BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon Philip Hammond MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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5 December 2018

Dear Chancellor

In my role as Chair of the Financial Policy Committee (FPC), I attach the FPC's formal response to the recommendations set out in your letter and accompanying annex of 29 October 2018.

In your letter, you acknowledge the achievements of the FPC in its first five years as a statutory committee, in its role primarily to identify, monitor, and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. These have included:

- Revising the capital framework for the UK banking system, setting out how the countercyclical capital buffer will be used, recommending the early introduction of a leverage ratio framework, and, alongside the Prudential Regulation Committee (PRC), undertaking an annual stress test of the UK banking system. The aggregate common equity Tier 1 (CET1) capital ratio of the major UK banks is now nearly three and a half times higher than before the global financial crisis.

- Taking action to guard against the risk of a marked loosening in underwriting standards in the mortgage market and a significant increase in the number of highly indebted households in the UK, and increasing the resilience of the UK banking system given rapid increases in consumer credit lending.

- Building resilience to cyber risk, through its programme of work designed to ensure there are clear baseline expectations for firms' resilience that reflect their importance for the financial system, regular testing by firms and supervisors, identification of firms that are outside the financial regulatory perimeter but which may be important for regulated firms, and clear and tested arrangements to respond to cyber attacks when they occur.

- And an annual assessment of risks and regulation beyond the core banking sector, designed to consider fragilities within the non-bank financial system and the transmission channels through which these could affect UK financial stability to examine the potential financial stability risks.

As you also set out, the UK is in unprecedented times as it undergoes the process of leaving the EU. Consistent with its statutory duties, since the EU referendum in 2016 the FPC and other authorities have identified risks of disruption to the financial system that could arise from Brexit and worked to ensure they are addressed. It has focused on outcomes that would have the greatest potential impact on financial stability.

Its most recent assessment is in the November 2018 Financial Stability Report, which was published on 28 November. This assessment also formed part of the Bank's response to the request from the Treasury Committee that the Bank analyse how the EU Withdrawal Agreement would affect the Bank's ability to deliver its objectives for monetary and financial stability, including in a 'no deal' scenario.

In the FPC's view, stress tests and supervisory actions have ensured major UK banks have levels of capital and liquidity to withstand even a severe economic shock that could be associated with a disorderly Brexit.

The FPC has reviewed a Disorderly Brexit scenario, with no deal and no transition period, that leads to a severe economic shock. The UK economic scenario in the 2018 stress test of major UK banks was sufficiently severe to encompass the economic shock in the Disorderly Brexit scenario. Based on this, the FPC judges that the UK banking system is strong enough to continue to serve UK households and businesses even in the event of a disorderly Brexit.

Major UK banks started the 2018 stress test with an aggregate CET1 capital ratio nearly three and a half times higher than before the global financial crisis. Despite facing loss rates consistent with the global financial crisis in the stress test, the major UK banks' aggregate CET1 capital ratio after the stress would still be twice its level before the crisis.

Since the financial crisis, major UK banks have substantially reduced their reliance on wholesale funding. At group level, they hold more than £1 trillion of high-quality liquid assets. Combined with banks' own prudent risk management, this liquidity means that the major UK banks are in the position of being able to meet their maturing obligations for many months without any need to access wholesale funding or foreign exchange markets. In addition, banks can currently access £300 billion of liquidity through the Bank of England's regular facilities. The Bank is able to lend in all major currencies.

In a disorderly Brexit, some market volatility would be expected. As demonstrated after the EU referendum in 2016, sterling markets are able to function effectively through markedly volatile periods. The strength of the core financial system, including banks, dealers and insurance companies supports the markets on which the economy relies. The Bank of England, alongside other domestic authorities and financial companies themselves, has put extensive contingency plans in place to support institutional resilience and market functioning during any period of heightened uncertainty.

