around the world. This is reflected both in the UK's reforms and the international programme of reform which is being led by the Financial Stability Board (FSB), the International Monetary Fund (IMF), and the Basel Committee on Banking Supervision (BCBS). The G20 highlighted the importance of macro-prudential policy in 2009 when it agreed 'to reshape our regulatory systems so that our authorities are able to identify and take account of macro-prudential risks'.[6]

2.16 The Government's clear position has always been that the interconnectedness and international nature of financial markets means that macro-prudential policy will be most effective when it is coordinated internationally. Not all systemic risk can, or should, be addressed on a domestic basis alone. Addressing systemic risks domestically may not be sufficient if the same or similar risks reside in other jurisdictions. A solution may need to be applied across many jurisdictions in order to be truly effective.

2.17 Macro-prudential regulation in the UK will be undertaken by the FPC, which will be established within the Bank by the Financial Services Bill. Chapter 3 sets out in more detail the role and powers of the FPC and its composition.

2.18 The Government expects that influencing macro-prudential policy in Europe and internationally will be an important element of the FPC's and the wider Bank's role, whether through the UK authorities' membership of international bodies such as the BCBS, or by advising the Government and others as to how best to communicate macro-prudential risks identified by the Committee.

2.19 International work on the implementation of macro-prudential policy is ongoing but much progress has already been made. In the EU, the Basel 3 accord will be implemented by the Capital Requirements Regulation and Directive 4 (CRR/D4), and the European Systemic Risk Board (ESRB) was established in December 2010 as an independent EU body, with the analytical, statistical, administrative and logistical support of the European Central Bank (ECB), to undertake macro-prudential oversight within the Union.[7]

2.20 The ESRB's core tasks are as follows:

- to collect and analyse information in order to identify systemic risks;
- when significant risks are identified, to provide warnings and issue recommendations for remedial action, in public where appropriate;
- to work with the European Supervisory Authorities (ESAs) to develop a set of indicators to identify and measure systemic risk; and
- monitor the follow-up to warnings and recommendations.

2.21 The ESRB is a coordination body. It does not undertake macro-prudential regulation in individual member states – each country is expected to make their own arrangements for macro-prudential responsibilities within each national jurisdiction. As the ESRB itself made clear in December 2011, "The effectiveness of macro-prudential policy in the Union also depends on the national macro-prudential policy frameworks of the Member States, since the responsibility for

[6] *Global plan for recovery and reform: the Communiqué from the London Summit*, Leaders of the group of 20, April 2009.

[7] More information on the ESRB can be found at http://www.esrb.europa.eu/home/html/index.en.html

the adoption of the measures necessary to maintain financial stability lies first within national frameworks."[8]

2.22 The Government's reforms, as set out in the Financial Service Bill, will comprehensively fulfil for the UK the recommendations of the ESRB regarding national macro-prudential mandates. The Treasury has provided an interim report to the secretariat of the ESRB regarding the implementation of its recommendations. More detail on how the Financial Services Bill complies with the ESRB's recommendations can be found in Annex B.

2.23 Outside the EU, a number of countries have established national macro-prudential authorities. For example, the Financial Stability Oversight Council (FSOC) has been set up in the United States, the Financial Sector Stability Council (FSSC) undertakes macro-prudential regulation of the Mexican financial system and the Bank of Malaysia has a macro-prudential role, to name but a few.

Macro-prudential tools

2.24 Of course, macro-prudential bodies need appropriate powers to intervene where systemic risks are identified. Depending on the nature of the body, levers might include powers to issue warnings or make recommendations, or powers to direct that specific action be taken.

2.25 In the UK, the Government believes that in order for the FPC to meet its objectives, it will need to be able to deploy macro-prudential tools to address the systemic risks that it identifies, via both recommendations and directions. The Government's proposals for the FPC's initial direction-making toolkit are set out in Chapter 4.

2.26 Some tools, however, have already been discussed and developed at international and EU levels. These are set out primarily in the Basel 3 accord and the EU's capital requirements legislation.

Basel 3

2.27 The BCBS published the Basel 3 accord in December 2010. The Basel 3 package of reforms strengthens the micro-prudential framework of internationally-agreed bank regulation and introduces a macro-prudential element into international banking supervision, including provision for a countercyclical capital buffer. The Government welcomes the agreement, particularly the new macro-prudential elements. Among other measures, the Basel 3 accord provides for a countercyclical capital buffer; an additional capital buffer that will be built up in relation to exposures to a particular national jurisdiction according to the relevant national authority's assessment of the build up of systemic risks within its jurisdiction. When losses materialise and the risk has passed, this requirement can be unwound. The countercyclical buffer regime will be phased-in in parallel with the new micro-prudential capital conservation buffer between 1 January 2016 and year end 2018, becoming fully effective on 1 January 2019.

The Capital Requirements Regulation/Directive 4

2.28 As mentioned above, the Basel 3 accord will be implemented in Europe by the CRR/D4. The UK has sought to secure full implementation of the Basel 3 accord in Europe. CRR/D4 will also make provision for the use of macro-prudential tools by national authorities within the European Union relating to firms covered by CRR/D4.

2.29 Although the Government agrees that sufficient minimum standards (such as those set out in the Basel 3 agreement) are an important element of international financial regulation, national authorities must be given discretion to impose standards above the minimum in order to address systemic risks as they emerge.

[8] *Recommendation of the European Systemic Risk Board of the macro-prudential mandate of national authorities*, ESRB, 22 December 2011.

2.30 The European Commission's proposals for the CRR/D4 were maximum harmonised, meaning that Member States would not have the flexibility to set Pillar 1 requirements at a higher level than the minimum agreed under Basel 3. The Government does not support the proposed maximum harmonisation approach as it would significantly constrain the ability of Member States to take action to address systemic risk and protect taxpayers.

2.31 On the 15 May 2012 at the EU's Economic and Financial Affairs Council (known as ECOFIN) the Chancellor of the Exchequer agreed to a Council general approach on CRR/D4. The text that the Government agreed would allow national authorities to operate national macro-prudential policy within a European framework of constrained discretion. The key elements of this framework are as follows:

- the countercyclical buffer;
- the text allows flexibility to increase requirements in the areas of:
    - minimum capital levels;
    - conservation buffer;
    - liquidity;
    - large exposures;
    - disclosure;
    - risk weights for commercial and residential property; and
    - risk weights for intra-financial exposures.

2.32 Macro-prudential authorities will be able to apply certain standards above the regulatory minimum without constraint within agreed thresholds. For example, macro-prudential authorities will be able to increase risk weights on residential property, commercial property and intra-financial sector exposures up to a certain level without prior approval.

2.33 If the macro-prudential authority wishes to apply requirements beyond the agreed threshold, or on any of the other measures listed above, it will be required to notify the ESRB, the European Banking Authority (EBA), and the Commission of its intentions. If any of these authorities provides a negative opinion then the measure must go to the Council. The Council can, however, only block the measure if there is a qualified majority in favour of blocking it.

2.34 The Government supports the system of constrained discretion applicable to the measures listed above. This system strikes an appropriate balance between discretion for national authorities to take action and coordination at the EU level.

2.35 The text voted through by the Economic and Monetary (ECON) committee also contains mechanisms which afford Member States significant flexibility to conduct macro-prudential policy. Negotiations are ongoing and the exact nature of the macro-prudential mechanisms might vary as a result of the discussions between the Council and the European Parliament.

3 The Financial Policy Committee

The role of the FPC

3.1 The recent crisis revealed that macro-prudential regulation is a vital element of financial regulation. In the UK, the existing "Tripartite" system of regulation focused too heavily on the soundness of individual firms and did not give sufficient attention to the aggregate behaviour and trends that can have devastating effects on the stability of the financial sector as a whole. The interconnectedness of financial institutions means that firms that are healthy when viewed in isolation can still be vulnerable to systemic risks.

3.2 The Government is committed to removing the "underlap" which was inherent in the "Tripartite" system – where no single body had the responsibility and the powers for overseeing the financial system as a whole – by creating a powerful, dedicated macro-prudential authority.

3.3 The FPC will be that expert macro-prudential body, established within the Bank, and tasked with identifying, monitoring and addressing systemic risks to the UK financial system. The Committee will be provided with appropriate, proportionate and effective powers to fulfil its macro-prudential mandate. Its discussions and decisions will be subject to robust transparency requirements to ensure that the FPC's actions and judgements are clearly explained, easily understood and subject to effective scrutiny by Parliament.

3.4 The FPC is being established within the Bank to ensure that macro-prudential policy-making (like monetary policy-making) is insulated from political pressures, to enable the Committee to benefit from the expertise and resources of the Bank and to facilitate the coordination of macro-prudential policy with closely related areas such as micro-prudential regulation. This is in keeping with the international consensus that central banks should play a key role in macro-prudential regulation, as set out in the conclusions of Jacques de Larosière's high level group on financial supervision in the European Union and the recommendations of the ESRB.

3.5 In order to ensure a clear delineation between the responsibilities of the FPC and the regulators, the legislation makes clear that the FPC will not be responsible for making decisions in respect of individual firms; that will be the responsibility of the PRA and FCA with regards to prudential supervision and conduct of business supervision respectively. Where relevant to sustaining systemic stability, the FPC will be able to use recommendation powers to steer the PRA and FCA's general policies towards types of firms and risks, including, for example, in the case of the PRA's strategic approach to large, systemically important firms.

Objectives

3.6 The FPC's primary objective will be to contribute to the Bank's objective to "protect and enhance the stability of the financial system of the United Kingdom." In order to delineate the FPC's macro-prudential role within that broad objective, the Financial Services Bill makes clear that the FPC's specific responsibility will be to contribute to the achievement of the Bank's financial stability objective by indentifying, monitoring and addressing systemic risks with a view to protecting and enhancing the resilience of the financial system.

3.7 The legislation sets out that these risks include, in particular:

- systemic risks attributable to structural features of financial markets, such as connections between financial institutions;
- systemic risks attributable to the distribution of risk within the financial sector; and
- unsustainable levels of leverage, debt or credit growth.

3.8 The FPC's stability objective has been drafted to ensure that the FPC will be responsible for tackling a broad range of systemic risks, as outlined in Chapter 2 of this document. On the advice of the Joint Committee on the draft Financial Services Bill, the Government amended the drafting of the FPC's objectives to make it absolutely clear that it does not matter whether these risks originate from within the UK or from abroad and that the definition of structural risks extends to the degree of interconnectedness between firms.

3.9 The Government amended the Financial Services Bill in the Lords stages of its Parliamentary passage to provide the FPC with a secondary objective to "support the economic policies of Her Majesty's Government, including its objectives for growth and employment."

3.10 Financial stability, like price stability, is a prerequisite for long-term sustainable growth. By acting as an effective macro-prudential authority and contributing to financial stability, the FPC will support strong, sustainable economic growth in the UK. The Government has always been clear that while the FPC's primary focus must be financial stability, the Committee must act proportionately and balance the pursuit of stability with the wider impact of its actions.

3.11 Financial stability therefore remains the FPC's primary objective, but the new secondary objective will hardwire economic growth into the decision-making of the Committee by ensuring that the FPC considers the impact of its decisions on the Government's economic objectives for growth and employment.

3.12 In addition to the new secondary objective, the Financial Services Bill already prohibits the FPC from taking any action that it believes would 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.

Membership

3.13 The FPC will perform a key function in the new regulatory architecture and the Government recognises the need for the FPC to include knowledgeable and experienced members.

3.14 The expertise of the Bank will be crucial to the success of the Committee, but it will also be important to inject a strong element of external expertise and challenge into the proceedings of the FPC. This is why the Financial Services Bill provides for four members to be appointed by the Chancellor from outside the Bank in order to provide this vital element of challenge. The Chief Executive of the FCA, which is completely independent from the Bank, will provide an additional external viewpoint on the FPC. The balance of the FPC's membership therefore closely resembles that of the Monetary Policy Committee (MPC), which strikes an appropriate balance between the expertise of the Bank executive and the regulators and the external challenge and direct experience provided by independent members.

3.15 The Chief Executives of the PRA and the FCA will sit on the FPC to ensure that the views of the regulators are taken into account as part of the FPC's decision-making process. They will also ensure that the FPC has access to micro-prudential and conduct of business regulation expertise where necessary. The Government believes that this arrangement will facilitate coordination between the FPC and the regulators.

3.16 The FPC will therefore be comprised of:

- the Governor of the Bank (acting as Chair of Committee);

- the Deputy Governors for financial stability and monetary policy;
- the newly created Deputy Governor for prudential regulation (who will also be the Chief Executive of the PRA);
- two senior Bank executives, responsible for financial stability and for markets;
- the Chief Executive of the FCA;
- four independent members appointed by the Chancellor; and
- a non-voting Treasury representative.

3.17 Monetary and financial policy are both vital to the smooth running of the UK economy and it will be important to ensure effective coordination between the FPC and the MPC. Therefore, the Committees will have significant cross-membership: the Governor, the Deputy Governors for monetary policy and financial stability and the Executive Director responsible for markets will sit on both the MPC and FPC. The Government agrees with the Treasury Select Committee (TSC) and the Joint Committee that scrutinised the Bill in draft that the work of these Committees should be complementary and should not generally come into conflict. However, in response to concerns raised about the need for coordination should such conflicts arise, the Financial Services Bill now allows for joint meetings of these Committees to take place if required.

Levers

3.18 The FPC will use a selection of levers to meet its objectives:

- identification of risks and stresses in the Financial Stability Report;
- the power to make recommendations; and
- the power to direct action by the PRA and FCA with regard to specified macro-prudential tools.

