BANK OF ENGLAND

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

Mark Carney
Governor

11 August 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 accompanying annex of 8 July. This letter is in three sections, reflecting your points on the Committee's objectives, its programme of work and its approach to communication and external consultation. The annex responds to each of your points in turn.

The Committee's objectives

Your letter outlined the objectives set for the FPC in the Bank of England Act 1998 ('the Act'):

- a primary objective of contributing to the achievement by the Bank of the Financial Stability Objective – where the FPC's responsibility 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; and

- subject to that, a secondary objective of supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. In your letter you have set out the Government's current economic policies, including a focus on measures to boost the UK's productivity and to improve competition, innovation and competitiveness in the UK financial services sector.

The Committee welcomes your affirmation of the primacy of its financial stability objective, and agrees with your characterisation of its primary objective as a vital pre-requisite for strong, sustainable and balanced economic growth, including by supporting productivity growth. As you note, the past seven years have demonstrated the damage caused to productivity by financial instability.

In pursuing its primary objective, the Committee seeks to ensure the financial system has the resilience to withstand stress while continuing to provide critical services to the real economy, including the provision of credit to business in support of productive investment. The Committee's view is that the core of the system is now significantly more resilient. The Committee also seeks to underpin the resilience of the system when the risks it faces become more pronounced. As the economy and the financial system emerge from the aftermath of the financial crisis, the Committee is alert to the possibility of a build-up of risk in the system.

When addressing any risks to financial stability, the Committee is well aware of its statutory duty not to act in a way that it judges would be likely to have a significant adverse effect on the capacity of the UK financial sector to contribute to the growth of the UK economy in the medium or long term. In this regard, it will continue to take account of the effect of its actions on the sustainable supply of finance to the real economy. It hopes to draw on the joint research work of the Bank and HM Treasury on measuring the supply of finance, in its broadest sense, for productive investment.

The Committee will also assess the cumulative effects of reforms to make the financial system more resilient and consider whether in aggregate they have unintended undesirable effects. In this context it will draw on the findings of the Open Forum being organised by the Bank on 11 November 2015, which will take stock of the reform agenda in financial markets. Where appropriate, the Committee will consider whether the improvements in resilience from those reforms could be achieved in ways that are further supportive of strong, sustained and balanced growth.

Subject to achievement of its primary objective, the Committee also remains committed to pursuing financial stability in ways that are in line with its secondary objective. It does so in three ways.

1. Although the Committee agrees that actions that seek to enhance resilience of the UK financial system would be expected to contribute positively to growth over the medium and long term, it recognises that action to increase resilience may in some circumstances have a short-term negative effect on growth. In such circumstances, it will take account of the costs and benefits of its actions to both its primary and secondary objectives.

2. The Committee will continue to design carefully its policies in pursuit of its primary objective in ways that as far as possible contribute to its secondary objective. As one recent example of considering this, the Committee's June 2014 recommendation on mortgage affordability exempted firms below a *de minimis* threshold.

3. The Committee will also assess its work programme, which it intends to refresh for 2016, to consider the extent to which policies in pursuit of its primary objective can also support its secondary objective directly. For example, the Committee's priority for ensuring diverse and resilient sources of market-based finance can contribute both to the resilience of the supply of funding to the real economy and promote finance for productive investment.

Broadening the focus of the work of the FPC

In many respects the Committee's work has already evolved in ways consistent with your letter, as set out in the July 2015 edition of the *Financial Stability Report*.

The Committee has made great progress in reforming the core of the financial system. The first concurrent stress test in 2014 highlighted the improvements in banks' capital strength, and wider reforms mean that the sector is now better placed to withstand stress and more able to serve the economy. The second concurrent stress test is underway.

The Committee's framework for the leverage ratio for UK banks and building societies has been agreed. By the end of the year, international standards for total loss absorbing capacity for G-SIBs will be established and the process of implementing European requirements on loss absorbing capacity will have begun.

The Bank will publish in the autumn additional details on its approach to making banks more resolvable, as part of implementing agreed reforms, by:

- Consulting on minimum requirements for own funds and eligible liabilities (MREL); and
- Consulting on aspects of implementing structural reform initiatives previously launched.

The Committee will conclude the design and calibration phase of its own work on the capital framework for UK banks later in Q4 by:

- Reviewing the overall calibration of the capital framework and clarifying the role of the buffers within that framework;
- Establishing the criteria and methodology for the systemic risk buffer that will be applied to ring fenced banks and large building societies; and
- Clarifying the future direction of stress testing, working jointly with the Board of the Prudential Regulation Authority (PRA).

The Committee's focus on the banking system will then turn to implementation of these reforms and to reviewing the impact as they are implemented in order to address any issues that arise.

