HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

16 March 2016

Mark Carney
Governor
Bank of England
Threadneedle Street
London
EC2R 8AH

Dear Mark,

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, at least once a year, 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 responsibilities 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. This covering letter sets out my perspective on the current economic context and the FPC's priorities for the year ahead.

The current economic environment remains challenging as the UK faces volatility in global markets and the prospect of a slowing world economy. Since the start of the year, financial markets have been volatile and we have seen a sharp retrenchment in risk appetite. The sudden onset and prolonged duration of this period of market fragility reinforces the need for a resilient and sound financial system that can weather periods of instability and economic uncertainty and continue to provide key services to the rest of the economy.

The Government has continued its work to secure our long-term economic future by placing the public finances on a path to achieving a surplus by 2019-20. The Government is implementing the measures set out in last year's Productivity Plan, aimed at driving the next phase of our growth and to raise living standards. The UK has been one of the fastest growing advanced economies in the world these past few years, we have made much progress in reducing unemployment and 2015 saw the employment rate hit a record high.

Since my previous remit letter to the FPC in July 2015, the Committee has continued its work to protect and enhance financial stability. The FPC has set out its views on the appropriate aggregate level of capital in the UK banking system, providing the industry with a clear indication of what is expected by the regulators. The Bank undertook its second stress test of the UK's largest banks and building societies, testing the resilience of the banking system to an emerging market economy shock.

While welcoming these accomplishments, we must remain vigilant to the global and domestic risks that we still face. The FPC has set out the policy framework for capital requirements faced by banks, building societies and investment firms, and its focus in 2016-17 should be to build on this achievement and implement a stable regulatory environment. The financial crisis has led to a wave of fundamental reforms across the world and 2016 marks the beginning of the phased implementation of many of these new requirements. I welcome the FPC's intention to consider the overall impact of regulation and look forward to your conclusions on this subject.

The importance of vigilance cannot be overstated. The UK has the potential to be the most prosperous of all the major nations in the next generation – and the FPC's primary objective of financial stability is a vital prerequisite if we are to fulfil that potential - but we face a number of risks to our economic and financial systems, both at home and abroad. As set out above, the FPC has set out a capital framework for banks, building societies and investment firms that will make the system many times more resilient than it was prior to the previous financial crisis. The FPC was created for the express purpose of identifying, monitoring and addressing systemic risks, regardless of where those risks may originate. I welcome the FPC's ongoing work programme to supplement its annual review of the regulatory perimeter with a series of in-depth analyses of sectors outside the core banking system to assess their transmission channels to financial stability. This will ensure that systemic risks will be considered regardless of their source.

Identifying risks to the financial stability of the UK is only half of the challenge for the FPC; the Committee also has responsibility for addressing those risks. The Committee has broad powers of recommendation, but also powers of direction over specified macroprudential tools. Last year the FPC was granted direction powers with regard to a leverage ratio framework and the residential mortgage market. The Treasury has consulted on extending these powers to the buy-to-let mortgage market and will bring forward a response to that consultation, including final secondary legislation, in due course. The Committee has already taken action in the residential mortgage market on mortgages at high loan to income multiples to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households, and the buy-to-let tools will further enhance the Committee's ability to address housing market risks. I remain committed to ensuring that the Committee has all the appropriate tools its needs.

The policy context on housing is evolving, with the announcement by the Government of the most ambitious house building plan since the 1970s. We have doubled the housing budget to over £2 billion per year, which will help deliver 400,000 affordable new homes by the end of the decade. We have announced further reforms to our planning system so it delivers more homes more quickly. We're releasing public land suitable for 160,000 homes and re-designating unused commercial land for Starter Homes.

The Government remains committed to UK financial services being the best regulated and most competitive in the world. The Government is pursuing policies to promote competition and innovation within the financial sector and to enhance the UK's competeviness as a financial centre. Through discharging both its primary and secondary objectives, the FPC will support the Government's policy towards the financial services industry. I welcome the FPC's commitment in its response to the previous remit to consider how its policy decisions might affect competition, innovation and the international competitiveness of the UK financial system.

The Government is also committed to improving the UK's productivity, with a particular focus in the area of financial services on facilitating long-term investment and developing reliable measures of finance for productive investment. The achievement of the FPC's objectives will contribute to achieving these goals. I am pleased that the FPC will 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.

The Bank of England and Financial Services Bill, which will soon come before the House for Report and Third Reading, will make some small changes to the FPC's governance arrangements in order place the Bank's policy committees on the same statutory footing as part of the Bill's provisions to improve the transparency and accountability of the Bank. The Bill will also add two new members to the FPC: the Deputy Governor for Markets and Banking, reflecting their role being placed into legislation; and an additional external member to maintain the balance of membership between the executive and non-executive members. These changes are part of a large programme of reforms which will ensure that the Bank of England is well equipped to fulfil its vital role of overseeing monetary policy and financial stability, a key part of the Government's long term plan to build a resilient economy.

I am grateful to you and all the members of the Committee for your continuing good work and dedication.

George Osborne.

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.

Section 9C(4) of the Act makes clear 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(1) of the Act allows me to specify what the economic policy of Her Majesty's Government is taken to be.

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 9D(2) and 9E(2) of the Act require that I specify the economic policy of the Government and make recommendations to the Committee at least once in every calendar year.

