BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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31 March 2014

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 19 March.

I am grateful for your positive assessment of the performance of the FPC in its first year as a statutory body. I particularly welcome your recognition that, consistent with the recommendations in your 2013 remit, the Committee has increased the focus of its work programme and brought greater clarity to its communications. I agree that an important priority for the Committee is to further increase public awareness and understanding of the FPC.

The FPC welcomes your remit and recommendations for the coming year and intends to act in accordance with them. I would also like to pick up on three points highlighted in your letter.

First, as you note, the Committee is focusing over the next 12-18 months on three key medium-term priorities: the capital framework for banks; ending 'too-big-to-fail'; and identifying and addressing any risks in shadow banking while working to support diverse and resilient sources of market-based finance. Work in these areas will involve extensive interaction with authorities internationally, where in some cases work is already well advanced, as well as domestically with the PRA, FCA and HM Treasury.

Second, over the past year the FPC has worked increasingly closely with the Monetary Policy Committee (MPC), in particular on developments in the housing market. The Committees have set out publicly – in the *Inflation Report* and the *Financial Stability Report* - how they have regard to each other's policy stance. The introduction of the financial stability knockout agreed by the MPC with the FPC as part of forward guidance has clarified the approach on the division of responsibilities between regulatory and monetary policies, consistent with the statutory objectives of the two Committees – that the tools available to the FPC and other regulators are the first line of defence against financial stability risks. That principle will continue once the 7% unemployment threshold is reached and the financial stability knockout no longer applies, allowing monetary policy to remain focused on its primary objective of maintaining price stability.

Third, the Committee has considered recently how best it can integrate work on the impact of potential policy actions into the development and calibration of such measures. The legislation requires that the Committee must include an estimate of the costs and an estimate of the benefits that would arise from compliance with any direction or recommendation, unless in the opinion of the Committee it is not reasonably practicable to include such an estimate. The Committee has discussed this issue recently and will examine carefully in all cases in which it uses these powers what is practicable in this area with a view to providing as much information as possible about the basis for its decisions. In deriving quantitative estimates of costs and benefits, it will be important to recognise that such estimates are inevitably highly uncertain, and that costs of compliance with regulatory actions are often tangible and immediate, while benefits can be material but more distant and uncertain. In some cases, therefore, the Committee may explore the practicality of publishing indicative ranges for the costs and benefits. The Committee may conclude, as it is able to under the legislation, that quantitative estimates are not reasonably practicable, though it will nevertheless set out qualitatively its reasoning for its policy actions.

In each of these areas, it will be important for the Committee to be transparent both to account for its decisions and to help improve understanding of the important role of the FPC.

With all best wishes.

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

On 19 March, 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 stability arising from developments in financial markets and its regular briefing includes intelligence gathered from market participants. It also considers risks to 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

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

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 once the unemployment threshold has been reached reiterated that this division of responsibilities between regulatory policy and monetary policy will continue once the 7% unemployment threshold is reached and the financial stability knockout no longer applies. 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 explained in its June 2013 *Financial Stability Report* (*FSR*). 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.

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 and FCA. It will also hold, at least annually, a regular dedicated discussion 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.

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 set out in its January 2014 Policy Statement "The Financial Policy Committee's powers to supplement capital requirements". 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, beginning this year, will also be a key element of the Committee's approach.

The Committee agrees on the importance of clear and consistent communication, especially on decisions reached by 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 ensure that its communications seek to avoid uncertainty.