In November 2017, the FPC published a checklist of actions that would mitigate risks of disruption to important financial services used by households and businesses to support their economic activity. It has since updated its judgements of progress against this checklist on a quarterly basis. In the UK, significant progress continues to be made towards mitigating the risks of disruption to cross-border financial services. The UK Government is taking forward further legislation to mitigate the risks of disruption. That legislation needs to be passed by Parliament prior to Brexit to be effective. This includes changes to domestic legislation to ensure the regulatory framework is workable when the UK is no longer a member of the EU. The absence of action by EU authorities to mitigate risks in uncleared OTC derivatives and personal data could also result in some disruption for UK households and businesses.

Irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the UK. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining more generally the UK authorities' ability to manage UK financial stability risks.

Yours

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

On 29 October 2018, 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 agrees 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 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 and infrastructure;
iii. Non-financial risks, including conduct risks and cyber security;
iv. Risks from very high levels of private sector debt, which can make the system less resilient and economic growth more fragile.

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. <u>Recommendations as to the interaction between the FPC's objectives</u>

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

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 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.

Some of the Committee's policies to date are likely to provide support for these initiatives directly. The Committee continues to focus on the provision of market-based finance which plays an important role in providing finance to the 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. To encourage more research on this topic, the Bank held an academic conference on Finance, Investment and Productivity in December 2016, which was summarised in the Bank's Quarterly Bulletin in Q1 2017. In February 2017, the Bank also released the results of an innovative new survey on 'The financial system and productive investment and financing decisions'. The Bank is continuing to undertake further research related to these issues.

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.

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

Through discharging its secondary objective - and subject to achieving its primary objective - the FPC will 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 United Kingdom, for the benefit of consumers. The FCA has an objective to promote effective competition in the interests of consumers. And the PRA has a secondary objective to act, as far as reasonably possible, in a way that facilitates effective competition when making policies to advance its primary objectives of safety and soundness, and insurance policyholder protection.

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*. That makes close liaison between the FPC and the MPC especially important. 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 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 of potential financial stability risks stemming from the UK housing market, and subsequent action, provides an 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. For example, joint briefing meetings have been held on topics of mutual interest such as the effect of low long-term interest rates, the channels through which adverse economic shocks could arise as the United Kingdom withdraws from the European Union and transmission channels via which a sharp slowdown in China and Hong Kong could adversely affect UK GDP growth. The FPC also decided to exclude central bank reserves from the exposure measure in the current UK leverage ratio framework, with the aim to ensure that the leverage ratio does not act as a barrier to the effective implementation of policy measures that might lead to an increase in central bank reserves.

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.

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 notification to the Chancellor that, in its judgment, is relevant to the exercise by the Committee of its responsibilities and functions under the Act. 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.

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

iii. Recommendations to the Treasury on legislative changes

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 generally 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 from market-based finance. 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 also holds, at least annually, a dedicated discussion on these risks. And it undertakes a regular deep analysis of certain market-based finance activities that merit further investigation. The FPC draws on this analysis to inform its judgement on the appropriate boundaries around, and within, the regulatory perimeter.

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 and a separate statutory conflict of interest code of practice 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 the financial system through its actions. To that end, it is continuing to develop its published indicators, which appear in its policy statements on how it uses its tools, and which it publishes regularly. As it set out in the June 2018 Financial Stability Report (Box 6), to review and update its core indicators, it will consider the evolution of the financial system, improvements in data availability and quality, and new research. 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. Concurrent stress testing exercises have now taken place each year since 2014 and the first biennial exploratory scenario was completed in 2017. The Bank has now published the results of the 2018 exercise – the annual cyclical scenario.

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 a meeting 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. As set out in the Record of the Committee's March 2015 meeting, this will include the range of views expressed in the FPC's regular briefing and issues meetings ahead of its policy meetings, in the event that these played a role in the forming of a consensus. 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.

As set out in the Record of the Committee's November 2015 meeting, while the legislation requires the Chair of a meeting of the Committee to seek decisions of the Committee to be reached by consensus wherever possible, the discrete nature of the decision on the countercyclical capital buffer (CCyB) may not always lend itself to a consensus-based process. The legislation allows the Committee to vote on the setting of the CCyB when the Chair forms the opinion that consensus cannot be reached. As agreed at that meeting, the Committee will be flexible in its approach to deciding how to set the buffer.

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

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 generally endeavour to continue to align the length of the consultation to the context, 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 UK 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.