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19 March 2014

REMIT AND RECOMMENDATIONS FOR THE FINANCIAL POLICY COMMITTEE

The Bank of England Act 1998, as amended by the Financial Services Act 2012 (the Act), requires me, on an annual basis, to specify what the economic policy of the Government is and to make recommendations to the Financial Policy Committee (FPC) about matters that the Committee should regard as relevant to the Committee's understanding of the Bank's financial stability objective and the Committee's responsibility in relation to the achievement of that objective. The Act also empowers me to make written recommendations to the Committee about its responsibility in relation to support for the Government's economic policy, as well as matters to which the Committee should have regard in exercising its functions.

This letter and the accompanying annex constitute the remit and recommendations for the FPC for the coming year. The annex, including the statement of the Government's economic policy, remains largely unchanged from last year, reflecting our commitment to seeing our long-term economic plan through to completion. This covering letter sets out my perspective on the current economic context and the FPC's priorities for the year ahead.

The UK is now growing faster than any other major European economy, but the recovery is not yet secure. While risks in the eurozone have reduced, concerns remain about persistent weak growth in some euro area economies and the uncertain impact of the ECB asset quality review and stress tests. Volatility in emerging economies, and the impact on global financial markets, could also pose risks to the domestic recovery.

A robust system of financial regulation is one of the fundamentals necessary for economic security, particularly for an open and internationally connected economy like the UK. That is why the Government has comprehensively reformed the UK's regulatory architecture to address failings exposed by the financial crisis.

The FPC, with its responsibility for identifying, monitoring and tackling risks to the financial system as a whole, is central to safeguarding UK financial stability. I have been impressed by the focus and clarity of purpose that the FPC has brought to this challenging mandate in its first year as a statutory body. The FPC acted promptly to assess the risks that could arise from upward movements in long-term interest rates, and thereby helped improve market awareness of how emerging market volatility could impact the UK financial system. It has given additional impetus to the initiatives underway to tackle the growing threat to the financial system from cyber attacks. The Committee has also rightly recognised, in its approach to bank capital and liquidity, for example, the importance of considering the impact of its actions on both of its objectives – contributing to the achievement of the Bank's financial stability objective and, subject to that, supporting the Government's economic policy. This is particularly crucial at this stage of the economic recovery.

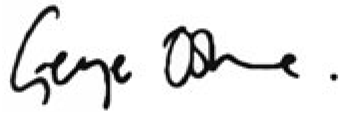
The housing market and the construction sector are recovering following a severe downturn caused by the recession and previous irresponsible lending practices. Although housing activity remains below long-term trends, the FPC is right to remain vigilant as the recovery progresses. A sustainable recovery in the housing market will only be secured if lenders continue to lend responsibly and borrowers do not take on unaffordable commitments. The FPC has also provided important clarity to markets and households about the suite of tools at its disposal to address housing market risks should they emerge in future.

I also welcome the FPC's decision to focus its forward work programme over the next 12-18 months on three key priorities – the medium term capital framework for UK banks; 'ending too big to fail'; and assessing risks in shadow banking, while working to support diverse and resilient sources of market based finance. I am pleased that the FPC's agenda closely matches that of the Financial Stability Board; it is important the UK is both at the forefront of shaping the international standards and in implementing them in the UK. The Committee should continue to work closely with the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) on these priorities. The FPC's policy recommendations should be supported, whenever practicable, by a published assessment of the costs and benefits, as required under the Act. I believe it will be particularly important in the context of the impact assessments of the FPC's proposals for the medium term capital framework and 'ending too big to fail'. Further progress in these priority areas, both domestically and internationally, is crucial if we are to finish the job of putting in place a robust system of financial regulation that safeguards financial stability, while continuing to promote greater competition and choice for the users of financial services.

The FPC and the Monetary Policy Committee should continue to have regard to each other's actions, to enhance coordination between monetary and macroprudential policy. As also noted in my remit letter to the Monetary Policy Committee, I share the Bank's view that the FPC's macroprudential tools, together with the microprudential supervision of the PRA and FCA, are the first line of defence against risks to financial stability.

I have been encouraged by the clarity and consistency in the FPC's communications over the past year. Given the important issues ahead, including the stress testing exercise, it will be important to ensure clear and timely communications to all stakeholders. More generally, I think there is still more to do to improve public understanding of the FPC's role. I know you share this goal and will be addressing this over the coming year.

The FPC has demonstrated its value and effectiveness during its first full year of operation, and I am grateful for your leadership and the contribution of all of the FPC's members.



GEORGE OSBORNE

REMIT AND RECOMMENDATIONS FOR THE FINANCIAL POLICY COMMITTEE

The Bank of England Act 1998 ("the Act") (as amended by the Financial Services Act 2012) sets out the objectives of the Financial Policy Committee. The Committee is to exercise its functions with a view to:

a) contributing to the achievement by the Bank of the Financial Stability Objective; and

b) subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment.

