EXPLANATORY MEMORANDUM TO

THE BANK OF ENGLAND ACT 1998 (MACRO-PRUDENTIAL MEASURES) ORDER 2013

2013 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 The instrument sets out the measures (referred to as macro-prudential measures) which the Bank of England's Financial Policy Committee (as established by the Bank of England Act 1998, as amended by the Financial Services Act 2012) may direct the Prudential Regulation Authority ("PRA") or Financial Conduct Authority ("FCA")to implement.

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

3.1 Article 2 sets out the macro-prudential measures which are prescribed by this Order in a table format. The second column specifies the regulator in relation to which each measure is prescribed. In the case of each measure prescribed by this Order the relevant regulator is the PRA. It would therefore have been possible to prescribe the measures without using a table format. However, a table format has been adopted as it is possible that in the future additional measures may be prescribed in relation to the FCA. A table format will facilitate additional measures being prescribed by way of amendment to this Order rather than a new, free standing order.

3.2 Article 2 refers to "own funds" without a definition being provided. This is a commonly used and commonly understood term in the financial services industry. It is therefore considered that no definition is needed. The Order contains a footnote reference to the relevant European law which sets out what own funds are required to satisfy regulatory requirements to assist the reader of the Order.

4. Legislative Context

4.1 The Order is made under section 9L of the Bank of England Act 1998, as amended by the Financial Services Act 2012. Section 9L confers a power on the Treasury to prescribe what "macro-prudential measures" are for the purposes of section 9H. Section

9H enables the FPC to direct the PRA or FCA to exercise its functions so as to ensure the implementation of a macro-prudential measure. Thus this Order sets out the limits of the FPC's power of direction under section 9H. Unless a measure is specified in an order under section 9H, the FPC cannot direct the PRA or FCA to implement it.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial 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) Order 2013 are compatible with the Convention rights.

7. Policy background

7.1 The Financial Services Act, which received Royal Assent on 19 December 2012, replaced the "Tripartite" structure and provided for three new bodies:

- the Financial Policy Committee (FPC);
- the Prudential Regulation Authority (PRA); and
- the Financial Conduct Authority (FCA).

7.2 The PRA will be responsible for the prudential regulation of all deposit takers, all insurers and investment firms which may pose a risk to the stability of the UK financial system. The FCA will be responsible for conduct of business regulation for all regulated financial firms, and the prudential regulation of those not covered by the PRA. The FPC, as a committee of the Bank of England, will have responsibility for overseeing the financial system as a whole, identifying potential risks to its stability and taking concerted action to address them.

7.3 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, will provide the FPC with two primary tools: powers of recommendation and powers of direction.

7.4 The FPC will have 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.

7.5 The FPC will have 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. Thus this order sets the scope of the direction making power of the FPC; the FPC may only direct the PRA to implement a measure that falls within one of the measures specified by this Order.

7.6 The Order provides that the FPC may direct the PRA to require UK banks or UK investment firms to maintain additional capital requirements by reference to their exposure to residential property, commercial property or other entities in the financial sector. Such a power is more generally referred to as a power to increase sectoral capital requirements (SCR).

7.7 This power would allow the FPC to target risks that emerge in particular sectors. The interim FPC, established on a non-statutory basis within the Bank of England, has stated in its recommendations that the over-exuberance that precedes crises often occurs in specific sectors before spreading further. A targeted power would be useful for addressing localised risks efficiently.

7.8 For example, if the FPC believed that systemic risks were arising from the growth of residential mortgage exposures, then it could use this power to require institutions to hold capital above normal micro-prudential requirements for exposures to that sector. If the FPC felt that lending to purchase commercial property was expanding beyond sustainable limits, it could impose additional requirements to hold additional capital in relation to commercial property exposures.

7.9 The Government announced in its September 2012 consultation on the FPC's power of direction that the FPC will also have a power to set the level of the Countercyclical Capital Buffer (CCB). The CCB is part of the Basel 3 agreement and will be implemented in Europe by the CRR/D4. The CCB "aims to ensure that banking-sector capital requirements take account of the macro-financial environment in which banks operate. It will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses."[1]Requiring banks, building societies and larger investment firms to build up capital during periods of over-exuberance should help to increase the resilience of the financial system and might also dampen the credit cycle. Unwinding these requirements in the downturn once the particular threat has passed, might help to mitigate contractions in the supply of lending.

7.10 Since this power stems from European legislation and will be transposed into UK law using a separate legislative vehicle once the European legislation has been finalised, it is not covered in this SI.

8. Consultation outcome

[1] *Basel 3: A global regulatory framework for more resilient banks and banking systems*, Basel Committee on Banking Supervision, December 2010.

8.1 The Government's consultation paper The Financial Services Bill: the Financial Policy Committee's macro-prudential tools was published on 18 September 2012. The consultation period closed on 11 December 2012 and seventeen responses were received. Very few respondents made direct comments on the draft Order published as part of the consultation. However, the Order reflects the Government's decision to exempt investment firms that are not regulated by the PRA from the scope of the FPC's power of direction.

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 has published 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 is available from the Bank of England's website. The Treasury expects that this statement will be republished following the establishment of the statutory FPC. The FPC will update this document as appropriate.

10. Impact

10.1 The impact on business, charities or voluntary bodies of the Sectoral Capital Requirements will mainly be positive, through a reduction in the frequency of financial crises. The benefits of this are estimated at between 0.29 and 4.97 annualised percent of GDP, depending on the level of the requirements, and the size and permanence of the impact of financial crises on UK GDP.[2]

10.2 There are likely to be costs in the short term. HM Treasury analysis assumes that the cost of additional macro-prudential capital requirements is passed on to consumers 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. There could be additional costs to regulated firms, including for example the cost of changing systems, collecting additional data and

[2] BCBS paper *An assessment of the long-term economic impact of stronger capital and liquidity requirements* and HM Treasury calculations, p 8 of the Impact Assessment attached to this Statutory Instrument.

compliance costs, but these costs will be dependent on how firms decide to react to requirements imposed by the FPC. If firms are heavily concentrated in sectors targeted by the FPC, they could face large costs if they chose to change their business model or overall strategy. However, for the purpose of the impact assessment – in line with the assumptions of the BCBS paper – it is assumed that these costs are fully passed on to consumers and firms through increases in lending spreads. It should also be noted that firms that already hold capital above the minimum requirements may be less affected by any additional requirements imposed by the FPC via the CCB if they choose to run down voluntary buffers, but this will depend on the preferences of firms regarding voluntary buffers above regulatory minimums.

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 legislation applies to small business. The impact assessment estimates that there are thirteen banks or building societies with twenty or fewer employees. These businesses have been included in the scope of the FPC's power of direction to avoid leakages which could compromise the effective of the powers. However, the Government has exempted investment firms that are not regulated by the PRA from the FPC's power of direction as it would be disproportionate to apply macro-prudential requirements to these firms.

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

Christopher Goodspeed at HM Treasury Tel: 020 7270 2690 or email: Christopher.goodspeed@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.