3.19 The FPC can make recommendations:

- to the regulators (the PRA and FCA);
- to the Treasury, for example relating to the Treasury's powers to extend or modify the perimeter of regulation;
- within the Bank, for example regarding the Bank's regulation of systemically important financial infrastructure such as payment and settlement systems; and
- to other persons, for example, directly to the industry or other regulatory bodies.

3.20 Recommendations to the regulators can be made on a 'comply or explain' basis. The regulators would then be required to comply with the recommendation or explain to the Committee and the public why they are not doing so.

3.21 The Government believes the breadth and flexibility of the FPC's powers to make recommendations, coupled with the ability of the FPC to make 'comply or explain' recommendations to the regulators, provides the FPC with a powerful tool to address systemic risks.

3.22 In practice, the Government expects recommendations to be the primary means by which the FPC will address the risks it identifies in many circumstances. However, there will be circumstances in which it is appropriate for the FPC to require the regulators to take action, for example, where decisive action or speed is needed, or where a direction would strengthen the hand of the regulators by giving them a clear mandate to take action. It is important that the FPC is a credible

regulator, and powers to require action will ensure that this is the case. When deciding which of its tools should be used in each case, the FPC will need to consider a number of factors, including the nature of the risk it is seeking to mitigate, the urgency of taking action and the potential benefits of allowing the regulators a degree of greater flexibility over implementation.

3.23 Given the significant statutory force of the direction power the Government recognises the importance of ensuring that the FPC's directive tools are well-designed, proportionate and subject to sufficient safeguards.

3.24 The FPC will therefore only be able to use its direction power over the PRA and FCA in relation to specific tools set out by the Treasury in secondary legislation under the Financial Services Bill. The Government's proposals for the FPC's initial macro-prudential direction powers are set out in Chapter 4.

3.25 The Government has stated in previous consultations[1] that in order to be suitable for inclusion in the FPC's toolkit, a potential tool must be:

- specific;
- subject to sufficient national discretion; and
- focused on system-wide rather than firm-specific characteristics.

3.26 The FPC's macro-prudential direction toolkit will be set in secondary legislation, but it is the Bank of England Act 1998, as amended by the Financial Services Bill, which provides the FPC with the power to make directions. This power is subject to a number of legislative conditions and safeguards:

- directions cannot relate to a specified regulated person. They may refer to all regulated persons or a specified class of regulated persons, for example "banks". Supervision of individual institutions will continue to be the responsibility of the regulators;
- directions may not require the regulators to implement the provisions of the direction by specified means or within a specified period. The regulators will possess the necessary expertise to determine how and when a direction should most effectively be applied to individual firms. However, the FPC will be able to make 'comply or explain' recommendations regarding the timing and means of the implementation of directions; and
- directions may not require the regulators to do anything that they do not have the power to do.

3.27 Box 3.A provides an illustrative example of how the FPC might use its direction power.

[1] *A new approach to financial regulation: building a stronger system*, HM Treasury, February 2011.

Box 3.A: A worked example of the FPC's direction power

By way of example, the FPC might identify a systemic risk posed by credit growth in the commercial real estate sector expanding too rapidly. First, the FPC will assess the risk and determine whether immediate action is necessary. If the FPC judges it appropriate, it might decide to impose additional capital requirements on commercial real estate assets via a direction to the PRA and FCA in order to mitigate the unsustainable credit growth and ensure that intermediaries make their balance sheets more resilient. In urgent or severe cases, the FPC might decide to direct the regulator to take action as soon as the risk is identified. In other cases, the Committee may initially highlight the risk in the FSR, perhaps alongside a recommendation to the industry to draw attention to the concern, or a recommendation to the regulator to monitor the sector more closely in order to gather more information about the risk. Once the FPC considers that a direction is appropriate, the series of events could then be as follows:

- the FPC issues a direction to the regulators to apply additional capital requirements for commercial real estate assets. Alongside this direction, the Committee issues a 'comply or explain' recommendation specifying in detail how this direction should be implemented and the timescale for implementation;
- the regulators will be required to provide one or more reports to the FPC on how it is complying with the direction. The FPC may specify exactly when it must receive these reports;
- unless publication is against the public interest, the FPC will publish the text of the direction as part of the record of the meeting. A copy of the direction will then be laid before Parliament by the Treasury;
- the regulators must comply with the direction as soon as reasonably practical. Except in cases of urgency, this will mean undertaking any relevant procedural requirements under FSMA 2000 before implementing the direction. The regulators will provide the necessary progress reports when required by the FPC;
- the FPC will publish an explanation of why the action is necessary in the next Financial Stability Report (FSR), including, where appropriate, an estimate of the costs and benefits of the action. The FSR will also include an update on the progress of the direction. The FSR will be laid before Parliament by the Treasury;
- the FPC will review the action within a year of issuing the direction to ensure that it is still necessary. A summary of this review will appear in the FSR. Reviews will continue at least annually whilst the direction remains in force. If the risk has been adequately addressed, the direction will be revoked; and
- EU law – particularly CRR/D4 – may require the FPC to comply with additional reporting and procedural requirements when directing the regulators.

Accountability and Governance

3.28 The Government strongly believes that the expanded responsibilities and powers of the Bank must be matched by increased accountability and transparency. With this aim in mind, the Government has amended the Financial Services Bill to reform the governance arrangements of the Bank.

3.29 A new Oversight Committee of the Bank, made up of the non-executive members of Court, will be created with a remit to oversee the performance of the Bank against its objectives and strategy. The Oversight Committee will be able to commission internal or external reviews of the

Bank's performance, which will be published. This will aid the Bank's accountability to Parliament and the public.

3.30 The FPC's macro-prudential toolkit will be set out in secondary legislation. In order to ensure Parliamentary scrutiny, orders which add or remove tools from the toolkit, or amend the terms of the tools will be subject to the affirmative procedure. Under this procedure a draft order can only become law if it is approved by a resolution of each House of Parliament. The Financial Services Bill allows for the toolkit to be amended immediately if necessary by reason of urgency, but a measure introduced in this way will cease to have effect unless approved by a resolution of each House of Parliament within twenty-eight days.

3.31 The Financial Services Bill requires the FPC to produce and maintain general statements of policy for each of its direction-making powers. These statements will set out how the Committee expects the tool to work, including its likely impact on financial stability and growth, and in what circumstances the FPC might expect to use the tool. The Government expects the FPC to publish draft policy statements for its proposed directive tools in time for these to be considered alongside Parliament's scrutiny of the secondary legislation.

3.32 The Government places great importance on the transparency and accountability of the FPC, and has amended the Financial Services Bill to require the FPC to produce and publish an explanation of each of its decisions to give directions, or to give recommendations to the PRA, FCA, Treasury or the Bank in relation to its regulatory responsibilities. These explanations will set out how the action is compatible with the Committee's objectives. Where appropriate, these explanations will include estimates of the costs and benefits of the policy action.

3.33 The FPC will also be required to review its decisions to ensure that any action taken is still necessary and proportionate. These explanations and reviews will be published in the FPC's Financial Stability Report.

3.34 These new measures supplement the existing transparency and accountability measures for the FPC in the Financial Services Bill including: published records of FPC meetings, publication of the semi-annual Financial Stability Report (FSR) and formal meetings between the Chancellor and the Governor following each FSR.

3.35 The Financial Services Bill requires that the FSR contain:

- the FPC's view of the stability of the UK financial system;
- an assessment of the developments that have influenced that position;
- an assessment of the strengths and weaknesses of the UK financial System;
- an assessment of the risks to the UK financial system;
- the FPC's view of the outlook for the stability of the UK system;
- a summary of the activities of the FPC, including the rationale for taking those actions; and
- an assessment of the effectiveness of the FPC's actions, including a summary of any reviews of outstanding policy actions.

3.36 A copy of each FSR will be laid before Parliament by the Treasury.

3.37 The Government and the Bank are aware that the FPC will be required to comply with a large number of administrative and reporting requirements, both by the Financial Services Bill and by EU legislation (for example, the requirements associated with the countercyclical capital buffer are set out in paragraph 4.13). The Bank's staff, including the FPC's own secretariat, will continue to support the FPC by undertaking the administrative and research work that the FPC

needs, including producing and publishing reports and information associated with the FPC's tools and decisions.

Interim FPC

3.38 In February 2011, the interim FPC was established to undertake, as far as possible, the role of the permanent body, in addition to vital preparatory work and analysis into potential macro-prudential tools.

3.39 The interim FPC has held six policy meetings and published three FSRs since its establishment. The Committee has made a number of recommendations to the FSA and the industry in order to improve the resilience of the UK financial system.

3.40 The Treasury asked the interim FPC to undertake analysis of potential macro-prudential tools and present it with recommendations for the permanent Committee's initial toolkit. In December 2011, the Bank published a discussion paper entitled *Instruments of Macroprudential Policy*, prepared by Bank and FSA staff, setting out detailed analysis of the potential directive tools considered most promising by the interim FPC at its September 2011 meeting, and seeking comments on this analysis.[2] The tools considered in this paper are listed in Box 3.B.

3.41 The interim FPC discussed potential tools at its March 2012 meeting and provided recommendations for the statutory FPC's direction powers to the Treasury on 23 March 2012. The Interim FPC recommended that the FPC should initially be given direction powers over:

- the countercyclical capital buffer;
- sectoral capital requirements; and
- a leverage ratio.

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[2] *Instruments of Macroprudential Policy,* Bank of England, December 2011.

Box 3.B: Tools considered by the interim FPC

The interim FPC considered a large number of potential tools as part of its work to provide recommendations to the Treasury regarding the permanent FPC's initial set of directive tools.

At its September 2011 meeting the interim FPC decided to focus on a subset of eleven tools that it felt were the most promising. Detailed analysis of the tools below was presented in the December 2011 discussion paper prepared by Bank and FSA staff:

- countercyclical capital buffer: an additional buffer of capital built up according to the regulator's assessment of systemic risk;
- sectoral capital requirements (variable risk weights): capital requirements added to exposures in particular sectors to address localised risks;
- minimum leverage ratios: a cap on the ratio of capital to total exposures;
- time-varying provisioning practices: requiring firms to hold provisions against expected losses, above those required by current accounting standards;
- restrictions on distributions: restrictions on distributions of profits to ordinary shareholders and to staff via discretionary remuneration;
- time-varying liquidity requirements: requirements to hold high-quality liquid assets above micro-prudential standards;
- loan to value (LTV) and loan to income (LTI) restrictions: restrictions on mortgage financing based on the ratio of the size of the loan to the value of the property or the borrower's income;
- margining requirements: this tool could be used to stipulate minimum collateral requirements for secured financing and derivatives transactions;
- use of central counterparties: requiring specific transactions to be completed via central counterparties;
- design and use of trading venues: requiring that certain transactions take place on a regulated trading venue and also imposing rules and minimum standards on trading venues to enhance their resilience; and
- disclosure requirements: improving firms' regular disclosure or requiring disclosure of exposure to specific risks in order to improve the quality and availability of information.

4 The Government's proposals for the FPC's macro-prudential directive tools

4.1 This document has made clear that a strong, stable and secure financial services sector is vital for the health and growth of the UK economy. The Government is committed to the establishment of an effective macro-prudential authority in the shape of the FPC, in line with a strong international consensus on the importance of macro-prudential regulation. Chapter 2 and the impact assessment included at Annex C set out in detail how the short term costs that may be imposed by macro-prudential interventions are heavily outweighed by the benefits that accrue from those actions, in terms of the reduction of the probability and severity of financial crises and the avoidance of the significant costs and damage they impose.

4.2 In order to accrue the benefits associated with effective macro-prudential regulation, it is vital that the FPC be given appropriate powers to act to mitigate systemic risk and protect financial stability. This chapter sets out the Government's proposals for the FPC's initial set of directive tools, taking into account the likely effectiveness of each tool as a macro-prudential instrument, in addition to the potential impact and costs. The impact assessment at Annex C discusses the costs and benefits of the Government's proposals for the FPC's initial toolkit in greater detail.

The countercyclical capital buffer

4.3 The countercyclical capital buffer (CCB) is part of the Basel 3 agreement and will be implemented in Europe by the CRR/D4.

4.4 The CCB "aims to ensure that banking-sector capital requirements take account of the macro-financial environment in which banks operate. It will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses."[1] Requiring banks, building societies and larger investment firms to build up capital during periods of over-exuberance should help to increase the resilience of the financial system and might also dampen the credit cycle. Unwinding these requirements in the downturn once the particular threat has passed, might help to mitigate contractions in the supply of lending.

4.5 The interim FPC recommended that the statutory FPC should be responsible for setting the level of the CCB and the Government proposes to legislate to provide for this.

4.6 On this approach, the FPC would be responsible for the quarterly decision on the CCB buffer rate for the UK. By adjusting the level up or down, the FPC would be able to adjust the capital held against UK exposures by banks, building societies and larger investment firms[2]. The CCB will be a buffer held in addition to minimum standards for firms' ratios of common equity tier 1 capital to risk-weighted assets (RWA). For example, if the FPC increased the CCB rate for the UK, firms would need to increase their capital ratios in proportion to their credit exposures in the UK

[1] *Basel 3: A global regulatory framework for more resilient banks and banking systems*, Basel Committee on Banking Supervision, December 2010.

