EXPLANATORY MEMORANDUM TO

THE BANK OF ENGLAND ACT 1998 (MACRO-PRUDENTIAL MEASURES) (NO.2) ORDER 2015

2015 No. [XXXX]

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 This instrument is made pursuant to sections 9I(2) and 9L of the Bank of England Act 1998 and defines new macro-prudential measures, by reference to which the FPC can issue directions to the regulators pursuant to section 9H of the Bank of England Act 1998. These new measures are:

- A minimum leverage ratio requirement for all PRA-regulated persons;
- An additional leverage ratio buffer for firms that are subject to systemic risk buffer;
- An additional leverage ratio buffer for globally systemically important institutions; and
- A countercyclical leverage ratio buffer for all firms subject to the minimum leverage ratio requirement.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 This instrument is being made by the Treasury in exercise of the powers conferred by sections 9Land 9I(2) of the 1998 Act, which were introduced by the financial Services Act 2012, which received Royal Assent on 19 December 2012. This order will provide the FPC with new macro-prudential tools.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

In my view the provisions of the Bank of England Act 1998 (Macro-prudential Measures) (no.2) Order 2015 are compatible with the Convention rights.

7. Policy background

7.1 The Financial Services Act 2012 provided for the reform of financial regulation in the UK. In the place of the Financial Services Authority (FSA), it establishes a new system of financial services regulators comprising:

- An expert macro-prudential authority, the Financial Policy Committee (FPC) within the Bank of England to monitor and respond to systemic risks in the financial sector;
- A focused micro-prudential regulator, the Prudential Regulation Authority (PRA), to regulate firms that manage complex risks on their balance sheets - specifically, all deposit takers, insurers and some large investment firms; and
- A focused conduct of business regulator, the Financial Conduct Authority (FCA), to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.

7.2 The FPC's powers are designed to allow the FPC to mitigate and address risks to the stability of the UK financial system, for example by influencing the behaviour of firms or placing requirements on them. The Bank of England Act 1998, as amended by the Financial Services Act 2012, provides the FPC with two primary tools: powers of recommendation and powers of direction.

7.3 The FPC has the power to make recommendations to the regulators (which can be made on a comply-or-explain basis), to the Treasury, within the Bank and to other relevant persons.

7.4 In addition to the power to make recommendations, the FPC also has the power to give directions to the regulators. The scope of the direction making power is confined to those measures specified by order by the Treasury. Accordingly, this order expands the scope of the direction making power of the FPC.

7.5 The recent financial crisis revealed serious weaknesses in the existing framework of internationally agreed standards of capital adequacy. Banks in most jurisdictions were only required to meet risk-weighted capital requirements and were not subject to leverage requirements. In the lead up to the crisis, some banks' balance sheets expanded

significantly while average risk weights declined. Banks funded increases in their lending through greater amounts of relatively cheaper debt rather than equity.

7.6 However, the riskiness of some assets turned out to be greater than initially thought. This meant that, as losses materialised, firms did not have enough capital to absorb them. Moreover, the crisis revealed that some types of capital instruments that banks were holding were not sufficiently loss absorbing. As market confidence decreased, firms were left vulnerable because of increased roll-over risk of their short-term debt, and funding was severely curtailed. At the height of the crisis, this led to firms having to deleverage quickly, selling into a falling market. The losses on these assets depleted firms' regulatory capital. Firms were forced to deleverage further due to market concerns that they were not adequately capitalised relative to the exposures they still held, resulting in a destabilising negative feedback loop.

7.7 There is international agreement that the leverage ratio is a crucial complement to risk-based capital requirements and can play an important role in mitigating the risks described above. Firms' leverage ratios were a useful indicator of failure during the last crisis, and the period immediately preceding the crisis was characterised by sharp increases in leverage. Firms with high leverage ratios have greater amounts of capital to absorb losses which materialise and have less reliance on debt financing. Those with low leverage ratios rely relatively more on debt to fund their lending, exposing them to the risks described above.

