

## **The Bank of England's decision making structure for macro-prudential policy and financial stability**

The aim of this report is to provide New Zealand Treasury with a good understanding of how macro-prudential and financial stability policy decisions are made at the Bank of England.

This report outlines the organisational structure of the BoE:

- the structure, membership and appointment process for the FPC and the PRC;
- the scope of decisions that fall to be made by each of the FPC and the PRC;
- how each of the FPC and the PRC makes decisions;
- what decisions are (or can be) delegated;
- how the FPC and the PRC coordinate their decision making;
- how the FPC and the PRC engage with external stakeholders (e.g. Treasury, the MPC)
- what review mechanisms exist for FPC or PRC decisions, or what recourse firms have in respect of those decisions; and
- how the Court and the IEO oversee the FPC's and PRA's functions/policy;
- transparency of decision making and operations and accountability mechanisms.

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## Defined terms:

|          |   |
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| ACS      | Annual Cyclical Scenario                            |
| ARCO     | Audit and Risk Committee                            |
| BES      | Biennial Exploratory Scenario                       |
| BoE      | Bank of England                                     |
| BRRD     | Bank Recovery and Resolution Directive (2014/59/EU) |
| CCyB     | Countercyclical Capital Buffer                      |
| CRD      | Capital Requirements Directive (2013/36/EU)         |
| CRR      | Capital Requirements Regulations (575/2013/EU)      |
| EBA      | European Banking Authority                          |
| ECB      | European Central Bank                               |
| FCA      | Financial Conduct Authority                         |
| FPC      | Financial Policy Committee                          |
| FSA      | Financial Services Authority                        |
| FSB      | Financial Stability Board                           |
| FSMA     | Financial Services and Markets Act 2001             |
| GovCo    | Governors' Committee                                |
| ICB      | Independent Commission on Banking                   |
| IEO      | Independent Evaluation Office                       |
| MPC      | Monetary Policy Committee                           |
| PRA      | Prudential Regulation Authority                     |
| PRAB     | PRA Board   |
| PRC      | Prudential Regulation Committee                     |
| RDC      | The FSA's Regulatory Decisions Committee            |
| ResCo    | Resolution Committee                                |
| SRB      | Systemic Risk Buffer                                |
| SRPC     | Supervisory Risk and Policy Committee of the PRA    |
| Treasury | HM Treasury (UK)                                    |

## Section A - Background

### Financial Services Act 2012

1. The UK's framework for financial stability and micro- and macro-prudential regulation and supervision was established by the Financial Services Act 2012 and came into effect in 2013.
2. The FSA was abolished and its prudential and conduct functions were split between two new authorities: the PRA and the FCA.

### FSA

3. The FSA had been created by the Labour government elected in 1997 under the legislative framework of FSMA 2000, which came into force on 1 December 2001.
4. The FSA united and replaced nine separate regulators, including the Securities and Investment Board, and took prudential supervision and regulation away from the Bank of England. Following the collapse of Barings Bank in 1995 due to the unauthorised trading activities of Nick Leeson in Singapore, there was a drive to move away from the self-regulation of financial services and to create one all-powerful regulator.

### PRA

5. The PRA is the micro-prudential regulator responsible for the regulation and supervision of all banks, building societies, credit unions, insurers and nine designated investment firms.<sup>1</sup>
6. The PRA is required to promote the safety and soundness of these firms in a way which both avoids adverse effects on UK financial stability and minimises the adverse effect that the failure of a firm could be expected to have on UK financial stability.<sup>2</sup>

### FCA

7. Legally the FCA is the rump of the FSA, housing the UK Listing Authority, and remains a separate legal body from the BoE. The FCA is the conduct regulator, responsible for conduct regulation and supervision of all those entities regulated and supervised by the PRA as well as the rest of the financial sector.
8. The FCA is also responsible for the prudential regulation and supervision of all those investment firms that are not regulated and supervised by the PRA. This

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<sup>1</sup> Investment firms are designated as PRA-investment firms by the PRA on the basis of the policy set out in the PRA's Statement of Policy; based on their size, measured by total assets, and whether their activities would have a material impact on the PRA's ability to advance its objectives in relation to another firm within the same group. See <http://www.bankofengland.co.uk/publications/Documents/other/pradesignationofinvestmentfirms.pdf>

<sup>2</sup> See section 2B(2)-(4), Financial Services and Markets Act 2000, as inserted by the Financial Services Act 2012.

is an important point for macro-prudential policy formation and implementation in terms of potential 'leakage'. For example, use of the FPC's Housing tools (LVR or DTI limits) or its Buy-to-let mortgage tools (LVR or DSCR limits) would necessitate a direction to both the PRA and the FCA if it was to capture all relevant lending activity and not create an incentive for lending to shift from firms supervised by the PRA to those supervised by the FCA.

### FPC

9. The FPC is the macro-prudential authority. It was created<sup>3</sup> to sit above the PRA and the FCA with responsibility for financial stability of the UK's financial system as a whole and the power to make recommendations and directions to the two regulators, as necessary.
10. Both the FPC and the PRA were housed in the Bank of England. Thus macro- and micro-prudential regulation and supervision were brought together within the same institution. Initially the FPC was a sub-committee of the BoE and the PRA a subsidiary.

### Bank of England and Financial Services Act 2016

11. The status of each of the FPC and the PRA within the BoE has since changed, with the coming into force of the Bank of England and Financial Services Act 2016.
12. The FPC has ceased to be a sub-committee of Court and has become a separate, independent committee of the BoE. The PRA was de-subsidiarised and its Board replaced by the PRC, a statutory committee of the BoE that now sits alongside the FPC and the MPC.
13. These changes were intended to establish a clear separation of responsibility for policy decisions, by each of the FPC, PRC and MPC, from the management and oversight responsibility of the Court of the BoE.

### Motivation for the Financial Services Act 2012

14. Prior to the 2012 Act, financial services were regulated and supervised by a tripartite system, which split responsibility and decision making between the Treasury, BoE and the FSA.
15. The tripartite was widely criticised for its role in the lead up to, and its failure to respond to, the global financial crisis. To summarise very briefly, the global financial crisis, which began in US subprime lending markets, quickly spread to the securitisation markets, which were complex and opaque. As confidence in these markets fell, institutions began to hoard cash, with dangerous implications for the liquidity and funding positions of banks.
16. One of the first casualties of this 'credit crunch', in September 2007, was the British bank Northern Rock, which relied on securitisations to fund its mortgage loan portfolio. In the UK there would be a number of further casualties:

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<sup>3</sup> The Bank operated an 'interim FPC' from February 2011, in anticipation of the Act coming into force in 2013.

Alliance & Leicester was taken over by Santander in July 2008; Lloyds TSB acquired Halifax Bank of Scotland in mid-September 2008; Bradford & Bingley was taken over by Abbey National at end-September 2008.

17. On 8 October 2008, the UK Government announced a recapitalization plan for UK banks and building societies. UK Financial Investments was established on 3 November to manage the Government's holdings of financial assets, including Northern Rock, Bradford and Bingley, 43.5% of Lloyds Banking Group and 70% of Royal Bank of Scotland.
18. A number of issues became apparent<sup>4</sup>:
  - 18.1. The FSA and the BoE did not have the tools necessary for the recovery and resolution of the institutions involved. This led to a spate of emergency legislation and ultimately to the Banking Act 2009.
  - 18.2. Micro-prudential supervision had become too siloed. The FSA was willing and able to share information with the BoE, which remained responsible for emergency liquidity funding and macro-economic oversight of the system. However, the FSA's conduct of micro-prudential supervision on a firm by firm basis meant it did not have an overall view on the crisis. Consequently the BoE's and the Treasury's ability to form a view on the macro-prudential risks was hampered.
  - 18.3. Managing the communication required between the FSA, BoE and the Treasury was difficult.
  - 18.4. There would also no doubt have been differences of view on trigger points; whether threshold conditions ceased to be met by firms and at what point in time. Again, the BoE and Treasury's lack of access to information would have left them second guessing the FSA's judgements and decisions (including decisions not to act).
  - 18.5. Perhaps due to not being as well sighted on the systemic nature of the crisis as it might have been, the BoE remained philosophically opposed to bailing-out banks because of the moral hazard, which led to frustration at Treasury over the slowness of action in respect of Northern Rock in the summer of 2007 and again in early 2008 when the BoE reluctantly signed up to the government's special liquidity scheme.
19. Treasury identified that a major deficiency in the UK's tripartite system was that no authority had clear, overall responsibility for identifying, monitoring and responding to risks building up in, and fault lines in, the system as a whole. The motivation for the 2012 Act was to eliminate this uncertainty.
20. Thus accountability lies at the heart of the design of the framework and remains an important focus, as reflected by the 2016 Act and its changes to the legal status and governance of the FPC, PRC and the Court.

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<sup>4</sup> See for example the Report of the House of Lords Economic Affairs Committee on Banking Supervision and Regulation, printed on 19 May 2009.

21. The FPC is at the centre of the macro-prudential framework, tasked with identifying, monitoring and taking action to mitigate systemic risk. The framework provides a number of channels to promote dialogue, and to ensure coordination and cooperation between the FPC and Treasury, while safeguarding the FPC's independence, as well as with the PRA and the FCA.<sup>5</sup> This outcome is greatly facilitated by having representatives of each of these entities as members of the FPC.
22. The FPC has the power to make recommendations to the Treasury on both:
  - 22.1. the macro-prudential toolkit it considers necessary to fulfil its objectives and responsibilities; and
  - 22.2. the regulatory perimeter for macro- and micro-prudential regulation and supervision.
23. Treasury retains the power to grant the FPC macro-prudential measures, subject to approval by Parliament, necessary for the FPC to use its most powerful tool, the power of direction. The PRA and the FCA are legally required to comply with a direction from the FPC as soon as reasonably practicable.<sup>6</sup>
24. In the four years since the framework came into legal existence, the authorities have demonstrated a good, and at times impressive, ability to coordinate the exercise of their functions in an efficient and timely manner. They continue to implement the regulatory agenda, post-financial crisis.
25. Whether the challenge of macro-prudential policy – anticipating and mitigating both the 'known unknowns' and the 'unknown unknowns' – is fully met by the framework can only be assessed over a much longer timeframe, and with a considerable time lag. There is thus an inherent limit to the effectiveness of the accountability framework that has been put in place.
26. Further, the effectiveness of the framework will ultimately hinge on a willingness to act, with all its political ramifications. As the Brexit negotiations intensify, and as the financial crisis continues to fade from memory, the transition from a single European rulebook for financial services to an independent UK regime will present opportunities and challenges for the regulation and supervision of UK financial services and for the financial stability framework.
27. Mark Carney, who asked the then-Chancellor George Osborne for a five-year term as Governor, has agreed to stay one additional year, until Brexit negotiations are concluded in 2019. This remains two years short of the full

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<sup>5</sup> The Treasury, the BoE and the PRA have a statutory duty to arrange to coordinate the discharge of their respective functions so far as they (a) relate to the stability of the UK financial system; and (b) affect the public interest, particularly where the BoE has given, or is considering giving, a public funds notification. Section 64, Financial Services Act 2012. The Financial Services Act 2012 also obliges the authorities to share information and to enter into an MoU on resolution planning and crisis management.

<sup>6</sup> Section 91, Bank of England Act 1998, as amended.

eight-year term preferred by Prime Minister Theresa May and the Chancellor, Philip Hammond.

## Section B - Rationale for, and design of, the committees

- **What were the main motivations for the UK's BoE to adopt and implement a committee decision-making structure?**

### Reasons for a committee structure

28. The reasons that Treasury designed the macro-prudential authority as, and granted macro-prudential policy decision-making to, a committee rather than a single individual were that:
- 28.1. it mirrored the arrangements for the MPC;
  - 28.2. expertise and understanding of the financial system from a range of BoE executives was required;
  - 28.3. stakeholders (e.g. Treasury, the MPC, the PRA, the FCA) which needed both to have their views considered and to be 'in the loop' could participate as members;
  - 28.4. the participation of external members was considered necessary to bring wider expertise and perspectives from the market; and
  - 28.5. the challenge of macro-prudential policy, identifying risks to financial stability that ran counter to the popular consensus, was more likely to be met if decisions were made by a group composed of members with different experience and perspectives.

### Origins of the MPC as a committee

29. The MPC was established in 1997 by the newly elected Labour government as part of the new monetary policy framework. The aim was to de-politicise interest rate decisions, by transferring decision making responsibility from Treasury to the MPC, an independent committee of the BoE.
30. The operation of monetary policy via a committee that includes both BoE Governors and external members helps maintain the credibility of interest rate setting as an independent activity free of political influence.

- **How many members sit on the committees? What is the balance between internal and external members?**

### Court

31. Court has five executive members from the BoE and up to nine non-executive members. It currently has twelve members.

32. Court members are:
  - 32.1. the Governor;
  - 32.2. four Deputy Governors (for Financial Stability; Markets and Banking; Prudential Regulation; and Monetary Policy); and
  - 32.3. seven non-executive, external, members, including the Chair.

### FPC

33. The FPC has thirteen members, of which six are from the BoE and seven are external members.<sup>7</sup>
34. The FPC members are:
  - 34.1. the Governor;
  - 34.2. four Deputy Governors (for Financial Stability; Markets and Banking; Prudential Regulation; and Monetary Policy);
  - 34.3. the BoE's Executive Director for financial stability (who reports to the Deputy Governor for Financial Stability);
  - 34.4. five external members appointed by the Chancellor;
  - 34.5. the Chief Executive of the FCA; and
  - 34.6. a non-voting member from Treasury.
35. Treasury's view was that the presence of external members would:
  - 35.1. ensure the credibility of the system;
  - 35.2. provide a wider range of experience and knowledge (e.g. in macroeconomics and from financial sectors other than banking); and
  - 35.3. divergent points of view to the FPC's discussions.

*"In particular, it will provide scope for the FPC to challenge the prevailing consensus – a vital role for a successful macro-prudential policy."*<sup>8</sup>

36. Treasury wanted its own representative on the FPC in order to:
  - 36.1. feed in the government's assessment of the macroeconomic climate;
  - 36.2. ensure that the government's economic priorities were taken into account;
  - 36.3. identify any potential fiscal impact of the FPC's decisions; and

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<sup>7</sup> The Bank of England and Financial Services Act 2016: (a) made the Deputy Governor for Markets and Banking a member of Court and the FPC and increased the number of external members to be appointed to FPC by the Chancellor from 4 to 5; (b) gave Treasury the power, after consulting with the Governor of the BoE, to add or remove a deputy governor and an external member from any of Court, the FPC and the PRC (but not the MPC, for which power to add a member in the event of an additional deputy governor being appointed by Treasury, resides with the Governor).