[2] Under the current Council text of the CRR/D4 small and medium investment firms may be exempted from the requirement to maintain a capital conservation and countercyclical capital buffer if such an exemption does not pose a risk to financial stability. Under the current European Parliament text, the provisions on capital conservation and countercyclical capital buffers and additional capital buffers for systemic institutions do not apply to investment firms that are not authorised to provide the investment services listed in points 3 and 6 of Section A of Annex I to Directive 2004/39/EC.

to be able to continue to operate without facing restrictions on distributions. To avoid being restricted by these capital conservation standards, firms will decide how best to achieve this new capital level. Typically, firms will raise new capital, retain earnings, divest assets or lower their average risk weight to meet the new requirement (though firms may also choose to reduce the level of their voluntary capital buffers). The transmission mechanism for additional capital requirements is discussed later in this chapter.

4.7 Additional capital will improve the resilience of firms by improving their ability to absorb losses. However, holding additional capital may impose costs on firms, regardless of which approach is taken to adjust the capital ratio. The CCB would be applied only when there is evidence of excessive credit growth likely to threaten the stability of the system (or evidence of other variables suggesting a growth in systemic risk) and the dampening effect it will have on over-exuberance should reduce the severity of financial crises.

4.8 The effectiveness of the CCB may be limited by the robustness of risk-weighted asset measures. If risks are developing in areas with low risk weights, increases in the CCB level would have a limited impact on lending behaviours in those sectors relative to the impact on high risk-weighted assets. The CCB is a relatively blunt tool and may be unsuitable for addressing risks building in isolated sectors. Combinations of CCB increases and capital requirements for specific sectors may be required to mitigate some risks effectively.

4.9 Firms would have up to a year to comply with increases in the CCB in order to provide sufficient time for them to meet the requirement. The FPC can set a deadline shorter than a year where justified by exceptional circumstances.

4.10 Immediate application of increases in the CCB could result in larger costs for firms as raising capital or changing the balance of their assets quickly can be costly. Firms whose capital ratios fall below the buffer level would face restrictions on distributions until the required capital position was reached. Reductions in the CCB may apply with immediate effect allowing firms to free up resources to help maintain credit supply.

4.11 As noted above, the CCB rate set by the FPC would apply to the UK exposures of banks, building societies and larger investment firms. The Basel 3 agreement and current legislative drafts of its implementation in the EU (CRD 4) provide for mandatory reciprocity between national regulators with regards to adjustments in the CCB rate up to 2.5 per cent, and voluntary reciprocity above this level. For example, if the FPC were to raise the CCB rate for UK banks' UK exposures, other national regulators would require banks and investment firms to hold an equivalent capital requirement against their UK exposures, at least up to rates of 2.5 percent. This helps to ensure a level playing field and prevents the effectiveness of this tool being undermined by foreign lenders who might otherwise step in to make up any reduction in credit supply. Other jurisdictions will set a national CCB rate that they feel is appropriate and firms that operate internationally will face a CCB that is effectively the weighted average of the CCB rates that apply in each jurisdiction where a firm's relevant credit exposures are located. For example, a firm with exposures to the UK and France would have a total buffer amount determined by the rate set by the FPC and the rate set by the French designated authority, weighted by its credit exposures to each jurisdiction.

4.12 As the CCB is expected to be provided for in the CRD4, the simplest way to incorporate it into UK law is via regulations made under section 2(2) of the European Communities Act 1972 ("the 1972 Act") to transpose into UK law the provisions of the CRD4 which relate to the CCB. This will mean that when setting the CCB rate, the FPC will not be using the direction-making power set out in section 9K of the Bank of England Act (as amended by the Financial Services Bill), rather it will be using a separate power provided to it by the regulations which will incorporate CRD4 into UK legislation.

4.13 The Council general approach on CRD4 agreed at ECOFIN on 15 May 2012 would place a number of procedural and reporting requirements on the designated authority for the CCB, including requirements to:

- calculate and publish for every quarter a reference "buffer guide" based on the deviation of the ratio of credit-to-GDP from its long-term trend;
- assess and set every quarter the appropriate countercyclical buffer rate for its Member State;
- if setting the buffer rate above zero for the first time, or when thereafter increasing the buffer rate, decide the date from which firms must apply the increased buffer rate;
- if setting the buffer rate at zero, or reducing the buffer rate (whether or not it is reduced to zero), decide an indicative period during which the buffer rate is not expected to be raised;
- publish the buffer rate and other relevant information on its website;
- notify the ESRB quarterly;
- take all reasonable steps to coordinate the timing of buffer rate announcements with other authorities;
- decide whether to recognise buffer rates in excess of 2.5 per cent set by other authorities in other Member States and third countries;
- if no rate has been set for a third country by a relevant third country authority, decide whether to set a buffer rate for that third country; and
- if a rate has been set for a third country by a relevant third country authority, decide whether to set a higher rate for that third country.

4.14 Due to the significant number of administrative tasks associated with the CCB, the Government intends to specify the Bank as the designated authority for the CCB, with responsibility for taking policy decisions in relation to the buffer delegated to the FPC. This will enable the Bank itself to undertake the administrative tasks required by CRD4, and allow the FPC to concentrate on taking the substantive policy decisions.

4.15 The Government believes that the FPC's decisions in relation to the CCB should be subject to comparable procedural and reporting requirements to the FPC's other tools. Therefore, in addition to the requirements imposed by the EU legislation, the Government intends to ensure that the CCB will be subject to the same transparency requirements as other FPC decisions, with a summary of the FPC's discussions when taking decisions on the CCB set out in the FPC's meeting record and the FPC's use of the CCB covered in the biannual FSR. The Government will make any necessary changes to achieve this in the regulations under the 1972 Act which incorporate CRD4 into UK law.

4.16 As mentioned in Chapter 2, the CCB regime will be phased-in in parallel with the new micro-prudential capital conservation buffer between 1 January 2016 and year end 2018, becoming fully effective on 1 January 2019. However, the Council general approach on CRD4 would allow Member States the flexibility to introduce the CCB earlier. If the final version of CRD4 includes this provision, the Government intends to use this flexibility to give the FPC power over the CCB buffer rate for the UK as soon as practicable after the directive comes into force.

4.17 The Government recognises that the reciprocity arrangements set out in paragraph 4.11 above will not be fully legally binding until 2019 (the effect of the transitional provisions in

CRD4 relating to the CCB is to permit Member States to cap the increase in a bank's capital ratio as a result of the tool to 0.625 per cent in 2016, rising to 1.25 per cent in 2017 and to 1.875 per cent in 2018 regardless of what buffer rates are set by individual jurisdictions). If the FPC increases the UK CCB rate before that date, the Government expects the FPC to seek to mitigate any leakage effects where possible.

Box 4.A: Consultation questions

1. Do you agree that the FPC should be responsible for setting the level of the CCB in the UK?
2. Do you have any views on the Government's proposal to give the FPC control over the CCB buffer rate for the UK before 2016?

Sectoral capital requirements

4.18 The interim FPC recommended that the statutory FPC should have a power of direction to vary financial institutions' capital requirements against exposures to specific sectors over time. The Government is minded to agree that the FPC should have this power and proposes to legislate to give the Committee the power to adjust requirements within the constraints set by European legislation.

4.19 This tool would allow the FPC to target risks that emerge in particular sectors, providing a more targeted tool than the CCB. The Council general approach on CRD4 explicitly allows national authorities to increase sectoral capital requirements for residential property, commercial property and intra-financial sector exposures, although the final text may provide further discretion over other sectors. The Committee stated in its recommendations that the over-exuberance that precedes crises often occurs in specific sectors before spreading further. A targeted tool would be useful for addressing localised risks more efficiently than by using increases in the level of the CCB alone.

4.20 For example, if the FPC believed that systemic risks were arising from the growth of residential mortgage exposures, the Committee could use this power to require institutions to hold capital above normal micro-prudential requirements for exposures to that sector. If the FPC felt that lending to purchase commercial property was expanding beyond sustainable limits, it could impose additional requirements on commercial property exposures. These requirements could be imposed on the stock of existing assets, new loans only or both. If the threat is from the whole book, then targeting requirements at a firm's stock of existing assets might be sufficient. On the other hand, if the threat to stability stems from the risks in exuberant current lending, it may be more desirable to target new loans. Applying requirements to new loans might enable sharper targeting of exuberance but would be administratively more complex to implement both for firms and for the regulator.

4.21 This additional requirement would increase the resilience of firms to potential losses from those exposures and could also dampen down over-exuberance by increasing the cost of supplying credit to that sector. However, the costs of meeting additional capital requirements or adjusting the balance of their exposures would need to be met by firms or passed onto shareholders or customers.

4.22 Although the targeted nature of this tool should allow the FPC to address localised risks more efficiently than imposing broad capital requirements, the impact of this tool is likely to be more concentrated as well. For example, imposing additional requirements on commercial property exposures could increase the short term costs to businesses of acquiring property. The FPC would need to be mindful of this type of impacts when determining whether to use this tool to mitigate a specific risk to stability.

4.23 There is a risk that imposing requirements of this sort would merely displace excessive risk taking into other sectors. As such, the FPC would need to monitor carefully the impact of any policy interventions using this tool and may need to consider adjusting general requirements (for example via the CCB) if displacement is a significant problem.

4.24 The interim FPC has stated that they would wish to avoid an "overly activist, fine-tuning approach". This suggests that the Committee would generally impose additional capital requirements on broad sectors, rather than on very specific exposures. It also implies that the FPC will not seek to vary or fine-tune sectoral capital requirements on a continuous or frequent basis. The Government agrees that this is a sensible approach. The Committee did, however, state that the ability to adjust requirements at a greater level of detail – for example on mortgage or other property-related lending based on its loan-to-value or loan-to-income ratio at origination – might prove useful. The Government believes that, on balance, using sectoral capital requirements in this way could be an effective way to address risks in these markets by influencing the cost of mortgage financing without imposing blunt quantitative restrictions on lenders. In addition, using capital requirements in this more targeted way would be less costly overall than imposing additional requirements to all residential mortgages, since it would only increase capital requirements on some types of mortgage lending. However, using the tool in this way could make it more costly for some consumers to gain access to mortgage finance. The Government will keep this tool under review to ensure that its use does not cause disproportionate adverse implications for the Government's objectives for housing and access to finance.

4.25 It should be noted that responsibility for supervision of individual firms and the models they use for determining risk-weighted capital requirements will continue to be the responsibility of the regulators – the PRA and FCA. The FPC would apply standards above microprudential minima to address systemic risks, and would be able to make recommendations on the regulators' general micro-prudential approach (for example, their approach to assessing the adequacy of firms' internal models) where that was relevant to stability.

Box 4.B: Consultation questions

3. Do you agree that sectoral capital requirements will be an effective macro-prudential tool for the FPC?
4. Do you agree that the FPC should have the ability to apply granular requirements e.g. differentiated by LTV or LTI for residential property related assets?
5. Do you have views on how macro-prudential sectoral capital requirements should be integrated with the existing micro-prudential framework?

Leverage ratio

4.26 The interim FPC recommended that the statutory FPC should have a power of direction to set and vary a minimum leverage ratio.

4.27 The Government acknowledges that a leverage ratio could potentially be a useful macro-prudential tool for the FPC, and that there could be financial stability advantages to the FPC having a direction power that is not linked to risk-weights, as a complement to risk-based macro-prudential tools such as the counter-cyclical capital buffer. The unweighted nature of the leverage ratio would guard against risk-weights underestimating the true riskiness of bank assets in an upturn, and provide a directly comparable figure across firms. Firms' leverage ratios were a useful indicator of failure during the last crisis, and the period immediately preceding the crisis was characterised by sharp increases in leverage.

4.28 However, because a leverage ratio is unweighted, imposing more stringent standards could impose greater costs on firms with low risk business models compared to those with high risk

business models. This is because low risk-weighted assets would otherwise have lower capital requirements. This could risk creating perverse incentives for low-risk institutions to "risk-up" and take on higher yielding but riskier exposures.

4.29 The Government strongly supports the inclusion of a backstop leverage ratio in the EU prudential toolkit and considers it an essential measure to ensure that leverage remains at sustainable levels. As the Government set out in its White Paper on banking reform:

> "An international consensus has developed that a leverage ratio (a minimum capital requirement that is independent of banks' risk-weights) would be a useful backstop to risk-based capital ratios. Basel 3 proposed that banks should be benchmarked against a 3 per cent Tier 1 leverage ratio (with the design and calibration of the ratio to be reviewed in 2017), with the view to introduce a binding minimum leverage ratio from 2018. The Government strongly endorses the principle of a backstop leverage requirement, and will continue to press for full implementation of Basel 3 in the UK through European legislation."[3]

4.30 The final position of the leverage ratio in the CRR/D4 is not finalised, but it is clear that a leverage ratio will not be implemented across the EU until 2018.

4.31 The Government believes that it is important to maintain consistency with international and European standards. The Government intends to provide the FPC with a time-varying leverage ratio direction-making tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards. The precise design of the tool will depend on the provisions of the relevant European legislation and will be set out in secondary legislation to be introduced by the Government at the time. In the interim, the FPC will be able to address risks stemming from unsustainable leverage or inaccurate risk weights in other ways, such as via recommendations or by adjusting sectoral capital requirements.

Box 4.C: Consultation questions

6. Do you agree that the FPC should have a direction-making power for a time-varying leverage ratio once international standards are in place?

Transmission mechanisms for capital requirement tools

4.32 The tools discussed in this chapter would enable the FPC to impose macro-prudential capital requirements on firms. This would enhance financial stability by increasing the loss-absorbing capacity of firms, making them more resistant to shocks and other losses. The FPC may also influence the behaviour of financial institutions via expectations regarding future policy decisions. For example, highlighting a risk in the Financial Stability Report may change the behaviour of firms if they expect future policy action regarding the risk.

