House of Commons

Treasury Committee

Budget 2013: Government and Office for Budget Responsibility Responses to the Committee's Ninth Report of Session 2012–13

Second Special Report of Session 2013–14

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The Treasury Committee

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The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth and Adam Wales (Senior Economists), Hansen Lu, Matthew Manning (on secondment from the FCA), Julia Rangasamy (on secondment from the Bank of England), and Duncan Richmond (on secondment from the NAO) (Committee Specialists), Steven Price (Senior Committee Assistant), Eldon Gallagher and Lisa Stead (Committee Assistants) and James Abbott (Media Officer).

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Second Special Report

The Treasury Committee published its Ninth Report of Session 2012–13, *Budget 2013* on 20 April 2013, as House of Commons Paper No. 1063. The Government Response to this Report was received on 20 June 2013, and the Office for Budget Responsibility Response was received on 6 June 2013. They are published as appendix 1and 2.

The response from the Government is in plain text and the Committee's conclusions and recommendations are in bold text.

Appendix 1: Government Response

Macroeconomy

1. The Committee recommends that the Government publish its analysis of the pros and cons of creating a 'bad bank' for the banks in which the Government has a stake. Such an analysis should include an examination of the fiscal and competition implications, and be completed by the time of the announcement of the Government's spending review in June 2013. (Paragraph 28)

The Chancellor announced at Mansion House on 19 June that in the case of the Royal Bank of Scotland (RBS) the Treasury will evaluate in detail the case for the creation of a bad bank.

The review will be undertaken by the Treasury and will look at a broad range of assets, such as commercial real estate in the UK and in the Ulster Bank, to assess the merits of creating a bad bank. The decision on whether to create a bad bank will be subject to the following three tests, whether it:

i. supports the British economy;

ii. is in the interest of the UK taxpayer, including the taxpayer's interest as an RBS shareholder; and

iii. will accelerate RBS's return to private ownership;

The Government will only establish a bad bank if, as a result of this work, we find that it would achieve these objectives. The Treasury will conclude the review and make a decision in autumn 2013.

For Lloyds, the three objectives of taxpayer value, maximising support for the economy and restoring private ownership are the same but, as the Chancellor said in his Mansion House speech, the bank is closer to meeting those objectives and therefore there is no need for creating a bad bank. As a result, the Government is actively considering options for share sales in Lloyds. However, it does not have a pre-fixed timescale or method of disposal and will only proceed with selling its shares if we achieve value for the taxpayer.

2. The Committee welcomes the Treasury's plans to investigate extensions to the FLS and looks forward to hearing the Government's proposals, especially those that focus on lending to businesses. We note that the Bank of England and the Treasury have a Joint Oversight Board to monitor the scheme closely. In view of our concerns over possible bias in the balance of lending between mortgages and SMEs we recommend that they provide the Committee with regular information on the details of the lending totals and distribution between the sectors. (Paragraph 33)

On 24 April, the Bank of England and HM Treasury announced an extension to the Funding for Lending Scheme (FLS). This extension builds on the success of the FLS so far, and has three main objectives: to give banks and building societies confidence that funding for lending to the UK real economy will be available on reasonable terms until January 2015; to increase the incentive for banks to lend to small and medium-sized enterprises (SMEs) both this year and next; and to include lending involving certain non-bank providers of credit, which play an important role in providing finance to the real economy. Further detail on the extension is available on the Bank of England's website.[1]

The Bank of England and HM Treasury are jointly monitoring the scheme through a Joint Oversight Board. This meets on a quarterly basis where officials from the Bank of England and HM Treasury monitor the performance of banks within the scheme and the key transmission stages. Further detail of this is available in the Bank of England Inflation Report published in November 2012. In brief, the four key stages are:

a) bank funding costs;

b) quoted terms and availability of credit;

c) loan applications and approvals; and

d) the flow of credit and effective interest rates.

Further information on the monitoring of the FLS and an assessment of its performance is available on the Bank of England's website and in their regular publications:

- Inflation Report November 2012, Bank of England;
- Inflation Report May 2013, Bank of England;
- Inflation Report February 2013, Bank of England; and
- Quarterly Bulletin 2012 Q4, Bank of England.

As part of the monitoring of the scheme, the Bank of England published the net lending data and drawings of individual banks on a quarterly basis. The scheme targets the UK real economy as a whole and the published data shows aggregate net lending including households and businesses. A sector-level break down is currently unavailable; however, as the extensions announced will provide stronger incentives to lend to SMEs, the Bank of England will publish net lending figures for 2014 by sector.

