BANK OF ENGLAND

**Mark Carney**
Governor

The Rt Hon Philip Hammond
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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3 July 2017

Dear Chancellor,

In my role as Chair of the Financial Policy Committee (FPC), I attach the FPC's formal response to the recommendations that you set out in your letter and accompanying annex of 8 March 2017.

In your letter, you set out your perspective on the current economic context and the FPC's priorities for the year ahead. Alongside this, the FPC has reviewed progress on the priorities it set at the end of 2013, and agreed its priorities for the next two to three years. These are summarised below, and are also set out in the June 2017 Financial Stability Report.

The FPC's primary responsibility is 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.

To help to meet its objectives, alongside its ongoing assessment of the risk environment, the FPC is prioritising three major initiatives over the next two to three years.

**1) Finalise, and refine if necessary, post-crisis <u>bank capital and liquidity reforms</u>**

Over the past three years, in line with international reforms following the global financial crisis, the FPC has established the medium-term capital framework for UK banks and has reviewed the Bank's work to stop banks from being 'too big to fail'. It has set the standards for risk-weighted capital and leverage ratio requirements for UK banks; developed its approach to stress testing to ensure that resilience adapts to the risks that banks face; and assessed and informed the Bank's work to ensure that banks can be resolved when they fail. This includes setting the framework for the systemic risk buffer which forms part of the ring-fencing regime. The FPC set out its assessment of progress towards making banks resolvable, and how this affects its assessment of the appropriate level of capital for the banking system, in the Bank's submission to a recent Treasury Committee inquiry on UK bank capital.

Together these reforms have made UK banks more resilient, allowing them to serve UK households and businesses even when shocks occur.

The FPC will now take stock of these reforms, including in light of recent developments in international regulatory standards and through more ways of assessing the resiliency of the banking system to shocks. Specifically, it will:

- Review the judgements underlying its overall calibration of the risk-weighted capital framework for UK banks, including taking into account progress towards ensuring banks are resolvable, changes in accounting standards, and reforms to the measurement of risk-weighted assets. The natural time for a full review will be in 2019, following the outcome of negotiations to finalise Basel III standards.

- Review the UK leverage ratio framework and its scope of application, taking into account progress towards an international standard for a leverage requirement.

- Take stock of overall liquidity and funding standards for UK banks and consider the case for a time-varying macroprudential liquidity standard. In 2012, the interim FPC said it would make sense to consider the benefits of a time-varying liquidity measure, once the international microprudential liquidity standard had evolved.

- Inform the Bank's work to develop its stress tests of the banking system, to capture better the interactions between banks in a stress.

**2) Complete post-crisis reforms to <u>market-based finance</u> in the UK, and improve the assessment of systemic risks across the financial system**

Firms other than banks play important roles in providing finance to the economy and diversifying risks. Their activities can also be a source of systemic risk. Since 2014, the FPC has completed an annual review of risks from, and regulation of, market-based finance, with an in-depth look so far at the activities of open-ended investment funds and insurers, and on changes in market liquidity.

The FPC will:

- Continue its annual review and programme of in-depth reviews on specific market-based finance activities. This will include the assessment that the FPC has asked the Bank to complete on the financial stability risks associated with derivatives transactions, including progress towards implementation of the mandated move to the use of central clearing and other post-crisis reforms.

- Support the Bank's work to develop a system-wide stress simulation, to help understand how the financial system as a whole is likely to respond to shocks.

- Consider whether macroprudential tools for market-based finance might be needed to address systemic risks originating from outside the banking system.

**3) Prepare for the <u>UK's withdrawal from the European Union</u>**

Exit negotiations between the UK and the EU have begun. There are a range of possible outcomes for, and a number of paths to, the UK's withdrawal from the EU.

The FPC will oversee contingency planning to mitigate risks to financial stability as the withdrawal process evolves.

Irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibilities, the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned, which itself exceeds that required by international baseline standards.

Across these priorities, the FPC remains committed to working with relevant authorities domestically and internationally, to protect and enhance the resilience of the UK financial system.