7.8 The leverage ratio restrains balance sheet growth, ensuring that firms preserve a minimum amount of capital to absorb losses regardless of the risk profile of their assets. The international standard proposed by the Basel Committee on Banking Standards (BCBS) is currently a minimum 3% leverage ratio. In other words, a bank would be able to increase its exposures only up to a maximum of 33 times relative to the amount of Tier 1 capital it holds. As exposures are not weighted by risk in the calculation of the leverage ratio, imposing leverage limits also provides additional protection against uncertainties and risks that are difficult to model. The additional protection provided by a leverage ratio can be particularly important during the upswing of the credit cycle, when, as the financial crisis showed, risk may be systemically underestimated by risk-based models and those who use them (including regulators).

7.9 The leverage ratio's relative simplicity can also help improve market transparency and comparability, particularly as investors have become more sceptical about risk-weights. International work on the consistency of risk-weights has highlighted this. For example, although some variability is to be expected because of supervisory discretion and the way that firms model their risks, Basel's review of the consistency of risk-weights applied in the trading book showed that there was considerable variability in risk-weights applied by different banks to the same hypothetical portfolio. Although work is ongoing to improve transparency and reduce variability of risk-weighted assets, it is still difficult for the market to compare how well-capitalised banks are using risk-based measures. The leverage ratio should help increase transparency and comparability of firms' solvency.

7.10 A proposed 3% minimum leverage ratio is one of the key elements of the Basel III agreement. In January 2014, the Group of Governors and Heads of Supervision (GHOS) agreed a final definition of the leverage ratio.[9] This is due to be disclosed by internationally active banks from 1 January 2015 to allow leverage ratios to be compared across jurisdictions. The BCBS will continue to monitor the implementation of the leverage ratio, and a final calibration of the leverage ratio is expected by 2017, following a review, with a view to migrating to a binding Pillar 1 minimum requirement from 1 January 2018.

7.11 A number of international jurisdictions – including Canada, Denmark, the Netherlands, Sweden, Switzerland and the United States – either already impose leverage ratio requirements on firms or are intending to do so.

7.12 On 26 November 2013, the Chancellor requested that the FPC undertake a review of the leverage ratio and its role in the regulatory framework. The Chancellor noted the strong progress that had been made internationally on bank capital standards and the ongoing work by the FPC to finalise the medium term capital framework for UK banks. In light of these developments, the Chancellor judged that it was an appropriate time for the FPC to consider all outstanding issues relating to the leverage ratio, including whether and when the FPC needed any additional powers of direction over the leverage ratio, and whether and how leverage requirements should be scaled up for ring-fenced banks and in other circumstances where risk-based capital ratios are raised. Subject to the FPC presenting a detailed and evidence based recommendation, the Chancellor said he would expect to be able to submit the Committee's proposals in this Parliament for approval.

7.13 On 31 October 2014, following almost a year of work and extensive consultation with stakeholders, the FPC published its response, the Review of the leverage ratio. The Review recommended that the FPC given new powers of direction over the leverage ratio framework for the UK banking sector. Specifically, the Review recommended that the FPC should have a power of direction to set:

- minimum leverage ratio requirement to be set at 3%
- supplementary leverage ratio buffer rate to be set as a proportion of the systemic risk-weighted capital buffers using a scaling factor of 35%
- countercyclical leverage ratio buffer rate to be set as a proportion of the countercyclical capital buffer rates using a scaling factor of 35%

7.14 These powers will allow the FPC to create a leverage ratio framework for UK firms that will ensure that they hold a minimum amount of capital relative to the size of their balance sheets. These requirements will depend on the systemic importance of the firm and the position of the UK in the credit cycle

7.15 This Order prescribes that the FPC may make directions to the PRA regarding:

- A minimum leverage ratio requirement for all PRA-regulated persons;

- An additional leverage ratio buffer for firms that are subject to systemic risk buffer;

- An additional leverage ratio buffer for globally systemically important institutions; and

- A countercyclical leverage ratio buffer for all firms subject to the minimum leverage ratio requirement.