4.33 Although imposing macro-prudential requirements or altering the behaviour of firms by other means will result in greater resilience and financial stability, these requirements may create costs to firms which might be amplified in the short run due to frictions in markets. If, for example, several banks attempt to raise new equity at the same time, investors might demand a premium. Furthermore, firms may not be able to reprice all loans instantaneously following an increase in funding costs, resulting in a larger increase in spreads on new or repricable loans. The PRA and/or the FCA, as the regulators of individual firms, will implement the macro-prudential policies of the FPC and will ensure that these policies are implemented in an appropriate manner and timescale to maximise their effectiveness.

[3] Banking reform: delivering stability and supporting a sustainable economy, June 2012, para 3.18, at p. 36.

4.34 As mentioned in paragraph 4.6, in principle, unless firms run down voluntary buffers, they can respond to an increase in capital requirements by:

- increasing retained earnings, for example by reducing cash dividend payments or bonuses;
- issuing new equity and reducing other forms of funding; and
- reducing risk-weighted assets by either reducing the size of their loan portfolios or shifting the composition of their balance sheets.

4.35 Retaining earnings would allow firms to build capital without the need to raise equity in the markets or deleverage. However, empirical evidence suggests that firms may be reluctant to cut dividend payments (firms may wish to maintain distributions to shareholders to reassure markets that their position is healthy), and banks may feel unable to cut remuneration (this is often declared as necessary to retain high quality staff). Greater flexibility in both of these areas could, however, emerge under a macro-prudential regime. In particular, capital conservation standards will apply automatically if a firm fails to maintain the CCB buffer, which will directly restrict the firm's ability to distribute earnings. The interim FPC has also made a number of recommendations to industry regarding distributions policies.

4.36 The resulting costs of raising new equity may be offset by perceptions that firms are safer as higher capital makes them more resilient, but any costs not offset by this would need to be met in some other way; possibly internalising the costs or raising the price of lending, leading consumers and businesses to change their borrowing behaviour. Increasing the price of lending will impact the behaviour of consumers and businesses, reducing the amount of consumption and investment funded by borrowing. This could negatively impact the output of the economy, but enhance the resilience of the financial system.

4.37 If firms chose to adjust by cutting risk-weighted assets, the quantity of credit supplied may be directly affected as firms deleveraged. How firms adjust their asset portfolios will be dependent on prevailing market conditions and their own reaction functions.

4.38 These actions could lead to a lower volume of credit which is likely to enhance the resilience of the financial system in exuberant conditions but may lower short-term output. Any decrease in investment could have a longer-term impact on output through a reduction in the capital stock. However, investment may be misallocated during credit booms and any short-term output costs are likely to be outweighed by a better allocation of credit, the benefit of lower long-term output losses due to less frequent financial crises and the beneficial impacts of reducing excess volatility in the supply of credit through the cycle. Illustrative estimates of the net benefits of providing the FPC with macro-prudential direction powers are included in the impact assessment at Annex C.

4.39 There is considerable uncertainty about firms' reaction functions to changes in capital requirements. It is not clear which of the actions set out above firms might take, nor whether they would all act in the same way or in different ways. Reactions may also differ depending on the nature of the change in requirements – firms might behave in a different way when faced with a broad change to the CCB buffer rather than a more specific adjustment to sectoral capital requirements. For example, a possible reaction to an increase in capital requirements in a specific sector might be that firms shift lending to sectors of equivalent risk that are not yet subject to macro-prudential capital requirements.

4.40 The Government expects that applying capital requirements to firms would have similar transmission mechanisms regardless of how they are imposed, but the distribution of costs is likely to differ between the tools and depend on how the tools are applied. For example, the Government expects that raising the level of the CCB would result in general increases in lending

spreads, which would impact all borrowers to some extent. Sectoral capital requirements imposed on particular sectors are likely to have a narrower transmission mechanism. For example, if the FPC applied additional requirements to commercial property assets, the Government expects that this would primarily impact businesses using commercial property intensively, with second round impacts on other businesses and households. Requirements placed on residential property assets would most likely impact the borrowing and consumption behaviour of households, via greater mortgage costs. This policy could impact the availability of mortgage financing, with knock-on effects for house ownership and prices. However, by mitigating the impact of an unsustainable residential property lending boom the FPC should decrease the severity of any resulting bust.

4.41 In the downswing, once the particular threat to stability had passed, the FPC might choose to release or reduce capital requirements. This might act to lower banks' cost of capital, permitting a reduction in the price of credit and an increase in lending and economic activity compared to the buffer remaining in place. The release of buffers may be less effective, however, if firms choose to maintain capital buffers above regulatory minima or if the market believes that threats to financial stability persist.

4.42 The FPC will produce and maintain statements of policy for each of the macro-prudential tools over which it has a power of direction. These statements will set out how the FPC expects its tools to work and include estimates of their impact on both financial stability and growth.

Scope of directive tools

4.43 The effectiveness and impact of macro-prudential tools will be determined, in part, by the scope of firms to which they can be applied.

4.44 The Government intends to legislate so the FPC's directive powers regarding the CCB and sectoral capital requirements can be applied to all firms that fall under the CRR/D4 regulation, namely credit institutions (including banks and building societies) and investment firms. The Government's intention is to carve out the smallest investment firms (such as small stockbrokers) from the FPC's tools, as their use in relation to these small, low-risk firms, could be disproportionate. The precise form of the exemption will depend on the final text of CRR/D4, therefore the Government will wait until the EU legislation is settled before determining what form the exemption might take.

4.45 Although the FPC's analysis of potential macro-prudential tools has focussed on the banking sector, the FPC has stated that the tools could, in addition to the firms mentioned above, apply to insurers and a variety of funds and investment vehicles. However, the Government believes that its proposed scope covers the main sources of systemic risk and forms an appropriate starting point for the FPC.

4.46 The Government recognises that the tools may potentially need to be extended to cover other sectors in future. In particular, there is a risk that the existence of macro-prudential tools in relation to firms covered by CRR/D4 might create incentives for regulatory arbitrage, which might result in risky activities migrating into other sectors in order to avoid being subject to macro-prudential regulation. In addition, the Government may need to consider extending the scope of the tools if significant leakage effects are observed. Residential mortgages, for example, are extended mainly by banks and building societies – which will be covered by the FPC's direction-making powers – but also by non-deposit taking mortgage lenders – which will not be covered. Such firms might therefore not face the same incentives as banks and building societies to curb their lending growth or re-price their loans, which could reduce the effectiveness of an FPC direction in curbing mortgage market exuberance.

4.47 In these circumstances, the FPC could of course use recommendation powers to mitigate any risks or leakages it identifies. However, if the FPC believes that the scope of its direction-

making powers need to be extended to other sectors, it has powers under the Bank of England Act to make recommendations to the Treasury to amend the secondary legislation to expand its set of directive tools.

4.48 The Government considers that there would be a case to expand the scope of the FPC's directive tools where the FPC provides evidence that:

- there are potential risks in those sectors that need to be addressed;
- the tools would work effectively in those sectors; and
- the tools would not create material unintended consequences or costs in excess of the benefits that the tools would be expected to deliver if implemented in those sectors.

Box 4.D: Consultation question

7 Do you believe that there is a case for the scope of the FPC's directive tools to be applied to firms that are currently outside the purview of CRR/D4?

8 Do you have any views on the best definition for exempting small investment firms from the FPC's directive tools?

Application of procedural requirements when implementing directions

4.49 When the PRA or FCA take action to implement a direction from the FPC, any procedural requirements that are applicable under the Financial Services and Markets Act (FSMA) 2000 would normally apply. For example, if the regulator makes rules to implement an FPC direction, it would be required to undertake consultation on those rules, including a cost-benefit analysis.

4.50 As the Government has made clear previously, in some cases, the FPC's actions will need to be implemented very quickly in order to be fully effective. Any delay by the regulator, for example, in order to undertake consultation, could prove damaging to stability. In urgent cases, both the PRA and FCA will have the ability to waive consultation requirements in order to take action quickly. In the case of the PRA, consultation requirements can be waived where a delay would be prejudicial to the safety and soundness of the firms it regulates and in the case of the FCA, the test is that a delay would be prejudicial to consumers. It is clear that where a delay in implementing an FPC direction could provoke severe financial instability, this would negatively impact both firms and consumers.

4.51 In addition, the Bank of England Act, as amended by the Financial Services Bill, allows the Treasury, when creating macro-prudential tools in secondary legislation, to modify or exclude any procedural requirements that would otherwise apply under FSMA 2000 on a tool-by-tool basis.

4.52 The Government recognises that normal procedural requirements such as consultation or cost-benefit analysis by the regulator may be of value when implementing FPC directions. Depending on the nature of the tool, directions from the FPC may be high-level, requiring the PRA or FCA to use their discretion to determine precisely how the FPC's aim can be best achieved. But with other tools the direction can be very specific, requiring no discretion whatsoever on the part of the regulators to implement it. In cases such as these, where a consultation or cost-benefit analysis by the regulator would in practice be of little value, the Treasury may choose to 'switch off' or modify the requirements for the regulators to consult or undertake cost-benefit analysis when implementing the tool.

4.53 However, the Government does not expect to use this power frequently and will only do so where full procedural requirements are clearly unnecessary. The Government expects that the normal requirements will apply for most tools. Given the novel nature of the FPC and its tools,

the Government does not initially intend to “switch off” or modify procedural requirements for any of the FPC’s initial tools in order to support transparency and public understanding around the tools. As mentioned above, the regulators already have the ability to waive procedural requirements in cases of urgency, for example where a delay could threaten financial stability, which provides an important safeguard where FPC directions need to be implemented quickly.

Box 4.E: Consultation question

9 Do you have any views on whether procedural requirements under FSMA 2000 should be modified or waived when the regulators implement FPC directions?

How the FPC’s toolkit will develop over time

4.54 As the Government has made clear in previous consultations macro-prudential policy is a relatively new area and the first years of the FPC’s operation will inevitably be a learning process. The majority of potential macro-prudential tools are untested, and whatever the final composition of the FPC’s directive toolkit, periods of adjustment will inevitably occur as more evidence becomes available. Macro-prudential tools, like macro-prudential regulation more generally, are also the subject of ongoing international discussion and debate.

4.55 The Government expects that the FPC’s toolkit will adapt and evolve over time as the international debate and academic literature on this subject develops and empirical experience becomes more widely available. As set out above, the scope of existing tools may need to be adjusted over time in order to mitigate leakages or regulatory arbitrage. The interim FPC have already highlighted additional tools that the FPC may recommend become part of its toolkit in future. These tools are discussed in the next chapter.

5 Other macro-prudential tools

5.1 This chapter discusses the tools that the interim FPC highlighted as potentially being the subject of future recommendations to the Treasury regarding the FPC's directive tools. The Government does not intend to include these tools in the FPC's initial set of direction powers.

Possible direction powers

Liquidity requirements

5.2 The Government notes that the interim FPC is waiting for micro-prudential standards in this area to evolve before recommending a liquidity requirement tool. The interim FPC sees benefit in the statutory FPC having a direction power to adjust liquidity requirements once an international framework is in place.

5.3 Maturity transformation (i.e. turning short-term funding into longer-term lending) is a key function of financial institutions, but it exposes many to risks deriving from stresses and volatility in funding markets. The FPC might use a liquidity tool to require institutions to increase buffers of high-quality liquid assets that could be drawn upon during periods of stress. These requirements could also mitigate pro-cyclicality by curbing credit expansion derived from short-term funding. When these requirements are withdrawn in the downturn, once the specific sources of risk had passed, this could lower the average cost of funding which would support credit supply.

5.4 The FPC also considered potential instruments focused on the overall maturity mismatch positions of banks, such as varying the Basel 3 Net Stable Funding Ratio (NSFR), which requires firms to fund their assets from long-term sources of funding. The NSFR is currently being developed in the Basel Committee.

5.5 The Government will consider the case for granting the FPC a direction power in this area when it receives a recommendation to that effect from the Committee.

Box 5.A: Consultation questions

10 Do you believe that liquidity requirements could be a useful tool for the FPC to have a direction power over once international standards have been developed?

Margining requirements

5.6 The Government notes that the interim FPC is waiting for international standards in this area to be developed before recommending a margining requirement tool. The interim FPC sees benefit in the statutory FPC having a direction power to apply minimum margining requirements once an international framework is in place.

5.7 Borrowers in secured financing markets are required to post collateral against their loans. Similarly, derivative counterparties must post margin to cover credit exposures. These requirements have been observed to follow a pro-cyclical pattern i.e. before the crisis margining requirements fell as markets became increasing buoyant, but these requirements rose rapidly once concerns regarding subprime and complex asset-backed securities emerged. The ability to

impose minimum requirements on these transactions may serve to counteract this procyclicality and enhance the resilience of funding markets. The Government notes that such a tool would likely need to be applicable to a wide variety of types of firms in order to be fully effective.

5.8 The Government will consider the case for granting the FPC a direction power in this area when it receives a recommendation to that effect from the Committee.

Box 5.B: Consultation question

11 Do you believe that margining requirements could be a useful tool for the FPC to have a direction power over once international standards have been developed?

Loan to value and loan to income ratios

5.9 The interim FPC's statement following its March 2012 meeting recognised the potential benefit in having a direction power to set maximum LTV/LTI ratios but stated that the Committee feels that it would require a mandate from Parliament, following a thorough public discussion, before asking for a direction power over a tool with such ramifications for individuals and businesses.