The progress made in fixing the fault lines in the banking system means that the Committee is now more able to broaden its focus to potential risks emanating from and associated with non-bank activities. By balance-sheet size, nearly half of the current UK financial system consists of non-bank financial institutions. Capital markets are an increasingly important source of financing for the UK corporate sector and beyond, and globally almost all net finance growth since the crisis has been in market-based finance. A broad agenda encompassing non-banks is necessary to ensure that any potential systemic risks from market-based finance are identified and also that risks do not migrate from one part of the financial system to another.

The Committee has instigated a programme of work by the Bank and FCA to review the drivers and potential risks associated with reduced liquidity in many core markets. Reduced liquidity has contributed to some sharp intraday price movements in certain markets. Greater volatility does not itself threaten financial stability, and to the extent it reflects the introduction of prudential requirements on market-making intermediaries, and more accurate pricing of liquidity, it is associated with a welcome increase in the resilience of the core of the financial system. Nonetheless, there are likely to be other relevant factors, such as structural changes in markets. This makes it all the more important that market participants are alert to these developments, price liquidity appropriately and manage it prudently. In September, the Committee will discuss the full report on market liquidity that it commissioned from Bank and FCA staff at its March 2015 meeting.

The Committee will also review a number of activities in the non-bank financial system over the next year, to consider potential systemic risks posed by: the investment activities of open-ended investment funds and hedge funds; securities financing transactions; the non-traditional, non-insurance and investment activities of insurance companies; and derivative transactions. These reviews will complement the Committee's annual stocktake of risks outside the core banking system. If the Committee identifies risks or structural vulnerabilities that cannot be addressed under the current regulatory framework, it will consider making recommendations to HM Treasury relating to the boundaries between and within regulated activities and products.

The Committee has also broadened its risk assessment and mitigation to non-financial risks to financial stability, working with other authorities as appropriate. Its work on cyber risk is one example of this so far, including the Recommendation on continued penetration ('CBEST') testing made at its June 2015 policy meeting. It highlighted the critical role of strong and effective governance at firms in order to build capability in defensive resilience and recovery across technology and personnel.

Communication and Collaboration

The Committee agrees with the importance placed on clear and consistent communication, which you have rightly highlighted each year in the FPC's remit. The Committee also attaches importance to its deliberations and decisions being open and transparent.

The Court of the Bank, in response to a suggestion from the Committee, amended the FPC's Code of Conduct in April 2015 to ensure its consistency with these principles.[1] The Code is now clear that:

- The Bank of England Act 1998 (paragraph 11(4) of Schedule 2A) requires the Chair of the FPC to seek to secure that decisions are reached by consensus wherever possible. When consensus is reached, individual members are fully entitled to explain their policy position but should respect the consensus. You have also recommended that communication by individual members regarding FPC decisions needs to be coordinated and consistent where decisions are reached by consensus;

- Where a decision is reached instead by vote, individual votes will be published in the Record of the meeting and individual members will be entitled to explain their individual positions; and

- In all circumstances, the Record will set out a summary of the Committee's deliberations in reaching its decisions, whether through consensus or a vote. Members of the Committee are confident in their freedom to express their views and to contribute their individual voices to the debate.

[1] See www.bankofengland.co.uk/financialstability/Documents/fpccoc.pdf.

The Committee will continue to fulfil its statutory responsibilities in an open and collaborative fashion, and will seek further ways to benefit from the views of industry participants, academics, other regulators and the public, as appropriate, to supplement its own expertise. It appreciates the importance of public consultation in developing its policy, and, when it consults publicly, will align the length of the consultation to the complexity and impact of its proposals. The Committee welcomes your recognition that in some cases, it may need to act without, or with only abbreviated, consultation in order to protect and enhance the stability of the financial system. This helpfully acknowledges that, given the nature of macroprudential policy, implementing certain policies with a lag could bring about the precise action that the Committee was seeking to avoid.

Yours sincerely,

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

On 8 July 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 ('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.

In line with the Act, the Committee seeks to further the Bank's financial stability objective primarily by identifying, monitoring and taking action to remove or reduce systemic risk, with a view to protecting and enhancing the resilience of the UK financial system. Those systemic risks include in particular those associated with: structural features of financial markets; the distribution of risk within the financial sector; and unsustainable levels of leverage, debt or credit growth.

The FPC will therefore consider:

i. Prudential risks associated with the banking system;
ii. Prudential risks associated with the non-bank financial system, including markets;
iii. Non-financial risks, including conduct risks and cyber security.