The Bank's Financial Stability Objective, under the Act, is to protect and enhance the stability of the financial system of the United Kingdom.

The responsibility of the Committee in relation to the achievement by the Bank of its Financial Stability Objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

The Act makes clear (section 9C(4)) that it does not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.

Section 9D(2) of the Act requires that I specify the economic policy of Her Majesty's Government within 30 days of the day section 9C comes into force and at least once in every year thereafter.

Section 9E(1) of the Act also requires me to make recommendations to the Committee about:

- matters that the Committee should regard as relevant to its understanding of the Bank's Financial Stability objective; and
- the responsibility of the Committee in relation to the achievement of that objective.

Section 9E(2) of the Act requires that I make such recommendations within 30 days of the day that section comes into force and at least once in every year thereafter.

In addition, section 9E of the Act empowers me to make recommendations to the Committee about:

- the responsibility of the Committee in relation to support for the economic policy of Her Majesty's Government, including its objectives for growth and employment; and
- matters to which the Committee should have regard in exercising its functions.

This document discharges the Treasury's duties under both section 9D and section 9E of the Act.

A. The Government's economic policy

The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries. This objective recognises that over a number of years preceding the recent financial crisis, economic growth in the UK was driven by unsustainable levels of private sector debt and rising public sector debt. This pattern of unbalanced growth and excessive debt helped to create exceptional economic challenges in the UK.

A stable and sustainable financial system has a key role to play in that objective as a provider of finance and financial intermediary services to the real economy, providing households and businesses with sufficient access to, and an appropriate allocation of, finance to support sustainable economic growth.

The Government's economic strategy consists of four key pillars:

- monetary activism and credit easing, stimulating demand, maintaining price stability and supporting the flow of credit in the economy;
- deficit reduction, returning the public finances to a sustainable position and ensuring that sound public finances and fiscal credibility underpin low long-term interest rates;
- reform of the financial system, improving the regulatory framework to reduce risks to the taxpayer and build the resilience of the system; and
- a comprehensive package of structural reforms, rebalancing and strengthening the economy for the future, including a package of measures to support businesses to invest and export.

Returning the financial system to full health, so that it can support the wider economy, is a key element of the Government's comprehensive economic strategy, which is designed to protect the economy, to maintain market confidence in the UK and to lay the foundations for a stronger, more balanced economy in the future.

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

The Financial Policy Committee is charged with contributing to the Bank's financial stability objective primarily by identifying, monitoring and addressing risks to the resilience of the UK financial system as a whole. The purpose of preserving stability is to contribute to avoiding serious interruptions in the vital functions which the financial system as a whole performs in our economy: notably, the provision of payment and settlement services, intermediating between savers and borrowers, and insuring against risk. In order to do so, the Committee should, amongst other things, monitor and consider those market issues and systemic conduct issues that could have material implications for the resilience of the financial system, as well as the systemic build-up of prudential risks and systemic vulnerabilities to business continuity risks.

The role of the Committee is a crucial complement to, but distinct from, those of the firm level regulators. The Act provides the Committee with the power to give directions and also recommendations, including on a 'comply or explain' basis, to both the Prudential Regulation

Authority and the Financial Conduct Authority. The Act makes clear that the Committee will not be responsible for making decisions in respect of individual firms. Where relevant to sustaining systemic stability, the Committee should use its recommendation powers to steer both the Prudential Regulation Authority and Financial Conduct Authority's general policies towards types of firms or risks, including, for example, in the case of the Prudential Regulation Authority's strategic approach to large systemically important firms.

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

i. Recommendations as to the interaction between the Financial Policy Committee's objectives

The Financial Policy Committee's primary objective of contributing to the Bank's financial stability objective by identifying, monitoring and reducing risks to the resilience of the financial system and its secondary objective relating to economic growth can and, where possible, should be complementary. There may, however, be circumstances where the Committee faces a trade-off between the secondary objective of supporting economic growth in the short term and the primary objective of addressing sources of systemic risk. The materiality of any such trade-offs may vary with the precise circumstances of the financial system at different points of the economic and credit cycles. The Committee is neither required nor authorised by the Act to exercise its functions in a way that would in its opinion 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.

Any such trade-offs should be managed and communicated transparently and consistently with the Committee's assessment of the costs and benefits of its actions, in the light of the Act's provisions.