5.10 The Government notes that other countries' experiences of tightening mortgage terms and conditions (including setting maximum LTV/LTI ratios) suggest this had been a somewhat effective way to limit financial instability. However, this tool has rarely been implemented in isolation from other measures, such as mortgage insurance. The Government also notes that this type of requirement can prevent borrowers who would otherwise be considered creditworthy from receiving mortgage financing.

5.11 The Government notes the view of the International Monetary Fund that the FPC should have a power of direction with regards to maximum LTV/LTI ratios, but agrees with the FPC that sectoral capital requirements can be used to address the majority of systemic risks stemming from the residential and commercial property markets.

5.12 The Government wishes to move the debate on this potential tool forward and encourages respondents to this consultation to provide their views on this subject.

Box 5.C: Consultation question

12 What is your assessment of the advantages and disadvantages of granting the FPC a power to set and vary maximum LTV and/or LTI ratios?

Disclosure requirements

5.13 The interim FPC asked if the Treasury would consider relaxing its requirement that macro-prudential direction powers be specific and ask Parliament to grant the FPC a broad power over information disclosure.

5.14 Information disclosure has been the subject of several of the interim FPC's recommendations to the FSA and the industry. The Government believes that interim FPC has shown that the recommendation power is sufficient in this area.

5.15 The Government notes that the Financial Services Bill allows for macro-prudential measure orders to be implemented immediately if the Treasury believes this is necessary by reason of urgency. The FPC could make use of this facility if an immediate power to direct disclosure was essential to maintain financial stability.

Box 5.D: Consultation question

13 Do you agree with the Government that recommendation powers will be sufficient to implement disclosure policies?

6 Draft legislation

6.1 This chapter contains a draft of the order that will set out the content of the FPC's initial toolkit.

Box 6.A: Consultation question

14 Do you have any comments regarding the Statutory Instrument?

Draft Order laid before Parliament under section 9M of the Bank of England Act 1998, for approval by resolution of each House of Parliament.

DRAFT STATUTORY INSTRUMENTS

201* No.

FINANCIAL SERVICES AND MARKETS

The Bank of England Act 1998 (Macro-prudential Measures) Order 201*

Laid before Parliament in draft

In accordance with section 9M of the Bank of England Act 1998(**a**), a draft of this Order has been laid before Parliament and approved by a resolution of each House;

The Treasury, in exercise of the powers conferred by section 9K of the Bank of England Act 1998(**b**), make the following Order:

Citation, commencement and interpretation

1.—(1) This Order may be cited as the Bank of England Act 1998 (Macro-prudential Measures) Order 201* and comes into force on [ ].

(2) In this Order—

"commercial property exposure" means an exposure which is (to any extent) secured on land or other immoveable property being used primarily for commercial or non-residential purposes;

"consolidated basis", in relation to a measure, means on the basis that the undertaking to which the measure applies and one or more other undertakings are to be treated as one single undertaking;

"credit institution" has the meaning given by Article 4 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions(**c**);

"excluded deposit taker" means—

(a) a credit union within the meaning of section 31 of the Credit Unions Act 1979(**d**); or

(b) a person with permission under Part 4A of FSMA 2000(**e**) to effect or carry out contracts of insurance as principal;

"exposure" means, in relation to a person ("P")—

(a) the maximum loss which may be incurred by P if P's counterparty (or any person connected with that counterparty) fails to meet their obligations (whether to P or to another person); or

(b) P realises assets from positions which are not reflected in P's balance sheet;

"financial sector entity" means any of the following:

(**a**) 1998 c.11. Inserted by section [3] of the Financial Services Act 201*.
(**b**) Inserted by section [3] of the Financial Services Act 201*. In relation to the first order under section 9K, subsection (2) does not apply by virtue of paragraph 6 of Schedule 20 to the Financial Services Act 201*.
(**c**) OJ L177, 30.6.2006, p.1.
(**d**) 1979 c.34.
(**e**) Inserted by section [9] of the Financial Services Act 201*.

(c) a credit institution;

(d) an investment firm;

(e) a financial institution (meaning an undertaking other than a credit institution or investment firm, the principal activity of which is to acquire holdings or to pursue one or more of the activities listed in points 2 to 12 and 15 of Annex I to Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions);

(f) an ancillary services undertaking (meaning an undertaking the principal activity of which consists in owning or managing property, managing data-processing services or any other similar activity which is ancillary to the principal activity of one or more credit intuitions, investment firms, insurance undertakings or reinsurance undertakings);

(g) an insurance undertaking;

(h) a third country insurance undertaking;

(i) a reinsurance undertaking;

(j) a third country reinsurance undertaking; or

(k) an insurance holding company (meaning an undertaking which is not a mixed financial holding company the main business of which is to acquire and hold participating interests in subsidiary undertakings which are exclusively or mainly insurance undertakings, reinsurance undertakings, third country insurance undertakings or third country reinsurance undertakings, and which has at least one subsidiary undertaking which is an insurance undertaking or a reinsurance undertaking);

"financial sector exposure" means—

(l) an exposure under, or which relates to, a contract with a financial sector entity; or

(m) an exposure to, or which relates to, the securities or other instruments issued by such an entity;

"first non-life directive" means Directive 73/239/EEC of the Council of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance(**a**);

"insurance undertaking" means an undertaking which has received authorisation as an insurance undertaking in accordance with the first non-life directive or the life assurance consolidation directive;

"investment firm" has the meaning given by section 424A of the 2000 Act(**b**);

"life assurance consolidation directive" means Directive 2002/68/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance(**c**);

"mixed financial holding company" means an undertaking which is not a credit institution, an insurance undertaking or an investment firm which has at least one subsidiary undertaking which is a credit institution, an insurance undertaking or an investment firm and which, together with its subsidiary undertakings, constitutes a financial conglomerate (within the meaning given by Article 2.14 of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate(**d**)) (disregarding any decision taken under Article 3(3) of that Directive);

"participating interest" has the meaning given by section 421A of FSMA 2000(**e**);

"PRA-authorised person" has the meaning given by section 2B of FSMA 2000(**f**);

"reinsurance directive" means Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance(**g**);

"reinsurance undertaking" means an undertaking which has received authorisation in accordance with Article 3 of the reinsurance directive;

(**a**) OJ L228, 16.8.1973, p.3.
(**b**) Inserted by SI 2006/2975.
(**c**) OJ L 345, 19.12.2002, p. 1.
(**d**) OJ L35, 11.02.2003, p.1.
(**e**) Inserted by SI 2008/948.
(**f**) Inserted by section 5 of the Financial Services Act 201*.
(**g**) OJ L323, 9.12.2005, p.1.

“requirement” includes a requirement to refrain from taking action;

“residential property exposure” means an exposure which is (to any extent) secured on land or other immoveable property being used primarily for residential purposes;

“solo basis”, in relation to a measure, means on the basis of the situation of the undertaking to which the measure applies;

“subsidiary undertaking” has the meaning given by section 420 of FSMA 2000;

“third country insurance undertaking” means an undertaking which would require authorisation in accordance with the first non-life directive or the life assurance consolidation directive if it had its head office in the EEA;

“third country reinsurance undertaking” means an undertaking which would require authorisation in accordance with the reinsurance directive if it had its head office in the EEA);

“UK bank” means a UK institution which has permission under Part 4A of FSMA 2000 to carry on the regulated activity of accepting deposits but which is not an excluded deposit taker;

“UK institution” means an institution which is incorporated in, or formed under the law of, any part of the United Kingdom;

“UK investment firm” means a UK institution which—

(n) has permission under Part 4A of FSMA 2000, and

(o) is an investment firm,

but which is not [*Exclusion for small investment firms*].

Macro-prudential measures

2.—(1) The measures listed in the first column of the table and any measure falling within a listed measure are prescribed in relation to the regulator specified in the second column of the table.

(2) Each of those measures may be applied on, or by reference to, a solo basis or on, or by reference to, a consolidated basis.

Macro-prudential measures

Macro-prudential measure	*Regulator*
To require UK banks to maintain additional own funds by reference to their residential property exposures, commercial property exposures or financial sector exposures or to impose requirements on UK banks by reference to the failure to maintain such additional own funds	PRA
To require UK investment firms which are PRA-authorised persons to maintain additional own funds by reference to their residential property exposures, commercial property exposures or financial sector exposures or to impose requirements on UK investment firms by reference to the failure to maintain such additional own funds	PRA
To require UK investment firms which are not PRA-authorised persons to maintain additional own funds by reference to their residential property exposures, commercial property exposures or financial sector exposures or to impose requirements on UK investment firms by reference to the failure to maintain such additional own funds	FCA
To require UK banks to treat residential property exposures, commercial property exposures or financial sector exposures as if they gave rise to an increased level of risk specified by the Financial Policy Committee	PRA
To require UK investment firms which are PRA-authorised persons to treat residential property exposures, commercial property exposures or financial	PRA

sector exposures as if they gave rise to an increased level of risk specified by the Financial Policy Committee	
To require UK investment firms which are not PRA-authorised persons to treat residential property exposures, commercial property exposures or financial sector exposures as if they gave rise to an increased level of risk specified by the Financial Policy Committee	FCA

Name
Name

Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

This Order specifies macro-prudential measures for the purposes of section 9G of the Bank of England Act 1998 (power of the Financial Policy Committee of the Bank of England to direct the Financial Conduct Authority and the Prudential Regulation Authority).

The Order specifies the imposition of requirements to maintain additional own funds (in other words, capital requirements) in relation to residential property exposures, commercial property exposures or financial sector exposures. The Order also specifies the imposition of requirements by reference to the failure to maintain such own funds. Such requirements might for example include an obligation not to make certain discretionary payments. The Order also specifies the imposition of requirements that firms treat such exposures as if they gave rise to an increased level of risk.

The Financial Policy Committee may give directions that any such requirements are to be imposed either on a solo basis (by reference to the position of the undertakings which are the subject of the direction) or on a consolidated basis (by reference to the position of the undertakings which are the subject of the direction, taken together with relevant members of that institution's group).

The Financial Policy Committee will, under section 9K of the Bank of England Act 1998, be able to direct the Prudential Regulation Authority to implement the measures specified in the Order in relation to UK banks and UK investment firms which are PRA-authorised persons (as defined by section 2B of the Financial Services and Markets Act 2000). The Financial Policy Committee will be able to direct the Financial Conduct Authority to implement the measures specified in the Order in relation to UK investment firms which are not PRA-authorised persons.

A Consultation questions and how to respond

A.1 The following table lists the consultation questions posed in this document.

Box A.1: List of consultation questions

1	Do you agree that the FPC should be responsible for setting the level of the CCB in the UK?
2	Do you have any views on the Government's proposal to give the FPC control over the CCB buffer rate for the UK before 2016?
3	Do you agree that sectoral capital requirements will be an effective macro-prudential tool for the FPC?
4	Do you agree that the FPC should have the ability to apply granular requirements e.g. differentiated by LTV or LTI for residential property related assets?
5	Do you have views on how macro-prudential sectoral capital requirements should be integrated with the existing micro-prudential framework?
6	Do you agree that the FPC should have a direction-making power for a time-varying leverage ratio once international standards are in place?
7	Do you believe that there is a case for the scope of the FPC's directive tools to be applied to firms that are currently outside the purview of CRR/CRD IV?
8	Do you have any views on the best definition for exempting small investment firms from the FPC's directive tools?
9	Do you have any views on whether procedural requirements under FSMA 2000 should be modified or waived when the regulators implement FPC directions?
10	Do you believe that liquidity requirements could be a useful tool for the FPC to have a direction power over once international standards have been developed?
11	Do you believe that margining requirements could be a useful tool for the FPC to have a direction power over once international standards have been developed?
12	What is your assessment of the advantages and disadvantages of granting the FPC a power to set and vary maximum LTV and/or LTI ratios?
13	Do you agree with the Government that recommendation powers will be sufficient to implement disclosure policies?
14	Do you have any comments regarding the Statutory Instrument?

How to respond

A.2 This paper is available on the Treasury website at www.hm-treasury.gov.uk.

A.3 Responses are requested by 11 December 2012. Please ensure that responses are sent in before the closing date. The Government cannot guarantee that responses received after this date will be considered. The Government will also engage directly with relevant stakeholders ahead of this date. For further details, please email financial.reform@hmtreasury.gsi.gov.uk.

A.4 Responses can be sent by email to: financial.reform@hmtreasury.gsi.gov.uk. Alternatively, they can be posted to:

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

A.5 When responding, please state whether you are doing so as an individual or on behalf of an organisation.