One of the Committee's powers is to make recommendations to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (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

i. Recommendations as to the interaction between the FPC's objectives

The Committee's primary objective is to exercise its functions with a view to contributing to the achievement by the Bank of the financial stability objective. The Act 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.

Subject to its primary objective, the Committee has a secondary objective of supporting the Government's economic policy, including its objectives for growth and employment.

In practice, actions that seek to protect and enhance the resilience of the UK financial system would be expected to contribute positively to growth over the medium and long term. Recent experience demonstrates that financial stability is a precondition for sustainable economic growth; a stable and resilient financial system should help to facilitate a sustainable efficient flow of funds within the economy and an effective allocation of savings to investment.

The Committee recognises that action to increase resilience may in some circumstances have a short-term effect on growth, even when that action will make a positive contribution to growth in the medium and longer term. In such circumstances, it will manage and communicate its approach transparently and consistently, having regard to proportionality and, where appropriate and practicable, the 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.

Further, the Committee will design carefully its policies in pursuit of its primary objective in ways that as far as possible are effective in achieving also its secondary objective. And it will regularly assess its work programme against its secondary objective to consider the extent to which policies in pursuit of its primary objective may also support its secondary objective.

ii. Recommendations regarding facilitating finance for productive investment

HM Government's package of measures to improve the productivity of the UK, as part of its economic policy, includes measures aimed at boosting the supply of finance for productive investment.

Some of the Committee's policies to date are likely to provide support for these measures directly. The Committee has established a medium-term priority to ensure resilient and diverse sources of market-based finance – which should better diversify funding for the real economy.

The Committee will continue to consider the capacity of the financial sector to supply finance for productive investment when judging whether its actions could 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.

The Committee will look at the effects of its policies cumulatively as they are implemented, to consider whether policies designed in pursuit of its primary objective give rise to unintended, undesirable consequences when considered in aggregate. In doing so, it will draw on the findings of the Open Forum being organised by the Bank on 11 November 2015, which will take stock of the reform agenda in financial markets. The Committee also hopes to incorporate the results of the joint research work that is now starting between HM Treasury and the Bank to create a better measurement of productive investment.

iii. Recommendations regarding support for the Government's policy towards the financial services industry

The FPC will, through discharging both its primary and secondary objectives, support the Government's policy towards the financial services industry.

In terms of the Government's policy towards competition in the financial services sector, other national authorities will play the primary role. For example, the Competition and Markets Authority is charged with a single primary duty to seek to promote competition, both within and outside the UK, for the benefit of consumers.

The FPC will, where practicable in the context of its financial stability objective, consider how its policy actions (or decisions not to act) might affect competition, innovation and the international competitiveness of the UK financial system.

D. Matters to which the Committee should have regard in exercising its functions

i. 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).*[2] 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.

ii. 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.

[2] 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.

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.

iii. 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 FPC will make such recommendations only where it identifies systemic risks that cannot otherwise be addressed.

The Committee has an established process to assess such systemic risks outside of the core banking sector. It receives regular briefings from the Bank, the PRA and the FCA on potential risks to financial stability presented by different sectors and activities.

It holds, at least annually, a dedicated discussion on the appropriate boundaries around, and within, the regulatory perimeter. It will also undertake a regular analysis of activities beyond the core banking sector, reviewing at least one activity per quarter.

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.

iv. Recommendations regarding enhancing the accountability of the FPC

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 Policy Statements on the leverage ratio and housing tools in July 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 to increasing confidence in the financial system. The first concurrent stress testing exercise took place in 2014 and the Bank has published 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. The Act (paragraph 11(4) of the Schedule 2A) requires the Chair of the Committee to seek to ensure that decisions are reached by consensus where possible. The Record of the FPC's policy meeting will continue to reflect the deliberations of the Committee in reaching a 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 seek to ensure that its communications avoid uncertainty.

v. <u>Recommendations as to engagement with financial sector participants and other external experts</u>

The FPC will continue to fulfil its statutory responsibilities in an open and collaborative fashion, seeking the views of industry participants, academics, other regulators and the public, as appropriate, to supplement its own expertise, and will further develop structures to do so.

When it consults publicly, the FPC will continue to align the length of the consultation to the complexity and impact of its proposals.

There may be cases where urgent action is required in order to protect and enhance the stability of the financial system – either directly or because implementation of the policy with a lag could bring about precisely the action that the Committee was seeking to avoid. In such cases, it may be appropriate for the Committee to act without, or with abbreviated, consultation.

When deciding whether and how to engage with external experts, the Committee will give careful consideration to whether the publication of a contemplated future policy action could give rise to actions aimed at avoiding future requirements, regulatory arbitrage, or financial sector participants taking other actions that could lead to risks to financial stability.