HM Treasury

Detail of outcome for FPC's housing market tools consultation

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Contents

1 Introduction

Background to this document

Housing tools

1.1 In his Mansion House speech on 12 June 2014 the Chancellor announced his intention to give the Financial Policy Committee (FPC) "new powers over mortgages, including over the size of mortgage loans as a share of family incomes or the value of the house". He said that the Treasury would consult on the tools, and that they would be in place before the end of this Parliament.[1]

1.2 The FPC is empowered to make recommendations to the Government that it be given powers of direction over specified tools.[2] In response to the Chancellor's announcement, on 2 October 2014, the FPC recommended that it be granted powers of direction over housing market tools in relation to owner-occupied mortgages and buy-to-let residential mortgages.[3] Specifically, the FPC recommended that it be granted the power 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 mortgage lending, both owner-occupied and buy-to-let, by reference to:

- Loan-to-Value (LTV) Ratios; and
- Debt-to-Income (DTI) Ratios, including Interest Coverage Ratios (ICR) in respect of buy-to-let lending.

1.3 In response to this recommendation, the Government is proposing that powers of direction are granted for LTV limits and DTI limits in respect of owner-occupied mortgages. The Government consulted on draft legislation from 30 October 2014 to 28 November 2014. This document summarises the responses received and how the Government intends to respond to the points raised by respondents.

1.4 The FPC also recommended that it be granted powers of direction over LTV limits and ICRs in respect of the buy-to-let mortgage market. The FPC argued that buy-to-let mortgages can pose risks to financial stability through similar channels to the owner-occupied sector. The Government intends to consult separately on these recommendations early in the next Parliament with a view to building an in-depth evidence base on how the operation of the UK buy-to-let housing market may carry risks to financial stability.

[1] See Mansion House 2014: Speech by the Chancellor of the Exchequer, available at https://www.Gov.uk/Government/speeches/mansion-house-2014-speech-by-the-chancellor-of-the-exchequer

[2] As set out in section 9P of the Bank of England Act 1998 (as amended by the Financial Services Act 2012)

[3] Financial Policy Committee statement from its policy meeting, 26 September 2014, available at http://www.bankofengland.co.uk/publications/Pages/news/2014/080.aspx

Leverage ratio

1.5 On 26 November 2013, the Chancellor wrote to the Governor of the Bank of England asking that the FPC undertake a review of the leverage ratio. On 11 July 2014, the FPC published a consultation paper setting out its initial proposal for a leverage ratio framework.

1.6 On 31 October 2014, the FPC published its conclusions and a recommendation on the required powers of direction in its *Review of the leverage ratio*. The FPC recommended that it be granted powers of direction over the PRA to set leverage ratio requirements and buffers including:

- a minimum leverage ratio requirement;
- a supplementary leverage ratio buffer that will apply to Global-Systemically Important Banks (G-SIBs) and other major domestic UK banks and building societies, including ring-fenced banks; and
- a countercyclical leverage ratio buffer (CCLB).

1.7 The Chancellor set out in a letter to the Governor that he accepted the FPC's recommendation and would seek to legislate in this Parliament. The Government published a consultation, including a proposal for draft legislation, on 7 November 2014, and the consultation ran until 28 November 2014.

1.8 This document summarises the responses received and how the Government intends to respond to the points raised by respondents.

Structure of this document

1.9 This document is structured as follows:

- Chapter 2 summarises the responses to the housing tools consultation and sets out how the Government intends to act in light of those responses;
- Chapter 3 summarises the responses to the leverage ratio framework consultation and sets out how the Government intends to act in light of those responses;
- Annex A lists the respondents to each consultation.

Next steps

1.10 Alongside the publication of this document, the Government has laid the statutory instruments in Parliament. The orders will need to be approved by both Houses of Parliament before they become law.

2 Responses to the housing tools consultation

Introduction

2.1 The Government's consultation on the FPC's housing market tools ran from 30 October to 28 November 2014. The consultation sought views on whether the powers of direction over owner-occupied mortgages that the Government proposed to grant the FPC are necessary and should be sufficient, subject to a separate consultation on buy-to-let, to ensure the FPC is able to address risks in the housing market.

2.2 The Government received 20 responses to this 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. The respondents are listed in Annex A.

Question 1: Do respondents agree that the FPC should be granted a power of direction over DTI?

Question 2: Do respondents agree that the FPC should be granted a power of direction over LTV?

Summary of responses

2.3 The majority of respondents recognised the benefits of the FPC having powers of direction over DTI and LTV. However, most respondents pointed out that these were blunt tools and raised specific issues which are considered in subsequent questions.

Government position

2.4 The FPC believes that taken together, these powers (alongside the PRA's[1], FCA's[2] and FPC's existing powers and subject to being granted powers of the buy-to-let mortgage market) are necessary, and should be sufficient, to tackle risks to financial stability from the housing market.

2.5 As the Government made clear in its consultation document, the UK mortgage market fulfils a critical role in supporting the UK housing market but can pose threats to financial stability. The Government believes that, in instances where the housing market appears to pose a systemic risk, regulation is absolutely necessary to mitigate this risk as financial crises have huge output costs. Furthermore, as the FPC explained in its statement on housing market powers of direction, more than two thirds of systemic banking crises were preceded by boom-bust housing cycles and recessions following property booms have been two or three times deeper on average than those without.

[1] The PRA has wide-ranging powers to control imprudent lending by individual institutions

[2] The FCA's mortgage affordability rules aim to ensure that mortgages are advanced only where there is reasonable chance that borrowers can repay without relying on uncertain house prices.

