EXPLANATORY MEMORANDUM TO

THE BANK OF ENGLAND ACT 1998 (MACRO-PRUDENTIAL MEASURES) ORDER 2016

2016 No. 1240

1. Introduction

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

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

2. Purpose of the instrument

2.1 This instrument confers on the Financial Policy Committee (FPC), the UK's macroprudential authority, powers to direct the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to take action with respect to loan-to-value (LTV) ratios and interest coverage ratios (ICRs) for buy-to-let (BTL) mortgages. The FPC will be able to limit the proportion of new mortgages extended at LTV ratios above or ICRs below a level specified by the FPC.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 Following the precedent in the Bank of England Act 1998 (Macro-prudential Measures) Order 2015 (SI 2015/909) and the Bank of England Act 1998 (Macro-prudential Measures) (No.2) 2015 (SI 2015/905), article 4 provides that, in certain circumstances, where the terms of a direction from the FPC are to be given effect through rules issued by the FCA or PRA then procedural requirements imposed on the FCA and PRA when it is to adopt new rules shall not apply.

3.2 Article 4(1)(a), (b), and (c) operate so that this disapplication is limited to a situation where the FPC has issued a direction to the FPC or PRA, pursuant to the measures outlined in this Order, and then decides to change the values in the direction and acts to do so by first revoking the original direction and then "within a reasonable period of time after the original revocation gives another direction which is in substance identical to the first direction except in relation to the values specified in the direction". The objective is to ensure that ordinarily the procedural requirements imposed on the PRA and FCA are retained, but that where the only amendment to rules is to give effect to a change in values stipulated in the direction then the requirement for a consultation is removed. The FCA and PRA will still be required to publish a cost benefit analysis so the effect of the rule change on business is visible.

3.3 HMT anticipates that article 4(1) is most likely to be invoked in a situation where the FPC has previously considered the impact of the policy and believes that changes to the calibration will result in the costs and benefits scaling up (or down) in line with the original assessment, negating the need for a second assessment. Disapplication may also be required in a scenario where the risks posed by the BTL sector to financial stability are unexpectedly increased in order to warrant a change to the calibration of the LTV and ICR measures. Accordingly, HMT expects that the duration between any revocation and issuance of a second direction changing the calibration will be very short, otherwise the FPC runs the risk of failing to contribute to the financial stability objective.

3.4 The FPC must act reasonably and proportionally when exercising its power to issue directions. It is therefore unlikely that the FPC will act in an unreasonable fashion in terms of issuing directions, including the timing of any issuance following a revocation. Further, there is an appropriate process of recourse should any party consider that the FPC's actions are unreasonable in relation to the issuance of any direction to which article 4((1) applies.

3.5 The PRA and FCA are required to comply with a direction as soon as reasonably practicable and the purpose of the disapplication of the procedural requirements is to expedite the process of compliance. The PRA and FCA do not have the power to refuse to act and HMT has considered whether there are circumstances where the PRA or FCA might consider that the period of time between the revocation of the first directive and the issuance of the second is not reasonable and has concluded that there are not. Of particular importance in this assessment is that the FCA and PRA are both represented on the FPC and have that avenue to express their views on matters of reasonableness of action. Further, any challenge, or difference of view on reasonableness of the period between the revocation and issuance will be against a body on which these bodies are represented and that there are unlikely to be differences of opinion over whether a period of time is "reasonable" or not.

Other matters of interest to the House of Commons

3.6 Disregarding minor or consequential changes, the territorial application of this instrument includes Northern Ireland and is not a financial instrument that relates exclusively to England, Wales and Northern Ireland.

4. Legislative Context

4.1 The primary objective of the FPC, as set out in the Bank of England Act 1998 (as amended), is to contribute to the achievement of the Bank of England of its financial stability objective. The FPC does this by identifying, monitoring and addressing risks to the financial system as a whole. This role complements the responsibilities of the PRA and FCA, who regulate individual firms for soundness and for conduct of business, respectively[1]. This action to address "systemic risk" is known as macroprudential policy.

4.2 The FPC acts to address systemic risk via its powers of recommendation and its powers of direction. Its powers of direction are limited to specified macroprudential tools that are set out in secondary legislation.

