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

18 March 2015

Mark Carney
Governor
Bank of England
Threadneedle Street
London
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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, on an annual basis, 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. The annex, including the statement of the Government's economic policy, remains largely unchanged from last year, reflecting our commitment to seeing our long-term economic plan through to completion. This covering letter sets out my perspective on the current economic context and the FPC's priorities for the year ahead.

This Parliament began with a budget deficit of 10% of GDP, unemployment at 8% and a system of financial regulation that was fatally flawed. As we enter the end of the Parliament, much progress has been made: the deficit has been cut in half, the UK was the fastest growing G7 economy in 2014, unemployment has fallen to 6% and we have fundamentally reshaped our system of financial regulation. But the task is not yet complete and the UK cannot be immune to external risks in the global economy, in particular weak growth and the threat of damaging deflation in the Eurozone, but also weaker growth and vulnerability in some emerging markets.

The Committee should remain vigilant to the potential financial stability risks posed to the UK by the continuing uncertainty in the Eurozone.

A robust system of financial regulation is one of the foundations of economic security, particularly for an open and internationally connected economy like the UK. That is why the Government has comprehensively reformed the UK's regulatory architecture to address the failings exposed by the financial crisis. The FPC is a key element of that new system, providing oversight of the system as a whole – something that had been lacking under the Tripartite system.

The FPC has been in operation for nearly two years and the progress made in that time has been impressive. The Committee has quickly established itself as a credible and effective macroprudential authority. Since its establishment, the FPC has taken a broad approach to tackling risks to the stability of the financial system: acting to improve disclosure standards; and moving to build resilience to cyber threats – to name but a few of the FPC's actions to date. I encourage the FPC to continue this broad approach. I believe that the issue of cyber resilience is vital to the ongoing stability of our financial system and the FPC should continue to work with the Treasury and the regulators to ensure that this issue is a strategic priority for firms' boards.

In 2014, the FPC focused on its medium-term priorities: the medium-term capital framework for UK banks; ending 'too big to fail'; and assessing risks in shadow banking, while working to support diverse and resilient sources of market based finance. The Committee put forward a proposal for a UK leverage ratio framework, the Financial Stability Board (FSB) published a proposal for a common standard on total loss-absorbing capacity for globally systemically important banks, and the Bank set out several priorities it will pursue to improve the availability of credit data about SMEs. These medium-term priorities are now much closer to finalisation, and I would urge the FPC to continue to make progress on these issues.

The Committee also undertook strategic work to plan for the financial stability implications of an independent Scotland. Fortunately, the people of Scotland chose to remain a part of the UK and the FPC's work was not needed, but I am grateful that the Bank took sensible precautions to manage the very significant risks a 'Yes' vote would have posed. This work to identify a potential risk and take appropriate action to address it before it became a threat to financial stability shows the important role that the FPC has in the new regulatory architecture.

In June 2014, the FPC took timely and proportionate action to limit financial stability risks stemming from the UK housing market – an area of vulnerability for the UK economy many times in the past. The Committee's action to restrict loan-to-income ratios for new residential mortgages and to increase mortgage underwriting standards deflated what could have been the next housing bubble. It is precisely this type of forward-looking, pre-emptive action that the FPC was established to undertake.

2014 also marked the Bank's inaugural stress test of the UK's banking system. This was an important development in the supervision of the UK's banks and building societies, which required a significant amount of work and preparation by the FPC and the Prudential Regulation Authority (PRA). That only a single bank was required to submit a revised capital plan as a result of the stress test, despite a severe but plausible scenario being used, speaks to the increased resilience of the UK's financial system, and the smooth running of the test is a testament to the professionalism of the Bank's staff.