2.6 Therefore, the Government intends to grant the FPC these powers. However, the Government believes that macroprudential regulation should only occur if and when it is necessary. Hence, the FPC, in accordance with its statutory objectives, would only use these tools if they considered it to be necessary to address material financial stability risks, and the FPC is required to use its powers in a proportionate way. Furthermore, the FPC is required to publish a cost-benefit analysis, whenever reasonably practicable, each time it uses its powers of direction. The Government is strongly in favour of these cost-benefit analyses and expects that the FPC will always produce a cost-benefit analysis when using its powers of direction unless there are very strong reasons to justify why, in that particular instance, it is not practicable to do so.

2.7 The FPC is required by Section 9T of the Bank of England Act 1998 to review any outstanding directions within a year of them being issued and then at least annually thereafter. The purpose of these reviews is to consider whether the direction ought to be revoked. These reviews are published in the Financial Stability Report (FSR). The Government expects that when reviewing outstanding directions, the FPC will consider if the direction is still required to address the original issue and that the direction is still consistent with its objectives and other general duties set out in Sections 9C and 9F of the 1998 Act. This provision will ensure that the FPC regularly reviews its actions to ensure they remain appropriate and proportionate.

2.8 Together, these requirements ensure that the regulation is only being applied when there is clear evidence that it is necessary for the financial stability of the UK.

Question 3: Do respondents agree with the proposed scope of mortgages to which the DTI and LTV limits could be applied? If not, please explain your reasoning.

Summary of responses

2.9 The majority of respondents agreed that DTI and LTV limits should only apply to new mortgages.

2.10 Respondents had mixed views on whether secured lending to consumers by the Government should be excluded from scope the of DTI and LTV limits. A slight majority of respondents argued that Government schemes should be included in scope of the limits. Many of these respondents were concerned that Government schemes could become the only option for first-time buyers and as a result become permanent features of the market. Some of these respondents also suggested that Government schemes could themselves result in systemic risk.

2.11 On the other hand, many of the respondents fully supported the exclusion of Government schemes. They argued that the Government should retain its ability to intervene in a targeted manner. Furthermore, they explained that it is appropriate that Government-backed loans are excluded as they pose little risk to financial stability and that the Government has the power to manage any risk by adjusting the policy settings.

2.12 Other specific issues raised included the treatment of mortgage insurance, new builds and shared equity schemes.

Government position

2.13 The Government notes that the majority of respondents, including those that opposed the exclusion of Government schemes from the scope of DTI and LTV limits, were concerned around the distributional consequences of using these limits. In light of this, the Government continues to believe it is appropriate that secured lending by Government to consumers (for example, Help to Buy: equity loan) should be excluded from the scope of DTI and LTV limits. Indeed, as set out in the consultation document, this would enable the Government to intervene in a targeted way to alleviate potential distributional consequences of these limits. Moreover, the Government will continue to take into account the financial stability implications of its schemes. In any case, given the FPC's role in protecting and enhancing financial stability, the FPC is required to assess all financial stability risks, including those that stem from Government schemes. It is worth noting that the FPC specifically assessed the Government's Help to Buy: Mortgage Guarantee Scheme. It concluded that it does not pose material risks to financial stability risks under current market conditions.

2.14 Furthermore, the Government does not believe that granting the FPC the power of direction to set DTI and LTV limits will result in Government schemes becoming the only option for first-time buyers. The FPC is required to use its powers in a proportionate way and review at least annually whether any outstanding directions ought to be revoked. The FPC is also required to publish a cost-benefit analysis, whenever reasonably practicable, each time it uses its powers of direction.

2.15 In relation to specific issues such as the treatment of mortgage insurance, new builds and shared equity schemes, the Government believes this will be a judgement for the FPC when issuing a particular direction. For example, if the FPC considers that a particular form of mortgage insurance alleviates financial stability risks it may decide to exclude mortgages that benefit from such protections from the scope of its intervention.

Question 4: What are respondents' views on the appropriate treatment of business loans to individuals secured on the borrower's home?

Summary of responses

2.16 Nearly all respondents agreed that it would not be suitable to include business loans to individuals secured on the borrower's home in the scope of the FPC's powers. Respondents felt by including such loans in scope, there could be a negative impact on small business lending. Some respondents went further by highlighting the fact that these loans generate economic activity, so it would be unduly restrictive to include them in scope of the FPC's powers.

2.17 Two respondents additionally suggested that rather than including these loans within scope, the FPC should monitor the situation over time to consider whether they pose a systemic risk and if so, whether inclusion of such loans would be justified.

Government position

2.18 Taking into account the comments received on this question, the Government intends to exclude business loans to individuals which have been secured on the borrower's home from the scope of the FPC's powers.

2.19 However, the Government recognises that this may create scope for leakage and could therefore reduce the effectiveness of the FPC's interventions. In these instances, the Government notes that the FPC could use its power of recommendation to deal directly with such leakage. If the FPC finds that this particular area becomes a material source of systemic risk, the FPC could recommend to HM Treasury that such loans be brought within scope of the FPC's powers.

Question 5: What are respondents' views on the proposed definition of 'debt' for the purposes of the DTI tool?