8. Consultation outcome

8.1 HM Treasury has consulted the FCA and the Bank of England in the preparation of this instrument. HM Treasury also held a public consultation including a draft of this instrument from 7 November 2014 to 28 November 2014[1]. HM Treasury received no material comments on the drafting of the instrument. HM Treasury received seven responses to this consultation; the replies represented the views of industry participants and industry bodies such as the British Banking Association. While the majority of respondents were in favour of the FPC having a power to set a minimum requirement, the views on the FPC's other proposed powers were more mixed. HM Treasury believes that the FPC has made a strong, evidence-based argument for the implementation of a leverage ratio framework as a complement to the existing risk-based capital requirements.

9. Guidance

9.1 The Treasury does not propose to issue guidance on the content of this Order. However under section 9M of the Bank of England Act 1998 the FPC is required to prepare and maintain a statement of the general policy that it proposes to follow in the use of its power of direction under section 9H in relation to the measures prescribed in orders made under section 9L. The FPC will publish a draft statement of policy which sets out its understanding of the measures prescribed in this order and how the FPC proposes, in general terms, to exercise its power of direction in relation to each measure. This draft statement will be available from the Bank of England's website. The Treasury expects that this statement will be republished once this Order comes into force. The FPC will update this document as appropriate.

10. Impact

10.1 The impact on business, charities or voluntary bodies of the leverage ratio requirements will mainly be positive, through a reduction in the likelihood, and therefore the frequency, of financial crises. Although the impact assessment does not quantify exactly how large a reduction in the probability of a crisis occurring will result from these powers, it estimates that a one per cent reduction in the risk of a crisis occurring has an annualised GDP benefit of £4.5 billion.

[1] Available at https://www.gov.uk/government/consultations/financial-policy-committees-leverage-ratio-framework

10.2 There are likely to be costs in the short term: firms bound by the leverage ratio will need to raise additional capital or adjust their assets to meet the new requirements. HM Treasury's impact assessment assumes that the cost of additional macro-prudential capital requirements is passed on to borrowers through increases in lending spreads. The increase in the price of credit will reduce consumption funded by borrowing, which has a negative impact on GDP over the short term. However, reduced investment by firms as a result of higher borrowing costs would have a long term negative impact on output. However, the intention of macro-prudential policy is to reduce consumption and investment funded by borrowing to reduce the severity of losses experienced following an unsustainable boom. A reduction in output would affect all UK residents to a greater or lesser degree.

10.3 Macro-prudential capital requirements will impose costs on regulated firms as they will have to bear the cost of raising and holding additional capital, shifting away from cheaper funding methods, to meet macro-prudential requirements. This cost will depend on the cost of capital for each firm. However, for the purpose of the impact assessment it is assumed that these costs are fully passed on to consumers and firms through increases in lending spreads.

10.4 An impact assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on www.legislation.gov.uk.

11. Regulating small business

11.1 The Bank of England estimate that 4 micro businesses and an additional 29 small businesses will be in scope of the FPC's leverage ratio framework. However, as these firms are small and relatively unsophisticated, the government believes that these firms will make use of internal modelling and so are unlikely to have average risk weights below 35% and, therefore, be bound by a leverage ratio requirement under the FPC's proposed calibration.

11.2 These firms have not been exempted because doing so would reduce the effectiveness of the FPC's leverage ratio powers and impair the Committee's ability to meet its objectives. Although small firms are unlikely to pose a systemic threat individually, their behaviour in aggregate could have material impacts on financial stability.

12. Monitoring & review

12.1 The Treasury will keep this Order under review. In addition, the FPC is empowered (by section 9P(2)(a) of the Bank of England Act 1998) to make recommendations to the Treasury as to the exercise of the Treasury's power to specify macro-prudential measures.

13. Contact

Chris Goodspeed at HM Treasury Tel: 0207 270 5690 or email: christopher.goodspeed@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.