<sup>8</sup> Para 2.42, HM Treasury, *A new approach to financial regulation: judgment, focus and stability*, July 2010.

- 36.4. in recognition of Treasury's legislative and other responsibilities, both domestically and in the international arena.<sup>9</sup>
37. The Treasury member is non-voting, and any views expressed by the Treasury member must be disregarded in determining whether the committee has reached a consensus.<sup>10</sup> These provisions are necessary to preserve the independence of the committee. This does not mean that the Treasury member cannot influence the discussion or debate, but in determining consensus, the Treasury member's view should not be taken into account.<sup>11</sup> The Treasury representative can, and is expected to help shape the discussion and the debate but is not part of the formal decision-making of the FPC, whether it be by consensus or a vote. If the Treasury member's agreement was needed for a consensus then Treasury could force a vote.<sup>12</sup> At that point the external members, appointed by the Chancellor, might feel conflicted.

### PRC

38. The PRC has twelve members, of which five are from the BoE and seven are external members.
39. The PRC members are:
- 39.1. the Governor;
  - 39.2. four Deputy Governors (for Financial Stability; Markets and Banking; Prudential Regulation; and Monetary Policy);
  - 39.3. six external members appointed by the Chancellor; and
  - 39.4. the Chief Executive of the FCA.

### MPC

40. The MPC has nine members, of which five are from the BoE and four are external members.
41. The MPC members are:
- 41.1. the Governor;
  - 41.2. three Deputy Governors (for Financial Stability; Markets and Banking; and Monetary Policy);
  - 41.3. the BoE's Chief Economist; and

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<sup>9</sup> Until the UK's withdrawal from the European Union is complete (expected to be in March 2019), Treasury is the government agency ultimately responsible for the implementation of European law as it relates to financial services. Treasury would be subject to infraction proceedings by the European Commission, and consequent financial penalties in the European Court of Justice, should there be a failure by the BoE (or the FCA) to implement macro or micro prudential regulation required by EU law.

<sup>10</sup> Paragraph 11(7), Schedule 2A, Bank of England Act 1998.

<sup>11</sup> See remarks by Mark Hoban, Financial Services Bill debate in the House of Commons, 23 April 2012, Hansard.

<sup>12</sup> See remarks by Mark Hoban, House of Commons Public Bill Committee; Financial Services Bill, 28 February 2012, column number 206, Hansard.

- 41.4. four external members appointed by the Chancellor. Note there is no Treasury representative on the committee representing Treasury's views, as there is on FPC.

• **How are members appointed?**

Court

42. All members of Court are appointed by the Crown acting through Treasury. The Chancellor selects the Chair.

FPC

43. The Governor, the four Deputy Governors and the Chief Executive of the FCA are members of the FPC by virtue of their offices.
44. The Executive Director for financial stability, Alex Brazier, was appointed a member of the FPC by the Governor, after consultation with the Chancellor, pursuant to the statutory power granted to the Governor to appoint one member.<sup>13</sup> The member appointed under this power must be a person with executive responsibility within the BoE for the analysis of threats to financial stability.<sup>14</sup>
45. Effectively six external members are appointed by the Chancellor: the five external members and the representative from Treasury. The Chancellor cannot appoint an external member of the MPC to the FPC.<sup>15</sup>

PRC

46. The Governor, three of the Deputy Governors and the Chief Executive of the FCA are members of the PRC by virtue of their offices.
47. The Deputy Governor for Monetary Policy, Ben Broadbent, was appointed a member of the PRC by the Governor, with the approval of the Chancellor, pursuant to the statutory power granted to the Governor to appoint one member.<sup>16</sup>

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<sup>13</sup> Section 9B(1)(d), Bank of England Act 1998.

<sup>14</sup> Section 9B(2), Bank of England Act 1998.

<sup>15</sup> Paragraph 6(2), Schedule 2A, Bank of England Act 1998.

<sup>16</sup> Section 30A(2)(f), Bank of England Act 1998 as amended by the Bank of England and Financial Services Act 2016.

48. A minimum of six external members are appointed by the Chancellor. The Chancellor has the power to appoint more than six external members if desired.<sup>17</sup> The Chancellor cannot appoint a member of the MPC or the FPC.<sup>18</sup>

### MPC

49. The Governor and the three Deputy Governors are members of the MPC by virtue of their offices.
50. The BoE's Chief Economist, Andy Haldane, was appointed a member of the MPC by the Governor, after consultation with the Chancellor, pursuant to the statutory power granted to the Governor to appoint one member<sup>19</sup>. The member appointed under this power must be a person who carries out monetary policy analysis within the BoE.<sup>20</sup>
51. Four external members are appointed by the Chancellor.<sup>21</sup>

- **What are the required skill-sets for members? Has there been any public discussion of constraints the BoE has found in terms of finding these skills?**

52. The skill-set required of external members of the FPC includes:<sup>22</sup>
- 52.1. strong and proven financial sector knowledge and experience;
  - 52.2. a solid understanding of economics;
  - 52.3. analytical ability;
  - 52.4. independence of thought and interpersonal skills;
  - 52.5. communication skills; and
  - 52.6. undisputed integrity and standing.
53. The skill-set required of external members of the MPC is broadly similar except that (a) financial sector knowledge and experience is not a pre-requisite, and (b) strong and proven knowledge and skills in economics are required.<sup>23</sup>

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<sup>17</sup> Section 30A(2)(g), *ibid.*

<sup>18</sup> Paragraph 8(2), Schedule 6A, Bank of England Act 1998, as inserted by the Bank of England and Financial Services Act 2016.

<sup>19</sup> Section 13(2)(b), Bank of England Act 1998.

<sup>20</sup> Section 13(3), Bank of England Act 1998.

<sup>21</sup> Section 13(2)(c), Bank of England Act 1998.

<sup>22</sup> See 'Candidate Brief – Appointment of External Member of the Financial Policy Committee of the Bank of England' at <https://publicappointments.cabinetoffice.gov.uk/wp-content/uploads/2016/06/FPC-candidate-pack-JULY-8-update.pdf>

<sup>23</sup> See 'Candidate Brief – Appointment of External Member of the Monetary Policy Committee of the Bank of England' at <https://publicappointments.cabinetoffice.gov.uk/wp-content/uploads/2015/05/MPC-candidate-pack-FINAL.pdf>

- **Do the committees use any specific methods to deal with risk of group-think?**

54. 'Group-think' remains a charge frequently levelled at the BoE, and other central banks. There are no specific methods used by the committees to address group-think, other than each member maintaining a general awareness of his or her unconscious bias. Governor Carney recently delivered a speech stressing the importance of diversity in addressing the risk of group-think.<sup>24</sup>
55. One of the reasons given for having external members on the committees was to help avoid the risk of group-think. Interestingly the Warsh review suggested in December 2014 that the MPC's one member, one vote, decision making helped reduce the chance of group think.<sup>25</sup>

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<sup>24</sup> See 'Reflecting diversity, choosing inclusion', speech given by Mark Carney, 9 February 2017:

<http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech958.pdf>

<sup>25</sup> See <http://www.bankofengland.co.uk/publications/Documents/news/2014/warsh.pdf>

## Section C - Design and operation of the committees

- **What are the decision-making arrangements for financial stability and prudential policy decisions in the UK?**
- **How are members resourced to undertake analytical work and what assistance are they given? Do they have access to internal staff resource? What staff papers do they have access to?**

### Treasury's role

56. The decision making arrangements for financial stability and prudential policy in the UK stem from the primary legislation<sup>26</sup> prepared by Treasury. That legislation provides the structural framework for these arrangements.
57. That framework also allows, and requires in order for it to operate, Treasury to prepare secondary legislation in response to macro-prudential risks as they arise. For example, within the framework the FPC has a power to direct the PRA and the FCA to take action in response to macro-prudential and financial stability risks. But the FPC can only use that power in respect of a specific macro-prudential measure (e.g. LVRs) where that measure has been prescribed by Treasury. Those measures are to be prescribed by Treasury as and when they are needed, and can be justified by the FPC. The framework thus embeds the need for the FPC and the Treasury to discuss and agree what macro-prudential measures the FPC needs to fulfil its statutory objectives and responsibilities, or, put another way, what tools the FPC needs for its macro-prudential toolkit.
58. The FPC has the power to make recommendations to the Treasury in respect of the need for a particular macro-prudential measure, the designation of activities with the PRA's regulatory perimeter and other matters.<sup>27</sup> So if the FPC identifies a macro-prudential risk and a measure that would address that risk, it can make a recommendation to the Treasury that it be granted a power to direct the PRA or the FCA to take action in accordance with that measure.
59. In practice Treasury would be aware of the FPC's likely recommendation, and would have the opportunity to voice concerns, well before the recommendation was made, through its member's participation at FPC and the interaction of BoE and Treasury officials.
  - 59.1. The emergence of a macro-prudential risk and the various policy options the FPC and the PRA were considering to address the risk

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<sup>26</sup> FSMA and the Bank of England Act 2009, as amended by the Financial Services Act 2012 and the Bank of England and Financial Services Act 2016.

<sup>27</sup> Sections 9P Bank of England Act 1998.

would be discussed at FPC level, probably at several consecutive quarterly FPC meetings before a formal recommendation was made.

- 59.2. The FPC, including the Treasury representative, would first ask BoE officials to develop the policy options it considered most suitable and to consider whether those policy options could be implemented via existing legal powers. If BoE officials considered that a new legal instrument was desirable it is likely that they would consult with their policy and legal counterparts at Treasury (and the FCA if necessary) before asking the FPC to make a formal recommendation. Ad hoc working group meetings would be arranged to consider the new powers needed and any consequential changes to the legislative framework.
60. Note that the FPC can only use its formal recommendation power if it advances its financial stability objective and only if the legal 'have regards' are met, including that the measure recommended is proportionate (in a cost-benefit sense) and would not prejudice the advancement by the PRA and the FCA of their objectives. Thus a considerable amount of policy ground work would have to be completed before the FPC made its recommendation to Treasury.
61. One example of that interaction was the leverage ratio framework.<sup>28</sup> In March 2012, the interim FPC (established prior to the coming into force of the provisions of the Financial Services Act 2012 that formally constituted the FPC) agreed it would advise Treasury that the statutory FPC should have powers of direction to set a leverage ratio. In response Treasury indicated that it intended to provide such a tool but no earlier than 2018. The Chancellor then wrote to the Governor in November 2013 requesting that the FPC consider whether it needed a formal power of direction over a leverage ratio framework, i.e. whether Treasury should prepare secondary legislation granting a macro-prudential measure in relation to the leverage ratio. The Chancellor's letter acknowledged that the FPC already had the power to make recommendations to the PRA as to the appropriate leverage ratio for banks, and that the PRA had

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<sup>28</sup> A leverage ratio framework that complemented the risk-weighted capital framework for banks had been discussed in policy circles, including at the FSB and BCBS, since the global financial crisis. By historical standards many banks in the USA and the UK had extremely high levels of gearing in the lead up to the global financial crisis; banks were using a disproportionate amount of debt relative to equity to finance their investments. This high level of gearing served to amplify the crisis as there was insufficient equity capital to absorb losses. One reason for this high gearing was that over time banks had reduced the risk weighting of their assets (which determines the amount of regulatory capital a bank must hold) through the use of internal models sanctioned by regulators. There was thus an increasing disquiet within policy circles with the risk-weighted framework. A leverage ratio framework, which took as its numerator the amount of the bank's equity capital and as its denominator the gross exposures of the bank, without any risk-weighting, was seen as a way to guard against this risk. A leverage ratio framework also appealed because of its simplicity relative to the complexity of the risk-weighted framework.

rule-making powers that could extend to implementing rule based requirements for UK banks in respect of a leverage ratio.

62. However, given the FPC's status as macro-prudential authority and its ongoing work on the 'medium-term capital framework', and the right amount of capital in the financial system as a whole, it was clearly considered the right body to consider the question of the desirability, design and calibration of a leverage ratio framework. The timing was no doubt influenced both by the ongoing work in the UK on the ring-fencing of retail banks and associated questions regarding the adequacy and location of capital within those groups, and progress at BCBS and in EU legislation in requiring banks to disclose their leverage ratio.
63. The Chancellor was explicit that the FPC's recommendation would (a) need to be supported by clear evidence that the tool would help the FPC achieve its objectives; and (b) have to explain the impact of a leverage ratio on the ability of banks to support growth in lending to UK consumers and businesses
64. The FPC published its terms of reference for its review in March 2014<sup>29</sup>, consultation paper in July 2014<sup>30</sup> and the results of its review in October 2014<sup>31</sup>. Unsurprisingly the FPC recommended to Treasury at its meeting in October 2014 that Treasury prescribe a macro-prudential measure which allowed the FPC to direct the PRA to require banks to hold a minimum amount of capital against their total exposures, as well as buffers. On the same day the FPC's review was published, Treasury published a letter from the Chancellor to the Governor agreeing to the FPC's recommendation and promising to bring forward the legislation necessary to grant FPC the macro-prudential measure. The Treasury then ran its own consultation process, from 7 November to 28 November 2014 on the proposal to grant the FPC the macro-prudential measure.<sup>32</sup> Included in the consultation was the draft statutory instrument prescribing the macro-prudential measure to the FPC. The statutory instrument was laid before Parliament and was made on 25 March 2015.<sup>33</sup>
65. It is clear from the process outlined above that there would have been considerable working level interaction between the BoE and the Treasury in order for the Treasury to consult and table the draft legal text for the macro-prudential measure so swiftly.