Summary of responses

2.20 The responses to this question were fairly balanced with around half of respondents agreeing with the Government's proposed definition and around half disagreeing with it. Those that disagreed mainly took issue with the fact that student loans were excluded from the definition of debt whilst they were included in the affordability assessment under the mortgage affordability rules. They added that it would be imprudent to ignore student debt for the purposes of the DTI calculation. A key concern for these respondents was the potential for significant operational costs resulting from the proposed approach as it could mean firms would have to produce two sets of data: one including student loans and one excluding student loans.

2.21 One respondent who agreed with the Government's proposed definition requested clarification that the definition of debt for the purposes of the DTI would not replace but simply supplement the FCA affordability rules.

2.22 Some respondents also discussed potential leakages of the policy. For example, the DTI tool would only apply at a point in time and therefore borrowers could pay off a range of debts on a temporary basis and increase borrowing after the mortgage lending decision has been made. This could weaken the effectiveness of the intervention.

Government position

2.23 The Government believes it is important to note that DTI and LTV limits are macroprudential tools, which interact with both microprudential and conduct tools but serve a distinct purpose. The FCA's mortgage affordability rules, which were strengthened through the Mortgage Market Review (MMR), will not be affected by the tools, and continue to be the conduct requirements for lenders to adhere to when undertaking mortgage lending. The housing tools would act in addition to this affordability assessment. The affordability rules are about lenders making individual lending decisions taking into account whether a borrower can afford a mortgage, whereas the FPC's housing tools are concerned with mortgage losses and over-indebtedness in the economy as a whole. Therefore, subject to the minimum standard set by the FPC's housing tools, firms will have the discretion to be more conservative in their individual lending decisions, according to their assessment of what the borrower can afford.

2.24 The Government continues to believe that student loans should be excluded from the definition of debt. Whilst student loans are likely to contribute significantly to household indebtedness among young graduates, they differ to other debts as:

- annual repayments are income contingent; relatedly the debt is not fixed – in some instances the loan is not fully repaid; and,
- they are unlikely to be used in a material way to top up restricted mortgage borrowing (because if students have another means to pay their tuition fees and expenses, then it would either be recorded as a different commercial debt or would be non-contractual and thus substitutable for a student loan).

2.25 This is consistent with the rationale for DTI limits as described by the FPC when recommending that it be granted powers of direction over DTI limits.[3]

2.26 However, the Government is keen to ensure that the legislation does not result in disproportionate costs to industry, whilst also ensuring that the legislation will enable the FPC to target financial stability risks from the UK housing market. Therefore, the Government has only defined the outer boundaries of the definition of debt. The FPC has indicated that, in using its power of direction, it will use its judgement to determine whether any direction should specify a narrower category of types of debt that will be included, basing this judgement on what is appropriate and proportionate to managing risks at that particular time. Therefore, firms will need to be able to monitor and report the different elements included in the debt definition. The Government expects that this will have a one-off transitional cost but expects the PRA to invite comments when developing this framework which will ensure firms will not incur disproportionate costs.

2.27 The Government recognises that there could be potential leakages from an FPC intervention but notes that the FPC has a broad power of recommendation and, if it judged that such leakages pose a systemic risk, the FPC could address these through recommendations.

> Question 6: What are respondents' views on how (if at all) a borrower's assets should be taken into account in calculating that borrower's DTI ratio?

Summary of responses

2.28 Nearly all respondents recognised that taking a borrower's assets into account would minimise any prejudicial impacts on individuals who simultaneously accumulated assets and debt.

2.29 However, a majority of these respondents were concerned that taking assets into account would have significant practical issues and could be particularly costly. Firstly, respondents suggested that the legislation would need to define which assets should be taken into account. They noted that defining categories of liquidity for the purposes of calculating a DTI ratio would be difficult to codify into legislation. One respondent explained this practical issue using the example of a work of art. This may not have a market price but could be considered a valuable asset and queried how they would be able to verify its value used for the purposes of the DTI calculation, asking whether self-certification would be permitted.

2.30 Many respondents also noted that this complication would result in a lengthening of the time it takes to assess borrowers for a mortgage. They argued that this would be very costly and could potentially be passed onto the consumer in the form of higher rates.

2.31 One respondent also noted that including assets in the DTI calculation could create a source of leakage and therefore reduce the efficacy of the policy.

2.32 Another respondent, whilst agreeing that a borrower's assets should not be taken into account when calculating their DTI ratio, argued that there needs to be an appropriate exemption for high-net-worth (HNW) individuals as the inclusion of assets is a critical part of their overall affordability assessment.

[3] *Financial Policy Committee statement from its policy* meeting, 26 September 2014, available at http://www.bankofengland.co.uk/publications/Pages/news/2014/080.aspx

Government position

2.33 In light of the consultation responses, the Government believes that the complications and costs associated with including borrower's assets in the DTI calculation outweigh the benefits of including them. Furthermore, the Government believes that including a borrower's assets could create a source of leakage thereby weakening the policy. Therefore, the Government will not legislate to have the borrower's assets included for the purposes of the DTI calculation.

2.34 However, whilst the Government recognises that certain classes of borrowers, such as HNW individuals, are especially reliant on their assets, it does not intend to legislate for an exemption. The FPC is tasked with addressing systemic risks and if the FPC assessed that certain classes of mortgage lending do not pose a systemic risk, then, in line with its requirements to have regard to proportionality, the FPC could make appropriate adjustments to its calibration and/or de minimis thresholds.

> Question 7: Do respondents agree with the proposed definition of 'income' for the purposes of DTI? If not, please explain your reasoning and provide an alternative definition if possible.

