Bank of England

The Rt Hon Jeremy Hunt
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
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Andrew Bailey
Governor

20 December 2023

Dear Jeremy,

In my role as Chair of the Financial Policy Committee (FPC), I attach the FPC's response to the recommendations set out in your letter of 22 November 2023. The FPC welcomes the recommendations made, and their response can be found in this letter and the Annex.

The latest Financial Stability Report (FSR), published on 6 December 2023, sets out the FPC's latest assessment of the resilience of the UK financial system, the main risks to UK financial stability, and the action it is taking to remove or reduce those risks. The overall risk environment remains challenging, reflecting subdued economic activity, further risks to the outlook for global growth and inflation, and increased geopolitical tensions. But so far, and while the FPC continues to monitor developments, UK borrowers and the financial system have been broadly resilient to the impact of higher and more volatile interest rates.

In April of this year, the Bank updated its Financial Stability Strategy[1] and the FPC set out its medium-term priorities (2023–2026)[2]. These show the Bank and FPC's approach to meeting the financial stability objective.

[1] The Bank's Financial Stability Strategy | Bank of England
[2] The Financial Policy Committee's medium-term priorities (2023–2026) | Bank of England

Consistent with its remit, the FPC is prioritising four areas over the next three years: market-based finance; structural changes and new risks; lessons learned from periods of stress; and the macroprudential oversight of operational resilience. Further details on the work of the Committee to help identify, monitor and address systemic risks to the resilience of the UK financial system (including in market-based finance) are set out in Section B of the Annex to this letter.

Returning inflation to target sustainably supports the FPC's objective of protecting and enhancing UK financial stability. When reaching its decisions, the FPC will continue to have regard to the policy settings and forecasts of the Monetary Policy Committee (MPC). The Committees are able to discuss areas of mutual interest, and will continue to do so. For example, in March 2023, the FPC briefed the MPC about global banking sector developments and on its judgement that the UK banking system maintained robust capital and strong liquidity positions, and was well placed to continue supporting the economy in a wide range of economic scenarios, including in a period of higher interest rates.

The Committee is fully committed to supporting the Government's economic policy in line with the FPC's secondary objective. The Committee will continue to assess, as an important element of its work, where it can support the Government's economic objectives. Where it judges that it can do so in a way that is consistent with its primary objective, the Committee will act accordingly. For example, we have described how the UK countercyclical capital buffer (CCyB) helps the FPC to achieve its primary and secondary objectives in our latest Policy Statement on the FPC's approach to setting the CCyB.

The Committee also supports the Chancellor's commitment to the effective regulation of financial services, retaining high international standards, given the crucial role they play in underpinning the FPC's primary objective, and subject to that, supporting the government's economic policy to achieve strong, sustainable and balanced growth. The UK is a leading international financial centre, and the IMF considers that the stability of the UK financial system is a global public good. The PRA's commitment to the faithful implementation of international standards, including Basel 3.1, supports this.

Yours sincerely,

Andrew Bailey

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

On 22 November 2023, 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 and the accompanying cover letter, provide the Committee's response, in accordance with section 9E(3) of the Act. The response is organised around the subheadings of the HM Treasury document.

A. The Government's economic policy

The Financial Policy Committee notes the Government's economic policy objective to achieve strong, sustainable and balanced growth, with price and financial stability being essential pre-requisites to achieve this objective in all parts of the UK and sectors of the economy.

The Committee notes the Government's economic strategy.

B. Matters that the FPC 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 it should consider all parts of the UK financial system, prioritising as appropriate, and that it should consider all types of systemic risks to the stability of the UK financial system, including financial and non-financial (such as cyber and operational) risk, prioritising as appropriate. The Committee agrees that the purpose of preserving stability is to contribute to avoiding serious interruptions in the vital functions which the financial system performs in our economy: notably, the provision of payment and settlement services, intermediating between savers and borrowers, and insuring against risk.

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, such as conduct risks, cyber security and climate change; and

iv. Risks from growth of private sector debt that could make the system less resilient and economic growth more fragile.

As part of its responsibilities, the FPC identifies, monitors and takes action to remove or reduce systemic risks in the system of market-based finance (MBF), including non-bank financial institutions (NBFIs).

Episodes of volatility in financial markets, such as the ‘dash for cash’ in March 2020, and the disruption to the functioning of UK government bond markets in late September 2022, have underlined the importance of continuing to improve the overall resilience of market-based finance.

The FPC’s approach to identifying, assessing, monitoring and mitigating vulnerabilities in MBF, was published in October 2023[3]. It noted that reforms are required in a number of areas, including to address structural liquidity mismatches, risks arising from margin requirements and margin calls, and risks arising from leverage in non-bank financial institutions.

The Committee continues to attach a high priority to supporting the work undertaken by the Bank and Financial Stability Board (FSB) to address vulnerabilities in market-based finance that could affect financial stability. Alongside international work, the Bank will continue to work to reduce vulnerabilities domestically where it is effective and practical.