#### The Bank of England

66. Within the BoE, decision making for financial stability is split between the macro-prudential authority, the FPC, and the micro-prudential regulator and supervisor, the PRA. As a general principle it is the FPC which moves first and

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<sup>29</sup> <http://www.bankofengland.co.uk/publications/Pages/news/2014/062.aspx>

<sup>30</sup> [http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs\\_cp.pdf](http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs_cp.pdf)

<sup>31</sup> [http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs\\_lrr.pdf](http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf)

<sup>32</sup> <https://www.gov.uk/government/consultations/financial-policy-committees-leverage-ratio-framework>

<sup>33</sup> [http://www.legislation.gov.uk/uksi/2015/905/pdfs/uksi\\_20150905\\_en.pdf](http://www.legislation.gov.uk/uksi/2015/905/pdfs/uksi_20150905_en.pdf)

the PRA/PRC which moves second in respect of financial stability and systemic risk.

67. Each one has a clearly defined statutory objective:
  - 67.1. The FPC is to contribute to the achievement by the BoE of the Financial Stability Objective.
  - 67.2. The PRA's general objective is to promote the safety and soundness of individual firms.<sup>34</sup>
68. The distinction between macro- and micro-prudential roles and responsibilities is further developed in legislation.
  - 68.1. The FPC has a range of macro-prudential tools granted to it by Treasury in regulations or orders approved by Parliament. The FPC also fulfils the role of UK macro-prudential authority under EU and UK legislation. For example the FPC sets the CCyB rate for UK exposures based on its view of the economic cycle.
  - 68.2. The PRA acts as micro-prudential regulator under FSMA, including:
    - 68.2.1. supervising PRA regulated firms;
    - 68.2.2. making rules implementing prudential policy;
    - 68.2.3. implementing structural reform for firms required to ring-fence their retail operations;
    - 68.2.4. making threshold condition assessments of firms to determine whether they should enter the UK's resolution regime under the Banking Act 2009 and the BRRD;
    - 68.2.5. granting new firm authorisations in accordance with FSMA and CRD/CRR;
    - 68.2.6. managing applications from individuals to perform Senior Manager and Senior Insurance Manager functions;
    - 68.2.7. managing applications for change of control and notifications of close links;
    - 68.2.8. handling the passporting of firms in accordance with the EU's single market directives;
    - 68.2.9. managing variations and cancellations of permission; and
    - 68.2.10. managing waivers and rule modifications for regulated firms as well as CRR permissions, including capital models.
69. However, given that systemic financial stability issues and the safety and soundness of individual firms can impact on each other, the FPC needs to be kept informed of risks at the micro-prudential level and the PRA needs the FPC's views on systemic, macro-prudential risk to identify risks to individual firms. The PRC and the PRA will generally look to the FPC for guidance (in the absence of a recommendation or direction) on the nature and scale of financial stability risks that it should factor into its supervision of firms. The PRA is required to consider UK financial stability effects of its supervision of firms and

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<sup>34</sup> See schedules 2 and 3 for the statutory objectives of each of the FPC and the PRA.

in pursuing its micro-prudential objective of promoting their safety and soundness.<sup>35</sup>

70. Because the FPC and PRC have this overlapping interest in financial stability and prudential policy issues, they work closely together in developing and implementing policy. This is reflected in:
- 70.1. the BoE's operational framework, including for prudential policy development;
  - 70.2. specific joint policy initiatives such as stress testing; and
  - 70.3. the implementation of macro-prudential measures, for example:
    - 70.3.1. the systemic risk buffer (SRB); and
    - 70.3.2. the countercyclical capital buffer (CCyB); and
  - 70.4. the FPC's legal duty to have regard to the PRA and/or the FCA's objectives and proportionality when:
    - 70.4.1. making recommendations;
    - 70.4.2. giving directions.

Each of these areas is discussed further below.

### Operational framework

71. The close cooperation of the FPC and the PRA/PRC is reflected and supported by the BoE's operational framework. Under Governor Carney the BoE has pursued an internal 'One Bank' strategy to promote the integration of work produced by different divisions and the sharing of data<sup>36</sup> and analysis across the BoE. The strategy stresses that all BoE officials work to support all three policy making committees. The BoE has also launched a coordinated research agenda focusing on the intersection of micro- and macro-prudential policy with monetary policy.
72. The cross-membership of the senior committees means that representatives from all areas of the BoE are well sighted on both micro- and macro-prudential issues as they develop in PPD. The Governor and the Deputy Governors for Prudential Regulation, Financial Stability, and Markets and Banking all sit on the PRC, FPC and GovCo.
73. The FPC has its own dedicated, but small, secretariat. The FPC Secretariat acts as a hub for the flow of information and analysis from relevant officials in all areas of the BoE to FPC members. It is also responsible for briefing members, particularly external members prior to each round of FPC meetings. These briefings involve in-depth presentations on topics to be discussed at the

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<sup>35</sup> Section 2B(3), FSMA.

<sup>36</sup> There are broad gateways for the sharing of information between the PRA and the rest of the BoE, including the FPC, in UK legislation. However, where firm specific information is held by the PRA it will be subject to strict confidentiality provisions under UK and EU law. An appropriate gateway has to be identified before it can be shared. These gateways are considered sufficient for financial stability purposes.

FPC meetings and provide external members with an opportunity to ask for further background detail and analysis.

74. Typically, each quarterly round of FPC meetings begins with a risk assessment briefing based on a broad range of indicators of financial stability and systemic risk identified by the FPC. This risk assessment is based on the BoE's ongoing surveillance of financial markets in the UK and globally, market intelligence and analysis from all areas of the BoE, including monetary policy, markets and banking (including the provision of liquidity), financial stability, together with the PRA's and FCA's supervisory insights and expectations.
75. The FPC has held joint briefings and discussions with both the MPC and the PRA Board/PRC on topics of common interest. The FPC and MPC held four joint briefing meetings in 2016.
76. The FPC will then hold two or three 'Issues' meetings, where policy papers are presented and discussed by members. It is not intended that formal policy decisions be made at these meetings. It is an opportunity for the members to have an open discussion. During Issues meetings the Chair will be interested to see whether any consensus is forming during the discussion, or whether there is a central position that it is likely the Chair will be able to suggest at the subsequent Policy meeting for decision.
77. The 'Policy' meeting is where papers are presented to the committee for formal decision, following a further discussion. The Chair will suggest a decision, including, if necessary, a specific calibration for a measure (e.g. the CCyB rate for UK exposures), that the Chair feels will garner consensus support.
78. The time period for a quarterly round, from initial briefing to the Policy meeting, is around four weeks.

#### Prudential policy development

79. Prudential policy development occurs within the Prudential Policy Division (PPD) of the BoE. PPD does not answer directly to the FPC or the PRC. Rather, policy development occurs within PPD and relevant external fora, e.g. the FSB, the BCBS, the EBA, the ECB, the G20, etc.
80. To the extent policy would affect the FPC or the PRC's objectives or powers then the FPC and/or the PRA would be kept informed and asked for steers in terms of their policy preferences.
81. In order for the policy development process to be joined up within the BoE, policy development issues are socialised internally through a sequence of committees. Policy issues that affect micro-prudential regulation and supervision would first go to SRPC and would then proceed either directly to PRC, if sufficiently important, or first to GovCo, so that all the Deputy Governors are sighted and have an opportunity to comment, and then to PRC, if appropriate.
82. If the micro-prudential issue is significant enough, FPC may be informed of the PRC's views and proposed approach. ResCo may also be informed if the topic has cross-over implications for recovery and resolution policy, for example, if

the issue relates to composition of the capital stack, the leverage ratio or structural reform/ring-fencing, and/or could otherwise affect firms', or the BoE's, resolution strategy. Policy matters specific to recovery and resolution would likely originate in the Resolution Division before progressing to ResCo and would be socialised with SRPC, GovCo, PRC and FPC as appropriate.

83. Macro-prudential policy would follow a similar process though there is no official sub-committee of the FPC (as SRPC is for the PRC). Significant macro-prudential policy issues would be expected to go to GovCo before being presented to FPC. It is likely that PRC would be kept informed as well, and a first step might well be to take a paper to SRPC first so that SRPC can decide whether to escalate the issue to PRC. The Director for PPD sits on SRPC. Again, the cross-membership of the statutory committees means that senior officials are sighted on proposals as they progress across the BoE.
84. Macro-prudential policy issues that originate in an external forum, for example if the FPC is asked to reciprocate a CCyB rate set by a member country of the European Systemic Risk Board, would first be considered by the BoE's International Steering Board, composed of representatives from across the BoE, including the PRA's supervision teams, Resolution, PPD, Legal Directorate, Supervisory Risk Specialists, etc.
85. SRPC and GovCo may also be kept informed depending on the nature and significance of the issue. This is likely if the issue would set a precedent.
86. Once agreement had been reached across the BoE at this working group level, a paper would be presented to FPC for decision, if required. For a relatively minor, and clear cut, decision on the reciprocation of a CCyB rate it is likely that the FPC would use written procedure rather than an actual meeting to make a decision.

### Stress testing

87. Perhaps the most notable joint exercise between the FPC and the PRA is the design of the 'ACS', the annual cyclical scenario, and the 'BES', the biennial exploratory scenario, for the stress testing of the UK's major banks. The design and analysis of the scenarios is led by the BoE's Financial Stability and Systemic Risk Division, though it draws on officials from across the Bank, including supervision, policy and risk specialists through specially formed working groups.
88. The ACS and the BES are signed off by both the PRC (formerly the PRA Board) and the FPC before being communicated to the relevant banks. Six months later banks' results are presented to both committees for the purposes of their separate objectives and functions. For example, depending on the nature of the scenarios, and each firm's response, the results may inform the FPC's view on the correct calibration of the CCyB rate for UK exposures and the PRA's view on the amount of CET1 capital a firm should have to meet not only its minimum capital requirements and CRD buffers but also its PRA buffer.

## Implementation of macro-prudential policy: the Systemic Risk Buffer

89. The Systemic Risk Buffer (SRB) is a discretionary macro-prudential buffer in the EU's Capital Requirements Directive. Article 133 CRD provides that each Member State may introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector, or one or more subsets of that sector, in order to prevent and mitigate long term non-cyclical systemic or macro-prudential risks not covered by CRR. The Member State is required to designate the authority in charge of setting the SRB.
90. In 2015 Treasury decided that, in order to fulfil the recommendations of the Independent Commission on Banking (ICB),<sup>37</sup> it would implement the SRB in the UK from 2019, in respect of large ring-fenced banks and building societies, defined as those institutions that hold more than £25 billion in deposits or shares.
91. In recognition of the macro-/micro- split of responsibilities between the FPC and the PRA, Treasury gave:
  - 91.1. the FPC the obligation to design the SRB framework;<sup>38</sup> and
  - 91.2. the PRA the obligation to apply the FPC's SRB framework to relevant firms.<sup>39</sup>
92. The FPC consulted on its SRB framework in January 2016 and adopted it in May 2016. The framework sets out how the FPC assesses the extent to which the failure or distress of a ring-fenced bank might pose a "long term non-cyclical systemic or macro-prudential risk"<sup>40</sup> and how buffer rates are to be determined:

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<sup>37</sup> The Independent Commission on Banking was established in June 2010 in the wake of the financial crisis to inquire into structural reform of the UK banking sector. The ICB produced its final report and recommendations in September 2011. These recommendations included the ring-fencing of the retail banking operations of the major UK banks from their riskier investment banking activities. It also recommended that large ring-fenced banks should not only maintain equity of at least 10% of risk weighted assets (RWAs) but also maintain (among other capital requirements and buffers) a further loss-absorbing buffer of up to 3% of RWAs, if the supervisor has concerns about the ring-fenced bank's ability to be resolved without cost to the taxpayer. See

[http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report\[1\].pdf](http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report[1].pdf)

<sup>38</sup> Regulation 34F of the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014, as amended by the Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.

<sup>39</sup> Regulation 34G of the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulation 2014, as amended by the Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.

<sup>40</sup> Defined in Regulation 34F(2)(b) as a risk of disruption to the financial system with the potential to have serious negative consequences for the financial system and the real economy in the United Kingdom.

- 92.1. The relevant criteria are judged to be the potential for abrupt reductions in the availability of credit to UK households and non-financial companies, measured by total assets.
- 92.2. A simple scoring and mapping system translates firms' total assets into an SRB buffer rate between 0% and 3%, in 0.5% increments.<sup>41</sup>
93. The PRA will be required to apply the framework created by the FPC in order to derive a buffer rate for each ring-fenced bank.<sup>42</sup> But the PRA is not required to set the buffer rate derived from the FPC's framework. The PRA may, "in exercise of sound supervisory judgement" set an SRB buffer rate for a firm which is different to the buffer rate derived from the FPC's framework.<sup>43</sup>
94. At this stage – the PRA is not required to set SRB buffer rates until January 2019 – it seems unlikely that the PRA would depart from the buffer rate derived from the FPC's framework unless there were exceptional circumstances. The PRA published a Statement of Policy in December 2016, entitled '*The PRA's approach to implementation of the systemic risk buffer*', which sets out that:

The PRA expects that it will exercise supervisory judgement to deviate from the SRB rates derived from the FPC framework or waive the requirement only in exceptional cases. The PRA expects that these will primarily be cases where the outcome of the methodology is not in adherence with the spirit of the FPC framework. An example of such a case could be actions by a firm to manipulate its systemic score deliberately, so that the rate derived from the framework underestimates its systemic importance.<sup>44</sup>

95. The PRA also has discretion in determining the consolidation level at which the SRB is to be applied by a firm, its sub-group or group. The PRA's Statement of Policy set out that, as one might expect given the SRB is intended to fulfil the ICB's recommendations on ring-fencing, the SRB is to apply at the level of sub-consolidation of the ring-fenced bank. Absent a sub-consolidation group, the PRA will determine the level of application on a case by case basis.<sup>45</sup>

#### Implementation of macro-prudential policy: the CCyB and the PRA buffer

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<sup>41</sup> A firm would have to apply its buffer rate to its total, world-wide, risk weighted exposures in order to derive an amount of common equity tier 1 capital that it would be expected to have to meet its SRB, over and above its minimum capital requirements and PRA buffer. Further, under CRD and related PRA rules, there is no double counting of capital for the purposes of capital buffers. Thus distinct capital would have to be applied against each of the CRD buffers: CCB, CCyB, SRB and GSII buffer.

<sup>42</sup> Regulation 34G(3), *ibid*.

<sup>43</sup> See Regulation 34G(5), *ibid*.