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

On 8 March 2017, the Chancellor set out a series of recommendations to the Financial Policy Committee (FPC) under sections 9E(1) and 9E(2) of the Bank of England Act 1998 ('the Act'). This document sets out the Committee's response, in accordance with section 9E(3) of the Act. The response is organised around the sub-headings of the HM Treasury document.

**A. The Government's economic policy**

The Financial Policy Committee notes the Government's economic policy, including its objectives for growth and employment.

**B. Matters that the Financial Policy Committee should regard as relevant to the Bank's financial stability objective, and the responsibility of the Committee in relation to the achievement of that objective**

The Committee acknowledges the matters that HM Treasury recommends the Committee to regard as relevant to the Bank's financial stability objective. The Committee welcomes the clarification that the purpose of preserving stability is to contribute to avoiding serious interruptions in the vital functions which the financial system as a whole performs in our economy: notably, the provision of payment and settlement services, intermediating between savers and borrowers, and insuring against risk. These vital functions are recognised in the Bank's 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. Recommendations as to the interaction between the FPC's objectives

The Committee's primary objective is to exercise its functions with a view to contributing to the achievement by the Bank of the financial stability objective. The Act does not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.

Subject to its primary objective, the Committee has a secondary objective of supporting the Government's economic policy, including its objectives for growth and employment. In practice, actions that seek to protect and enhance the resilience of the UK financial system would be expected to contribute positively to growth over the medium and long term. Recent experience demonstrates that financial stability is a precondition for sustainable economic growth; a stable and resilient financial system should help to facilitate a sustainable efficient flow of funds within the economy and an effective allocation of savings to investment.

The Committee recognises that action to increase resilience may in some circumstances have a short-term effect on growth, even when that action will make a positive contribution to growth in the medium and longer term. In such circumstances, it will manage and communicate its approach transparently and consistently, having regard to proportionality and, where appropriate and practicable, the costs and benefits of its actions in the context of its primary and secondary objectives. More broadly, the Committee will set out how its actions contribute to its objectives, including its judgement as to the balance of risks to those objectives and how those risks have evolved and are expected to evolve.

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

### ii. Recommendations regarding facilitating finance for productive investment

HM Government's 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 more robust analysis of the issues through further research.

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*. As part of the MPC's guidance on the future stance of monetary policy announced in August 2013, the FPC was asked to assess whether the stance of monetary policy posed a significant threat to financial stability that could not be contained by the substantial range of mitigating policy actions available to the FPC, the FCA and the PRA in a way consistent with their objectives. That recognised that monetary policy has an important role to play in mitigating financial stability risks, but only as a last line of defence. The MPC's further guidance on the setting of monetary policy reiterated that this division of responsibilities between regulatory policy and monetary policy would continue once the 7% unemployment threshold was reached, as it was in February 2014, and the financial stability knockout no longer applied. In addition, with the conventional instrument of monetary policy constrained by the lower bound to interest rates, the FPC's actions may be particularly relevant to the level of aggregate demand, the way the financial system transmits changes in monetary policy to the economy and, therefore, for the MPC's objectives. That makes close liaison between the FPC and the MPC especially important at the current juncture.

In reaching its decisions, the Committee considers the policy settings and forecasts of the MPC, as first explained in its June 2013 *Financial Stability Report (FSR)*.[1] The FPC's consideration over the past three years 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.

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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.

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, four joint briefing meetings were held in 2016 on topics of mutual interest such as the effect of low long-term interest rates. 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 Notices to the Chancellor unless there is an exceptional reason not to do so, in which case the Bank will notify HM Treasury that the FPC is not being informed. Where the FPC is notified, the Committee's briefing will include an assessment of the implications for systemic stability of the failure or distress of the institution in question given its circumstances.

iii. 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 it has set out in its Policy Statement 'The Financial Policy Committee's powers to supplement capital requirements', published in January 2014, its two Policy Statements on the leverage ratio and housing tools, published in July 2015, and its April 2016 Policy Statement 'The Financial Policy Committee's approach to setting the countercyclical capital buffer'. 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. Three concurrent stress testing exercises have now taken place since 2014. In October 2015 the Bank set out its approach to stress testing the UK banking system for the next three years, and the Bank has now published the key elements of the 2017 exercise: an annual cyclical scenario and a biennial exploratory 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 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.