In March 2023, the FPC made a recommendation that The Pensions Regulator (TPR) take action as soon as possible to mitigate the financial stability risks in LDI funds that had crystallised in September 2022 by specifying the minimum levels of resilience for the LDI funds and LDI mandates in which pension scheme trustees may invest. The FPC has since welcomed the published guidance and the steps taken by TPR and the Financial Conduct Authority (FCA) to ensure the continued resilience of LDI funds. To better allow TPR to implement and enforce guidance on LDI resilience over the long term, and in the context of TPR’s other objectives, the FPC also recommended that TPR should have the remit to take into account financial stability considerations on a

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[3] **Financial Stability in Focus: The FPC’s approach to assessing risks in market-based finance | Bank of England**

continuing basis[4]. The Committee continues to work closely with TPR, the FCA, and overseas regulators so that these vulnerabilities are monitored and tackled.

The FPC also continues to carry out horizon scans across a wide range of non-bank activities and markets – within and outside the regulatory perimeter – in order to facilitate ongoing vigilance of a broader set of risks in the sector and assess and develop policy responses. As part of this work, the Bank launched the hypothetical scenario for its system-wide-exploratory scenario exercise (SWES) in November 2023. The SWES will play an important role in helping to improve understanding of the behaviours of banks and NBFIs in stressed financial market conditions.

As part of its responsibilities, the FPC has taken a number of actions to monitor potential systemic risks from cyber attacks, including establishing a cyber-vulnerability testing framework (CBEST), setting 'impact tolerances' for how quickly the financial system must be able to make critical payments following a severe but plausible cyber or operational incident, and using regular cyber stress tests to test firms' ability to meet the impact tolerance in severe but plausible scenarios. The FPC is aiming to improve the macroprudential oversight of operational resilience and will provide updates on its work in due course.

The FPC also continues to monitor risks to financial stability that could arise from cryptoassets, their associated markets and the adoption of the underlying technology.

The Committee has also considered the need for the regulatory system to adapt so the public can have similar confidence in new forms of digital money as in existing forms, allowing them to be widely used and trusted. UK authorities have taken important steps towards putting in place a regulatory regime for the sector and the Committee has welcomed recent publications including a Discussion Paper on the proposed approach to regulating systemic stablecoins.

The Committee is considering the potential financial stability implications of continued adoption of artificial intelligence (AI) and machine learning (ML) in financial services. AI and ML could deliver significant benefits to the UK financial services sector, but given the rapid pace of innovation and potentially widespread use cases, the FPC will further consider the financial stability risks in 2024. Working alongside other relevant authorities, the Committee will also seek to ensure that the UK financial system is resilient to risks that may arise from widespread adoption of AI and ML.

[4] The **Government's response** to the Work and Pensions Select Committee Report into LDI accepts the FPC's recommendation that TPR should incorporate financial stability considerations in its decision making and balance them with its objectives as a pensions regulator.

The Committee continues to have regard to the risks from climate change, including physical risks and risks from the transition to net zero, as relevant to its primary objective. The findings from the climate change focused Biennial Exploratory Scenario exercise (CBES), published in May 2022, were an important step in helping to assess better these risks. It advanced both the Committee’s and financial firms’ understanding of risks to the financial system and provided insights on how participating UK banks and insurers might seek to adapt their business models in the face of different climate scenarios.One of the Committee's powers is to make Recommendations to the Prudential Regulation Authority (PRA) and the 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. In early 2023, the Committee was briefed on developments in the global banking sector when a number of banks came under stress.

The Committee has also been working closely with the FCA on the Bank and FCA joint review of money market funds and has recently welcomed the consultation paper on UK-based money-market fund regulation, published by the FCA on 6 December 2023.

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.

The Committee will continue to work closely with the Prudential Regulation Committee (PRC) to ensure coordination between microprudential and macroprudential policy, so far as it is possible while complying with its objectives. For example, the Committee regularly coordinates with the PRC on stress testing and reviews of the leverage ratio, and is briefed on work related to the approach to operational resilience. The FPC has also worked closely with the Financial Market Infrastructure (FMI) Board and will continue to do so with the FMI Committee.

The Bank will also continue to work in an open and collaborative way with other relevant bodies, including TPR and the Payments System Regulator, for the purpose of pursuing its financial stability objective.

C. The responsibility of the FPC in relation to support for the Government's economic policy

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

Subject to its primary financial stability 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, and therefore the FPC's primary and secondary objectives will often be complementary. Financial stability is a precondition for sustainable economic growth; a resilient financial system should help to facilitate a sustainable and 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, where the Committee faces potential conflicts, it will consider these in light of the recommendations made to it in its remit, and 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.

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.

For example, the Committee regularly reviews its mortgage market recommendations, with regard to its primary and secondary objectives. Recent analysis published in the December 2023 FSR, finds the withdrawal of the FPC's affordability test, had so far had only a limited effect on borrower resilience, as was expected at the time of withdrawal. The analysis also suggested that the withdrawal had a small positive impact on access to the mortgage market, given the rise in interest rates and fall in mortgage approvals since the withdrawal.

Further, the Committee will routinely assess, as an important element of its work, where it can support the Government's economic objectives. Where it judges that it can do so in a way that is consistent with its primary objective, the Committee will act accordingly, in a way that is consistent with the recommendations set out in the remit letter.