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 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. In particular, a stable financial system is an important provider of finance for productive investment, which is a key driver of growth and prosperity across the economy. This Government will undertake a package of measures to boost the productiveness of the UK economy as part of its overarching strategy to achieve strong, sustainable and balanced 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;
- completing the reform of the financial system and 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.

Continuing to strengthen the financial system, 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 (FPC) 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 (for individuals, businesses and financial market participants). In order to do so, the

Committee should, amongst other things, monitor and consider those market issues and systemic non-financial risks (such as cyber security) that could have material implications for the resilience of the financial system, as well as the systemic build-up of prudential risks.

The Committee is responsible for the stability of the system as whole. The FPC should ensure that it identifies, monitors and addresses risks stemming from all parts of the financial system; prioritising as appropriate, but considering all components of the system. In the last Parliament the Committee focused its energies on rebuilding the resilience of the banking sector. With the current programme of reform in this area nearing finalisation, the Committee is broadening its focus to include systemic risks to, or stemming from, other sectors such as financial markets, institutional investors, or insurance.

As well as broadening the scope of its focus within the financial system, the FPC should continue to consider a broad range of different types of risk. In addition to the risks stemming from financial institutions' balance sheets, the FPC should consider itself responsible for identifying, monitoring and addressing systemic non-financial risks, such as cyber risks, that affect the entire financial system. The Committee should work with the firm-level regulators and other bodies as appropriate to address the risks it identifies in this area.

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 (PRA) and the Financial Conduct Authority (FCA). 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 PRA and FCA's general policies towards types of firms or risks, including, for example, in the case of the PRA'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

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

The FPC'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 PRA and FCA.

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 regarding facilitating finance for productive investment

The Government's framework for raising productivity is built around:

- **encouraging long term investment** in economic capital, including infrastructure, skills and knowledge; and
- **promoting a dynamic economy** that encourages innovation and helps resources flow to their most productive use.

Subject to achievement of its primary objective, the FPC should support the Government's economic objectives by acting in a way that, where possible, facilitates the supply of finance for productive investment provided by the UK's financial system. When explaining how its actions are consistent with its objectives, the FPC should consider the impact of its policy actions on the ability of the financial sector to provide finance for productive investment.

The Committee should consider the impact on finance for productive investment when making any judgements as to whether its actions would 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 for the purposes of compliance with section 9C (4) of the Act.

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

This Government has an ambition that the UK should have the best regulated and most competitive financial services in the world. Ensuring financial stability, the Committee's primary objective, is an essential prerequisite for achieving that ambition. Subject to achieving that, the Committee should act in a way that supports the Government's overall strategy for financial services, covering, in particular:

- Competition and innovation. The Government is keen to see more competition and innovation in all sectors of the industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models within the industry.
- Competitiveness. The Government wishes to ensure that the UK remains an attractive domicile for internationally active financial institutions, and that London retains its position as the leading international financial centre. In its assessment of the costs and benefits of its policy actions, the Committee should, wherever practical and relevant, take these considerations into account.

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

<u>i. Recommendations as to the interactions between monetary policy and macroprudential policy</u>

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 (MPC) and the FPC'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 MPC and the FPC. The Bank has implemented a programme of regular joint meetings of the MPC and FPC to further improve interaction between the two Committees. To enhance that coordination, where appropriate, the FPC 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 MPC. In the same way, the Government has also asked the MPC 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 FPC.

<u>ii. Recommendation that the Financial Policy Committee have regard to risks to public funds</u>

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.

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.

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

The Act allows the FPC 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 PRA and the purposes for which the FCA 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 PRA or the FCA 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 PRA or the FCA, and any resulting action by those bodies in those areas would not create material unintended consequences or costs in excess of the benefits.

iv. Recommendations regarding enhancing the accountability of the FPC

The FPC's performance and procedures are reviewed by the Court of the Bank of England 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 FPC 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 requirement imposed by paragraph 11 (4) of Schedule 2A of the Act to achieve consensus wherever possible, communication by individual members regarding FPC decisions needs to be coordinated and consistent where decisions are reached by consensus. The record of the FPC's policy meeting should continue to set out the deliberations considered in reaching the 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.

v. Recommendations as to engagement with financial sector participants and other external experts

The FPC already operates to high standards of transparency and accountability, including frequent appearances before Parliament and an active programme of public speeches. An important element of this accountability is the FPC's dialogue with financial market participants and other external experts. The FPC should endeavour 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 the Committee's own expertise. When seeking the views of external experts, the FPC should ensure that:

- any supporting documentation is sufficiently detailed so as to provide a comprehensive description of the FPC's views or proposed actions;
- respondents are given adequate time to consider the proposals and produce any response that they wish to provide; and
- wherever practicable, as set out in statute, a robust quantitative assessment of the impact of any proposed policy action is included in the documentation provided, including an estimate of the private costs to businesses.

In cases where the FPC consults publicly, the length of any consultation should be proportionate to the complexity and impact of the proposals, and the FPC's consultation periods should match best practice in the public sector.

These recommendations as to engagement with financial sector participants and other external experts should not prevent the FPC from making a Direction or Recommendation without, or with a more abbreviated, consultation where in line with its statutory duties, it considers it necessary to do so by reason of urgency, in order to protect and enhance the resilience of the UK financial system.

When deciding whether and how it would be appropriate to engage with external experts, the FPC should consider whether the publication of a contemplated future policy action may lead to actions aimed at avoiding future requirements, regulatory arbitrage, or financial sector participants taking other actions which could lead to risks to financial stability.