<sup>44</sup> Paragraph 4.5, PRA Statement of Policy, '*The PRA's approach to implementation of the systemic risk buffer*', available at:

<http://www.bankofengland.co.uk/pradocuments/publications/sop/2016/srbapproach.pdf>

<sup>45</sup> Paragraph 4.2, *ibid*.

96. The CCyB is a mandatory macro-prudential buffer under the EU's CRD. All banks, building societies and investment firms are expected to have sufficient common equity tier 1 capital to meet their CCyB.
97. Each firm's CCyB is unique as it is calculated by applying the firm's weighted average CCyB rate, which depends on the CCyB rate set by the relevant macro-prudential authority in each jurisdiction in which the firm has relevant assets, to its total risk weighted assets.
98. Treasury gave the FPC the responsibility for assessing and setting the CCyB rate for UK exposures each quarter.<sup>46</sup> The FPC also has the power to recognise CCyB rates set in non-EEA jurisdictions and to recognise rates above 2.5% in EEA jurisdictions.<sup>47</sup>
99. The PRA, as part of its implementation of CRD and CRR, made rules requiring firms to calculate their CCyB using (a) the CCyB rate for UK exposures set by the FPC; (b) the CCyB rates of up to 2.5% set by EEA authorities; and (c) the CCyB rates for exposures in other jurisdictions recognised by the FPC or above 2.5% in EEA jurisdictions.<sup>48</sup>
100. There is thus a clear sequence of events that starts with the FPC's macro-prudential judgement as regards:
  - 100.1. the UK economy and whether the provision of credit is outpacing GDP and therefore warrants a positive CCyB rate for UK exposures;
  - 100.2. whether it is appropriate, in the FPC's judgement, to start building capital across the system during the up-swing in credit provision in order to provide a cushion that can be relied on during the eventual down-swing; and
  - 100.3. whether to recognise the CCyB rates set in other jurisdictions.
101. The FPC's judgement, and that of other macro-prudential authorities, is then implemented at the micro-prudential level by the PRA.
102. One complication that was identified during the early operation of this framework was the likelihood that some firms might be asked to have two separate amounts of capital for the same risk.
103. Prior to the implementation of CRD and the CCyB, the PRA had, for some firms, factored counter-cyclical risk at a systemic level into its assessments of their capital adequacy, and therefore of the amount of capital that those firms were expected to have in order to meet their Pillar 2 capital buffers. This was not done consistently across the whole population of PRA authorised firms.
104. Consequently, in order to avoid double counting of risks in different capital buffers, and to give primacy to the FPC's macro-prudential authority and

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<sup>46</sup> Regulation 10(1), The Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014.

<sup>47</sup> CCyB rates of up to 2.5% that are set by authorities in the EEA apply automatically to UK institutions, regardless of the FPC's views.

<sup>48</sup> See Capital Buffers, Rules 3.1(4)-(7), PRA Rulebook:

<http://www.prarulebook.co.uk/rulebook/Content/Chapter/211277/06-04-2017>

responsibility for forming a judgement on the counter-cyclical risk in the UK economy and to set the UK CCyB rate in a meaningful fashion, the FPC and the PRC decided in March 2016 (when the FPC set a positive UK CCyB rate for the first time, at 0.5%) that it would be appropriate for the PRA to reduce firms' PRA buffers by up to 0.5% of UK exposures, to reflect any overlap.<sup>49</sup>

105. This approach and the PRA's implementation, which was expected to be completed in March 2017 (when the FPC's decision in March 2016 to set a 0.5% UK CCyB rate was to come into force), was then disrupted by the UK's referendum on membership of the EU. As a result of the Leave vote, the FPC decided at its July 2016 policy meeting that it would reduce the UK CCyB rate from 0.5% to 0%. Given that the PRA's approach to reducing relevant firms' PRA buffers was predicated on there being a positive CCyB rate of at least 0.5% in force (and therefore no reduction in firms' overall capital buffer expectations) the FPC made, at the same time as its decision to cut the UK CCyB rate on 1 July 2016, a recommendation to the PRA that:

where existing PRA supervisory buffers of PRA-regulated firms reflect risks that would be captured by a UK countercyclical capital buffer rate, it reduce those buffers, as far as possible and as soon as practicable, by an amount of capital which is equivalent to the effect of a UK countercyclical capital buffer rate of 0.5%.

106. This recommendation was set out in the *Financial Stability Report* published on 5 July 2016. On the same day the PRA released a statement that it would reduce firms' PRA buffers by an amount equivalent to a UK CCyB rate of 0.5% on UK exposures as soon as practicable.<sup>50</sup>

107. The practical outcome was to give effect to the FPC's desire to reduce the amount of capital held across the system, notwithstanding that the CCyB rate of 0.5% set in March 2016 was not due to come into force until March 2017. It was also a one-off adjustment which means that henceforth the FPC's decisions on the UK CCyB rate will have the impact the FPC intends across the system without any adjustments being necessary at the micro-prudential level.

108. The two sets of FPC and PRC meetings, in March and June-July 2016, illustrate how the FPC and the PRC work not only in sequence but also closely and effectively together in short time frames.

109. Officials from a range of divisions across the BoE would have had to evaluate and quantify the impact of the FPC's decisions on the CCyB and of the PRA's reduction of PRA buffers, and its legal and operational workability, all within the

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<sup>49</sup> See the 'PRA statement on the interaction between the PRA buffer and the CRD IV combined buffer' at:

<http://www.bankofengland.co.uk/prs/Documents/publications/reports/prstatement0316.pdf>

<sup>50</sup> See 'PRA statement on adjustments to firms' PRA buffers':

<http://www.bankofengland.co.uk/prs/Documents/publications/reports/prstatement0716.pdf>

context of their separate objectives and powers. It would clearly have been undesirable for the FPC to make its recommendation to the PRA without knowing whether the PRC/PRA could give practical effect to it.

#### FPC's powers of recommendation

110. Indeed, when making a recommendation to the PRA and/or the FCA the FPC has a legal duty to avoid prejudicing the advancement by the PRA and/or the FCA of any of its objectives, and to act in a proportionate manner.<sup>51</sup> Thus, in practice, macro-prudential policy initiatives which entailed making a recommendation to the PRA would only be presented to the FPC if the PRC/PRA could act upon them legally and within the PRA's statutory objectives.
111. The FPC has broad powers to make recommendations to the PRA, the FCA, Treasury, other areas of the BoE, or any other person.<sup>52</sup> The recipient of a recommendation from the FPC is not legally required to comply with it. However, in the case of the PRA and the FCA, it seems unlikely that the FPC would make a recommendation, particularly one to the PRA, without knowing whether the regulator could or would be likely to comply.<sup>53</sup>

#### FPC's powers of direction

112. The exercise by the FPC of its powers of direction is subject to the same legal considerations and duties as a recommendation. Prior to asking the FPC to exercise a power of direction, BoE officials would establish that the PRC/PRA (and/or FCA if relevant) could legally implement the direction and what subsequent decisions would be required of the PRC (and/or FCA).
113. Under section 9H of the Bank of England Act the FPC can give a direction to either the PRA or the FCA requiring the regulator to exercise its functions so as to ensure the implementation of the prudential measure in question. The FPC can only exercise this power in respect of a macro-prudential measure prescribed by Treasury.
114. To date Treasury has prescribed the following macro-prudential measures, and thus given the FPC powers of direction over:

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<sup>51</sup> The making of a recommendation by the FPC to the PRA is explicitly listed as one of the FPC's statutory functions in section 9G of the Bank of England Act and therefore the FPC is subject to the legal 'have regards' in section 9F when doing so.

<sup>52</sup> Sections 9O – 9R, Bank of England Act 1998.

<sup>53</sup> Note that under section 9Q(3) of the Bank of England Act, the FPC can make a recommendation to the PRA or FCA on a 'comply or explain' basis. However this does not create a legal obligation for the PRA (or FCA) to comply. It also seems improbable that the PRA or FCA would not explain, publically, any non-compliance with an FPC recommendation, whether or not it was made on a 'comply or explain' basis. Further, it is difficult to see circumstances in which it would be desirable politically for the FPC to make a recommendation on a 'comply or explain' basis to the PRA, if the PRA does not intend to, or cannot, comply with the recommendation.

- 114.1. sectoral capital requirements: to require UK banks to maintain additional capital by reference to their exposures to residential property, commercial property or the financial sector;<sup>54</sup>
  - 114.2. housing: to set limits on mortgage lending by reference to loan-to-value percentages and/or debt-to-income ratios;<sup>55</sup>
  - 114.3. the leverage ratio: to secure that UK banks and investment firms satisfy a minimum leverage ratio and meet leverage ratio buffers;<sup>56</sup> and
  - 114.4. buy-to-let mortgages: to set limits on lending for buy-to-let mortgages by reference to loan-to-value and/or interest coverage ratio.<sup>57</sup>
115. So far the FPC has only given one direction, to the PRA in respect of the leverage ratio, which it revoked in June-July 2016 following the UK's referendum on membership of the EU.

### Recovery and resolution

116. In other scenarios, for example recovery and resolution, the FPC would have oversight of the system as a whole, and could act first to address systemic risk that is at the root cause of a firm's impending or potential failure. However, the FPC cannot exercise its powers in respect of individual firms.
117. In terms of dealing specifically with a failing firm, it would be the PRA which would move first before other parts of the BoE (e.g. Resolution Division or the Markets and Banking teams which operate the Sterling Monetary Framework and provide emergency liquidity assistance) would act formally.<sup>58</sup> The FPC would monitor the systemic implications of any such action and exercise its powers at a system-wide level as necessary.

- **Are the committee structures informal or enshrined in legislation and are there sub committees?**
- **What decisions do the committees, or any sub-committees, make and what can be delegated to a sub-committee or individual?**

118. The FPC, PRC and MPC are statutory committees. As a general rule the statutory committees cannot delegate the exercise of the functions or the powers prescribed to them, unless explicitly permitted to do so.

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<sup>54</sup> The Bank of England Act 1998 (Macro-prudential Measures) Order 2013.

<sup>55</sup> The Bank of England Act 1998 (Macro-prudential Measures) Order 2015.

<sup>56</sup> The Bank of England Act 1998 (Macro-prudential Measures) (No.2) Order 2015.

<sup>57</sup> The Bank of England Act 1998 (Macro-prudential Measures) Order 2016.

<sup>58</sup> Note that in order to comply with both the CRD and the BRRD, the supervision and resolution functions of the BoE must be kept separate and operationally independent of one another, Article 4(7) CRD and Article 3(3) BRRD.

119. The FPC has no formal power to delegate decision making. In the absence of such a power it remains solely responsible for fulfilling its objectives and exercising its powers.
120. The PRC has been granted the power to delegate certain decisions (see further below). PRC has established the SRPC as a sub-committee in order to take decisions that are within the decision matrix approved by PRC, i.e. that relate to certain categories of firms and types of decision. Other sub-committees composed of senior officials are constituted as necessary to operate below, and report to, SRPC.
121. Otherwise the BoE has the power to establish such committees as are necessary to perform its functions.

#### FPC decisions

122. To achieve its objective and its statutory responsibility the FPC has been given powers by Treasury to:
  - 122.1. give directions to the PRA and the FCA to implement relevant macro-prudential measures that have been specifically prescribed by Treasury to the FPC in Regulations or Orders in Council, following public consultation;
  - 122.2. make recommendations to the PRA, the FCA, the Treasury, the BoE (for example in respect of the provision of emergency liquidity assistance) and other persons;
  - 122.3. where designated by Treasury as the UK's macro-prudential authority, exercise powers under CRD or other legislation, for example:
    - 122.3.1. setting the CCyB rate for UK exposures each quarter;
    - 122.3.2. designing the framework for the UK's systemic risk buffer;
    - 122.3.3. deciding whether to recognise the CCyB rate set by authorities in other jurisdictions in respect of exposures in those jurisdictions;
    - 122.3.4. disclose its views about, or information about, possible systemic risks, whether in the records of its meetings or in the bi-annual *Financial Stability Report*.
123. Otherwise the FPC is not required to make any particular decisions. It is required to:
  - 123.1. fulfil its objective of contributing to the BoE's Financial Stability Objective and, subject to that supporting the economic policy of the Government, including its objectives for growth and employment;
  - 123.2. fulfil its statutory responsibility 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; and
  - 123.3. publish the *Financial Stability Report* twice a year and to set out the FPC's:
    - 123.3.1. view of the stability of the UK financial system;

- 123.3.2. assessment of the developments that have influence the current position;
- 123.3.3. assessment of the strengths and weaknesses of the UK financial system;
- 123.3.4. assessment of the risks to the stability of the UK financial system; and
- 123.3.5. view on the outlook for the stability of the UK financial system.

#### PRC delegations and decisions

124. The PRC is required to delegate the day to day management of the PRA and the drafting of the PRA's prudential regulation strategy to the PRA chief executive,<sup>59</sup> who is also the Deputy Governor for Prudential Regulation. The BoE has published a statement setting out the functions that have been delegated to the chief executive and the terms and conditions of that delegation.
125. The PRC also has an explicit power<sup>60</sup> to delegate such of its functions as it thinks fit to:
- 125.1. a member of the PRC;
  - 125.2. a sub-committee of the PRC consisting of:
    - 125.2.1. members of the PRC; or
    - 125.2.2. one or more members of the PRC and one or more officers, employees or agents of the BoE;
    - 125.2.3. an officer, employee or agent of the BoE; or
    - 125.2.4. a committee consisting of officers, employees or agents of the BoE.
126. The PRC has delegated certain decisions to SRPC, to continue the previous relationship between the PRA Board and the SRPC. SRPC is not a statutory committee. Rather it is a creature of the PRC's authority to delegate authority to a committee to take certain decisions.
127. The delegation of supervisory and policy decision within the PRA to SRPC, and further down, to specially constituted Supervisory Assessment Panels, Panels of Heads of Division and further to individual Heads of Division, is guided by a decision matrix.
128. The PRA divides its regulated firms into five categories and its decisions into three Types<sup>61</sup> in order to decide at what level of delegation decisions should be made. This decision matrix is based on both quantitative and qualitative analysis. The PRA also considers the substitutability of the services that each firm provides and the extent to which this could mitigate the impact of failure, in

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<sup>59</sup> Paragraph 17(2), Schedule 6A, Bank of England Act 1998, as inserted by the Bank of England and Financial Services Act 2016.