Summary of responses

2.35 A clear majority of respondents agreed with the Government's proposed definition of income (i.e. gross income), with many arguing that the definitions should remain consistent with those used by lenders already. The majority of respondents added that this definition should be fixed and disagreed that the FPC should be allowed to use its judgement to specify more precisely what types of income should be included, based on what is appropriate and proportionate to managing risks at a particular time. They were concerned that such a variable approach would have disproportionate cost implications.

2.36 Some respondents felt that there should be a clear and consistent definition of income set out in the legislation to enable a consistent computation across the industry.

2.37 Two respondents pointed out that net income should be used instead of gross income. They argued that net income more accurately reflects the borrower's ability to make mortgage repayments as it deducts taxes, national insurance, and other payments.

Government position

2.38 In light of the consultation responses, the Government has decided to define income as "the amount of annual income (gross or net of tax and national insurance) verified by the lender when deciding to provide credit to borrower". The Government believes this strikes the appropriate balance between consistency and certainty for lenders as well as flexibility for the FPC.

2.39 Furthermore, the Government does not intend to create disproportionate costs and will therefore not enable the FPC to completely vary its definition of income. Nonetheless, the Government notes that net income is a more accurate measure of a borrower's income that can be used to make mortgage payments (and other outstanding credit commitments) than gross income. However, gross income has historically been the figure collected by firms and reported in regulatory returns and deviating from this definition of income may result in significant operational costs. Given that the new Product Sales Data (PSD), coming into force in January 2015, will collect both gross and net income data, the Government will provide the FPC with the flexibility to establish which of these measures is preferable. The Government would expect the

FPC to carefully monitor the data from the new PSD before deciding to use the net income definition. This will also mean that firms will have sufficient time to embed the necessary systems changes resulting from the new PSD. The Government believes that this will ensure that the FPC has sufficient flexibility whilst also minimising any operational costs.

Question 8: What are respondents' views on the appropriate treatment of existing buy-to-let mortgage debt, and income derived from rental yields (after costs) on buy-to-let properties?

Summary of responses

2.40 Regarding the treatment of buy-to-let (BTL) debt, there was broad agreement among respondents that such debt should not be taken into account when considering a borrower's overall indebtedness, with many respondents highlighting that such debt is self-servicing from the rental income. On BTL income, respondents appreciated that lenders could have individual approaches to treating such income, but would generally only take it into account if it could be demonstrated that it exceeds all costs from operation and maintenance of a BTL business. As such, respondents noted that aligning the income definition with that taken into account by lenders, and reported into PSD, would be the best approach.

2.41 Some responses commented more broadly on whether BTL lending should be subject to equivalent macroprudential policies as owner-occupied lending, with some arguing that it should. A number of respondents noted that they would consider BTL limits as equivalent to regulating the BTL market generally, which the Government has said that it does not want to do, most recently in the consultation for implementing the Mortgage Credit Directive. In discussing the impact of regulation of the BTL market, some responses emphasised the importance of the private rental sector, while others questioned the potential for BTL lending to contribute to housing and credit cycles.

Government position

2.42 In light of the responses, the Government will not amend the proposed scope of the FPC powers regarding BTL income and debt.

2.43 The responses highlighted some of the considerations and complexities of introducing forms of regulation to the BTL market. It remains the Government's intention to consult separately on the FPC's recommendations relating to BTL, and it expects to do so early in the next Parliament, in order to build and assess the evidence for introducing such instruments.

Question 9: Do respondents agree that the FPC should be able to apply DTI and LTV limits to a proportion of new mortgages calculated on either a value or volumes basis? If not, please explain on which basis the tools should apply and why.

Summary of responses

2.44 The majority of respondents agreed that DTI and LTV limits should only apply to new mortgages. One respondent mentioned concerns about imposing limits retrospectively.

2.45 The main issue raised by respondents related to whether the FPC should be able to apply limits on a values or volumes basis. There were mixed views on this point with many respondents agreeing that the FPC should be able to apply limits on either basis. However, a few respondents argued that a volume limit would be more appropriate for two reasons. Firstly, a volume limit would maintain consistency with the FPC's recommendation on LTI limits in June 2014.[4] Secondly, they suggested a volume limit would be less impacted by geographical house price variations. One respondent preferred the limits to be set on a values basis and argued that setting limits on a volumes basis may incentivise lenders to favour higher loan amounts.

2.46 A few respondents queried the de minimis threshold suggesting specific thresholds that should be set to exclude small and medium-sized firms. They argued this was important to maintain proportionality.

Government position

2.47 The Government intends to legislate to grant the FPC power of directions to apply limits to a proportion of new mortgages. The legislation does not allow the FPC to apply limits retrospectively.

2.48 As set out in the consultation, it is important that the FPC has the ability to target the precise threat to financial stability and whilst in some cases applying a DTI or LTV limit on a values basis may be more effective, in other cases a volumes basis may be more effective. If there is a financial stability concern over the risk to lenders' balance sheets of high LTV or DTI lending, a values measure may be more appropriate. However, if the FPC is concerned about the number of households with high LTV mortgages, or the number that are highly indebted, they may exercise the tools on a volumes basis. Whilst limits using either approach could be calibrated to have similar aggregate impacts, the distribution of those affected may be different under each approach and the FPC will therefore have the flexibility to choose which is most relevant at any given time. Furthermore, the FPC is required to exercise its functions with regard to the principle of proportionality. Therefore, in light of this and the responses to the consultation, the Government believes that it is appropriate for the FPC to be able to apply limits on either a values or volumes basis.

