BANK OF ENGLAND

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

Mark Carney
Governor

26 March 2015

Dear Chancellor

In my role as Chairman of the Financial Policy Committee (FPC), I attach the FPC's formal response to the remit and recommendations that you set out in your letter and attachment of 18 March.

The FPC welcomes your positive assessment of the performance of the FPC over the past year and your remit and recommendations for the coming year. The Committee intends to act in accordance with them, as detailed in the attachment to this letter.

In the Committee's view, global risks to the outlook for financial stability in the UK remained elevated over the past year, including those related to continuing uncertainty in the euro area. The Committee, in consultation with the PRA Board, has taken into account developments in the global economic and financial environment in setting this year's stress test scenario – the scenario and hurdle rates for the 2015 stress test exercise will be published on 30 March.

Consistent with your suggestion in 2013, in order to focus its efforts the FPC has set out three medium-term priorities, in addition to its overarching priority to monitor, and if necessary mitigate, risks to financial stability from the macroeconomic and financial environment. The FPC intends to continue to make progress on these over the coming year.

The FPC has two medium-term priorities linked to bank capital: establishing the medium-term capital framework and ending too-big-to-fail. In 2015, the Committee will consider the systemic buffer framework for domestic systemically important banks, including institutions other than ring-fenced banks. Given the Bank's obligation under the European Bank Recovery and Resolution Directive to establish requirements for loss absorbing capacity in resolution for all banks, the FPC will review the overall framework for setting those requirements. The Committee also intends to review the calibration of the overall capital framework for the UK banking system.

On the FPC's third medium-term term priority to ensure diverse and resilient market-based finance, the FPC intends to carry out its annual assessment of financial stability risks and regulation beyond the core banking system later this year. The Committee will also continue to explore financial stability risks arising from procyclicality in the availability of finance, including via collateral markets.

More broadly, the Committee remains concerned about the risk that market liquidity could prove fragile in stressed conditions, and judges that there is a need for market participants to be aware of these risks. The FPC will continue to highlight the importance of the work being undertaken in international fora in this area. Domestically, the Bank and FCA are also planning to gather information from asset managers operating in the UK. Furthermore, the Bank is developing a research agenda to assess the impact of structural changes on market liquidity.

The Committee agrees with your view on the importance of ensuring the resilience of the core UK financial system and its infrastructure to cyber threat. HM Treasury has continued its work, alongside other Government agencies, the FCA and the Bank to help progress work in this area following the FPC's recommendation to do so in 2013. The Committee looks forward to receiving a more complete set of results this year from vulnerability testing of core firms and financial market infrastructures, in order to assess levels of resilience.

Following your requests, the FPC set out its views on the powers of Direction necessary to manage financial stability risks from leverage and the housing market in 2014, and welcomes that, following Parliamentary debate, instruments granting the FPC powers of Direction related to the leverage ratio framework and owner-occupied residential mortgage lending will now come into force with effect from 6 April. As you note, the Committee's draft Policy Statements set out publicly the general policy that the FPC expects to follow in using these powers of Direction, as well as the Committee's view on the possible impact of the tools on financial stability and growth. The FPC will continue to increase public understanding of these tools, and others such as the countercyclical capital buffer, as it develops further its strategy for using them including by drawing on domestic and international experience.

In addition to powers of Direction over tools related to owner-occupied residential mortgage lending, the FPC recommended in September 2014 that HM Treasury exercise its statutory power to grant the FPC power of Direction over tools related to buy-to-let lending. The FPC welcomes the Government's intention to consult on tools related to buy-to-let lending later in 2015.

The Committee will continue to make evidence-based arguments for any future Recommendations to HM Treasury to grant it further powers of Direction, as you note it did for the leverage ratio and housing market tools in 2014. The Committee supports the need, as you suggest, for regulators to undertake comprehensive consultation with the industry and the public when a new power of Direction is first introduced by the FPC in order to establish a robust and well thought through framework for implementation. Once the framework is established it is an important feature of countercyclical macroprudential instruments that their calibration can be changed in a timely way in response to financial stability risks because delayed implementation may lead to the very adverse outcome the tool is seeking to limit being brought forward.

The FPC regularly considers the policy setting and forecasts of the Monetary Policy Committee (MPC) in reaching its decisions, and the sharing of relevant information, briefing and analysis across the two Committees has increased over the past year. To enhance information sharing further, the Bank announced in response to the Warsh Review that four joint briefing meetings of the FPC and MPC would be scheduled in 2016.

The Committee also works closely with the PRA Board and the 2014 stress testing exercise provided a good example of this. The FPC and the PRA Board discussed the scenario and hurdle rate framework ahead of the decision on each being taken; and the stress test results were used by the PRA Board as part of its evaluation of the capital adequacy of individual institutions and by the FPC as part of its evaluation of the resilience of the system as a whole.

The Committee has continued to develop its relationship with the FCA. Joint work by FCA and Bank staff on the systemic importance of hedge funds, which fed into the FPC's assessment of financial stability risks outside the core banking sector, provides a good example of this interaction. The FCA also gives a regular presentation at FPC briefing meetings. The Committee looks forward to receiving work from the Bank and the FCA over the coming year to consider the financial stability risks relating to market liquidity.

