EXPLANATORY MEMORANDUM TO

THE BANK OF ENGLAND ACT 1998 (MACRO-PRUDENTIAL MEASURES) 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 defines new macro-prudential measures, which the Financial Policy Committee (FPC) can issue directions to the regulators in relation to, as provided for by Section 9H of the Bank of England Act 1998 (the "1998" Act). These new measures are:

- A measure to require regulated persons who enter into relevant mortgage contracts to ensure that no more than a specified proportion of relevant mortgage contracts entered into after the date of a direction made with reference to this order have a loan-to-value percentage greater than the maximum loan-to-value percentage specified in the direction.
- A measure to require regulated persons who enter into relevant mortgage contracts to ensure that no more than a specified proportion of relevant mortgage contracts entered into after the date of a direction made with reference to this order have a debt-to-income ratio greater than the maximum debt-to-income ratio specified in the direction.

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

3.1 None.

4. Legislative Context

4.1 On 26th September 2014 the FPC issued a statement on housing market powers of direction in which it recommend that the Treasury should exercise its statutory powers to enable the FPC to direct, if necessary to protect and enhance financial stability, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to require regulated lenders to place limits on residual mortgage lending, both owner-occupied and buy-to-let, by reference to (1) loan to value ratios, and (2) debt to income ratios. The full FPC statement on housing market powers of direction can be found at http://www.bankofengland.co.uk/financialstability/Documents/fpc/statement021014.pdf.

4.2 This instrument is being made by the Treasury in response to the Financial Policy Committee's statement and in exercise of the powers conferred by section 9L of the 1998 Act, 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) Order 2015 are compatible with the Convention on Human 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 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 The FPC 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.

7.5 In his Mansion House speech of 12th June 2014 the Chancellor of the Exchequer announced that he wanted to give new powers to the FPC to ensure that the housing

market did not imperil financial stability. To that end the Chancellor announced that he would give to the FPC powers over mortgages including the size of mortgage loans as a share of family incomes or the value of the house being mortgaged. The Chancellor's Mansion House speech can be found at https://www.gov.uk/government/speeches/mansion-house-2014-speech-by-the-chancellor-of-the-exchequer.

7.6 The FPC responded to the Chancellor's announcement with its statement on housing market powers of direction (see paragraph 4.1).

7.7 HM Treasury is exercising its statutory powers to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on owner-occupied residual mortgage lending, by reference to (1) loan to value ratios, and (2) debt to income ratios.

7.8 The LTV ratio for a new mortgage is calculated as the ratio of mortgage value to property value at origination (i.e. at the time the mortgage is granted). An LTV limit could potentially reduce defaults in a lender's mortgage book. Furthermore, it reduces the loss to the lender in the event of default.

7.9 A DTI ratio for a new mortgage is calculated as the ratio of the mortgage value and the applicant's stock of existing mortgage and non-mortgage debt (e.g. unsecured lending) to the applicant's income. A DTI limit constrains the value of the loan that a lender can extend, relative to the borrower's income, given the borrower's other existing credit commitments. Thus, it can, all else equal, lower the probability of default of borrowers and limit any increase in aggregate household indebtedness which could pose systemic risk. In relation to the DTI limit, the FPC is able to decide what is included in the definition of debt and choose between gross income and net income for the definition of income.

7.10 These powers are to be used by the FPC if it believes that they are necessary for preserving financial stability.

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 30 October 2014 to 28 November 2014. The consultation, a full summary of responses and the Government position can be found at https://www.gov.uk/government/consultations/the-financial-policy-committees-housing-market-tools.

8.2 HM Treasury received 20 responses to the consultation. Responses were received from a range of market participants including banks, non-bank mortgage providers, homebuilders, industry bodies and the FCA's independent advisory panels.

8.3 HM Treasury received no material comments on the drafting of the instrument.

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 An LTV limit acts by setting the minimum size of deposit that a borrower needs to buy a property (or equity in the property to obtain a further advance or a re-mortgage with an increase in the loan). A DTI tool works by limiting the value of the loan that a mortgage lender can extend relative to the borrower's income.

10.2 It is neither possible nor accurate to produce a final set of monetised costs and benefits of granting the FPC direction powers over LTV and DTI limits, given the countless ways the FPC could use these powers. The Treasury's impact assessment published alongside this explanatory memorandum includes quantitative estimates where possible and proportionate for an arbitrary calibration. This is for illustrative purposes and should not be considered an indication of the costs of granting the FPC powers of direction.

10.3 Broadly speaking, the main cost of both the LTV and DTI limits will be on the wider macroeconomy from an overall reduction in mortgage lending (if the policy is binding). Firms in scope (i.e. regulated lenders) of the LTV limits may face minimal administrative costs whilst we expect firms in scope of DTI limits could face higher administrative costs.

10.4 The main benefit of both the LTV and DTI limits will be a potential reduction in systemic risk. This could reduce the likelihood and impact of a financial crisis which would bring about substantial benefits (reducing the likelihood of crises by 1% is estimated to produce a net benefit of £4.5 billion per annum).

10.5 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 There are currently 13 small lenders and 20 micro-lenders in scope of the FPC's powers of direction. As described above, it is not possible to monetise the costs and benefits of granting these powers as the FPC could use them in countless ways.

11.2 Whilst the effect of DTI and LTV limits will depend on the limits the FPC chooses to set at any given time, broadly, the effect will be twofold. First, small and micro-lenders in scope of the FPC's powers of direction will be directly impacted by any limits. Second, non-financial small and micro-businesses might not be able to get access to mortgage-related funding.

11.3 These firms have not been exempted because doing could reduce the effectiveness of FPC actions. Although small firms are unlikely to pose a systemic threat individually, their behaviour in aggregate could have material impacts on financial stability. However, if the FPC assessed that, for a given action, small firms are not systemically important, then, in line with their requirements to have regard to proportionality, they could apply a de minimis threshold to carve out these firms. The choice of the level and basis of the threshold is not included in the legislation but is rather left at the FPC and regulators' discretion given it depends on the calibration the FPC decides to use.

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

Ali Uppal at HM Treasury Tel: 0207 270 1609 or email:
Ali.Uppal@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.