4.3 The FPC has issued a recommendation to HM Treasury regarding the powers of direction it believes it needs to address systemic risks in the UK housing market, including the BTL market in September 2014[2]. The FPC recommended that it be granted powers of direction over residential mortgages with reference to loan-to-value

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[1] Readers should note that the FCA is also responsible for the prudential regulation of firms that do not take deposits (e.g. asset managers or hedge funds).
[2] This recommendation is available at http://www.bankofengland.co.uk/publications/Pages/Records/fpc/2014/1410.aspx

(LTV) ratios and debt-to-income (DTI) ratios, including Interest Coverage Ratios (ICRs) in respect of BTL mortgages. The powers relating to owner-occupied mortgages were granted in 2015 – see the Bank of England Act 1998 (Macro-prudential Measures) Order 2015. This instrument grants the powers of direction that were recommended by the FPC in relation to BTL mortgages.

5. Extent and Territorial Application

5.1 The extent of this instrument is the entirety of the United Kingdom.

5.2 The territorial application of this instrument is the entirety of the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury Simon Kirby MP has made the following statement regarding Human Rights:

"In my view the provisions of the Bank of England Act 1998 (Macro-prudential Measures) Order 2016 are compatible with the Convention rights."

7. Policy background

What is being done and why

7.1 The primary objective of the FPC, as set out in the Bank of England Act 1998 (as amended), is to contribute to the achievement of the Bank of England of its financial stability objective. The FPC does this by identifying, monitoring and addressing risks to the financial system as a whole. This role complements the responsibilities of the PRA and FCA, who regulate individual firms for soundness and for conduct of business, respectively. This action to address "systemic risk" is known as macroprudential policy.

7.2 The FPC acts to address systemic risk via its powers of recommendation and its powers of direction. The FPC has broad powers of recommendation and can issue recommendations to anyone. Recommendations made to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) can be made on a "comply or explain" basis, where the regulator must explain publicly if it chooses not to comply with the recommendation. The FPC's powers of direction are limited to specified macroprudential tools that are set out in secondary legislation and directions can only be made to the PRA or FCA.

7.3 The FPC and the government believe that the housing market can pose direct and indirect risks to financial stability. The direct risks arise because mortgage lending is the single largest asset class held by UK banks in aggregate, which means that their performance is inextricably linked to the performance of the housing market. This also means that many banks are likely to be affected by movements in the housing market at the same time. It is therefore important to ensure that banks are resilient to risks emanating from the housing market. The indirect threat arises because mortgages are the single largest liability of UK households. Highly indebted households cut back spending sharply when they experience shocks to their income (e.g. unexpectedly becoming unemployed)[3], which is why recessions that follow periods of rapid credit growth tend to be deeper and longer lasting as the sharp cut back in spending by highly indebted households exacerbates the original economic

[3] See http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf pages 56 and 57.

shock. As well as the risks common to all residential mortgage lending, BTL lending and BTL borrowers have characteristics that entail potential risks that are particular to this activity. These BTL specific risks are considered in paragraphs 7.7 to 7.15.

7.4 Having identified these direct and indirect channels of risk, the FPC recommended that the government should grant it additional powers of direction relating to residential mortgage lending, both owner-occupied and buy-to-let. The government has legislated to grant the requested powers regarding owner-occupied mortgages. While owner-occupied mortgages account for the majority of the UK mortgage market, BTL lending represents a material segment of residential mortgage lending. This instrument grants similar powers with respect to buy-to-let mortgages, thereby completing the government's response to the FPC's recommendation.

7.5 This instrument will grant the FPC the ability to set limits on the proportion of new buy-to-let mortgages that are extended above a specified Loan-to-Value ratio (i.e. the ratio of the amount borrowed to the value of the property) and/or below a specified Interest Coverage Ratio (ICR) (i.e. the ratio of the expected rental income to the interest payments on the mortgage). For example, the FPC could use these powers to require the PRA and FCA to ensure that no more than 15% of new buy-to-let mortgages (either by volume or by value) are at LTVs above 95%. The limit on the proportion of the specified mortgages could be set to zero, effectively acting as a hard cap (or minimum) on the LTI ratios and/or LCRs on mortgages offered to buy-to-let borrowers.

7.6 The FPC will use these powers, if necessary, to address systemic risk within the UK buy-to-let market. The potential financial stability risks posed by the buy-to-let market are discussed below.

Financial stability risks from the buy-to-let market

7.7 The main channels through which the buy-to-let market may carry risks to financial stability are credit risk, the risk of amplification of the house price cycle, and the possible interaction of high indebtedness with these two channels. These channels are explained in detail in the paragraphs below.

7.8 The first channel through which buy-to-let lending could pose a risk to UK financial stability is through credit risk. This risk stems from the adverse impact that losses arising from buy-to-let lending can have on lender balance sheets and, in turn, on the resilience of the financial system. Mortgages are the single largest asset class on banks' balance sheets, so many firms will be affected by wide-spread failure of borrowers to service their mortgages.