<sup>60</sup> Paragraph 17(1), *ibid.*

<sup>61</sup> See schedule 3.

both benign and stressed circumstances. Firms are told which category they have been assigned, giving them a broad indication of the level of supervisory interaction to expect.

129. Type A decisions regarding Category 1 firms<sup>62</sup> are reserved for the PRC. This will include significant authorisation, threshold condition and enforcement issues regarding Category 1 firms.
130. As regards waivers and the approval of firms' use of Internal Ratings Based (IRB) models, the level of decision making will depend on the likely impact of the decision. A decision to remove a Category 1 firm's IRB model, for example, would probably be sufficiently impactful, in terms of the implications for the firm's capital requirements, for the decision to rest with PRC. However, the sheer volume of review and analysis associated with waivers and model approvals means that the PRC will be heavily reliant on the work done by officials, SRPC and other specific committee set up to handle the process.
131. The PRC has non-delegable responsibility for:
  - 131.1. rule-making under FSMA, as it is a significant and broad power that the PRA has been granted to effectively make subordinate legislation;
  - 131.2. determining, reviewing and revising the PRA's strategy;
  - 131.3. giving, reviewing and revising the PRA's statutory guidance about how it intends to advance its objectives in discharging its general functions in relation to different categories of PRA-authorised persons or PRA-regulated activities;
  - 131.4. giving and revoking statutory directions;
  - 131.5. annually reporting to the Chancellor on the adequacy of resources allocated to the PRA and the extent to which the exercise of these functions is independent of the BoE's other functions; and
  - 131.6. reporting on the PRA's secondary competition objective.

### ResCo

132. ResCo is a committee of the BoE constituted by the Governor to provide advice on the discharge of the BoE's responsibilities as the UK's resolution authority under BRRD. Formal decision-making rests with the Deputy Governor for financial stability, unless explicitly reserved to the Governor.
133. Other members of ResCo are the Deputy Governors for Prudential Regulation and Markets and Banking, the Executive Directors for Resolution, Prudential Policy and the Directors of Financial Market Infrastructure and the Director for Banking.

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<sup>62</sup> Category 1 firms are those whose size, interconnectedness or business type give them the capacity to cause significant disruption to the UK financial system by failing or carrying on their business in an unsafe manner, or in the case of insurers to cause disruption to the interests of a significant number of policy holders, in each case as determined by the PRA from time to time.

- **How are decisions made? (eg, “individualistic” committee (voting) or “collegial” committee (consensus)?)**

### FPC and PRC

134. In respect of both the FPC<sup>63</sup> and the PRC<sup>64</sup>:
- 134.1. the chair is required to seek to secure that decisions of the committee are reached by consensus wherever possible;
  - 134.2. if the chair forms the opinion that consensus cannot be reached, a decision is to be taken by a vote of all those members present at the meeting; and
  - 134.3. in the event of a tie, the person chairing the meeting is to have a second casting vote.
135. The reasons for decisions having to be made by consensus is not clear from the various Treasury papers that preceded the legislation creating the FPC.<sup>65</sup> The requirement for the Chair to try and achieve consensus forces the Governor to take into account, and to seek to reach accommodation with, the views of the external members. If that accommodation cannot be reached then the committee proceeds to a vote, to unblock the issue. This appears to be an attempt to ensure that the external members are heard and their views taken into account rather than being automatically dismissed as a minority. There are now five external members on the committee, so even if they allied with the Chief Executive of the FCA they would not represent a majority of the twelve voting members on the FPC. As mentioned above, the Chair has a second casting vote in the event of a tied vote.

### MPC

136. The procedural provisions that apply to the FPC and the PRC are in contrast to the MPC. There is no requirement for the chair of the MPC to seek to secure that decisions of the MPC are reached by consensus. The MPC is required to

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<sup>63</sup> Paragraph 11(4)-(6), Schedule 2A, Bank of England Act 1998.

<sup>64</sup> Paragraph 12(4)-(6), Schedule 6A, Bank of England Act 1998, as inserted by the Bank of England and Financial Services Act 2016.

<sup>65</sup> See the Treasury consultation paper ‘A new approach to financial regulation: judgement, focus and stability’ (July 2010), ‘A new approach to financial regulation: building a stronger system’ (February 2011), the Treasury white paper ‘A new approach to financial regulation’ (June 2011), the Treasury policy paper ‘A new approach to financial regulation: securing stability, protecting consumers’ (January 2012).

take decisions by a vote of all those members present at the meeting. In the event of a tie the chair of the MPC has a second casting vote<sup>66</sup>.

- **How are regulatory (individual institution) decisions made, including enforcement, approvals and waivers (for example how is enforcement and policy split), and what procedures are available for review of these decisions (we would also be interested in how this issues are dealt with by the FCA)?**

### Enforcement

137. Under the previous regime, the FSA's enforcement cases were dealt with by the Regulatory Decisions Committee (RDC). This ensured the independence of enforcement decisions from the supervisory teams and committees that were responsible for day-to-day supervision and policy issues and that assembled the evidence for enforcement.
138. When the PRA was established it was decided not to have an RDC and to fold enforcement decisions into the functions of the decision making committees, i.e. PRA Board, SRPC or subordinate panels of Heads of Division, with the appropriate decision maker determined by reference to the PRA's decision making matrix (and the Category of firm and the Type of decision). Some further adjustments were made, for example the Chief Executive of the FCA was to be excluded from enforcement decisions made by the PRA Board.
139. For this approach to work, staffing and operational issues would have to have been addressed to ensure that the PRC would be quorate when it came to making an enforcement decision; that certain key members of the PRC did not have to recuse themselves from an enforcement decision because of their involvement in supervising the firm and/or investigating the case.

### Approvals and waivers

140. Approvals and waivers are handled in the PRA's Authorisation and Waivers team; firms would apply to the Authorisation and Waivers team and their supervisory contact. The decision on whether to grant the approval or waiver would be escalated to the appropriate decision making committee based on the Category of firm and Type of decision.
141. Coordination with the FCA is required in respect of dual-regulated firms. Some of the FSA's legacy rules remain rules of both the PRA and the FCA. In such cases a firm would need a waiver or modification from both regulators. In

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<sup>66</sup> Paragraphs 11(4) and (5), Schedule 3, Bank of England Act 1998.

cases that deal with prudential rules or regulations the PRA takes the lead and coordinates with the FCA as appropriate.

### Review

142. A firm typically has a statutory right of review by the Tribunal<sup>67</sup> in respect of supervisory decisions, enforcement, approvals and waivers. See further below.

- **How would the committees deal with conflicts between monetary and financial [*stability*] objectives (and any other objectives) and what is the co-ordination mechanism between the FPC and PRAB?**
- **How do the committees coordinate with other internal governance structures and MPC?**

143. As outlined above, the FPC, PRC and MPC have over-lapping membership; access to the same analysis; and regularly hold joint briefing meetings. This facilitates not only information sharing but also the formation of a common understanding in respect of not only the key economic judgements but also each committee's likely policy response to various scenarios.

144. The Chancellor has encouraged the committees to foster this coordination of macro-prudential and monetary policy. The Chancellor has recommended, in his remit letters to each of the FPC and the MPC, that each committee have regard to the actions of the other in its own policy making and that each committee note in the records of its meetings, its policy statements and the BoE's *Financial Stability Reports* and *Inflation Reports*, how it has had regard to the policy settings and forecasts of the other committee.

145. While it is impossible to predict how the FPC and the MPC might react in extreme or stressed scenarios there are examples of how the policy functions interact.

146. When the MPC first introduced its forward guidance for interest rates, it provided the FPC with a 'knock out' power if the FPC judged that the monetary policy setting posed a significant threat to financial stability that could not be contained by the macro- and micro-prudential tools available.

147. The low interest rate environment and its effect on the business models and long term viability of both banks and insurance companies has been a concern of the FPC and PRC for some time and remains a topic of discussion and

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<sup>67</sup> Upper Tribunal (Tax and Chancery), Rolls Building. A firm would submit the relevant form, setting out its argument, and attach the PRA's Decision Notice that it was contesting.

analysis across the BoE. Both stress test scenarios announced by the BoE in March 2017<sup>68</sup> dealt with this issue.

147.1. The ACS for 2017 sets out a scenario where interest rates rise to 4%, with loan impairments rising as a result but banks earning higher interest income.

147.2. This is in contrast with both:

147.2.1. the ACS for 2016 which posited a scenario where the official cash rate was cut to 0%; and

147.2.2. the BES for 2017 which considers how the UK banking system might evolve if recent headwinds to banks' profitability, including persistent low interest rates, persist or intensify.

148. Housing is another area of policy that draws on analysis from across the BoE. The FPC's consideration of macro-prudential risks associated with mortgage lending in the UK draws on, among other things, the MPC's macro-economic forecasts and assessments.

149. In terms of prudential policy development, see the description above in relation to prudential policy development. In terms of supervisory issues there is a similar process of coordination between SRPC, PRC, GovCo and ResCo, with the FPC kept informed as appropriate, of any existing or potential systemic risks.

- What relationships do the committees have with government and other stakeholders, including mechanisms to take account of Government economic policy or policy recommendations?

### Government economic policy

150. Both the FPC and the MPC are required to take account of government economic policy, including the Government's objectives for growth and employment. That policy and those objectives are set out by the Chancellor in his annual remit and recommendation letters to the Governor as Chair of each of the FPC and the MPC.<sup>69</sup> The Treasury's view at FPC is also represented by a non-voting member.

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<sup>68</sup> See

<http://www.bankofengland.co.uk/financialstability/Documents/stresstesting/2017/keyelements.pdf>

<sup>69</sup> The Chancellor's remit letter to the FPC from March 2017 can be found here:

<http://www.bankofengland.co.uk/financialstability/Documents/fpc/letters/chancellorletter080317.pdf>

151. The Chancellor also has the power to make recommendations to the FPC and the MPC as to matters they should have regard to in the exercise of their functions. In the FPC's case this has included recommendations such as:
- 151.1. facilitating finance for productive investment;
  - 151.2. undertaking cost-benefit analyses for policy (notwithstanding that this is already 'baked in' to various pieces of legislation);
  - 151.3. maintaining London and the UK's position as a financial centre and promoting its competitiveness;
  - 151.4. consulting with relevant experts and markets participants (again, reinforcing public law and legislative provisions to that effect).
152. As regards the PRA, the Chancellor may, by notice in writing to the PRC, make recommendations about aspects of the Government's economic policy to which the PRC should have regard<sup>70</sup> when considering:
- 152.1. how to advance its statutory objectives; and
  - 152.2. the application of the regulatory principles set out in FSMA.<sup>71</sup>
153. The Chancellor can make such recommendations at any time provided s/he does so at least once each Parliament. Treasury is required to publish the notice and lay a copy before Parliament.

### FCA

154. The PRA and the FCA have a duty to cooperate with each other in their supervision of dual-regulated firms and to have an MoU in place for this purpose. The views of the FCA are represented at both FPC and PRC by the FCA's Chief Executive being a member.
155. The PRA, and the BoE as resolution authority, are also required to consult with the FCA, as well as Treasury, in respect of decisions to exercise stabilisation powers in recovery and resolution.

### The Pensions Regulator

156. The PRA maintains an MoU with The Pensions Regulator, setting out arrangements for cooperation and coordination in carrying out their respective regulatory responsibilities under FSMA and the Pensions Acts 2004 and 2008 and other relevant legislation.

### FSCS

157. The PRA is responsible for the oversight of, and rules relating to, the Financial Services Compensation Scheme (FSCS) in respect of deposit and insurance policy protection.

### Competition: CMA, FCA and PSR

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<sup>70</sup> Section 30B, Bank of England Act, as inserted by the Bank of England and Financial Services Act 2016.

<sup>71</sup> See schedule 3.

158. Competition aspects of the PRA's work have been the subject of some focus. The regulatory principles of the FSA and the PRA (see schedule 3) had included a reference to competition. This was made more prominent with the introduction of the PRA's secondary competition objective in 2014.
159. The Competition and Markets Authority, the FCA and the Payment Services Regulator are the main competition authorities in the UK as relates to financial services, and that can touch on the BoE's work in relation to financial stability.
160. The CMA was established in April 2014, taking over many of the functions of the Office of Fair Trading to become the UK's primary competition and consumer authority, with economy-wide responsibilities and powers to promote competition and ensure markets work well for consumers, businesses and the economy.
161. The FCA, in addition to its supervisory responsibilities, is the competition authority for regulated financial services. It has had a competition objective and duty since its inception in April 2013.
162. The Payment Systems Regulator was established as a subsidiary of the FCA with the overriding goal of promoting competition and innovation and ensuring that payment systems are operated and developed in the interests of those that use them.

• **How do the committees deal with any conflict of interest issues?**

163. The issue of potential conflicts of interest of various members of the BoE's committees has arisen relatively frequently over the past few years. The Treasury Select Committee has raised the issue in respect of, for example, Richard Sharp and Clara Furse (external members of the FPC) and Charlotte Hogg (former Deputy Governor for Markets and Banking).

Appointment

164. Before appointing external members to any of the FPC, PRC and the MPC the Chancellor is required to consider whether the person has any financial or other interest that could substantially affect the functions as member that it would be proper for the person to discharge.<sup>72</sup>

Standing provisions regarding conflicts of interest

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<sup>72</sup> Section 9B(3)(b) Bank of England Act 1998 for the FPC; paragraph 2(b) of Schedule 6A Bank of England Act 1998, as inserted by the Bank of England and Financial Services Act 2016, for the PRC; and section 13(4) of the Bank of England Act 1998, as amended by section 7(4) of the Bank of England and Financial Services Act 2016, for the MPC.