1 http://www.bankofengland.co.uk/markets/Pages/FLS/default.aspx

Monetary Policy

3. The changes to the monetary policy remit announced by the Chancellor at the time of Budget 2013 create uncertainty. Their effects will become evident when the Monetary Policy Committee's interpretation of it is clearer. (Paragraph 102)

In publishing this at a time of wide-ranging debate this review sought to bring certainty and a clear process. Monetary policy has a critical role in supporting the economy as the Government delivers on its commitment to necessary fiscal consolidation, and it remains the primary tool for responding to changes in the economic outlook. At Budget 2013 the Government reaffirmed the 2 per cent inflation target and updated the Monetary Policy Committee (MPC)'s remit to clarify the trade-offs that are involved in setting monetary policy to meet a forward-looking inflation target. The Government's commitment to medium-term price stability remains absolute. It represents an essential pre-requisite for economic prosperity.

In reaffirming the 2 per cent inflation target the Government ruled out alternative monetary policy frameworks ending any recent uncertainty about the UK's monetary policy framework. In setting the remit, the Government reviewed the monetary policy framework in historical and international context, and the operation of monetary policy in a number of economies in recent years. The Review was published alongside Budget 2013 and provides further background on the changes that have been made to the remit and the absolute commitment to medium-term price stability that remains at its core.

4. The initial indications are that the MPC's interpretation is one of continuity, rather than change, but the Treasury Committee will use its regular hearings with the MPC to elicit greater clarity about the effects of the change and will launch an inquiry into the conduct of monetary policy. (Paragraph 103)

The Government welcomes the Treasury Committee's continued scrutiny of the conduct of monetary policy. As the Review of the monetary policy framework notes, accountability is an important principle that underpins the UK's monetary policy framework. The MPC's remit sets out that the Bank is accountable to Parliament through regular reports and evidence given to the Treasury Committee.

5. The Bank of England Act 1998 should be amended to require parliamentary approval of remit changes. This would create a higher hurdle to any change and provide enhanced scrutiny. (Paragraph 106)

The Bank of England Act 1998 states that the objectives of the Bank of England in relation to monetary policy are to maintain price stability, and subject to that, to support the economic policy of the Government. Section 12 of the Act requires the Chancellor to specify what price stability is taken to consist of and the Government's economic policy objectives at least once in every period of 12 months beginning on the anniversary of the day the Act came into force.

At Budget 2013 the Chancellor specified price stability as an inflation rate of 2 per cent measured by the 12–month increase in the Consumer Prices Index (CPI), which is the operational target for monetary policy. The Chancellor also confirmed that the

Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries.

The Bank of England Act does not require parliamentary approval of remit changes. Such approval could lead to a prolonged period when the monetary policy framework is publicly under review in Parliament. Greater political uncertainty could be damaging for the credibility of the framework.

The public finances

6. The Government is forecast to meet the rolling fiscal mandate, but not the supplementary target. It has again proposed no further spending cuts or tax rises in order to meet the latter, but has nevertheless kept the target in place. The Government has said that will set a new framework once the exceptional rise in debt has been addressed, taking account of the OBR's assessment of the long-term sustainability of the public finances. We agree with the Government that a new fiscal framework should be published only when the public finances are returning to a more stable position. Public consultation should then take place on the basis of those proposals in an environment that does not endanger market credibility. (Paragraph 62)

At this time of rising debt, the Government remains committed to restoring debt to a sustainable, downward path and reducing the deficit. The Government's judgement is that significant changes to the path of consolidation in the short term would constrain the operation of the automatic stabilisers, limiting their ability to support the economy. The Government is retaining the existing supplementary debt target and the Office for Budget Responsibility (OBR) will continue to assess the Government's performance against it.

As set out in the June Budget 2010, once the public finances are closer to balance, the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

The Charter for Budget Responsibility, approved by the House of Commons in May 2011, sets out the Government's fiscal objectives, fiscal mandate and supplementary debt target. The House of Commons would need to approve any modifications to the Charter, including changes to the supplementary debt target.

7. The OBR turned out to be overoptimistic in its forecast of receipts from the sale of the 4G spectrum. This Committee will ask the OBR for an explanation. We would expect the OBR to consult the NAO. In 2013–14, the OBR estimates that more than £3 billion will be received from the UK-Swiss tax agreement, following the initial £0.3 billion payment from Switzerland in January 2013. We will monitor closely whether the agreement with Switzerland produces the receipts the OBR has forecast for this financial year. (Paragraph 64)

The Government welcomes the Committee's continued scrutiny of policy costings. The sums expected from the sale of the 4G spectrum and Swiss tax repatriation were certified by the independent OBR, which means that in its opinion they represented a reasonable and central view given the information available at the time.