7.9 Mortgages are the single largest asset class on UK banks' balance sheets. Distress in this market could impact banks' capital, impair their access to finance and reduce their ability to provide core services to the economy. A reduction in house prices would reduce the value of the collateral available to banks and increase their risk of losses on mortgage assets if they had to call in the collateral because of borrowers' inability to make the necessary payments.

7.10 BTL lending may also have the potential to amplify housing market cycles, both in the upturn and in the downturn. Housing is the main source of collateral for the real economy, and so can give rise to a self-reinforcing loop of rising house prices and overextension of credit growth. This amplification could generate indirect costs on the wider economy and increase financial stability risks.

7.11 In an environment of rising house prices, BTL borrowers seeking capital gains (i.e. gains from increases in the value of the property tied to the loan) may have incentives to enter the market. Since BTL borrowers and owner-occupiers operate within a single housing market, any increase in demand associated with BTL borrowers would potentially increase the price of houses for both owner-occupiers and BTL borrowers.

7.12 Rising prices during a period of economic prosperity, when people have more disposable income, could result in greater financial stability risks if it resulted in all mortgage borrowers taking on larger loans. The FPC's previous action to limit the flow of high Loan-to-Income (LTI) mortgages provides some insurance against the increased indebtedness of owner-occupiers in this scenario, but it would result in more owner-occupiers being excluded from the market. The powers contained in this instrument will ensure that the FPC is able to cover the majority of residential mortgage finance in the UK as they will complement the existing powers on owner-occupied mortgages.

7.13 In an environment of falling house prices, BTL borrowers could exacerbate the scale of house price falls if they choose to exit from the market and sell their investments. This risk may be particularly acute in an environment of rising interest rates, especially among highly-indebted BTL borrowers who are vulnerable to interest rate rises. Survey evidence suggests that around 40 percent of BTL borrowers would respond to their rental income falling below their interest payments by seeking to sell their property.[4]

7.14 These powers will allow the FPC to tackle both the direct and indirect financial stability risks posed by BTL mortgages as they will be able to limit the proportion of riskier mortgages on bank balance sheets and limit the number of households that might over-extend themselves by borrowing at high LTVs or low ICRs, resulting in a more stable financial system.

7.15 The private rented sector has an important role to play in providing good quality accommodation for those who cannot at this point afford to buy a home, or who do not wish to commit to home ownership for personal or employment reasons. Buy-to-let properties make an important contribution to widen and balance the overall housing market. The government is ensuring the right balance of regulation to protect the interests of tenants, tackle the small minority of rogue landlords, whilst avoiding excessive red tape which could restrict supply or force up rents. While the government recognises the importance of the BTL sector to the economy and the housing market, it believes that it is also important that the FPC should have the necessary tools to address potential financial stability risks stemming from this market.

Public interest

7.16 The FPC's powers will be of interest to the public, particularly businesses that engage in BTL lending and members of the public who intend to take out a BTL mortgage, or are considering doing so. If the FPC use these powers, they will not apply to the existing stock of mortgages, but new loans would be caught. Data from the Council of Mortgage Lenders shows that 51,500 buy-to-let mortgages were advanced in the second quarter of 2016 (including both purchases and remortgages). Readers should

[4] Based on responses to the Bank's NMG survey The analysis relating to this finding is not published in the public domain, but the underlying data can be accessed from the Bank of England website: http://www.bankofengland.co.uk/research/Pages/onebank/datasets.aspx

note that many buy-to-let investors have portfolios of multiple properties and may have more than one buy-to-let mortgage to their name.

Options other than legislation that have been considered

7.17 Alternatives to new legislation have been considered. If the requested powers were not granted to the FPC, the Committee could make use of its other tools. These tools include:

- powers of recommendation;
- alternative FPC tools such as sectoral capital requirements (SCRs) or the countercyclical capital buffer (CCyB); or
- relying on the firm-level regulators to make use of microprudential policy tools.

7.18 The benefits of powers of direction as opposed to the FPC's powers of recommendation are twofold: (1) they provide greater certainty to the FPC as the PRA and FCA are required to comply with the direction; and, (2) they allow for greater accountability and policy predictability as the FPC is required to maintain a statement of policy for each of its direction powers.

7.19 The existing FPC tools (e.g. the Countercyclical Capital Buffer and Sectoral Capital Ratios) would be less effective at addressing the specific channels of risk identified because they work through capital charges for banks rather than directly impacting the ability of highly indebted borrowers. The CCyB and SCR and the proposed BTL tools will operate in together, as necessary, to reduce risk overall.