165. Thereafter members of the FPC, PRC and MPC are required to keep potential conflicts of interest under review and to declare them to the committee if necessary.
166. If a member of the FPC, PRC or MPC has any direct or indirect interest (including any reasonably likely future interest) in any dealing or business which falls to be considered by the relevant committee,
- 166.1. the member must disclose that interest to the committee when it considers the dealing or business; and
- 166.2. the committee must decide whether the member is to be permitted to participate in any proceeding of the committee relating to any question arising from its consideration of the dealing or business, and if so to what extent and subject to what conditions (if any).<sup>73</sup>

### Codes of Practice

167. The BoE is required to issue and maintain codes of practice describing how members of the FPC, PRC and MPC are to comply with the above requirements. The codes of practice set out principles, guidelines and procedures for identifying, monitoring and managing actual or potential conflicts of interest. They stipulate that if a committee member becomes aware of a breach of the code of practice, the member shall report the breach to the committee as soon as possible.
168. The BoE can revise or replace a code at any time but must consult with the Treasury before doing so. It is expected that Court will review the codes and their application by the committees on an annual basis.
169. The codes of practice for the FPC and the MPC were approved by Court on 16 December 2016, and can be found at the links below.
- 169.1. For the FPC:  
<http://www.bankofengland.co.uk/financialstability/Documents/fpcconflictsinterestcodepractice.pdf>
- 169.2. For the MPC:  
<http://www.bankofengland.co.uk/monetarypolicy/Documents/mpcconflictsinterestcodepractice.pdf>
170. The PRC's conflicts of interest code of practice was approved by Court in March 2017 and can be found at:  
<http://www.bankofengland.co.uk/prc/Documents/about/prconflicts.pdf>

### Register of Interests

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<sup>73</sup> Paragraph 14, Schedule 2A, Bank of England Act 1998, for the FPC; paragraph 14(1) of Schedule 6A of the Bank of England Act 1998, as inserted by the Bank of England and Financial Services Act 2016, for the PRC; and paragraph 13B, Schedule 3, Bank of England Act 1998, for the MPC.

171. The Secretary of the BoE is responsible for maintaining a register of committee members' declared interests and for reviewing the register, together with the BoE's General Counsel.

#### Annual Report

172. The BoE publishes information on the business interests of its committee members in its Annual Report, in addition to the remuneration paid by the Bank to committee members.

#### Code of Conduct

173. As part of the Governor's 'One Bank' strategy, a code of conduct was introduced for all BoE officials, including Governors. The Code sets out five principles for BoE staff to adhere to, consistent with the Nolan principles of public life: integrity, inclusiveness, impartiality, accountability and empowerment. One stated aim is to at least meet the same standards expected of regulated firms via the Senior Managers Regime.

174. The Code details specific processes and policies that staff are to follow and comply with, including making an annual declaration of compliance. Under the Code all BoE staff are to declare their personal financial relationships, business relationships, and outside interests and to declare and seek permission for personal financial transactions.

#### Post-Charlotte Hogg resignation

175. In the wake of Charlotte Hogg's resignation as Deputy Governor for Markets and Banking in March 2017 due to an undisclosed potential conflict of interest, the BoE announced that it was reconfiguring its reporting lines and internal structures in order to safeguard more effectively the governance of its Code of Conduct, compliance and disciplinary processes. This will involve:

175.1. senior management responsibility for bank-wide risk management moving from the Chief Operating Officer to the Deputy Governor for prudential regulation;

175.2. the Head of Compliance reporting to:

175.2.1. the General Counsel, who in turn reports directly to the Governor; and

175.2.2. the Chair of ARCO, who is tasked with ensuring the independence of the BoE's compliance function;

175.3. senior management responsibility for the Code of Conduct will rest with the General Counsel, who will report to the Chair of ARCO.

176. Further, Court has commissioned a review by its non-executive directors (excluding the Chair) that will examine:

176.1. the lessons from the Charlotte Hogg case;

176.2. the extent to which changes to reporting lines and internal structures outlined above are adequate; and

- 176.3. what the BoE should do to ensure full and timely compliance now and in the future, especially among the BoE's senior officials and members.
177. The review by the Court's non-executives is to be assisted by the IEO, the Internal Audit division and the National Audit Office as appropriate. The BoE has committed to making the findings and recommendations of the review public.

## Section D - Transparency and accountability

- **How do the committees provide transparency on its operation and decisions?**

178. The BoE's framework for governance and accountability is set by the Bank of England Act 1998, as amended. The BoE and its statutory committees are accountable to Parliament, principally through the House of Commons Treasury Select Committee. Members of the FPC, PRC and MPC regularly appear before the Treasury Select Committee, and other relevant committees.

179. The framework includes requirements for:

179.1. Annual reports from each of the FPC and the PRA to the Chancellor, to be laid before Parliament;

179.2. Oversight by the National Audit Office;

179.3. The FPC to publish:

179.3.1. records of its quarterly meetings;

179.3.2. explanations for the use of its direction and recommendation powers;

179.3.3. consultation documents and statements of policy in respect of its macro-prudential powers;

179.3.4. its views in the BoE's bi-annual *Financial Stability Report*,

179.4. The PRA to publish:

179.4.1. documents outlining its approach to banking and insurance supervision;

179.4.2. consultation documents, supervisory statements, statements of policy and policy statements (when making rules)

179.4.3. a report to Treasury, also to be laid before Parliament, in the event of a regulatory failure<sup>74</sup>;

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<sup>74</sup> The PRA's duty to investigate and report on regulatory failure arises where it appears to the PRA that (a) relevant public expenditure has been incurred in respect of a PRA-authorized person, and (b) that expenditure might not have been incurred but for a serious failure in (i) the system established by FSMA for the regulation of PRA-authorized persons and their activities, so far as it relates to the functions of the PRA, or (ii) the operation of that system, so far as it relates to those functions. The Treasury can direct the PRA that it appears to the Treasury that those conditions have been met and the PRA must therefore prepare a report. (section 74, Financial Services Act 2012)

- 179.4.4. an Annual Competition Report setting out the ways in which the PRA has delivered, and intends to deliver, against its secondary competition objective.
180. The BoE has promoted initiatives of its own to increase transparency and accountability.
181. As regards financial crisis management and recovery and resolution, the BoE has a statutory duty to notify the Treasury immediately if there is a material risk to public funds.<sup>75</sup> More specifically, the Bank as resolution authority is required, under the Banking Act 2009, to obtain Treasury consent if the exercise of stabilisation powers has implications for public funds. There is a Memorandum of Understanding between the BoE and Treasury on financial crisis management to ensure close coordination and cooperation where there is a risk to public funds.<sup>76</sup>

#### National Audit Office

182. The FCA is subject to full audit by the National Audit Office (NAO). The NAO has the power to launch value for money studies in respect of its use of resources.
183. Since the Bank of England and Financial Services Act 2016 came into force the Comptroller and Auditor General of the NAO have had the power to carry out examinations into the economy, efficiency and effectiveness with which the BoE has used its resources in discharging its functions, though any such examination cannot be concerned with the BoE's policy objectives or the merits of any policy decisions taken by the FPC, MPC or PRC.<sup>77</sup> This helps Parliament to hold to account those responsible for the use of public resources. There is a Memorandum of Understanding between the BoE and the NAO.<sup>78</sup>
184. The Bank is also now required to prepare an additional statement of accounts in relation to prudential regulation functions, audited by the BoE's auditor.<sup>79</sup>

#### FPC: Record

185. As regards the FPC, the BoE was already required to publish a record of each meeting of the FPC before the end of the period of six weeks beginning with the day of the meeting,<sup>80</sup> unless publication of information would be against the

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<sup>75</sup> Section 58(1), Financial Services Act 2012.

<sup>76</sup> See

<http://www.bankofengland.co.uk/about/Documents/mous/statutory/moufincrisis.pdf>

<sup>77</sup> Section 7D, Bank of England Act, as inserted by the Bank of England and Financial Services Act 2016.

<sup>78</sup> See

<http://www.bankofengland.co.uk/about/Documents/mous/statutory/mouforboeandnao.pdf>

<sup>79</sup> Section 7(2A), *ibid.*

<sup>80</sup> Section 9U(1), Bank of England Act 1998.

public interest in which case that information could be redacted from the record.<sup>81</sup>

186. The record must specify any decisions taken at the meeting (including decisions to take no action) and must set out, in relation to each decision, a summary of the Committee's deliberations.<sup>82</sup>
187. The term "decision" is not defined in the legislation. However, it is specified that when the FPC (a) decides to use its formal powers of direction or recommendation, or (b) makes or revokes a request in respect of Article 458 CRR (the national macro-prudential carve-out)<sup>83</sup>, or (c) sets the CCyB rate<sup>84</sup>, that decision, and the committee's deliberations, must be set out in the record.
188. This list of decisions is not interpreted to be exclusive of other decisions, as that term is commonly understood, being included in the record. Thus other decisions, particularly those that relate to the exercise of other formal powers ascribed to the FPC by legislation, for example decisions relating to the design and calibration of the framework for the Systemic Risk Buffer<sup>85</sup>, are also likely to be decisions that would fall within the statutory requirements relating to the record.
189. The FPC is often presented with policy options and asked for a steer by officials on its preferred approach. Typically, these are not regarded as decisions,

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<sup>81</sup> Section 9U(8), Bank of England Act 1998.

<sup>82</sup> Section 9U(2), Bank of England Act 1998.

<sup>83</sup> Under section 2AA(3) or (4) of the Bank of England Act 1998 the BoE is responsible for the application of Article 458 of the CRR so far as it relates to a measure which has been prescribed to the BoE by Treasury as a power of direction (under section 9L of the Bank of England Act 1998). In principle, some of the macro-prudential measures that have been conferred on the BoE could be used in circumstances that fall within Article 458.

Article 458 CRR is known as the national macro-prudential carve-out because it provides that in certain instances, where the national macro-prudential authority of a Member State (in the UK the FPC) identifies changes in the intensity of macro-prudential or systemic risk in the financial system, with the potential to have serious negative consequences to the financial system and the real economy in the UK, it may, for up to two years, exercise/apply macro-prudential powers to mitigate that risk, if the risk cannot be adequately addressed under existing powers under CRD/CRR (e.g. by imposing Pillar 2 measures on institutions). There are strict EU notification and approval steps that must be followed. Section 2AA of the Bank of England Act makes clear which of those European law obligations reside with the Treasury or the BoE (which would make a notification on behalf of, and following a request from, the FPC).

<sup>84</sup> Under the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014 (2014/No. 894).

<sup>85</sup> This duty and power was granted under Regulation 34F of the Capital Requirements (capital Buffers and Macro-prudential Measures) Regulations 2014 as amended by the Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015 (2015/No. 19).

though the record is likely to set out the high level nature of the committee's discussion on these topics.

190. Note that there is no requirement to identify the views of individual members of the committee<sup>86</sup> nor how they voted (if the committee failed to reach a consensus and resorted to a vote)<sup>87</sup>, though the committee may decide to do so.

#### FPC: explanation of use of powers of direction, recommendation

191. If the FPC uses its formal powers of direction or recommendation it is required to prepare an explanation, including a cost benefit analysis, of the reasons for the FPC's decision to exercise the power in the way in which it is being exercised<sup>88</sup>. The FPC must also set out its reasons for believing that the exercise of the power is compatible with both:

191.1. the BoE's Financial Stability Objective and, subject to that, supporting the economic policy of the Government, including its objectives for growth and employment, and

191.2. the FPC's statutory 'have regards' (see schedule 2).

192. The explanation and associated reasons would be published in the record of the meeting at which it was decided to exercise the relevant power. The explanation and reasons would also be reproduced in the next *Financial Stability Report* to be published<sup>89</sup>.

#### FPC: Financial Stability Report

193. The FPC is required to prepare and publish two financial stability reports in each calendar year. The Bank of England Act specifies what the reports must include:
- 193.1. the FPC's view of the stability of the UK financial system at the time when the report is prepared;
  - 193.2. an assessment of the developments that have influenced the current position;
  - 193.3. an assessment of the strengths and weaknesses of the UK financial system;
  - 193.4. an assessment of risks to the stability of the UK financial system;
  - 193.5. the Committee's view of the outlook for the stability of the UK financial system;
  - 193.6. a summary of the activities of the Committee in the reporting period;
  - 193.7. an assessment of the extent to which the exercise by the FPC of its functions (both since the previous *Financial Stability Report* and previously) has succeeded during the reporting period in achieving the

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<sup>86</sup> Section 9U(7) Bank of England Act 1998.

<sup>87</sup> Paragraph 11(4)-(7), Schedule 2A, Bank of England Act 1998.

<sup>88</sup> Section 9S, Bank of England Act 1998.

<sup>89</sup> As required by section 9W(5), Bank of England Act 1998.

BoE's Financial Stability Objective and, subject to that achieving the Government's economic policy, including its objectives for growth and employment;

193.8. the explanation for any decision by the FPC to use its power of direction or recommendation (see above) during the period since the last *Financial Stability Report*;

193.9. a summary of the FPC's review of a direction or recommendation made by the FPC (the FPC is required to review a direction within 12 months and a recommendation within regular intervals to be determined by the FPC<sup>90</sup>);

194. Publication of the Financial Stability Report can be in such manner as the FPC thinks fit, though it must provide a copy to Treasury and Treasury is required to lay a copy before Parliament<sup>91</sup>.

#### Consultation documents and statements of policy

195. The development and implementation of policy by the FPC and the PRA can be subject to either an explicit duty or a public law duty to consult on proposals. This gives stakeholders, including regulated entities, an opportunity to comment.

196. Where Treasury has prescribed a macro-prudential measure, the FPC is required to maintain, and the BoE is required to publish, a statement of the general policy that the FPC proposes to follow in relation to the exercise of its power of direction in so far as it relates to the measure.<sup>92</sup> The statements published to date identify a set of core indicators that must be routinely reviewed to guide the use of each measure. These statements, and the indicators chosen, provide an important basis for explaining FPC decisions, including decisions not to act, to the outside world.

197. Either or both of the FPC and Treasury, working together, may consult publically, on the proposed macro-prudential measure before it is granted. When Treasury lays a draft Regulation or Order before Parliament, typically it will be accompanied by a draft of the FPC's statement of policy, so that Parliament can understand how the measure is expected to be implemented.

#### PRA

198. The PRA has published two key documents outlining its approach to banking supervision and insurance supervision. This is in order to meet the statutory requirement that it publish guidance on how it intends to advance its objectives.<sup>93</sup>

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<sup>90</sup> Section 9T, Bank of England Act 1998.

<sup>91</sup> Section 9W(9)-(11), Bank of England Act 1998.

<sup>92</sup> Section 9M, Bank of England Act 1998.