Confidentiality

A.6 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

A.7 If you would like the information that you provide to be treated as confidential, please mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

A.8 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

Code of practice for written consultation

A.9 This consultation process is being conducted in line with the Consultation Principles set out by the Cabinet Office:

http://www.cabinetoffice.gov.uk/sites/default/files/resources/Consultation-Principles.pdf

A.10 If you feel that this consultation does not conform with these principles, please contact:

Thomas Eland
Transport, regulation and competition
HM Treasury
1 Horse Guards Road
London
SW1A 2H

B The ESRB's recommendations

Table B.1: The ESRB's recommendations

Topic	Substance of recommendation	Action taken
A – Objective	Specify that the objective of macro-prudential policy is to contribute to financial stability by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth. Ensure that macro-prudential policies can be pursued at national level upon the initiative of the macro-prudential authority.	Clause 3 of the Financial Services Bill states that the FPC is too meet its objective by " ... the identification of, monitoring of, and taking action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system." The Bill provides the FPC with a secondary objective to support the economic policies of the Government, including those for growth and employment. The Bill provides the FPC with a number of policy levers. (See below)
B –Institutional arrangements	Designate in the national legislation a macro-prudential authority and set out its decision-making process. Where a single institution is designated as the macro- prudential authority, establish mechanisms for cooperation among all relevant authorities. Ensure that the central bank plays a leading role in the macro-prudential policy. Mandate the authority to cooperate and to exchange information also cross-border, in particular by informing the ESRB of the actions taken to address systemic risks at national level.	The FPC will be a committee comprised of Bank of England Executives, the Chief Executives of the PRA and FCA, and independent members. The Bill requires that the FPC must seek to avoid exercising its functions in a way that would prejudice the advancement of the objectives of the regulators. The Bill states that the Chair of the FPC must seek "to secure that decisions of the Committee are reached by consensus wherever possible." Where this is not possible, the Committee will vote. The Bank of England has overall responsibility for financial stability. The Bill requires the FPC to have regard to the international obligations of the United Kingdom; this includes the UK's responsibilities with regard to the ESRB.
C–Tasks, powers, instruments	Entrust the authority with the tasks of identifying, monitoring and assessing risks to financial stability and of implementing policies to achieve its objective by preventing and mitigating those risks. Ensure that the authority has the power to gather relevant information, and that information is shared between relevant bodies. Enable the authority with the power to recommend on the perimeter of national regulation. Ensure that the authority has control over appropriate instruments for achieving its objectives. Clear and expeditious procedures should be established for assigning instruments to the authority.	See response to recommendation A. Clause 3 of the Bill confers on the FPC the power to direct the PRA or the FCA to provide the Bank of England with specified information or documents. The Bill provides the FPC with the power to make recommendations to the Treasury regarding the perimeter of regulation. The Bill provides for the FPC to have a number of macro-prudential levers. These include: • a power of direction with regard to the PRA and FCA over specified macro-prudential tools; • a power of recommendation with regard to the PRA and FCA (backed by 'comply or explain'); and • a power to make recommendations to other persons.

D – Transparency and accountability	Ensure that macro-prudential policy decisions and their motivations are made public in a timely manner. Ensure that macro-prudential strategies are published. Entrust the authority with the power to make public and private statements on systemic risk. Ensure accountability to the national parliament. Ensure legal protection for the authority and its staff when they act in good faith	The Bill requires a record of each of the FPC's policy meetings be published within six weeks of the meeting and for the Financial Stability Report (FSR) to include explanations of its policy decisions. The Bill requires that the Bank of England publish its financial stability strategy and any revisions to the strategy. The FPC will be given the power to make recommendations to the regulators and the industry. In addition to this, the Bill requires the FPC to publish semi-annual FSRs that will set out the FPC's analysis of the risks facing the financial sector. The Treasury will lay before Parliament a copy of each FSR and any direction by the FPC to the regulators. The Chancellor and the Governor will meet following the publication of each FSR to discuss the report and other matters relating to the stability of the UK financial system. Section 244 of the Banking Act 2009 provides the Bank of England with immunity from liability in damage when acting as the central bank of the UK or protecting or enhancing the stability of the financial system of the UK.
E – Independence	Ensure that the authority is as a minimum operationally independent. Ensure that organizational and financial arrangements do not jeopardize the conduct of macro-prudential policy.	The Bill states that the FPC will be established within the Bank of England which is independent of Government. The Government has no legal means to direct action by the FPC, but the Treasury will be able to make recommendations to the FPC. The FPC will be able to call upon the resources of the Bank of England and the regulators while exercising its functions.

C Impact Assessment

C.1 The following pages contain the consultation stage impact assessment for providing the FPC with macro-prudential direction powers. This assessment should be read in conjunction with the impact assessment for the Financial Services Bill.

Title: Financial Policy Committee: macro-prudential tools	Impact Assessment (IA)
IA No:	**Date:** 18/09/2012
Lead department or agency: HM Treasury	**Stage:** Consultation
Other departments or agencies:	**Source of intervention:** Domestic
	Type of measure: Secondary legislation
	Contact for enquiries: financial.reform@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: AMBER

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£68,600m	N/A	N/A	No	NA

What is the problem under consideration? Why is government intervention necessary?

The last financial crisis revealed the need for macro-prudential regulation of the financial services sector. Left unchecked, macro-prudential risks can create instability - with all the associated costs that such disturbances cause - even if individual firms are believed to be sound.The Financial Servces Bill will establish a Financial Policy Committee (FPC) within the Bank of England to identify, monitor and address systemic risks to the UK financial sector.

What are the policy objectives and the intended effects?

The FPC will identify and address systemic risks to the UK economy. The active management of systemic risks will increase the stability and resilience of the UK financial system, minimising the damaging impacts of financial instability.

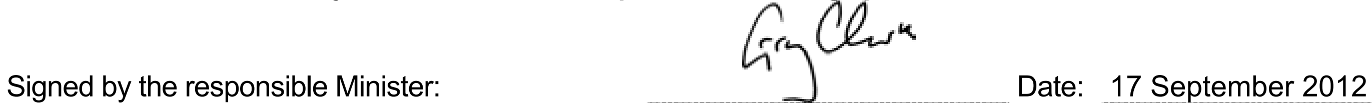
What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Two policy options have been considered: "do nothing" (the base case where the Government does not provide the FPC with direction powers for any macro-prudential measures) and the preferred option of providing the FPC with direction powers to set the level of the Countercyclical Capital Buffer (CCB) and impose sectoral capital requirements. The preferred option will result in a reduction in the annual probability of a financial crisis occuring, benefitting the UK by preventing the damage to output that is associated with these events.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.



Signed by the responsible Minister: ______________ Date: 17 September 2012

Summary: Analysis & Evidence

Policy Option 1

Description: "Do nothing" scenario

FULL ECONOMIC ASSESSMENT

Price Base Year 2010	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	**High:** 0	**Best Estimate:** 0

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

Zero. The Government would not grant the FPC direction powers and so no regulatory costs would be incurred above those already being implemented. This scenario is the baseline for determining the incremental cost of option 2.

Other key non-monetised costs by 'main affected groups'

None.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

Zero. The Government would not grant the FPC direction powers and benefits would not differ from those accruing from regulation currently being implemented.

Other key non-monetised benefits by 'main affected groups'

None.

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Give the FPC direction powers

FULL ECONOMIC ASSESSMENT

Price Base Year 2010	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 23,800	**High:** 102,900	**Best Estimate:** 68,600

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0		300	**2,500**
High	0		1,500	**12,300**
Best Estimate	0		900	**7,400**

Description and scale of key monetised costs by 'main affected groups'

Imposing macro-prudential capital requirements on financial institutions will impose costs on them. It is assumed for the purpose of this impact assessment that these costs will be passed on to consumers of bank lending in the form of higher lending spreads. The higher cost of borrowing has knock-on impacts on output, which is a cost to the UK as whole. These costs are estimated in this impact asessment.

Other key non-monetised costs by 'main affected groups'

There are no significant non-monetised costs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		3,100	**26,300**
High	0		13,700	**115,200**
Best Estimate	0		9,000	**76,000**

Description and scale of key monetised benefits by 'main affected groups'

Financial crises result in significant output losses. By identifying, monitoring and addressing systemic risks the Financial Policy Committee will reduce the probability of financial crises occuring. The benefit of a reduction in the probability of a financial crisis occuring can be measured in terms of the output losses avoided. This avoidance of output losses is a benefit to the UK as a whole.

Other key non-monetised benefits by 'main affected groups'

Using additional macro-prudential capital requirements to increase the resilience of firms and to restrain over-exuberance should mitigate the depth and severity of downturns and dampen credit booms. Smoothing the supply of credit through the cycle should lead to lower volatility of output. Lower volatility of output could lead to longer periods of expansion which would lead to increased levels of output. This would be a benefit to the UK as a whole.

Key assumptions/sensitivities/risks | **Discount rate (%)** 3.5

The key assumptions of this assessment are: 1) that the FPC raise and then lower capital requirements evenly over the period between 2014 and 2023, peaking at 2.5%, 1.5% and 0.5%; 2) that the costs of additional capital requirements are fully passed on through lending spreads to consumers; and 3) that UK GDP is equal to £1300 billion over the period.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Evidence Base (for summary sheets)

Introduction

1. This assessment should be read in conjunction with the impact assessment *A new approach to financial regulation* which has been prepared for the Financial Services Bill. That assessment analyses the costs and benefits of reforming the UK's system of financial regulation as envisioned in the Financial Services Bill.
2. This assessment adds to that analysis by considering the impact of macro-prudential supervision by the Financial Policy Committee (FPC) including the use of direction powers provided to it by secondary legislation.

Objective

3. The objective of this legislation is to provide the FPC with the necessary macro-prudential tools to achieve its objectives to protect and enhance the stability of the UK financial system by tackling systemic risks and to support the Government's economic objectives. The tripartite system of regulation did not place clear responsibility for monitoring systemic risks with any regulator. The Financial Services Bill will rectify this omission by establishing the FPC within the Bank of England. Macro-prudential regulation will complement the "twin peaks" system of regulation by identifying, monitoring and addressing systemic risks thereby reducing the frequency and severity of financial crises and smoothing the economic cycle.

Description of options considered

"Do nothing" option

4. This option is the base case for this assessment. In this option the FPC would not be given powers to direct the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to implement macro-prudential measures.
5. "Do nothing" does not mean "no change in the regulatory environment". It only means that the FPC would not be given direction powers; the other reforms as provided for in the Financial Services Bill – and assessed by the impact assessment published alongside the Bill - are assumed to have been implemented.
6. Other changes to the regulatory environment will continue to happen. These may include the implementation of changes to EU law or changes to domestic regulatory practice including the continuation of current FSA regulatory initiatives by the FCA or the PRA, the implementation of the Independent Commission on Banking's recommendations and Capital Requirements Regulation and Directive IV (CRR/D IV). Future changes to FCA or PRA rules will be subject to cost benefit analysis in essentially the same way as proposed changes to FSA rules currently are.

The preferred option - give the FPC direction powers

7. In this option the FPC will be given the power to direct the implementation of macro-prudential measures by the PRA and/or the FCA.
8. The Government proposes to legislate to provide the FPC with the power to set the level of the Countercyclical Capital Buffer (CCB) and a power to direct the PRA/FCA to adjust sectoral capital requirements. It should be noted that the power to set the level of the CCB is not being provided by the macro-prudential order under 9K of the Bank of England Act 1998 as amended by the Financial Services Bill, but has been included in this assessment for the sake of transparency and simplicity. As the CCB will be provided for by the Capital Requirements Directive IV, the FPC will be provided with the power to set the CCB by Section 2(2) of the European Communities Act 1972.
9. Setting the level of the CCB will allow the FPC to dampen the procyclical nature of financial services markets by requiring institutions to hold additional capital in the upswing building resilience through additional loss absorbing capacity. This requirement would be in addition to their microprudential capital requirements. At other times, reducing the required buffer, back towards the minimum level

and so unwinding the previous increase, could help to mitigate an excessive contraction in lending supply during a downturn of the credit cycle.

10. The power to direct the PRA/FCA to adjust sectoral capital requirements will allow the FPC to impose capital requirements on exposures to specific sectors in addition to microprudential requirements. This is a more targeted approach than the CCB. For example, if the FPC felt that activity in the commercial real estate sector posed a systemic risk, the Committee might require firms to hold extra capital against loans for commercial real estate in addition to the microprudential requirements. This could be achieved by altering (where legally possible) risk weights for sectoral exposures directly. The interim FPC has noted that the over-exuberance that preceded previous financial crises has tended to emerge first in specific sectors. Applying additional capital requirements to exposures to these sectors could allow the FPC to address risks in a more efficient manner and before they become deep-rooted and jeopardise the stability of the financial system as a whole.
11. The Government intends to provide the FPC with a time-varying leverage ratio direction-making tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards. The precise design of the tool will depend on the provisions of the relevant European legislation and will be set out in secondary legislation to be introduced by the Government at the time. This assessment does not include the impact of providing the FPC with a leverage ratio tool as the Government does not propose to create this power at this time. However, some indicative thoughts on how the inclusion of a leverage ratio power would impact this assessment are included in the sections below.
12. The FPC's direction powers will be applicable to firms that fall under the purview of the Capital Requirements Regulation/Directive IV (CRR/D IV), i.e. banks, building societies and investment firms.
13. It should be noted that this assessment covers the direction powers that the FPC will possess at its foundation. The FPC may recommend that its toolkit is expanded or modified in future, and no attempt is made to gauge the impact of potential future macro-prudential measures. The impact of these tools will be assessed if and when the Treasury legislates to provide them.

Analysis of costs and benefits

Introduction

14. As explained above, the "do nothing" option provides the base case for this impact assessment and it is assumed that other changes to the regulatory environment – changes which would happen irrespective of changes to the regulatory structure or organisation - would impact the costs and benefits of each option identically. The net present value (NPV) of each option would therefore be increased or decreased by the same amount, with the ranking of options therefore unaffected.
15. The costs and benefits of the "do nothing" option are therefore assumed to be zero and the costs and benefits of the preferred option are measured as incremental to the "do nothing" option.
16. The transitional and ongoing costs of establishing the FPC have been considered in the impact assessment for the Financial Services Bill. This assessment considers the costs and benefits of the FPC utilising macro-prudential direction powers to address systemic risks.
17. The cost and benefit figures produced in this assessment are purely illustrative and should not be considered as estimates of actual costs and benefits. The costs and benefits of the Government's preferred option will depend on factors that it is impossible to predict with certainty.