2.49 The Government does not intend to define a de minimis threshold in legislation. It is important that the FPC has the discretion to set the de minimis threshold or to give this discretion to the PRA and FCA. Whilst having a threshold specified in legislation could provide additional certainty to firms, it could have two consequences. First, if the threshold at which firms are excluded from scope is set too high and does not capture firms that FPC would consider systemic at a given point in time, the FPC's ability to deal effectively with systemic risks could be constrained. Secondly, if the threshold is set too low, it may capture firms that the FPC would not consider systemic at a given point in time and result in an unnecessary cost to these firms by including them in scope. Clearly, it is impossible to set a threshold ex-ante that is appropriate for all possible calibrations. Therefore, the Government believes it is appropriate for the FPC to have the discretion to set the de minimis threshold. If the FPC assessed that certain firms are not systemically important when using its limits, then, in line with its requirements to have regard to proportionality, the FPC could apply a de minimis threshold to carve out these firms.

2.50 The FPC is required to publish a cost-benefit analysis, whenever reasonably practicable, each time it uses its powers of direction. The Government is strongly in favour of these cost-benefit analyses and expects that the FPC will always produce a cost-benefit analysis when using its powers of direction unless there are very strong reasons to justify why, in that particular instance, it is not practicable to do so.

[4] See *Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending, October 2014,* available at http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf.

Question 10: Do respondents agree with the Government's proposed approach in relation to re-mortgages and further advances on existing mortgages? If not, please describe an approach that you believe would be suitable.

Summary of responses

2.51 The majority of respondents agreed with the proposed approach for re-mortgages and further advances on existing mortgages.

2.52 Several respondents commented that to ensure consistency, definitions need to be agreed, arguing that to ensure consistency with the approach taken by the PRA with respect to implementing the LTI limits, these limits should not apply to re-mortgages with no increase in principal. They believe this will ensure that households seeking to re-mortgage, and who have already passed an affordability test, will not be penalised by the introduction of LTV or DTI limits.

2.53 One respondent highlighted that the introduction of LTV or DTI limits could create a new cohort of so-called 'mortgage prisoners'. This is a set of high LTV/DTI borrowers who find themselves unable to re-mortgage, even to a more affordable rate, because limits have been introduced in the interim. This could affect borrowers who are seeking to move to better rates on their existing property, or to downsize to a property with a smaller mortgage.

Government position

2.54 Given that respondents agreed with the Government maintaining consistency, particularly with the approach the PRA take when implementing LTI limits, and in light of other comments, the Government will retain its proposed approach on re-mortgages and further advances on existing mortgages when they introduce the LTV and DTI limits.

2.55 Under the Government's approach, borrowers who are re-mortgaging on an existing property with no increase in principal will not be captured by the FPC's limits, but borrowers who are downsizing to a new property will be captured. While the Government recognises the potential impact in creating 'mortgage prisoners' who are unable to move to more affordable properties, all new housing transactions at high LTV or DTI levels will affect the overall dynamics of the housing market, which the FPC may be trying to influence. It is also worth noting that the FPC may set a limit on high LTV or DTI lending that allows a proportion of lending to exceed the limit, in a similar way to their June 2014 recommendation on LTI limits. In these circumstances, lenders would still be able to offer high LTV or DTI loans to some borrowers, if the lender judged it to be appropriate.

Question 11: What views do respondents have regarding the potential impact of the Government's proposals?

Summary of responses

2.56 Responses to this question raised concerns about the potentially broad impact of the use of LTV and DTI limits. Some respondents noted that the imposition of limits would restrict access to mortgage finance for otherwise creditworthy borrowers, with first-time buyers highlighted as a group that would be particularly affected by these tools, or could result in "mortgage prisoners" who would be unable to re-mortgage at higher LTV/DTI ratios than their current loans.

2.57 Respondents in the construction industry raised concerns about the impact of these tools on home building and suggested that the FPC should take this into consideration when deciding upon the calibration of these tools.

2.58 Many respondents stressed the importance of the FPC acting in a proportionate way when applying these tools, stating that regional variations in property prices and average incomes could warrant more granular application of the tools than a single nationwide limit.

2.59 Some respondents felt that it was difficult to provide a view on the impact of these tools in the absence of a calibration and stressed that it would be important for the FPC to be open and consultative when setting the calibration of these instruments. Two respondents were particularly critical of the impact analysis undertaken by the FPC and the PRA regarding the June 2014 recommendation on LTI limits, with one stating that the regulators do not have to meet HM Treasury Green Book standards of cost-benefit analysis.

Government position

2.60 The Government recognises that the use by the FPC of these tools could have wide-ranging impacts as well as specific distributional consequences, but believes that these tools are more targeted than interest rate changes (which have far wider economic impacts) and will have significant benefits for financial stability.

2.61 The Government notes that the FPC is only permitted to take action if it judges it to be necessary to address financial stability risks, and that the FPC has a statutory obligation to exercise its functions with regard to the principle of proportionality, and is required to publish a cost-benefit analysis exercising its powers of direction (unless it judges that it is not reasonably practicable to do so). Both the costs and benefits will therefore be carefully considered by the FPC whenever it considers deploying these tools. This ensures problems such as the issue of "mortgage prisoners" are considered. For instance, in its June recommendation on LTI limits, the FPC recommended that no more than 15% of the total number of new mortgage loans could be at LTI ratios at or above 4.5. This type of portfolio limit alleviates the problem of "mortgage prisoners" as it does not operate as a hard cap.