<sup>93</sup> For the most recent iteration of '*The Prudential Regulation Authority's approach to banking supervision*', March 2016, see

199. The PRA also publishes a range of issue specific documents: Discussion Papers, Consultation Papers, Policy Statements (providing feedback on consultations on proposed rules), Statements of Policy (where the PRA details its policy on a matter) and Supervisory Statements (setting expectations for firms and explaining how supervisors will exercise their judgement in applying rules and policy). The PRA's quarterly regulatory digest sets out recent regulatory decisions.
200. The PRA publishes its regulatory decisions (for example in respect of internal models, waivers and enforcement), though it may decide not to, or redact certain sections for reasons of commercial sensitivity. These are available on the Financial Services Register maintained by the FCA.

#### Bank of England initiatives

201. The BoE announced a series of changes aimed at reinforcing transparency, accountability and governance in December 2014<sup>94</sup>. The core components of the BoE's proposed approach were grouped under four headings:
  - 201.1. Improvements to MPC transparency, including the MPC's response to the Warsh review, and the announcement of the MPC's intention to publish the minutes of its discussions and its *Inflation Report* alongside the announcement of its policy decision on interest rates.
  - 201.2. Release of BoE records, mainly archive material of minutes of Court meetings held between 1914 and 1987 as well as redacted minutes of Court during the financial crisis (2007-2009), as requested by the House of Common Treasury Select Committee.
  - 201.3. Governance of the Bank, including proposals to simplify and clarify the governance and structure of Court.
  - 201.4. Governance of the Bank's policy responsibilities, including proposals for aligning the status of the FPC and the PRA Board with that of the MPC, which were implemented through the Bank of England and Financial Services Act 2016.
202. The BoE has in place a number of other initiatives, some of them long-standing, that assist both with transparency and accountability to a wider set of stakeholders. For example:
  - 202.1. The BoE has a well-established Agency function and network which is responsible for engaging with, and monitoring, businesses and companies drawn from all regions and sectors of the UK.
  - 202.2. To support its transparency aim, the BoE established a Stakeholder Relations Group to give external economists and analysts equal and timely access to information behind policy and operational decisions through policy briefings, roundtables and seminars.

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<http://www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1603.pdf>

<sup>94</sup> 'Transparency and accountability at the Bank of England', 11 December 2014.

- 202.3. The BoE held its first ‘Open Forum’ in November 2015 with the aim of engaging with as wide a set of stakeholders as possible. Participants included policy makers, academics, financial institutions as well as media representatives.
- 202.4. The BoE publishes the private views and discussion and research papers of BoE officials on its own online blog ‘bank underground’.
- 202.5. Pursuant to the Chancellor’s recommendation in his remit letter to the FPC of July 2015<sup>95</sup>, the BoE established a panel of external experts and academics to consult on policy proposals.

## MPC

- 203. Minutes of MPC meetings are published simultaneously with interest rate decisions and record the votes of individual members as well as a full account of the policy discussion and any differences of view. As recommended by the Warsh Review, actual transcripts, as opposed to official minutes, of the MPC’s policy meetings will be published with an eight year lag, beginning with the March 2015 policy meeting.
- 204. Note that it is only minutes and transcripts of the policy meeting that are (to be) published. Prior to the ‘policy meeting’, at which the policy decisions are taken, the committee may meet several times to discuss information and policy options.
- 205. The factors influencing the MPC’s policy decisions, together with an analysis of the UK economy, are published quarterly in the BoE’s *Inflation Report*. The *Inflation Report* also includes the MPC’s forecasts for inflation and output growth.

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<sup>95</sup> The Chancellor recommended that the FPC should “endeavour 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 the Committee’s expertise”, though the Chancellor recognised that these recommendations on engagement with external experts and participants “should not prevent the FPC from making a Direction or Recommendation without, or with a more abbreviated, consultation where in line with its statutory duties, it considers it necessary to do so by reason of urgency, in order to protect and enhance the resilience of the UK financial system”. See section D(v) (Matters to which the Committee should have regard in exercising its functions) in ‘Remit and Recommendations for the Financial Policy Committee’ of 8 July 2015, available at:

<http://www.bankofengland.co.uk/financialstability/Documents/fpc/letters/chancellorletterfpc080715.pdf>

- **How to do the committees best manage public messaging and communications from individual committee members? (eg, dissenting voices; public speeches)**

206. External communication by FPC members has been recognised as an important tool in raising the profile of the FPC, of its work, and in fostering an understanding of the importance of financial stability and the benefits of macro-prudential policy. Relative to the MPC it is clearly the lesser known committee.
207. FPC members make a number of speeches each year (typically in double figures) at regional and sectoral events; give interviews to the media; and publish their own articles and opinion pieces.
208. MPC members, particularly external MPC members, who are in the minority when it comes to MPC policy decisions are well known for publicising their dissenting views. It would be inappropriate for FPC and PRC members to do so explicitly, so long as FPC and PRC decisions continue to be made by consensus. This does not preclude FPC and PRC members giving speeches which set out their own analysis of, and views on, financial stability and systemic risks. As a result, differences in emphasis and appreciation between the members may become discernable, though this is only to be expected and should not be problematic.
209. Draft speeches by FPC members can be expected to be vetted in advance by BoE officials, including the FPC secretariat, Legal Directorate, the private secretaries of the Governors and any relevant senior policy figures.
210. The requirement that the FPC and PRC reach decisions, where possible, by consensus has been put under some pressure by the Treasury Select Committee in its questioning of individual members. To date members have trod a fine line between standing behind and explaining the committee's consensus view while also explaining the challenge that they provided to that consensus view and how the member's concerns were satisfied.
211. The BoE has published a document entitled '*Communications Guidance for FPC Members*', dated 28 April 2016.<sup>96</sup>

- **What accountability processes are in place for the FPC and PRAB decisions (including the role of the court and IEO and review of decisions in respect of individual entities)?**

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<sup>96</sup> See <http://www.bankofengland.co.uk/financialstability/Documents/fpccoc.pdf>

212. As mentioned above, the FPC and PRC are accountable to Parliament. They are also accountable, in terms of their operation and management, to Court.
213. Court has delegated to FPC the statutory requirement to set the BoE's financial stability strategy in relation to the Financial Stability Objective, after consulting Treasury, at least every three years. The FPC is answerable to Court in this respect as well as more broadly within the Court's statutory duty to keep the BoE's functions and performance under review.

#### Independent inquiry

214. Treasury has the power under FSMA to order an independent inquiry into a regulatory failure by the PRA, to be carried out by a third party.
215. Treasury also may appoint an independent person to conduct a review of the economy, efficiency and effectiveness which the BoE has used its resources in discharging its functions as the PRA.<sup>97</sup> A copy of the report must be laid before Parliament and published in such manner as Treasury thinks fit.

#### Judicial review

216. The FPC and PRC are subject to the principles of public law and administration and should make reasonable and proportionate decisions that are within the scope of their powers, and should consult parties affected by their decisions as appropriate.
217. Policy decisions of the FPC and the PRC are potentially subject to challenge by judicial review, though the courts may grant the FPC and the PRC a degree of latitude in making highly specialised policy judgements.

#### The Tribunal

218. Supervisory decisions made by the PRA/PRC (or the FCA or the BoE) in respect of individual firms are also subject to challenge by firms or individuals in the Financial Services and Markets Tribunal. The Tribunal also has jurisdiction in respect of decisions relating to the assessment of any compensation or consideration under the Banking Act 2009, i.e. following use of the stabilisation powers in recovery and resolution.
219. For example, where a firm is aggrieved at a decision made by the PRA in relation to:
- 219.1. the firm's application in respect of its permission to carry on regulated activities;
  - 219.2. a penalty or public censure imposed by the PRA;
  - 219.3. the PRA's use of its own-initiative power (e.g. where the PRA has imposed conditions on a firm's authorisation);
  - 219.4. its designation as a designated-investment firm;
  - 219.5. conditions imposed on its internal model approval;

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<sup>97</sup> Section 7F, Bank of England Act 1998, inserted by the Bank of England and Financial Services Act 2016.

219.6. whether an instrument qualifies as CET1 capital; or  
219.7. the SRB buffer rate that is to apply to the firm,  
then the firm has a statutory right to refer the matter to the Tribunal.<sup>98</sup>

220. The Tribunal has the power:

220.1. in disciplinary cases, to determine the appropriate action for the decision maker to take; and

220.2. in any other case, can only remit the matter to the decision maker to reconsider in accordance with the Tribunal's findings. The Tribunal is limited to findings as to (a) issues of fact or law; (b) the matters to be taken into account in making the decision; and (c) the procedural steps to be taken in making the decision.

### Complaints

221. Part 6 of the Financial Services Act 2012 required the BoE and the PRA and FCA to establish, as part of their accountability mechanisms, arrangements for the investigation of complaints against them. This largely replicated the scheme that had operated in respect of the FSA.

### Practitioner Panel

222. FSMA requires the PRA to maintain an independent statutory panel to represent the interests of practitioners; to consult practitioners on PRA policies and practices and to consider their views. The panel is representative of PRA regulated persons and can be nominated by trade associations. Members serve a three year term and meet every six weeks.

### Court

223. Court manages the affairs of the BoE as a corporation while specific policy responsibilities are reserved to the MPC, FPC and PRC, as set out in relevant statutes.

224. Court's responsibilities under the Bank of England Act 1998 are to determine the BoE's organisational objectives and strategy, ensure the effective discharge of the BoE's functions and the most efficient use of its resources (as further described below in relation to reserved matters of Court).

225. Court has a statutory obligation to keep under review the performance of the BoE in relation to its objectives, the exercise of its statutory functions and the processes of the MPC, FPC and PRC, whose meetings the members of Court

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<sup>98</sup> The right to refer a matter to the Tribunal is usually set out in legislation alongside the power that has been granted to the PRA. This means that most of the rights arise in FSMA, which grants the PRA many of its supervisory powers. It may arise under other relevant legislation. For example, the right to refer the PRA's decision on a firm's SRB buffer rate arises under Regulations 34I in the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014, as amended, alongside the PRA's discretion in those Regulations to determine that buffer rate.

are entitled to attend as observers. Court has no policy responsibilities but it can commission external performance reviews, including, retrospectively, into policy decisions. Court has responsibility for monitoring the BoE's response to recommendations arising from any such reviews.

226. The role of Court changed when the Bank of England and Financial Services Act 2016 came into effect. The over-arching aim of the governance changes was to provide a robust framework for keeping under review the discharge of the BoE's responsibilities, and to hold the BoE to a high level of public accountability.
227. It acts now as a unitary board, with executive and non-executive directors together, in line with best practice in UK private sector corporate governance. There is a majority of non-executive directors, including a non-executive Chair. Court was reduced in size, from 19 directors pre-crisis, to 12 directors in 2016.
228. Court delegates the day to day management of the BoE to the Governor, including the discharge of statutory functions, subject to legal limits (for example matters conferred by statute on the sub-committees of Court or the policy committees can only be exercised by those groups) but reserves certain key decisions to itself. Reserved matters of Court include:
  - 228.1. approval of the BoE's organisational objectives, including its objectives for financial management and strategy;
  - 228.2. approval of the BoE's financial framework (how the BoE's sources of income support its activities, e.g. cash ratio deposits)<sup>99</sup>;
  - 228.3. approval of the BoE's annual operating and capital expenditure budgets and any material changes to them;
  - 228.4. approval of capital or revenue projects in excess of £5 million;
  - 228.5. approval of the BoE's risk tolerance statement and its framework for monitoring and managing risk;
  - 228.6. high-level succession planning and recommendations in relation to appointments at Governor and Deputy Governor levels;
  - 228.7. changes in the rules on financial dealing for staff, including members of the MPC, FPC and PRC;

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<sup>99</sup> Note that the PRA's supervisory functions and certain special projects (e.g. ring-fencing implementation by the PRA) are financed by a levy on the firms the PRA regulates and supervises. The PRA consults on its fees and fee rates to meet its annual funding requirement ("AFR"). In June 2016 the PRA announced that it would distribute a refund of unspent money from its AFR for 2015/2016.

The PRC is required to prepare and adopt an annual budget for the PRA (since the PRA was de-subsidiarised, this is referred to technically as an annual budget for the BoE to perform the PRA's functions). The budget must be approved by Court (clause 18, Schedule 6A, Bank of England Act 1998 (as amended)).

The PRC is required, at least once a year, to make a report to the Chancellor on (a) the adequacy of the resources allocated to the BoE's functions as the PRA; and (b) the extent to which the exercise of the BoE's functions as the PRA is independent of the exercise of its other functions (clause 19, schedule 6A, Bank of England Act 1998 (as amended)).

- 228.8. changes in Codes of Conduct for staff and members of the MPC, FPC and PRC;
  - 228.9. statements of responsibilities of designated Senior Managers within the BoE; and
  - 228.10. approval of the objectives of the BoE's Sterling Monetary Framework and any change that increases the risk exposure of the BoE.
229. Court has formed sub-committees to help it discharge its responsibilities. These are:
- 229.1. The Audit and Risk Committee (ARCO), which assists Court in meeting its responsibilities for an effective system of risk management, internal control and financial reporting.
  - 229.2. The Remuneration Committee, which advised Court on pay and other remuneration of the BoE's most senior executives, including Governors and external members of the FPC, MPC and PRC.
  - 229.3. The Nominations Committee, which advises Court on appointments to senior positions within the BoE and advises Court on recommendations to be made by Court to Treasury as to appointments and reappointments as members of Court.
  - 229.4. Transactions Committee, which may be consulted by the Governor about any loan, commitment or other transaction which is not in the ordinary course of the BoE's business, and where it is not practicable for the Governor to consult the full Court.
230. And Court has delegated to FPC its function of reviewing, every three years, and if necessary revising, in consultation with Treasury, the BoE's financial stability strategy in relation to the BoE's Financial Stability Objective.
231. The PRC's responsibility for determining its prudential policy strategy (how the PRA will deliver its statutory objectives)<sup>100</sup> is not delegated by Court. It is prescribed to the PRC in primary legislation.<sup>101</sup> However the PRC consults Court before it adopts its prudential regulation strategy each year.
232. One of the changes made in 2016 was for the Oversight sub-committee, which oversaw the activities of the FPC, to be disbanded and the oversight functions given to Court. Court members can attend meetings of the committees as observers.
233. Court directors are accountable to Parliament and appear before Parliamentary Committees to give evidence. Court minutes are published, usually with a six-week lag.