Costs of the Government's preferred option

18. This assessment uses a paper published by the Basel Committee on Banking Supervision (BCBS) in August 2010 *An assessment of the long-term economic impact of stronger capital and liquidity requirements*[1], which estimates the impact of additional capital and liquidity requirements, as the basis for its analysis of the costs of applying additional macro-prudential capital requirements. The

[1] Available at http://www.bis.org/publ/bcbs173.htm

paper uses a variety of macroeconomic models and data for thirteen countries to estimate the impact of higher capital requirements on lending spreads and, following on from the change in spreads, output. The paper's conservative assumptions (i.e. that the cost of increased capital requirements is fully passed through to consumers and firms via lending spreads and that the cost of capital does not decrease as firms become less risky) makes the cost estimate a likely upper bound. This reduces the risk to this impact assessment that costs have been underestimated.

19. The BCBS analysis has also been used in part for the impact assessments for the Financial Services Bill and the Banking Reform White Paper. The results of this paper are in line with other studies by the Organisation for Economic Co-operation and Development (OECD) and FSA staff[2]. The BCBS paper examines the impact of permanent increases in capital ratios on steady state output, while the FPC will impose counter-cyclical requirements and will not act in a way that will significantly impair the ability of the financial sector to contribute to economic growth in the medium or long term. However, the Government considers the estimates in the BCBS paper to be suitable for producing illustrative costs of potential requirements imposed by the FPC.

20. The paper assumes that, in order to meet a required increase in the TCE/RWA[3] ratio, banks raise equity and reduce other forms of cheaper funding increasing their private costs. Higher costs resulting from this shift are passed on to consumers and firms via increases in lending spreads, which imposes a cost on long term steady state output. This cost to output can be considered the cost of additional capital requirements. This assumption about firms' behaviour is a strong one. An occasional paper published by the FSA states that historically, in the UK, adjustments in capital ratio requirements are met half by raising new capital and about half through reductions in risk-weighted assets[4]

21. The paper estimates that for each additional percentage point increase in the TCE/RWA ratio there is an annual cost to the level of output equal to 0.09% of output. Using the figure for UK output in 2010 to be about £1300 billion, this equates to an illustrative annual cost of £1.2 billion per 1 percentage point increase in capital requirements. The paper estimates long-term output costs, although there may be additional short term costs resulting from FPC actions if there are market frictions that hamper transition to new requirements.

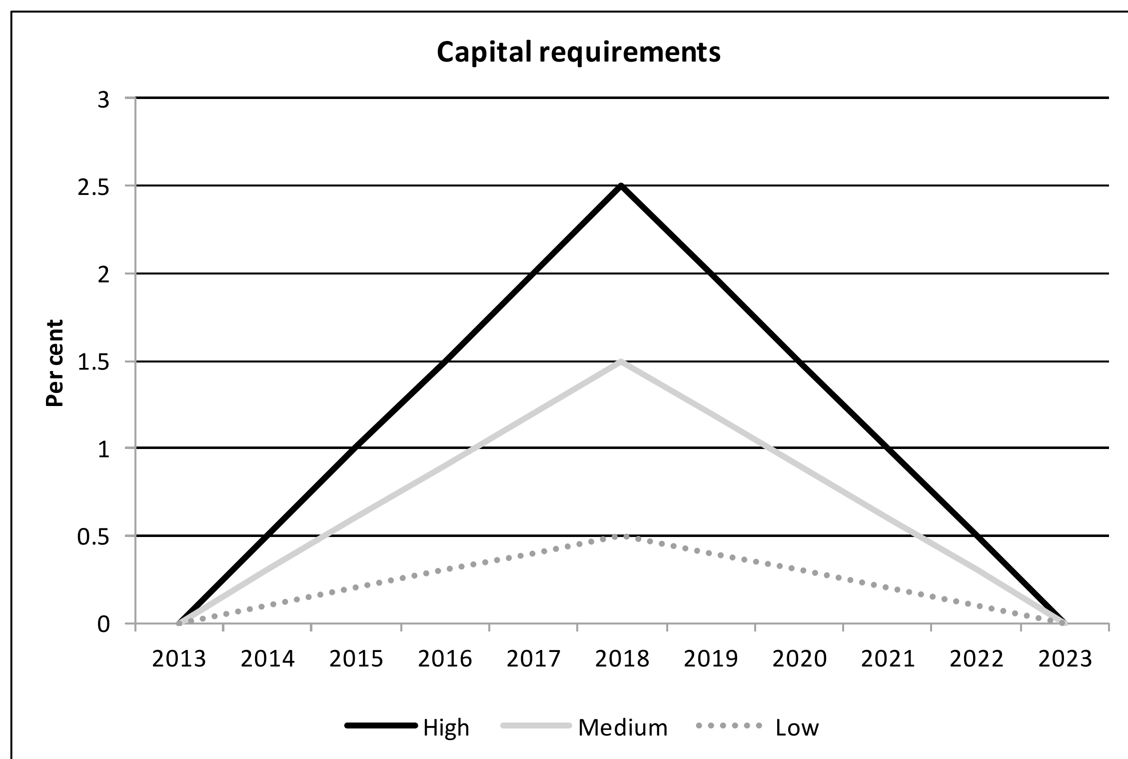
22. The cost figures for the period examined in this impact assessment are the product of three assumed scenarios: that the FPC raise and then lower capital requirements evenly over the period between 2014 and 2023, peaking at 2.5%, 1.5% and 0.5% (Chart 1 shows these assumptions graphically). These three scenarios have been formulated in order to provide a range of cost estimates. However, the Government does not believe that any one of these scenarios is more likely than the others. As it is impossible to foresee the actions of the FPC, a steady rate of increase followed by a steady decrease has been assumed. This reflects the Government's expectation that the FPC will act symmetrically. These scenarios are illustrative and it is possible that the FPC's actions may differ significantly from them.

[2] See Slovik, P. and Cournède, B. (2011). *Macroeconomic Impact of Basel III*. OECD Working Paper No. 844 and S de-Ramon et al (May 2012), *Measuring the impact of prudential policy on the macroeconomy: A practical application to Basel III and other responses to the financial crisis*, Occasional Paper Series No. 42, Financial Services Authority

[3] The capital ratio is the ratio of tangible common equity (TCE) to risk-weighted assets (RWA). TCE is net of goodwill and intangibles. RWA are measured using historical definitions under Basel I and Basel II.

[4] Occasional Paper Series No. 42, Financial Services Authority.

Chart 1: Capital requirement scenarios



Source: HMT assumptions

Costs to regulated firms

23. Macro-prudential capital requirements will impose costs on regulated firms as they will have to bear the cost of raising and holding additional capital, shifting away from cheaper funding methods, to meet macro-prudential requirements. This cost will depend on the cost of capital for each firm. There could be additional costs to regulated firms, including for example the cost of changing systems, collecting additional data and compliance costs, but these costs will be dependent on how firms decide to react to requirements imposed by the FPC. If firms are heavily concentrated in sectors targeted by the FPC, they could face large costs if they chose to change their business model or overall strategy. However, for the purpose of this impact assessment – in line with the assumptions of the BCBS paper – it is assumed that these costs are fully passed on to consumers and firms through increases in lending spreads.

24. It should also be noted that firms that already hold capital above the minimum requirements may be less affected by any additional requirements imposed by the FPC via the CCB if they choose to run down voluntary buffers but this will depend on the preferences of firms regarding voluntary buffers above regulatory minimums[5].

Costs to the economy

25. This analysis assumes that the cost of additional macro-prudential capital requirements is passed on to consumers through increases in lending spreads. The increase in the price of credit will reduce consumption funded by borrowing, which has a negative impact on GDP over the short term. However, reduced investment by firms as a result of higher borrowing costs would have a long term negative impact on output. However, the intention of macro-prudential policy is to reduce consumption and investment funded by borrowing to reduce the severity of losses experienced following an unsustainable boom. A reduction in output would affect all UK residents to a greater or lesser degree.

[5] The following papers provide evidence that banks manage capital to maintain buffers over and above regulatory minima. FSA Occasional Paper 22, *What determines how much capital is held by UK banks and building societies? I Alfon, I Argimon and P Bascuñana-Ambrós, July 2004, FSA.* FSA Occasional Paper 31, *On the Behaviour and Determinants of Risk-Based Capital Ratios: Revisiting the Evidence from UK Banking Institutions,* W Francis and M Osborne, July 2009, FSA.

Potential cost of a leverage ratio

26. A leverage ratio tool would impose costs to firms only if their leverage ratios exceeded the maximum required by the FPC. Firms who exceeded the maximum ratio could reduce their leverage by raising new capital, limiting distributions or by reducing their assets. In order to be consistent with the analysis in the rest of this assessment, it should be assumed that firms raise new capital in order to meet the requirement. The cost of meeting, for example, a 3% leverage ratio could be estimated by applying an average cost of capital to the capital shortfall of the industry's current position plus a suitable premium to take account of other factors (such as the price impact of multiple firms competing for a limited pool of available capital). The inclusion of a leverage ratio tool would increase the costs estimate of this analysis.

Benefits of the Government's preferred option

27. The benefits of macro-prudential supervision can be estimated by calculating the change in the present value of the total output losses from financial crises (i.e. the output lost as a result of these events) as a result of the reduction in the frequency of financial crises. This reduction in the frequency of crises will result from the FPC using its powers to address systemic risks that would have gone on unchecked under the previous regulatory system.
28. The BCBS paper contains estimates of the output loss avoided as a result of a reduction in the frequency of financial crises. These estimated benefits increase as the reduction in probability increases and as the assumed output loss increases. For example, if it is assumed that financial crises have only a temporary effect on output, the benefits are smaller than if a permanent output loss is assumed. Chart 2 shows how the costs differ between these assumptions. The paper and this assessment make use of three assumptions for the scale of the benefits: that crises have no permanent impact on output, that crises have a moderate permanent impact and that crises have a large permanent impact. The benefits of reducing the probability of crises occurring increases as the scale of output losses is increased.
29. The BCBS estimates of benefits from a one percentage point reduction in the probability of a financial crisis occurring range from 0.19 per cent (when crises are assumed to not have a permanent impact) to 1.58 per cent (when crises are assumed to have a large permanent impact). The probability of a crisis occurring falls as additional capital requirements are imposed. Applying additional capital requirements increases the loss absorbing capacity of banks, making them more resilient, and should reduce over-exuberance as the cost of providing credit increases. A number of other studies have examined the relationship between capital requirements and the probability of a financial crisis occurring.[6]
30. The annualised benefits of higher capital requirements are taken from the BCBS analysis. The annualised output loss avoided for each of the three assumptions used is shown below.

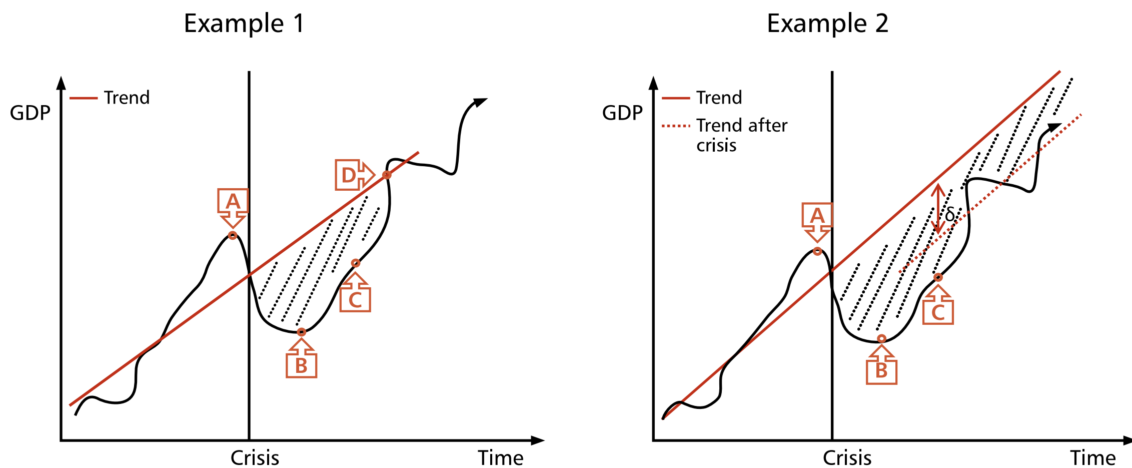
Table 1: Benefits of applying additional capital requirements (annualised % of GDP)

Additional capital requirement (%)	No permanent impact	Moderate permanent impact	Large permanent impact
1	0.29	0.96	2.41
2	0.49	1.62	4.05
3	0.6	1.98	4.97

Source: BCBS paper *An assessment of the long-term economic impact of stronger capital and liquidity requirements* and HM Treasury calculations

[6] For example, NIESR Discussion Paper 351, *The impact of global imbalances: Does the current account balance help predict banking crises in OECD countries?*, R Barrell, E P Davis, D Karim, I Liadze, NIESR and Brunel University or FSA Occasional Paper 38, *Optimal regulation of bank capital and liquidity: how to calibrate new international standards,* R Barrell, E P Davis, T Fic, D Holland, S Kirby and I Liadze, NIESR and Brunel University.

Chart 2: Measuring the cost of crises



Point A: pre-crisis peak. Point B: post-crisis trough. Point C: GDP growth equals trend GDP growth for the first time after the crisis. Point D: the level of GDP returns to the pre-crisis level.

Source: Basel Committee on Banking Supervision paper *An assessment of the long-term economic impact of stronger capital and liquidity requirements*

31. The probability of a crisis occurring is likely to be cyclical and because the FPC will apply additional requirements counter-cyclically, the marginal reduction in the probability of a crisis occurring is likely to be higher than implied by the BCBS paper, which examines the average reduction in probability in the long-term. By applying additional requirements when risks are building, the FPC will achieve greater stability benefits.