2.62 The PRA and FCA will also be required to undertake consultations and produce cost-benefit analyses before introducing rules to implement limits for the first time. The FPC published a cost-benefit analysis alongside its June recommendation on LTI limits and stated in its most recent Financial Stability Report that it would build on this approach. The Government welcomes this and expects that the regulators will continue to build on this approach and produce comprehensive quantitative estimates of the costs and benefits of any rules.

Question 12: Do respondents agree with the Government's proposed approach in relation to procedural requirements? If not, please explain an approach that you consider would be appropriate.

Summary of responses

2.63 Respondents were broadly supportive of the Government's proposed approach regarding procedural requirements, noting that it might be important for FPC directions to be implemented in a timely fashion, although some respondents called for the procedural requirements to apply in all cases and mentioned the importance of the regulators taking a consultative approach to setting new requirements.

2.64 Some respondents suggested that requirements imposed by the FPC should be time-limited or that the FPC should make clear in what situations it would consider removing LTV and DTI requirements so as to avoid permanent increases in the regulatory burdens.

Government position

2.65 As set out in the consultation document, if the PRA/FCA implement an FPC direction through a rule change, then on first application of those rules following the direction, the PRA/FCA must carry out all procedural requirements (i.e. consultation and cost-benefit analysis). However, where the FPC subsequently changes the calibration of a measure, the PRA/FCA would only be required to carry out a cost-benefit analysis. The Government believes that this approach strikes the right balance between accountability and responsiveness. The Government notes that the FPC is required by statute to produce an explanation when using its power of direction, including cost-benefit analysis whenever reasonably practicable, and believes that this mechanism will ensure that the FPC is held to account for its actions.

2.66 The calibration and duration of the FPC's interventions are for the Committee to decide and it would be inappropriate for the Government to fetter the discretion of the FPC in this regard. The Government notes that the FPC is required to produce a policy statement for each of its macroprudential tools, which will explain in depth how the FPC intends to use the tool and what situations would warrant its use. This statement should provide regulated persons with a significant amount of information about the FPC's housing market tools and how it intends to use them. The FPC intends to publish a draft policy statement for these tools in early February to help inform the Parliamentary debate on the FPC's housing tools.

2.67 The Government expects that, where the PRA and/or FCA implement a direction from the FPC regarding its housing market tools by means other than the introduction or amending of rules, the regulators will publish a cost-benefit analysis that is proportionate to the potential impact of the tools alongside implementation. The Government believes that the accountability of the regulators and the FPC are of paramount importance and that high quality, rigorous cost-benefit analysis will be a key mechanism for holding them to account for their actions.

Question 13: Do respondents have any comments regarding the Statutory Instrument?

Summary of responses

2.68 Only one respondent offered comments on the draft statutory instrument. They gave comments on the definitions of loan to value percentage and excluded mortgage contract given in the draft instrument.

Government position

2.69 The Government believes that the drafting of the statutory instrument published alongside this document is appropriate and sets out the FPC's housing market powers with sufficient clarity.

Other issues: Regional impacts

Summary of responses

2.70 Many respondents were concerned that DTI and LTV limits could have stronger impacts on specific regions such as London and the South East.

2.71 Others argued that the limits should apply on regional basis given the dynamics of the housing market can vary substantially across different regions and that region. One respondent added that regional caps have been used successfully in Korea.

Government position

2.72 The Government notes these concerns. The FPC's main function is to identify, monitor and take action to remove or reduce systemic risks with a view to enhancing the resilience of the UK financial system. So, although any direction given by the FPC could be focused on a class of firms or a particular type of risk, within the boundaries set by the legislation, the FPC will always be motivated to take action in relation to those risks that affect the stability of the UK financial system as a whole or a significant part of it.

3 Responses to the leverage ratio consultation

Introduction

3.1 The Government's consultation on the FPC's proposed leverage ratio framework ran from 7 November to 28 November 2014. The Government sought views on the FPC's proposals and the draft secondary legislation that would grant the FPC powers of direction over the leverage ratio framework.

3.2 The Government's consultation proposed to grant the FPC the leverage ratio powers put forward in the FPC's *Review of the leverage ratio.* The recommended powers are:

- a minimum leverage ratio requirement that would apply to all PRA-regulated banks, building societies and investment firms;
- an additional leverage ratio buffer to be applied to systemically important firms as a proportion of their systemic risk buffers (SRB) or their G-SIB[1] capital buffer that would supplement minimum requirements; and
- a CCLB that would be applicable to all firms subject to the minimum leverage ratio requirement.

3.3 The Government received 7 responses to this consultation, with many of the respondents stating that their views had not moved on materially since the FPC's consultation over the summer. Responses were received from banks, building societies and industry bodies. The respondents are listed in Annex A.

A minimum leverage requirement for all firms

> Question 1: Do you agree that the FPC should have a power to require the PRA to apply a minimum leverage requirement to all firms?

Summary of responses

3.4 The majority of respondents were in favour of the FPC having a power to set a minimum leverage ratio requirement, though some responses stressed the importance of consistency with internationally agreed leverage ratio standards. These responses noted that the FPC's proposal to set a minimum leverage ratio requirement for the largest UK banks and building societies as soon as practicable is much faster than the agreed timetable for Basel III and European leverage ratio requirements.

[1] The legislation refers to G-SIBs as "global systemically important institutions" ("G-SIIs")

3.5 Two respondents argued that HMT should have a role in determining an overall leverage target for the UK financial system, similar to the inflation target set for the Monetary Policy Committee, rather than leaving this decision to the judgement of the FPC.