We have described how the UK countercyclical capital buffer (CCyB) helps the FPC to achieve its primary and secondary objectives in our latest Policy Statement on the

FPC's approach to setting the CCyB[5]. The CCyB is designed to reduce the impact of the financial cycle on the real economy and to ensure that the financial system acts to absorb rather than amplify shocks. As a result, active use of the CCyB should increase the long-term level of growth for the UK economy as well as support higher employment. This effect is likely to be particularly strong when the CCyB is cut or reduced if the banking system faced losses that could otherwise cause it to restrict lending to defend capital positions by more than was warranted by the macroeconomic environment. A strategy of using the CCyB actively in response to the financial cycle rather than having a higher baseline level of capital requirements, means that the FPC expects to be able to build resilience for the banking system efficiently - which should lead to a higher overall level of economic growth. And by taking into account the economic cost of raising capital when increasing the CCyB, the FPC lowers the cost of building resilience on economic growth. This approach ensures the CCyB contributes to both the FPC's primary objective and its secondary objective of supporting HM Government's economic policy, including its objectives for growth and employment.

ii. Recommendations regarding support for the Government's economic 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 economic policy towards the financial services industry, including the areas of the Government's strategy for financial services, as set out in the remit letter, in relation to growth and competitiveness; competition and innovation; home ownership; and boosting productive finance.

The FPC will, where practicable in the context of its financial stability objective, consider how its policy actions or decisions might affect these areas.

The Committee will use its regular communications to outline how it is able to support these areas in a way which is consistent with its objectives.

For example, the Committee recognises the importance of innovation in financial services, including in areas such as AI, ML, cryptoasset technology and digital money. But the benefits can only be realised and innovation be sustainable if it is undertaken safely and accompanied by effective public policy frameworks that mitigate risks and maintain broader trust and integrity in the financial system.

The Committee will continue to consider the impact of its policy actions on the ability of the financial sector to provide finance for productive investment.

[5] **The Financial Policy Committee's approach to setting the countercyclical capital buffer - Policy Statement (bankofengland.co.uk)**

Over the period Nov 2020 and April 2023, the industry-led Productive Finance Working Group - convened by the Bank, HMT and FCA - made important progress in a number of areas to develop practical solutions to the barriers to investment in long term less liquid assets, including work to support the successful delivery of the Long-Term Asset Fund (LTAF) structure. Three LTAFs have been authorised by the FCA.

The Committee has supported the Bank's plans to design and launch a survey on access to finance and investment decisions, in collaboration with the Department for Business and Trade. Findings of this survey are expected to be published in 2024.

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 resilient 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 MPC especially important.

In reaching its decisions, the Committee considers the policy settings and forecasts of the MPC, as first explained in its June 2013 FSR.[6] The FPC takes into consideration the MPC's forecasts in its discussions of the macro-economic back-drop, including in the most recent November 2023 MPR. 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 able to attend the other Committee's briefing meetings. The Committees are able to jointly discuss areas of mutual interest, and continues to do so.

ii. Recommendation that the FPC 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

[6] 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**.

consistent with its statutory objectives, and takes account of any such risks in formulating its actions.

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 dedicated discussions 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 any such areas, 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 has continued to develop its published indicators, which appear in its policy statements on how it uses its tools (recently updated in July 2023)[7], and which it publishes regularly[8]. These indicators are considered alongside a

[7] See **The Financial Policy Committee's approach to setting the countercyclical capital buffer - Policy Statement (bankofengland.co.uk)**

[8] See **FPC core indicators - December 2023**

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 the analysis of this information.

Concurrent stress tests of banking sector resilience are also a key element of the Committee's approach to increasing confidence in the financial system. Regular concurrent stress testing exercises began in 2014 and the first biennial exploratory scenario was completed in 2017. Following that publications have included a desktop stress test in May 2020, a 'reverse stress test' in August 2020, a solvency stress test in 2021, the CBES in May 2022, and the latest (2022/3) annual cyclical scenario in July 2023. The FPC and PRC have agreed that the Bank will run a desk-based stress test exercise in 2024.

In 2024, the Bank plans to take stock of and update its framework for concurrent bank stress testing, drawing on lessons learned from its first decade of concurrent stress testing, and so continue to support the FPC and PRC in meeting their objectives.

As part of wider work, the 2022 cyber stress test was published in March 2023 and the Bank is carrying out a system-wide exploratory scenario, which was launched in June 2023.

On the mortgage market, the Committee has committed periodically to review its Recommendations.

As noted in Section B, the FPC has recently set out its approach to identifying and assessing risks associated with market-based finance, and ways it intends to develop this approach[9].

The Committee agrees on the importance of clear and consistent communication, to support both public confidence in the financial system and build public trust in the Committee's actions. The FPC Record gives a full summary of Committee deliberations, including differences of views amongst members, and plays an important role in public accountability. The Committee will use its communications to explain how its actions have contributed to the achievement of both the Bank of England's Financial Stability Objective and have supported the economic policy of the Government.

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.

[9] **Financial Stability in Focus: The FPC's approach to assessing risks in market-based finance | Bank of England**

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

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.