Both the Independent Commission on Banking and the Parliamentary Commission on Banking Standards recommended introducing a leverage ratio to strengthen the capitalisation of our major banks. I believe that the leverage ratio is a key part of the new framework that the Government and the Bank of England are putting in place to strengthen the UK banking sector. In November 2013, I wrote to you requesting that the FPC undertake a review of the leverage ratio. In October 2014, the FPC put forward a final recommendation for a UK leverage ratio framework for UK banks and a proposed calibration for that framework. I agreed with that recommendation and brought forward legislation to grant the FPC the necessary powers of direction to implement that framework. Some work remains in order to finalise the leverage ratio requirements that will be faced by firms; the Bank will consult on the Systemic Risk Buffer framework for domestically systemically important banks this year.

In my June 2014 Mansion House speech, I announced that I was determined to work with the FPC to ensure that the Committee had appropriate powers over the UK housing market to maintain its stability. The Committee recommended in October 2014 that it be granted powers of direction in relation to the housing market. Specifically, the FPC recommended that it be granted powers to direct the PRA and Financial Conduct Authority (FCA) to require regulated lenders to place limits on mortgage lending, both owner-occupied and buy-to-let, by reference to Loan-to-Value ratios and Debt-to-Income ratios. The Government has legislated to grant these powers with respect to owner-occupied mortgages. These powers will grant the FPC the means to safeguard the stability of Britain's financial system from any future risks posed by our housing market. The Government will consult separately on these recommendations early in the next Parliament with a view to building an in-depth evidence base on how the operation of the UK buy-to-let housing market may carry risks to financial stability.

The FPC should prioritise building public understanding of how these new tools work and how the FPC intends to use these powers. I note that the Committee has already taken action on this issue by publishing draft statements of policy in order to inform the Parliamentary debates on the relevant legislation.

The FPC should continue to make evidence-based arguments for recommendations to grant it further powers of direction. These powers are accompanied by responsibilities. The FPC's policy recommendations and directions should be supported, whenever practicable, by a published assessment of the costs and benefits, as required under the Act. These assessments will be particularly important for the FPC's new powers, as the Committee seeks to build public understanding of how the tools work and how they will be used. I am encouraged by the commitment in December's Financial Stability Report to build on the approach that the

Committee established last year for quantitative analysis of its policy decisions. The FPC should encourage the regulators to undertake comprehensive consultation with the industry and the public before they implement FPC policy.

The FPC and the Monetary Policy Committee (MPC) should continue to have regard to each other's actions, to enhance coordination between monetary and macroprudential policy. As also noted in my remit letter to the MPC, I share the Bank's view that the FPC's macroprudential tools, together with the microprudential supervision of the PRA and FCA, are the first line of defence against risks to financial stability. I welcome the Bank's intention, announced on 11 December 2014, to enhance the interaction between the MPC and the FPC by scheduling four joint briefing meetings in 2016.

The Committee should also continue to work closely with the PRA and FCA, recognising that it is through the firm-level regulators that the majority of the FPC's policy is implemented. Close cooperation will help the Bank and FCA meet their respective objectives and compound the benefits to the financial system and the wider economy.

The FPC has achieved much since its establishment, but the Committee's work to protect and enhance financial stability will continue in 2015. I welcome the Committee's plans to complete its work on the medium-term capital framework – a welcome milestone on the path to a more stable financial system – and to guide the Bank's 2015 stress test of UK banks' resilience to global risks.

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

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 recent 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.

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;
- reform of the financial system, 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.

Returning the financial system to full health, 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 conduct issues that could have material implications for the resilience of the financial system, as well as the systemic build-up of prudential risks and systemic vulnerabilities to business continuity risks.

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 Prudential Regulation Authority'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, and matters to which the Committee should have regard in exercising its functions

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 Prudential Regulation Authority and Financial Conduct Authority.

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 as to the interactions between monetary policy and macroprudential policy

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 also announced its intention to hold 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.

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

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.

As a Committee of the Bank's Court of Directors, 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.

iv. 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 Prudential Regulation Authority or the Financial Conduct Authority 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.

v. Accountability

The Financial Policy Committee'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 Financial Policy Committee 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 Financial Policy Committee 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.