Government position

3.6 The Government believes that the FPC has made a convincing case for it to be granted the ability to set a minimum leverage ratio requirement. The financial crisis highlighted the importance of firms having sufficient capital relative to their exposures regardless of the riskiness of their activities. The Government notes that the FPC intends to apply this minimum only to the largest firms before 2018 and that other firms will be required to meet this minimum in line with the agreed timetable for an international minimum leverage ratio standard. Further, the FPC has committed to review the UK framework once there is international agreement to maintain international consistency.

3.7 The Government has established the FPC as a policy committee within the independent Bank of England so that its decisions are insulated from political concerns. The Government believes that the FPC is best placed to take judgements about the level of leverage in the UK financial system which is prudent, whilst also ensuring the ability of that system to contribute to economic growth in the UK.

3.8 The FPC is required by Section 9T of the Bank of England Act 1998 to review any outstanding directions within a year of them being issued and then at least annually thereafter. The purpose of these reviews is to consider whether the direction ought to be revoked. These reviews are published in the FSR. The Government expects that when reviewing outstanding directions, the FPC will consider if the direction is still required to address the original issue and that the direction is still consistent with its objectives and other general duties set out in Sections 9C and 9F of the 1998 Act. This provision will ensure that the FPC regularly reviews its actions to ensure they remain appropriate and proportionate.

A supplementary leverage buffer for systemically important firms

Question 2: Do you agree that the FPC should have a power to require the PRA to apply a leverage ratio buffer to UK G-SIBs with reference to their G-SIB capital buffer?

Question 3: Do you agree that the FPC should have a power to require the PRA to apply a leverage ratio buffer to UK domestic systemically important banks with reference to their systemic risk buffer?

Summary of responses

3.9 There were a range of views on the supplementary leverage ratio buffer. Some respondents were strongly in favour of additional requirements for systemically important firms, while others were unconvinced that the issues the FPC is seeking to address with a leverage ratio framework are more prevalent in larger, more systemically important institutions.

3.10 One respondent stated that they believe that the additional leverage ratio buffers applied to these firms would be super-equivalent to international requirements for leverage ratios and that they should not be applied until these buffers are required by European legislation. The respondent believed that imposing supplementary leverage ratio buffers before a European standard is in place would place UK firms at a competitive disadvantage as branches of foreign banks operating in the UK would not be subject to these requirements.

3.11 A number of respondents noted that the framework for the SRB has not been set and that the details of this framework would determine the overall expected leverage ratio requirements for firms subject to the SRB. These respondents called for a comprehensive consultation on this framework that considers the impact of SRB designations for firms and their overall leverage ratio requirement. Respondents welcomed the approach set out in the Chancellor's letter of 31 October to the Governor, and stressed the importance of the FPC giving due regard to the factors noted by the Chancellor in his letter.

Government position

3.12 There is international agreement that firms that are systemically important, either globally or domestically, should be required to hold additional capital buffers reflecting the higher costs to the wider financial system of their distress or failure. The Government notes that several other jurisdictions, including the Netherlands, Switzerland and the US have already announced that they will apply higher leverage requirements to systemic firms. The Government notes that additional capital buffer requirements for global systemically important banks will be phased in from 2016, so firms will not need to meet the full capital or leverage ratio requirements for some time.

3.13 The Government believes that the FPC's leverage ratio framework will be more effective if it is consistent with international practices and standards and notes that the FPC intends to review its leverage ratio framework in 2017 in the light of developments towards an international standard.

3.14 The Chancellor has made clear that he believes that a comprehensive and lengthy consultation on the SRB framework is necessary prior to its introduction. The Chancellor's letter to the Governor of 31 October stated that this consultation should address the impact of different levels of calibration for the SRB on important factors such as:

- the levels of lending to the real economy;
- the degree of competition in retail banking; the impact on lenders with low average risk weights; and
- the maintenance of a diverse set of business models in the banking industry.

The Government welcomes the Bank's announcement of a consultation on the SRB framework in 2015.

3.15 The Government believes that the FPC has made a compelling case for applying supplementary leverage ratio buffers to systemically important firms and that it is significant that other jurisdictions are taking similar action to ensure the soundness of systemically important firms. The Government welcomes the FPC's commitment to review its leverage ratio framework in 2017 and notes the Committee's obligation to annually review outstanding directions as set out in paragraph 3.8. The Government intends to grant the FPC a power to set supplementary leverage ratio buffers as outlined in its *Review of the leverage ratio.*[2]

[2] http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf

A countercyclical leverage ratio buffer for all firms

> Question 4: Do you agree that the FPC should have a power of direction to require the PRA to impose a countercyclical leverage ratio buffer as soon as practicable?
>
> Question 5: What would be the advantages and disadvantages of tying the rate of the CCLB to the rate of the CCB in the statutory instrument?

Summary of responses

3.16 The majority of respondents were against the FPC being given a power of direction with regards to a CCLB. Some were against additional buffers in general, but others had specific concerns about the CCLB. These respondents cited the following issues as concerns: lack of international application of this tool, in particular the lack of binding reciprocation arrangements that are in place for the countercyclical capital buffer (CCB); and a lack of evidence supporting the use of this tool or the CCB.