In all of its work, it will be important for the Committee to be transparent – to make its policies more effective, to account for its decisions and to improve understanding of the FPC's role. To these ends, the Record of the FPC's policy meeting will continue to set out the deliberations of the Committee in reaching its policy decisions – whether they are made by consensus whenever possible as required by the Act, or if necessary through a vote.

Yours sincerely,

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

On 18 March 2015, the Chancellor set out a series of recommendations to the Financial Policy Committee (FPC) under sections 9E(1) and 9E(2) of the Bank of England Act 1998 (as amended by the Financial Services Act 2012) (the Act). This document sets out the Committee's response, in accordance with section 9E(3) of the Act. The response is organised around the sub-headings of the HM Treasury document.

A. The Government's economic policy

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

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

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

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

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

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

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

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

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

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

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

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

The actions of the FPC can have implications for the objectives of the Monetary Policy Committee (MPC) and *vice versa.* As part of the MPC's guidance on the future stance of monetary policy announced in August 2013, the FPC was asked to assess whether the stance of monetary policy posed a significant threat to financial stability that could not be contained by the substantial range of mitigating policy actions available to the FPC, the FCA and the PRA in a way consistent with their objectives. That recognised that monetary policy has an important role to play in mitigating financial stability risks, but only as a last line of defence. The MPC's further guidance on the setting of monetary policy reiterated that this division of responsibilities between regulatory policy and monetary policy would continue once the 7% unemployment threshold was reached, as it was in February 2014, and the financial stability knockout no longer applied. In addition, with the conventional instrument of monetary policy constrained by the lower bound to interest rates, the FPC's actions may be particularly relevant to the level of aggregate demand, the way the financial system transmits changes in monetary policy to the economy and, therefore, for the MPC's objectives. That makes close liaison between the FPC and the MPC especially important at the current juncture.

In reaching its decisions, the Committee considers the policy settings and forecasts of the MPC, as first explained in its June 2013 *Financial Stability Report (FSR).*[1] The FPC's consideration over the past year of potential financial stability risks stemming from the UK housing market, and subsequent action, provides a recent example of this. The Committee will continue to explain how it has regard to the stance of monetary policy and the MPC's forecasts. More generally, overlapping membership of the Committees should foster coordination.

This is enhanced by the sharing of relevant information, briefing and analysis to all members of both Committees. For example, FPC and MPC members are free to attend the other Committee's briefing meetings. The Committees also have joint discussions where the circumstances warrant it. The two Committees have already conducted joint briefing meetings focused on topics of mutual interest, such as credit conditions and housing. To enhance this interaction further, the Bank announced that four joint briefing meetings will be scheduled in 2016.

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

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

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

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

The Act provides for the Committee to make recommendations to HM Treasury relating to the boundaries between and within regulated activities and products. The Committee receives regular briefing on the relevant risks to financial stability arising from less regulated sectors and activities from the Bank, PRA

[1] Box 3 of the June 2013 *Financial Stability Report* discusses how the FPC has regard to the policy actions of the MPC: http://www.bankofengland.co.uk/publications/Documents/fsr/2013/fsrfull1306.pdf.

and FCA. It will also hold, at least annually, a regular dedicated discussion on the appropriate boundaries around, and within, the regulatory perimeter. The Committee held its first dedicated discussion of financial stability risks beyond the core banking sector in June 2014 and intends to do the same again in June 2015.[2]

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

v. Accountability

The Committee is accountable to Parliament and the public. FPC members are subject to a clear code of conduct designed to preserve the Committee's reputation for integrity and independence of judgement. Members need to be, and be seen to be, independent of Government and other influences. To promote accountability, all FPC members stand ready to give evidence to the Treasury Committee, including by giving evidence following each *FSR.* As required by the Act, the Governor also meets with the Chancellor after each *FSR* to discuss matters relating to the stability of the UK financial system, with a public record of the meeting published within six weeks.

Consistent with its statutory objectives and functions, the Committee recognises the importance of reducing uncertainty and boosting confidence in financial markets through its actions. To that end, it is continuing to develop its published indicators, which it has set out in its January 2014 Policy Statement 'The Financial Policy Committee's powers to supplement capital requirements' and its two draft Policy Statements on leverage ratio and housing tools in January 2015. These indicators are considered alongside a wider set of information, varying over time depending on emerging risks, including market and supervisory intelligence. And the Committee will explain its decisions and judgements in the context of both this analysis and its published indicators.

Annual concurrent stress tests of banking sector resilience are also a key element of the Committee's approach. The first concurrent stress testing exercise took place in 2014 and the FPC and PRA Board are in the process of finalising for publication the scenario and hurdle rate framework for the 2015 exercise.

The Committee agrees on the importance of clear and consistent communication, especially on decisions reached by consensus – a requirement of the Act is that the Committee seeks to take decisions by consensus where possible. The Record of the FPC's policy meeting will continue to reflect the deliberations of the Committee in reaching consensus to ensure that its decision making is transparent and accountable. Where a consensus cannot be reached, the results of any vote, including individual members' votes, and the balance of arguments will be set out in the Record of the meeting; and members will be free to explain their vote subsequently. In such circumstances, the Committee will ensure that its communications seek to avoid uncertainty.

[2] Box 9 of the June 2014 *Financial Stability Report* summarises the FPC's dedicated discussion of risks beyond the core banking sector in 2014: http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf.