EXPLANATORY MEMORANDUM TO

THE BANK OF ENGLAND ACT 1998 (MACRO-PRUDENTIAL MEASURES) (AMENDMENT) ORDER 2021

2021 No. [XXXX]

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 is made pursuant to sections 9I(2) and 9L of the Bank of England Act 1998. It makes amendments to the following Orders (the "macro-prudential measures Orders") which have been previously made under the same provisions:

- The Bank of England Act 1998 (Macro-prudential Measures) Order 2013/644
- The Bank of England Act 1998 (Macro-prudential Measures) (No.2) Order 2015/905
- The Bank of England Act 1998 (Macro-prudential Measures) Order 2015/909
- The Bank of England Act 1998 (Macro-prudential Measures) Order 2016/1240

2.2 These Orders confer on the Financial Policy Committee ("the FPC"), the UK's macroprudential authority, powers to direct the Prudential Regulation Authority ("the PRA") and the Financial Conduct Authority ("the FCA") to take action with respect to specified macro-prudential measures. The intention of these amendments is to ensure that the macro-prudential measures Orders appropriately track the PRA's new powers that are being introduced under the Financial Services Act 2021.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 This instrument comes into force on the day after the day on which it is made. This is in line with the most recent macro-prudential measures Order (the Bank of England Act 1998 (Macro-prudential Measures) Order 2016) made pursuant to sections 9I(2) and 9L of the Bank of England Act 1998. It is important that the instrument comes in to force as soon as possible after the instrument is made, to ensure that the macro-prudential measures Orders are appropriately updated to track the PRA's new powers which are being introduced as a result of the Financial Services Act 2021.

3.2 The Financial Services Act 2021 provides the PRA with rule-making powers in relation to certain holding companies. As a mirror to this, the Financial Services Act 2021 also extends the FPC's existing powers of direction to allow the FPC to make directions to the PRA in relation to holding companies that have been approved or designated by the PRA. To fully implement these changes, this instrument amends the macro-prudential measures Orders so that the existing macro-prudential measures are capable of being applied to such holding companies. This instrument is therefore required to come into force as soon as possible to minimise any gap in the FPC's powers of direction with respect to the PRA.

3.3 Furthermore, the FPC and PRA are currently undertaking a joint review of the UK leverage framework, which is due to complete in the autumn of 2021. At this point the FPC's macro-prudential measures will need to reflect the changes introduced by the Financial Services Act 2021. This will ensure that the FPC's powers of direction with respect to the leverage framework are operable in practice within the new regime and can be used if the FPC considers it is necessary or desirable to do so to further the Committee's statutory objectives. Further detail on the UK leverage framework is provided in section 7 of this Explanatory Memorandum.

3.4 The macro-prudential measures Orders do not alter or extend the powers of the PRA. The PRA has existing powers to place requirements on certain firms to meet the measures set out in the macro-prudential Orders. The FPC can also make recommendations to the PRA regarding how it uses its powers to place requirements on firms (this can be in relation to, but is not limited to, the measures set out in the macro-prudential measures Orders). The macro-prudential measures Orders provide the FPC with the power to direct the PRA to use its existing powers to take action with respect to specified macro-prudential measures. The amendments to the macro-prudential measures Orders made by this instrument allow the FPC to direct the PRA to implement the measures in those Orders in relation to certain holding companies. The amendments therefore do not in themselves significantly diminish the legal rights of the persons affected, impose new duties on such persons which are significantly more onerous than before, or require them to adopt different patterns of behaviour. The instrument does not involve criminal sanctions.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.5 The territorial application of this instrument includes Scotland and Northern Ireland.

3.6 The powers under which this instrument is made cover the entire United Kingdom and the territorial application of this instrument is not limited by either the Act or by the instrument.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the whole of the United Kingdom.

4.2 The territorial application of this instrument is the whole of the United Kingdom.

5. European Convention on Human Rights

5.1 The Economic Secretary to the Treasury (John Glen MP) has made the following statement regarding Human Rights:

"In my view the provisions of The Bank of England Act 1998 (Macro-prudential Measures) (Amendment) Order 2021 are compatible with the Convention rights."

6. Legislative Context

6.1 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's financial stability objective. The FPC does this by identifying, monitoring and addressing risks to the financial system as a whole. This action to address "systemic risk" is known as macro-prudential policy and complements the responsibilities of the PRA and FCA, who regulate individual firms for soundness and for conduct of business, respectively[1].

6.2 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 macro-prudential tools that are set out in secondary legislation (the macro-prudential measures Orders).

6.3 The Financial Services Act 2021 makes changes to the UK regulatory regime. This includes:

- Amending the Financial Services and Market Act 2000 ("FSMA") to allow the PRA to make rules applying to financial holding companies and mixed financial holding companies that are approved under section 192R of FSMA or designated under section 192T(2)(c) of FSMA ("holding companies").
- Amending section 9H of the Bank of England Act 1998 (directions to the FCA or PRA requiring macro-prudential measures) to include holding companies in the definition of regulated persons to whom a macro-prudential measure can relate to.
- Granting HM Treasury the power, via statutory instrument, to revoke the provisions in the Capital Requirements Regulation ("the CRR") which the PRA will replace with its own requirements in its rulebook. In January, the Government published its intent to revoke provisions in the CRR which relate to the leverage ratio[2] (see paragraph 7.10 of this Memorandum).

6.4 This instrument makes various amendments to the macro-prudential measures Orders to ensure they appropriately reflect the new regime and can operate effectively. This instrument is being made by HM Treasury in exercise of powers conferred by sections 9L and 9I(2) of the Bank of England Act 1998, as amended by the Financial Services Act 2012.

7. Policy background

What is being done and why?

7.1 The FPC's powers are designed to allow the FPC to address systemic risks that threaten the stability of the UK financial system. The Bank of England Act 1998 provides the FPC with two primary tools: powers of recommendation and powers to issue directions to the PRA and the FCA.

7.2 The scope of the direction making power is confined to those measures specified by order by HM Treasury. To date, HM Treasury has granted the FPC power to issue directions in relation to macro-prudential measures specified in four Orders, the relevant instruments are:

- The Bank of England Act 1998 (Macro-prudential Measures) Order 2013/644
- The Bank of England Act 1998 (Macro-prudential Measures) (No.2) Order 2015/905
- The Bank of England Act 1998 (Macro-prudential Measures) Order 2015/909
- The Bank of England Act 1998 (Macro-prudential Measures) Order 2016/1240

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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] https://www.gov.uk/government/consultations/implementation-of-the-investment-firms-prudential-regime-and-basel-3-standards-consultation

7.3 The Financial Services Act 2021 delegates responsibility for the implementation of certain prudential standards to the PRA, subject to a new accountability framework[3]. In addition, it also creates new rule making powers for the PRA with respect to holding companies.

7.4 The intention of this instrument is therefore to ensure the FPC's macro-prudential measures appropriately track the changes introduced by the Financial Services Act 2021, and to ensure that the FPC's tools are operable in practice within the new regime.

Changes related to holding companies

7.5 The Financial Services Act 2021 provides powers for the PRA to make rules which apply to holding companies for the purposes of the CRR and the Capital Requirements Directive, including sub-consolidated and consolidated prudential requirements and rules regarding matters such as governance and group-risk. This power is designed to ensure the holding companies' provisions, which have been introduced through the transposition of the Capital Requirements Directive V (CRDV), can be maintained effectively over time, including for the purpose of the implementation of standards recommended by the Basel Committee on Banking Supervision and ensures the application of the accountability framework contained in the Financial Services Act 2021 wherever this power is exercised.

7.6 Schedule 3 to the Financial Services Act 2021 also provides for the FPC to make directions or recommendations that relate to holding companies, ensuring a coherent regime under which holding companies become responsible for meeting consolidated and sub-consolidated requirements.

7.7 To fully implement these changes some of the macro-prudential measures Orders must be amended so that the measures are capable of being applied to such holding companies. This instrument therefore amends the macro-prudential measures Orders covering the FPC's powers over sectoral capital requirements and the leverage ratio so that the FPC can direct the PRA to implement those measures with respect to certain holding companies. This ensures the scope of the FPC's powers appropriately tracks changes to the PRA's powers in respect of holding companies introduced by the Financial Services Act 2021.

7.8 The instrument includes various other consequential changes. Where the existing macro-prudential measures Orders refer to actions by the PRA in, for example, disapplying certain procedural requirements, they will be amended to include references to any actions taken in relation to rules set for holding companies. Terminology on the use of consolidated basis has also been aligned across the macro-prudential measures Orders. These measures can be applied on a solo basis or on a consolidated basis, i.e. in relation to individual firms or in respect of a group of companies. Where the measures are applied on a consolidated basis, they can be applied at different levels of consolidation: on a consolidated or sub-consolidated basis, i.e. across a whole group of companies or to a group of companies within such a group.

[3] The accountability framework is set out in Part 9D of the Financial Services and Markets Act 2000 (inserted by the Financial Services Act 2021).