Unquantifiable benefits

32. Using additional macro-prudential capital requirements to increase the resilience of firms and to restrain over-exuberance should mitigate the depth and severity of downturns and dampen credit booms. This would mean lower volatility of output as the supply of credit will be smoother across the cycle. The benefits of lower output volatility are difficult to quantify but could be substantial. Academic literature[7] postulates that lower output volatility may lengthen expansions as lower volatility suggests lower risk, which impacts on risk premiums, lower precautionary saving and greater certainty for prospective investment decisions.

33. The BCBS paper estimates the reduction in the standard deviation of output by comparing the results of a model in two scenarios: the result of a technology shock on output; and the result of the same shock on output in a stricter regulatory environment. Their estimates for the reduction in volatility in output are below.

Table 2: reductions in the volatility of output

Increase in TCE/RWA ratio from baseline scenario (percentage points)	Decrease in the standard deviation of output (per cent)
2	1.9
4	3.9
6	6.0

Source: BCBS paper *An assessment of the long-term economic impact of stronger capital and liquidity requirements*

[7] For example *The Long and Large Decline in U.S. Output Volatility*, Olivier Blanchard and John Simon, *Brookings Papers on Economic Activity* , Vol. 2001, No. 1 (2001), pp. 135-164
Published by the Brookings Institution. Available at http://www.jstor.org/stable/1209161

Potential benefits of a leverage ratio

34. A leverage ratio would enable the FPC to constrain any leverage growth that it felt was excessive or unsustainable. This could have financial stability benefits by limiting the amount of risk that firms are able to take on for a given amount of capital. This financial stability benefit could be estimated in a similar fashion to the other benefits in this assessment, i.e. by assuming a reduction in the probability of future crises occurring and translating this into output losses avoided. The inclusion of a leverage ratio tool would increase the benefits estimate of this analysis.

Assumptions, risks and sensitivities

35. In order to monetise the impact of macro-prudential requirements imposed by the FPC, this assessment uses the UK's 2010 Gross Domestic Product (GDP) figure of £1300 billion (consistent with the Impact Assessment of the Financial Services Bill) to convert the cost and benefits of additional capital requirements, which are given as percentages of GDP in the BCBS paper, into pound sterling figures that can then be discounted to give the numbers seen in the summary pages of this document. This assessment uses the 2010 GDP figure for the whole of the assessment period. This, of course, is an unrealistic assumption, but as the costs and benefits of this policy are expressed as proportions of output the relative net benefit would remain the same regardless of the GDP figure used to convert the costs and benefits into sterling. The 2010 figure has been used to ensure consistency with the estimates produced in the impact assessment *A new approach to financial regulation* for the Financial Services Bill.

36. The absolute figures would change if a different GDP figure was used (e.g. a higher GDP figure would mean higher cost and benefit numbers and *vice versa*). However, as the relative net benefit would remain the same and these are illustrative figures, changing the GDP assumption makes no meaningful difference to this analysis.

37. The BCBS paper on whose methodology this assessment is based makes several assumptions in order to make its estimates. A particularly important assumption is that banks would fully pass on the cost of additional capital requirements through higher lending spreads. In practice, banks may choose to recoup these costs by other means: increasing non-lending revenue, lowering rates paid on deposits, or by lowering operating costs. Use of these other means would reduce the need to raise the price of borrowing and lower the impact on output as the price of credit would not increase as much as if firms fully pass through the cost of raising and holding additional macro-prudential capital. As such, the BCBS estimate can be considered a conservative estimate of likely costs.

38. This impact assessment assumes that the annualised costs and benefits of additional capital requirements imposed by the FPC occur in the year that the requirement is imposed. In reality, there will be an implementation period between the policy announcement and compliance with the requirement. Some costs and benefits may accrue during this transitional period as firms modify their behaviour to meet the new requirement. It should also be noted that FPC policy decisions will be implemented by the PRA and/or the FCA which may impact the implementation period or method.

39. A key risk to this assessment is the behaviour of firms. Individual firms will decide how to react to policy changes by the FPC, e.g. whether to internalise or pass on costs, which could impact the level of costs and/or benefits of macro-prudential policy.

The FPC's behaviour

40. The assumption about the behaviour of the FPC is the key sensitivity of this assessment.

41. This assessment makes some assumptions regarding the FPC's behaviour. As it is impossible to know how the FPC will act many years in advance, the scenarios presented in this assessment should be considered illustrative. The possible policy actions of the FPC are too numerous too model them all, so this analysis considers three scenarios. These scenarios provide a range of illustrative costs but should not be considered likely policy paths. In fact, given the position of the economy in the credit cycle and the interim FPC's declared intention to not front-run Basel III in the long-term, significant tightening in requirements in the near future is unlikely. However, these scenarios have been assumed in order to provide illustrative costs and benefits for the purpose of this assessment.

42. This assessment has assumed that the FPC will raise and decrease capital requirements at a steady pace, not in discrete one percentage point bands as found in the BCBS paper. Where the model assumes a capital requirement that falls between these bands, the benefits and costs have been interpolated. For example, an additional capital requirement of 1.5 percentage points would equate to an annual output cost of 0.135 per cent (0.09 percent multiplied 1.5). As the relationship between capital requirements and reduction in the probability of a crisis occurring is not linear, only the additional benefit above the percentage band is interpolated. Continuing with the additional 1.5 percentage points example, the benefits in this case are assumed to be equal to the benefits from a one percentage point increase (0.29 per cent if no permanent damage is assumed) plus half the additional benefit of a 2 percentage point increase (0.5 multiplied by 0.2) giving a full annual benefit of 0.39 per cent.

43. No assumption is made as to the split of usage of tools by the FPC. Both the CCB and sectoral capital requirements work by requiring firms to hold additional capital, and the assumed increase in capital requirements could be imposed by using a single tool exclusively or through a mixture of both. A one percentage point increase in the TCE/RWA ratio is assumed to have a constant cost whether imposed via the CCB or sectoral requirements.

Rationale and evidence that justify the level of analysis used in the IA

Proportionality

44. There are many various combinations of tools that could be given to the FPC, far too numerous to undertake individual impact assessments as alternate options for all of them. The Government has therefore performed this impact assessment on the basis of comparing the "do nothing" scenario to implementing the Government's preferred option.

45. The Government's preferred option has been developed based on the analysis and recommendations of the interim FPC and responses to the Government's consultations on the reforms to be implemented by the Financial Services Bill[8]. The consultations and the interim FPC's analysis considered a wide range of potential tools and feedback was received from a diverse pool of respondents.

46. Given the previous consideration of potential tools and the recommendations made by the interim FPC, this assessment does not consider the impact of the many various combinations of tools that the FPC could be granted control over.

Wider impacts

Statutory equality duties

47. The Government has considered the proposed reforms in relation to its public sector equality duties under the Sex Discrimination Act 1975, the Race Relations Act 1976, the Disability Discrimination Act 1995, section 75 of the Northern Ireland Act 1998 and the Equality Act 2010. It has concluded that no relevant issues arise. All UK residents would be affected to a greater or lesser extent by a financial crisis having a severe impact upon the UK economy or by the output costs of increased lending spreads.

Environmental, social and sustainable development impacts

48. The Government does not anticipate any impact upon greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development. This assumes that the proposed FPC direction powers would not change the relationship between certain environmental phenomena and GDP.

Economic impacts

49. The requirements imposed by the FPC could be imposed across all firms that fall within the scope of CRD IV. This may include micro and small-to-medium enterprises. The FSA estimates that there are thirteen banks/building societies with twenty or fewer employees (six of which have ten or fewer

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[8] The Government's previous consultations can be found at http://www.hm-treasury.gov.uk/press_08_12.htm. The Bank published a discussion paper entitled *Instruments of macroprudential policy* in December 2011, which can be found at http://www.bankofengland.co.uk/publications/Pages/news/2011/160.aspx. The interim FPC's recommendations can be found at http://www.bankofengland.co.uk/publications/Pages/news/2012/034.aspx

employees). The FSA estimates that there are 1981 investment firms that meet the EU criteria for classification as a small or medium sized enterprise. Exempting these firms from macro-prudential requirements imposed by the FPC would limit the effectiveness of the tools.

50. Smaller businesses are generally more reliant on bank funding than large corporates, as they don't have direct access to capital markets. These firms may be more exposed to the impact of an increase in lending spreads than larger firms, but this will depend on the availability of alternatives to bank financing. It should be noted that because small firms are reliant on bank funding, they are more exposed to contractions in credit supply following financial crises. These firms are therefore likely to benefit greatly from macro-prudential policy reducing the probability of financial crises and smoothing the credit cycle.

51. The Government believes that there may be a small impact on competition within the banking sector resulting from the FPC's direction powers. The proposed scope of the FPC's tools is banks, building societies and investment firms. Although this covers the majority of lenders, there are some credit providers outside this scope that will not be subject to the requirements imposed by the FPC, which could provide those firms with an advantage relative to firms in scope. For example, sectoral capital requirements on residential mortgages will not apply to non-deposit taking mortgage lenders. This could help non-bank lenders compete against the established banking sector.

52. The current draft of the CRD IV provides for mandatory reciprocity up 2.5 percentage points for any requirements imposed by via the CCB. This means that any requirements imposed by the FPC will also apply to the UK exposures of foreign banks, which should preclude foreign banks having a competitive advantage over UK banking firms.

53. There will be significant benefits resulting from macro-prudential regulation by the FPC. Financial crises are characterised by large output costs, which often spread beyond the financial sector to the wider economy. Reducing the likelihood of financial crises occurring will result in fewer crisis events, avoiding these potential output losses. The Government expects the FPC to act counter-cyclically. Requirements imposed in the upswing can be unwound after any losses have crystallised.

Transmission mechanisms

54. The FPC will mitigate systemic risks both directly and indirectly. Policy decisions by the FPC to impose macro-prudential requirements on firms will enhance their resilience by increasing their loss-absorbing capacity. The FPC may also influence the behaviour of financial institutions both through their actions which may alter relative prices faced by them, and via expectations regarding future policy decisions, e.g. highlighting a risk in the Financial Stability Report may change the behaviour of firms if they expect future policy action regarding the risk.

55. Imposing macro-prudential requirements or altering the behaviour of firms will result in costs to firms which might be amplified in the short run due to frictions in markets. If, for example, several banks attempt to raise new equity at the same time, investors might demand a premium as their appetite at current prices could be limited. Furthermore, firms may not be able to reprice all loans instantaneously following an increase in funding costs, resulting in a larger increase in spreads on new or repricable loans.

56. In principle, unless banks run down voluntary buffers, banks can respond to an increase in capital requirements by:

    - Increasing retained earnings for example by reducing dividend payments or bonuses;
    - Issuing new equity and reducing other forms of funding; and
    - Reducing risk-weighted assets by either reducing the size of their loan portfolios or shifting the composition of their balance sheets.

57. Retaining earnings would allow firms to build capital without the need to raise equity in the markets or deleverage. However, empirical evidence suggests that dividend payments are sticky (firms may wish to maintain distributions to shareholders to reassure markets that their position is healthy), and banks may be unlikely to cut remuneration (this is often justified as necessary to retain high quality staff). Greater flexibility in both of these areas could, however, emerge under a macro-prudential regime.

58. The resulting funding costs of raising new equity may be offset by perceptions that firms are safer as higher capital makes them more resilient, but any costs not offset by this would need to be met in some other way; possibly internalising the costs or raising the price of lending leading to consumers and businesses to change their borrowing behaviour (as set out earlier in this assessment this would impact the volume of credit and therefore output).

59. If firms chose to adjust by cutting risk-weighted assets, the quantity of credit supplied would be directly affected as firms deleveraged. How firms adjust their asset portfolios will be dependent on prevailing market conditions and their own reaction functions.

60. These actions will lead to a lower volume of credit which is likely to enhance the resilience of the financial system, especially in exuberant conditions, and lower short-term output. Any decreases in investment by businesses would have a longer-term impact on output as investment is necessary to maintain capital per worker. However, investment may be misallocated during credit booms and any output costs would be outweighed by the output losses avoided by reducing the occurrence of financial crises and the beneficial impacts of smoothing the supply of credit through the cycle.

61. This assessment uses capital requirements to provide illustrative costs to output, but the distribution of costs is likely to differ between the tools and depend on how the tools are applied. For example, the Government expects that raising the level of the CCB would result in general increases in lending spreads, which would impact all borrowers to some extent. Sectoral capital requirements imposed on particular sectors are likely to have a narrower transmission mechanism. For example, if the FPC applied additional requirements to commercial property assets, the Government expects that this would primarily impact businesses, with second round impacts on households.

62. On the other hand, requirements placed on residential property assets would most likely impact the borrowing and consumption behaviour of households, via greater mortgage costs, to a greater extent than businesses. This policy could impact the availability of mortgage financing, with knock-on effects for house ownership and prices. However, by mitigating the impact of an unsustainable residential property lending boom the FPC should decrease the severity of any resulting bust.

One in One Out rule

63. This policy deals with systemic financial risk and is therefore out of scope of the governments One In One Out rule for new regulation

Summary and preferred option

64. The Government believes the benefits of providing the FPC with direction powers to implement macro-prudential powers clearly outweigh the costs, but welcomes views on this analysis.

65. This assessment will be updated to reflect any important points or questions raised by respondents to the Government's consultation.

66. The Government's final position on macro-prudential tools will be implemented via secondary legislation following the Royal Assent of the Financial Services Bill.

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