7.20 Although there are synergies between micro and macroprudential regulation, the objectives of the PRA and FPC differ. The PRA's remit is to promote the safety and soundness of individual firms, whereas the FPC is charged with removing or reducing systemic risks with a view to protecting and enhancing the resilience of the UK financial system. This means that relying on microprudential tools to achieve macroprudential objectives is likely to be less effective than targeted action by the FPC.

7.21 These alternatives are discussed in more detail in the Impact Assessment annexed to this document.

Consolidation

7.22 The instrument makes some minor amendments to the Bank of England Act 1998 (Macro-prudential Measures) (No.2) Order 2015 and the Bank of England Act 1988 (Macro-prudential Measures) Order 2013. The Treasury does not intend to consolidate these Orders at this time, given the minor nature of the amendments and that the provisions of the Orders remain clear despite these amendments.

8. Consultation outcome

8.1 The Treasury's consultation was published on 17 December 2015 and closed on 11 March 2016. It set out the Treasury's view of the role of BTL lending in the economy, the channels through which BTL lending could pose a risk to financial stability, and outlined the tools requested by the FPC. It also included a consultation stage impact assessment and detailed draft legislation. HM Treasury's consultation noted the positive role of BTL properties in the economy and set out the financial stability risks that BTL lending may pose and how the FPC's recommended tools would address these risks.

8.2 There were 20 responses to the consultation, consisting of: 11 lenders, seven associations or trade bodies; one charity; and one joint response from two professors. Not all respondents answered every question posed by the consultation document.

8.3 Almost three quarters of respondents (approximately 88% of those who answered the question) agreed that buy-to-let lending does or could carry risks to the stability of the UK financial system. Of these, some respondents agreed outright but most respondents agreed conditionally. One respondent disagreed outright that BTL lending posed a risk to UK financial stability. Again, nearly three quarters of respondents agreed that the powers of direction should be granted to the FPC or that these were the right levers for the FPC to target.

8.4 A more detailed summary of the responses to the Treasury's consultation is available on its website.

9. Guidance

9.1 The FPC intends to publish a policy statement for the powers of direction provided for by this instrument that would provide more detailed guidance on the Committee's approach to using these powers and the core indicators it would use as a guide to policymaking. This statement will be updated from time to time as required. A draft of the policy statement is available on the Bank of England's website at http://www.bankofengland.co.uk/financialstability/Pages/fpc/policystatements.aspx

10. Impact

10.1 The impact on business, charities or voluntary bodies is that BTL lenders are estimated to face a one-off transitional cost, in aggregate, of approximately £3.8m to facilitate broader data collection.

10.2 The impact on the public sector relate to the administrative costs to the Bank of England, which would be a maximum of £50,000 of one-off costs and £30,000 per annum thereafter.

10.3 An Impact Assessment is submitted with this memorandum and is published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses.

11.2 No specific action is proposed to minimise regulatory burdens on small businesses. However, the FPC may decide to exclude small businesses when using these powers. The FPC is required by Section 9F (3) (a) of the Bank of England Act 1998 to have regard to the principle of proportionality. The FPC has opted to do this in the past, applying a de minimis threshold to its June 2014 recommendation regarding Loan-to-Income (LTI) ratios for residential mortgages. The FPC specified that firms that lent less than £100 million or write fewer than 300 regulated mortgage contracts a year would fall outside the scope of the policy would not have the policy applied to them.

11.3 As set out above, HM Treasury undertook a three-month consultation on the proposed powers of direction for the FPC, and specifically sought views on the impact on small and micro-businesses as set out in the consultation stage Impact Assessment (IA).

Although HM Treasury did receive responses from small businesses, these responses did not provide views on the small and micro-business assessment in the IA. The final IA includes a small and micro-business assessment that reflects comments from the Regulatory Policy Committee on the consultation stage IA. No mitigating actions are included in this instrument as, when considered in aggregate, small and micro firms can pose systemic risks to financial stability. However, the FPC will judge when deciding to use its powers whether it is appropriate to exclude small and micro firms from the scope of the action. The government believes that the FPC, as the UK's macroprudential authority, is best placed to make this judgement.

12. Monitoring & review

12.1 This instrument includes a review provision as required by sections 28-32 of the Small Business, Enterprise and Employment Act 2015. As such, the instrument will be reviewed within five years of coming into force and then at least every five years subsequently. These reviews will assess whether the macroprudential powers have achieved their objective of managing systemic risks in the housing market and if this objective could be achieved with less regulation.

13. Contact

13.1 Christopher Goodspeed at HM Treasury (telephone: 0207 270 5690 or email: Christopher.goodspeed@hmtreasury.gsi.gov.uk) can answer any queries regarding the instrument.