3.17 Three respondents were strongly in favour of the FPC's suggestion that some firms might be given up to twenty-four months to comply with additional leverage ratio requirements imposed via the CCLB, rather than the twelve months usually allowed for CCB requirements. These responses argued that building societies would benefit from this additional compliance time as they have less capital-raising capability than banks. These respondents suggested that the statutory instrument should make provision for the FPC to specify this extended compliance time or that the instrument should provide that twelve months would be the minimum compliance time allowed.

3.18 Respondents believed that the key benefits of tying the rate of the CCLB to the rate of the CCB in the statutory instrument would be greater certainty about how the tool would be used. Respondents acknowledged that this greater certainty would come at the price of less discretion for the FPC in the use of this tool.

Government position

3.19 The Government believes that the FPC has made a strong case for applying a CCLB alongside the CCB. Although there is relatively little international experience of the use of this type of tool, the FPC has put forward a sound theoretical argument for countercyclical leverage ratio requirements. The Government notes that the thinking on countercyclical capital tools is still developing internationally and that the FPC will review its leverage ratio framework in 2017 in light of progress in this area. As set out above, the FPC is required to annually review any outstanding direction to determine if they should be revoked. The Government notes that the FPC is required to have regard to the principle of proportionality when exercising its functions and expects that the Committee would only use the CCB and the CCLB in a manner which is proportionate. The FPC's policy statement for its capital requirements tools states that "when the FPC does not judge there to be material threats to resilience in the United Kingdom, it expects the CCB rate applied to UK exposures … to be zero.'[3] Given that the CCLB will be set as a proportion of the CCB in the majority of cases, the Government expects that the level of the CCLB will also be zero in these circumstances. The Government believes that the requirement to act proportionately justifies granting the FPC this power of direction over the CCLB.

[3] http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement140113.pdf

3.20 The Government supports the FPC's suggestion that some firms could be given longer compliance periods for CCLB requirements. However, the implementation of directions is a matter for the PRA and the FPC cannot direct the PRA with regards to how a macroprudential tool should be implemented. The Government notes that the FPC can make recommendations to the regulators regarding the implementation of directions and would encourage the FPC to make such recommendations where it believes a longer compliance deadline may be warranted.

3.21 The Government believes that the FPC should have discretion regarding the use of the CCLB, which would enable it to use the tool flexibly, tailoring its use to the situation at hand, in order to meet its statutory objectives. However, the FPC's use of the CCLB would of course be subject to the requirement on the FPC to have regard to the principle of proportionality and to produce an explanation, including cost-benefit analysis whenever it is reasonably practicable to do so. The Government notes that the FPC's *Review* set out how the FPC expects to use this tool and that the Committee will provide more information about the tool and how it will be used in a draft Policy Statement that will be published in early February.

Procedural requirements

Question 6: Do you agree that all procedural requirements should apply to changes in the minimum requirement and additional buffer or would there be benefits in waiving procedural requirements in some situations?

Question 7: Do you agree that the procedural requirements for the countercyclical leverage ratio buffer should mirror the approach used for the CCB?

Summary of responses

3.22 All respondents were in favour of the FPC and PRA being held accountable for decisions relating to the proposed leverage ratio framework and believed that procedural requirements when implementing FPC directions via rules would be a key part of this accountability and supported the Government's proposal to not waive procedural requirements for changes to the minimum requirement and additional buffer (i.e. the supplementary buffer for systemically important firms). Approximately half of respondents felt that the approach to procedural requirements for the CCLB set out in the Government's consultation document was appropriate, while the other half believed that procedural requirements should not be waived in any circumstances.

Government position

3.23 The Government agrees that the accountability of the FPC and the PRA are of the utmost importance and that regulatory authorities should take an open and consultative approach when making regulatory policy.

3.24 In its 7 November consultation document, the Government set out its proposed approach that all procedural requirements should apply when making changes to the calibration of the minimum leverage ratio requirement or the additional buffers for systemically important firms and that procedural requirements for the CCLB should apply as follows.

- If the FPC sets the CCLB rate as a fixed proportion based directly on CCB rates, the PRA will be required to consult, including an assessment of the costs and benefits, before first applying any requirements. However, to the extent that this scaling factor remains unchanged the PRA will not be required to consult or carry out a cost-benefit analysis when the FPC changes the UK CCB rate or other CCB rates change.

- If the FPC wishes to subsequently change the scaling factor used to calculate the CCLB, the PRA would be required to produce a cost-benefit analysis of the action.
- If the FPC decides to use the CCLB independently from the CCB, then the PRA would be required to consult, including an assessment of the costs and benefits, before making any rules to implement the FPC direction.

3.25 The Government believes that the approach outlined in its 7 November consultation document, in conjunction with the statutory requirement that the FPC produce explanations, including a cost-benefit analysis whenever reasonably practicable, will ensure that the FPC and the PRA will be held to account for the use of leverage ratio requirements.

A List of respondents

Leverage Ratio Consultation	Housing Tools Consultation
Coventry Building Society	Bovis Homes
The British Banking Authority	BSA
The Building Society Association (BSA)	Chartered Institute of Housing
HSBC	Council of Mortgage Lenders
Santander UK	The City of London Law Society
Virgin Money	Financial Services Consumer Panel (FCA)
Yorkshire Building Society	Genworth Financial
	Holmesdale Building Society
	Home Builders Federation
	Intermediary Mortgage Lenders Association
	Nationwide
	Paragon
	Peabody
	Royal Institute of Charted Surveyors
	Santander UK
	Shelter
	Smaller Business Practitioner Panel (FCA)
	Sukhija Financial Limited
	Virgin Money
	Yorkshire Building Society

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