Specifically, the Act requires the Committee to explain the use of its powers, and also to prepare explanations of how decisions to exercise the following powers are compatible with the Committee's objectives and other general duties:

- its direction making powers;
- its powers to make recommendations within the Bank relating to the exercise of the Bank's functions in relation to payment systems, settlement systems and clearing houses;
- its powers to make recommendations to the Treasury; and
- its powers to make recommendations to the Prudential Regulation Authority and Financial Conduct Authority.

In discharging this requirement the Committee should set out publicly how its actions are assessed to contribute to its objectives, including its judgement as to the balance of risks to those objectives, how those risks are judged to have evolved and how they are expected to evolve.

ii. Recommendations as to the interactions between monetary policy and macroprudential policy

In general, the objectives of price stability and financial stability will be complementary over the longer-term. As with both the Monetary Policy Committee's and the Financial Policy Committee's primary and secondary objectives, there may, however, be occasions when there are short-term trade-offs to be made between these objectives.

In order to foster coordination of monetary and macroprudential policy, there is overlap between the membership of the Monetary Policy Committee and the Financial Policy Committee. To enhance that coordination, where appropriate, the Financial Policy Committee should note in the records of its meetings, its policy statements and its Financial Stability Reports how it has had regard to the policy-settings and forecasts of the Monetary Policy Committee. In the same way, the Government has also asked the Monetary Policy Committee to reflect in any statements on its decisions, the minutes of its meetings and its Inflation Reports how it has had regard to the policy actions of the Financial Policy Committee.

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

A key element of the Government's economic strategy is reform to strengthen the resilience of the financial system, minimise risks to taxpayer funds and reduce the perceived implicit taxpayer guarantee. The Financial Services Act 2012 places obligations on the Bank, in pursuing its financial stability objective, to notify the Treasury where there is a material risk of public funds being required and to notify the Treasury of any subsequent changes to such a risk.

As a Committee of the Bank's Court of Directors, the Financial Policy Committee should, in exercising its responsibilities and functions under the Act, have regard to whether there is a material risk of public funds being required, such that the Bank's obligation to notify the Treasury would be triggered. The Committee should seek where possible to minimise such risks whilst recognising that it will be for the Chancellor and the Treasury to determine whether any use of public funds would be in the public interest. Where it identifies such a risk, the Committee should take it into account in its assessment of the costs and benefits of its actions, and should reflect its assessment in its publications and wider communications (subject to deferred publication on public interest considerations).

Similarly, where the Bank makes a public funds notification that, in its judgment, is relevant to the exercise by the Committee of its responsibilities and functions under the Act, the Bank should alert the Committee to that notification.

The Chancellor and the Treasury have sole responsibility for any decisions on whether and how to use public funds in support of financial stability. The Treasury will need to satisfy itself that any use of public funds would offer good value for public money and to this end may, as appropriate, request further information from the Bank.

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

The Act allows the Financial Policy Committee to make a number of written recommendations to the Treasury on the need for legislative changes; these include changes to the scope of activities regulated under the Financial Services and Markets Act 2000, to the scope of activities prudentially regulated by the Prudential Regulation Authority and the purposes for which the Financial Conduct Authority may make product intervention rules. The Committee may also recommend that the Treasury gives it additional or revised powers of direction.

In order to aid the Treasury's assessment of the case for making these legislative changes, the Committee should provide, along with its written recommendations, evidence that:

- there are potential risks which the Committee, the Prudential Regulation Authority or the Financial Conduct Authority need to address in those areas that cannot be effectively mitigated within the current regulatory powers;
- the Committee's proposals would address effectively those risks; and
- changes to the potential actions by the Committee, the Prudential Regulation Authority or the Financial Conduct Authority, and any resulting action by those bodies in those areas would not create material unintended consequences or costs in excess of the benefits.

v. Accountability

The Financial Policy Committee's performance and procedures are reviewed by the Court on an ongoing basis. The Bank is accountable to Parliament through its publication of the twice annual Financial Stability Reports (FSR) and evidence given to the Treasury Committee. Finally, through the publication of the record of its meetings, the FSR, policy statements for its direction-making powers, the explanations of its decisions and its wider communications, the Financial Policy Committee is accountable to the public at large. Therefore, the Committee should attach high priority, in so far as consistent with its statutory objectives and functions, to reducing uncertainty and boosting confidence in financial markets, notably by continuing to develop the set of published indicators that it uses to monitor and assess risks to financial stability, by providing clear, focussed and consistent messages about the planned regulatory response to identified financial stability risks and making sure that its policy actions are as predictable as possible. Recognising the requirements in the Act to achieve consensus wherever possible, communication by individual members regarding Financial Policy Committee decisions needs to be coordinated and consistent where decisions are reached by consensus. Where consensus cannot be reached and a vote is taken, as required by the Act, the balance of arguments should be reflected in the record of the meeting. In such circumstances, members should be free to explain their differences and will be publicly accountable accordingly.