## IEO

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<sup>100</sup> The prudential regulation strategy is published in the Strategic Report section of the PRA's Annual Report. See for example the PRA's Annual Report and Account 2016 at: <http://www.bankofengland.co.uk/publications/Documents/annualreport/2016/prareportprint.pdf>

<sup>101</sup> Section 2E, FSMA.

234. The Independent Evaluation Office was established in September 2014 as an independent unit of the BoE, reporting directly to the Chair of Court, to whom it is accountable.
235. The IEO's terms of reference<sup>102</sup> explicitly link its genesis and purpose to the wide-ranging powers that have been granted to the BoE. The IEO's objective is to support Court in its governance responsibilities – specifically, to help discharge the Court's statutory duty to keep the performance of the BoE under review – and in enabling the Bank to operate more effectively across the full range of policy areas. The ultimate aim is to build public trust in the BoE; to support the legitimacy and effectiveness of the BoE's policy decisions.
236. The IEO is responsible for giving Court objective assessments of the performance of the BoE's policy functions and making recommendations on any improvements.
237. The IEO is led by a dedicated Director and a small permanent team of officials with knowledge and experience of the Bank's core policy functions. It is expected to coordinate with other oversight functions within the BoE – the BoE's Internal Audit team and the Supervisory Oversight Function of the PRA – and externally with the National Audit Office as required.
238. Typically the IEO is given two specific evaluations or reviews to complete each year by the Chair of Court. The IEO's work focuses on the quality of inputs into and supporting infrastructure for policy making, and not the actual policy decisions made by the FPC, PRC and MPC.
239. Two in-depth evaluations have been commissioned for 2017:
- 239.1. the BoE's approach to sterling liquidity; and
  - 239.2. the BoE's resolution function.
240. Previous evaluations have included:
- 240.1. the PRA's approach to its insurance objective;
  - 240.2. the BoE's approach to financial market infrastructure supervision;
  - 240.3. the PRA's approach to its secondary competition objective;
  - 240.4. forecasting performance;
  - 240.5. the BoE's response to the Warsh report.
- These are available online. The IEO has stated that it expects to publish its evaluations, together with a response from the relevant business area, unless there are public interest grounds for withholding the report, as determined by the Chair of Court.

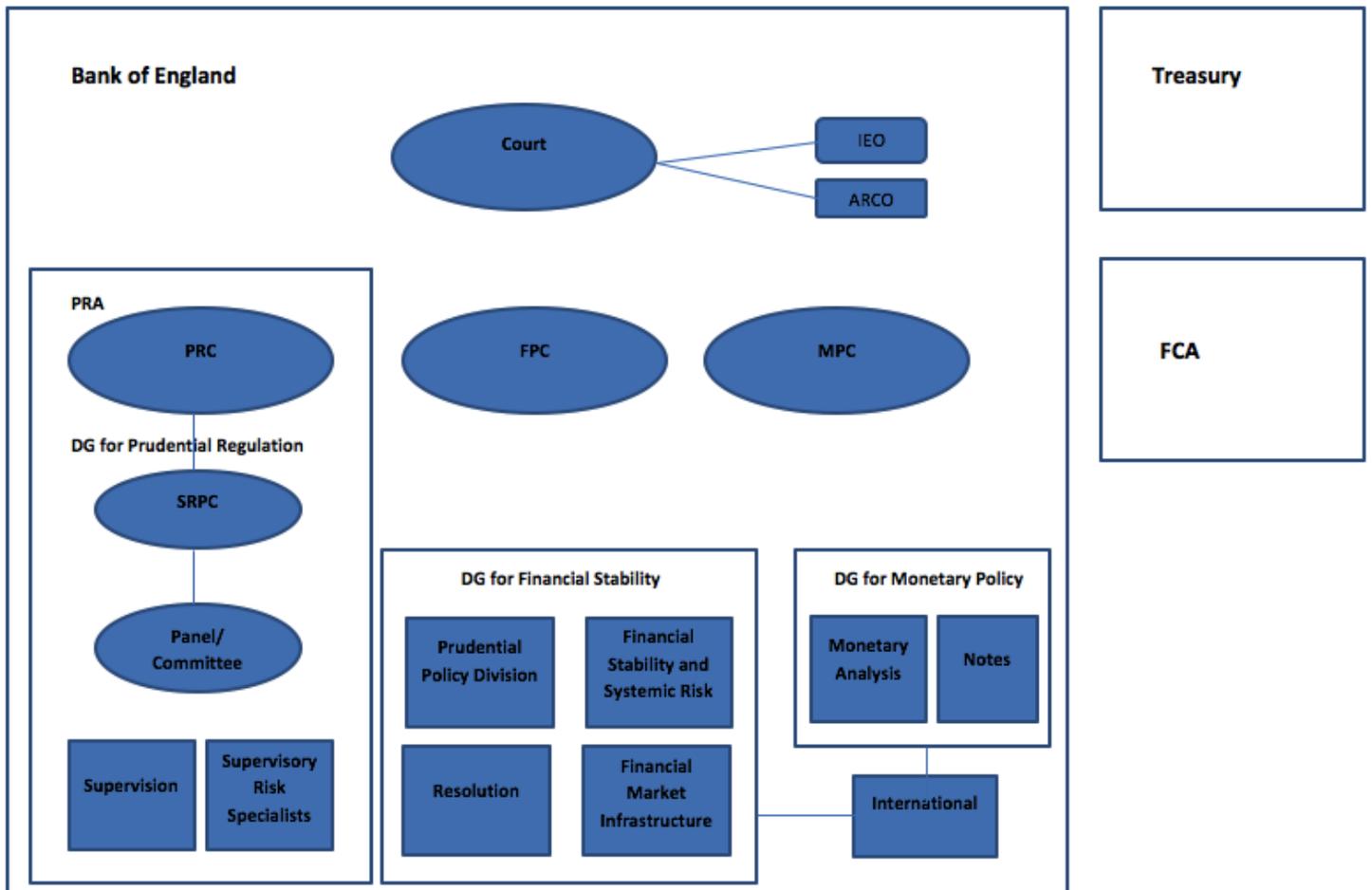
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<sup>102</sup> See <http://www.bankofengland.co.uk/about/Documents/ieo/termsofreference.pdf>

## **Section E - Applicable lessons for New Zealand**

241. It is too early yet to draw any conclusions on the effectiveness of the financial stability framework adopted in the UK. What has been noticeable is the need for staff resource to support the functions of the FPC and the PRC, to coordinate internally with relevant officials and externally with other authorities, and to brief external members.
242. While there are clear benefits to housing the macro- and micro-prudential regulators in the same institution – in terms of efficiencies, coordination, cooperation and timeliness of responses – the system can prove unwieldy. For a policy proposal to be adopted by the FPC it would need to go through at least two or three rounds of quarterly meetings. This increases the time pressure and congestion of issues on the FPC's agenda, which can be subject to sudden change as events unfold. As was noted in the Warsh review, the danger for a committee structure is for inertia to set in.
243. The danger of group-think is difficult to address. The presence of external members on the committees improves, to a certain extent, the credibility of the BoE's intellectual openness and transparency. However, it can make decision making more unwieldy. The requirement to operate by consensus means that external members have to be willing and able to challenge Governors. It introduces risks that either (a) an authoritarian Governor forces through policy, or (b) proposals are watered down to the lowest common denominator.
244. In terms of transparency, there is also a trade-off with the sound policy reasons for central banking opaqueness, for example financial stability at system and firm levels, as well as market disclosure implications for firms.
245. Recruitment of external members can prove difficult in terms of striking a balance between financial sector experience and conflicts of interest, perceived or otherwise. This is crucial for the integrity and legitimacy of the central bank as a technocratic institution.

# Schedule 1 - BoE organisation chart



## Schedule 2 – FPC objectives and miscellaneous

### FPC's statutory objectives and responsibility

The FPC is the UK's macro-prudential authority. Its statutory objective is to contribute to the achievement by the BoE of the Financial Stability Objective<sup>103</sup> and, subject to that, supporting the economic policy of the Government, including its objectives for growth and employment.

The FPC has a statutory responsibility 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.<sup>104</sup>

Those systemic risks include, without limitation:

- systemic risks attributable to structural features of financial markets, such as connections between financial institutions;
- systemic risks attributable to the distribution of risk within the financial sector; and
- unsustainable levels of leverage, debt or credit growth.<sup>105</sup>

'Systemic risks' are defined to mean a risk to the stability of the UK financial system as a whole or of a significant part of the system. It is immaterial whether the risk arises in the UK or elsewhere.<sup>106</sup>

The FPC's legal 'have regards':

- (1) In the exercise of its functions, [...], the Financial Policy Committee must have regard to the Bank's financial stability strategy.
- (2) In working with the FCA or the PRA or exercising functions in relation to either of them, the Committee must, so far as it is possible to do so while complying with [the BoE's Financial Stability Objective and, subject to that, supporting the Government's economic policy, including its objectives for growth and employment], seek to avoid exercising the Committee's functions in a way that would prejudice—

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<sup>103</sup> Section 9C(1), Bank of England Act 1998 sets out the FPC's objectives. Section 2A of the Bank of England Act 1998 sets out that the BoE's 'Financial Stability Objective' is to protect and enhance the stability of the financial system of the UK. Section 9A requires Court to determine the BoE's strategy in relation to the 'Financial Stability Objective', consulting with the FPC and Treasury. The BoE's financial stability strategy was set out in the BoE's 2014 Annual Report. See page 38 onwards at:

<http://www.bankofengland.co.uk/publications/Documents/annualreport/2014/boereport.pdf>

<sup>104</sup> Section 9C(1) and (2), Bank of England Act 1998, as inserted by the Financial Services Act 2012.

<sup>105</sup> Section 9C(3), Bank of England Act, as inserted by the Financial Services Act 2012.

<sup>106</sup> Sections 9C(5) and (6), *ibid*.

- (a) the advancement by the FCA of any of its operational objectives, or
  - (b) the advancement by the PRA of any of its objectives.
- (3) In the exercise of its functions, the Committee must also have regard to—
- (a) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
  - (b) the contribution to the achievement by the Bank of the Financial Stability Objective that the Committee can make by disclosing its views about possible systemic risks or disclosing other information about possible systemic risks;
  - (c) the international obligations of the United Kingdom, particularly where relevant to the exercise of the powers of the Committee in relation to the FCA or the PRA.<sup>107</sup>

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<sup>107</sup> Section 9F, Bank of England Act 1998.

## Schedule 3 – PRA objectives and miscellaneous

### PRA's statutory objectives

The PRA is the micro-prudential regulator and supervisor responsible for the prudential regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms.

Its general objective is to promote the safety and soundness of PRA-authorized persons. That objective is to be advanced primarily by:

- (a) seeking to ensure the business of PRA-authorized persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- (b) seeking to minimize the adverse effect that the failure of a PRA-authorized person could be expected to have on the stability of the UK financial system.

<sup>108</sup>

Adverse effects include disruption to the continuity of financial services.

### Insurance objective

The PRA also has an objective specifically in relation to insurance: contributing to securing of an appropriate degree of protection for those who are or may become policyholders.

The PRA must, so far as is reasonably possible, act in a way which:

- (a) is compatible with its general objective and its insurance objective; and
- (b) the PRA considers must appropriate for the purpose of advancing those objectives.<sup>109</sup>

### Secondary competition objective

The PRA has secondary objective to facilitate effective competition in the services provided by its regulated entities.

### Regulatory principles

#### **3B Regulatory principles to be applied by both regulators**

(1) In relation to the regulators, the regulatory principles referred to in section 1B(5)(a) and 2H(1)(a) are as follows—

- (a) the need to use the resources of each regulator in the most efficient and economic way;

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<sup>108</sup> See section 2B(2)-(4), Financial Services and Markets Act 2000, as inserted by the Financial Services Act 2012.

<sup>109</sup> Section 2C, *ibid.*

- (b) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- (c) the desirability of sustainable growth in the economy of the United Kingdom in the medium or long term;
- (d) the general principle that consumers should take responsibility for their decisions;
- (e) the responsibilities of the senior management of persons subject to requirements imposed by or under this Act, including those affecting consumers, in relation to compliance with those requirements;
- (f) the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons [(including different kinds of persons such as mutual societies and other kinds of business organisations)] subject to requirements imposed by or under this Act;
- (g) the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under this Act, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives;
- (h) the principle that the regulators should exercise their functions as transparently as possible.

### Decision matrix

In order to help decide the appropriate decision maker, i.e. whether a decision should be made by the PRC, SRPC, a Supervision Assessment Panel, a Panel of Heads of Department and Managers or by a Head of Division, the PRA uses a decision matrix.

The choice is determined by (a) the category of the firm in conjunction with (b) the anticipated impact of the decision on a firm's ability to carry out its business effectively and/or the impact on the PRA's objectives. In summary, the more significant the firm and the greater the decision's impact, the more senior the composition of the decision making committee.

### Category of firm

The PRA divides all deposit-takers and designated investment firms it supervises into five categories of impact:

#### Category 1

The most significant deposit-takers or designated investment firms whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.

#### Category 2

Significant deposit-takers or designated investment firms whose size, interconnectedness, complexity and business type give them the capacity to cause some disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.

#### Category 3

Deposit-takers or designated investment firms whose size, interconnectedness, complexity and business type give them the capacity to cause minor disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.

#### Category 4

Deposit-takers or designated investment firms whose size, interconnectedness, complexity and business type give them very little capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.

#### Category 5

Deposit-takers or designated investment firms whose size, interconnectedness, complexity and business type give them almost no capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector may have the potential to generate some disruption.

#### Types of decision

Statutory decisions are divided into one of three types by PRA officials.

|        |  |
|--------|--|
| Type A | Decisions which: (i) the PRA expects to have a significant impact on a firm's ability to carry out its business effectively or (ii) the PRA considers could have a significant impact on its objectives.   |
| Type B | Decisions which: (i) the PRA expects to have a moderate impact on a firm's ability to carry out its business effectively, (ii) the PRA considers could have a moderate impact on its objectives or (iii) may set a sensitive precedent but which would otherwise have fallen under Type C. |

|        |   |
|--------|---|
| Type C | Decisions which: (i) the PRA expects to have a low impact on a firm's ability to carry out its business effectively, (ii) the PRA considers could have a low impact on its objectives, or (iii) relate to which a precedent has already been set. |
|--------|---|