<u>*Changes related to the total exposure measure*</u>

7.9 The instrument also makes further amendments to the Bank of England Act 1998 (Macro-prudential Measures) Order 2015/905, which relates to the FPC's powers over the leverage ratio, by amending the definition of the "total exposure measure".

7.10 The leverage ratio is intended to be a broadly risk-insensitive measure of a bank or investment firm's level of leverage (i.e. the ratio of its equity to a measure of its total exposure) and seeks to provide an important complement to the risk-based capital regime. The total exposure measure is the denominator in the calculation of the leverage ratio (Tier 1 capital is the numerator). It is currently defined by reference to the CRR.

7.11 The current definition includes central bank reserves, the exclusion of which the FPC has recommended to ensure that leverage ratio capital requirements do not impede the effective transmission of monetary policy. Since 2016, the FPC has implemented its preferred leverage ratio through its power of recommendation rather than direction.

7.12 In addition, the government has stated its intention to move the detail of the leverage framework exclusively into rules made by the PRA through the powers introduced by the Financial Services Act 2021 which means the PRA will become responsible for defining the total exposure measure on an ongoing basis (subject to the new accountability framework established by that Act).

7.13 To reflect the transfer of the leverage framework from the CRR into PRA rules, this instrument amends the definition of the total exposure measure such that it instead refers to the rules made by the PRA rather than the CRR. This instrument also provides for the FPC to make specifications as to how the total exposure measure is defined for the purpose of implementing a direction in relation to the leverage ratio (e.g. to exclude central bank reserves, if it so chooses). This essentially replicates what the FPC currently achieves through its power of recommendation. As set out in section 144E of the Financial Services and Markets Act 2000, as inserted by the Financial Services Act 2021, where the PRA makes rules to comply with an FPC direction or recommendation those specific changes are not subject to the new accountability framework introduced by the Financial Services Act 2021.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 HM Treasury does not intend to consolidate this instrument or the macro-prudential measures Orders.

10. Consultation outcome

10.1 In its consultation on the Implementation of the Investment Firms Prudential Regime and Basel 3 standards, HM Treasury included a statement noting that it intended to update the macro-prudential measures Orders in order to make them consistent with the new regulatory regime, following the enactment of the Financial Services Bill (now Act)[4]. HM Treasury used this statement as the basis on which to consult with the FPC, as required by section 9(L) of the Bank of England Act 1998. The FPC noted that it agreed with the government's proposed approach outlined in this explanatory memorandum. HM Treasury also consulted closely with officials from the Bank of England and PRA.

10.2 Given the technical nature of the changes, draft legislation was shared with industry representatives on an informal basis prior to finalisation to seek their views. They did not raise any concerns with the substance of the changes in this instrument, although did note concerns around the wider UK leverage framework.

11. Guidance

11.1 HM Treasury does not propose to issue guidance on the content of this instrument. 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.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 An Impact Assessment has not been prepared for this instrument because in line with Better Regulation guidance, HM Treasury considers that the net impact on businesses will be less than £5 million a year. Due to this limited impact, a de-minimis impact assessment has been carried out and is published alongside this instrument.

13. Regulating small business

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

13.2 Most of the macro-prudential measures Orders can be applied to any PRA-regulated UK bank or investment firm. In practice the government believes there is no incremental effect on small businesses from these changes. The changes do amend some macro-prudential measures Orders to allow these measures to be applied to PRA-approved or designated holding companies, consistent with the Financial Services Act 2021. However, this change will primarily be relevant for larger financial institutions.

14. Monitoring & review

14.1 This instrument amends four existing macro-prudential measures Orders. Two of these orders already include a statutory review clause; the Bank of England Act 1998 (Macro-prudential Measures) Order 2013/644 and the Bank of England Act 1998 (Macro-prudential Measures) Order 2016/1240. This instrument amends the two other Orders; the Bank of England Act 1998 (Macro-prudential Measures) Order 2015/909 and the Bank of England Act 1998 (Macro-prudential Measures) (No.2) Order 2015/905 so that they also include a statutory review clause.

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/958183/Prudential_Consultation.pdf

14.2 As such, all four Orders will be reviewed within five years of their respective statutory review clauses 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 to the UK financial sector and if this objective could be achieved with less regulation.

15. Contact

15.1 Will Crabtree at HM Treasury email: will.crabtree@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.

15.2 Lowri Khan, Director for Financial Stability at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Economic Secretary to the Treasury (John Glen) can confirm that this Explanatory Memorandum meets the required standard.