Taxation

8. The change to National Insurance Contributions as part of the Government's implementation of the Single-tier State Pension is the single most significant measure in the Budget for the conduct of fiscal policy. It will not come into effect until after the next election, however. The change will result in higher National Insurance Contributions for employees with defined benefit occupational pension schemes and their employers. There is a risk that this may result in the closure of existing pension schemes. (Paragraph 111)

In January 2013 the Government set out its plans to replace the current two-tier system of basic and State Second Pension with a flat-rate, single tier payment set above the basic level of means-tested support. The Government recognises that the ending of contracting out, necessary as part of this reform, will have an impact on individuals in contracted out schemes and their employers.

The large majority of contracted out employees reaching State Pension age during the first two decades of single tier, around 90 per cent, will get enough extra single-tier pension to offset the increase in National Insurance contributions (NICs) they will pay over the rest of their working lives and any potential adjustments to their occupational pension schemes.

By announcing the single tier start date at the Budget the Government has given employers as much notice as possible to plan for the reforms, and has specified the start date in the Pensions Bill introduced into the House of Commons on 9 May to provide certainty. The Government will work with employers to ensure that the end of contracting out goes as smoothly as possible while continuing to support the provision of good workplace pensions.

Contracting out has proved complex for schemes to administer. While its end will leave legacy issues, it will also be an opportunity to move forward without the legislative restrictions of contracting out. Following abolition, private sector employers will be free to change the benefits their pension schemes provide (as they will no longer be required to meet the Reference Scheme Test), and where their rules prevent them from doing so, the Government will introduce a statutory over-ride which will allow them to change their rules, but only to the extent that they are detrimentally affected by the loss of the rebate. The Pensions Bill contains measures to introduce the over-ride.

9. Tax complexity and instability remain of considerable concern to the Committee. We recommend that the Government set out, in its response to this Report, its assessment of the overall progress it has made against its commitment to simplifying the tax system. The Committee further recommends that in future Budgets the Chancellor make a statement as to whether the overall changes announced simplify the tax system. (Paragraph 120).

The Government is committed to simplifying the tax system, ensuring it is straightforward to understand and easy to comply with. Tax policy making has been improved, with consultation on policy design and scrutiny of draft legislative proposals as the cornerstones. Budget 2013 represents a clear simplification of several areas of the tax system. The Budget announced a significant simplification for thousands of companies by having a single corporation tax rate from 2015. The Government also announced a consultation on simplifying tax administration for the self-employed by using Self Assessment to collect Class 2 NICs. Both of these measures had been recommended by the Office of Tax Simplification (OTS). These build on previously-announced simplifications such as simplifying the administration of IR35 and removing little-used tax reliefs.

Assessing and measuring complexity is not clear cut. The OTS has said that the length of legislation is not a good measure of the complexity of a tax system. The Government also believes that complexity is not just about the tax rules. It is also about how those rules are administered, and the ease with which taxpayers can both calculate and pay their tax.

The Government therefore announced at Autumn Statement 2012 that it would significantly expand online services at Her Majesty Revenue and Customs (HMRC) over the next three years to vastly improve taxpayers' experience of the tax system. The OTS is also working on a project to identify and analyse the reasons for tax complexity, and is developing a complexity index to measure the relative complexity of different parts of the tax system. The Government looks forward to the results of this work.

10. The proposed Employment Allowance may remove a significant number of small businesses from the burden of administering and paying National Insurance Contributions. The Government must ensure that the administrative structure of the scheme facilitates this, rather than resulting in additional administrative burden for employers. (Paragraph 121)

The Employment Allowance will be introduced from April 2014, delivered through standard payroll software and HMRC's Real-Time Information system. To ensure maximum take-up, it will be simple to administer: employers will only need to confirm their eligibility through their regular payroll processes. This confirmation will ensure that up to £2,000 will be deducted from their employer NICs liability over the course of the year's Pay As You Earn (PAYE) payments

The additional burden of the Employment Allowance will be minimised—there will be no complicated forms to fill in. Employers will be able to take the allowance all in one month or as soon as they can if their employer NICs liability in early months is less than the full £2,000, thereby helping improve their cash flow situation there and then.

The Government will engage with representative bodies on the details of the new allowance, including the definition of an employer, to ensure the system is as simple and effective as possible.

11. The Committee accepts the need for the Government to maintain some flexibility in how it sets fuel duty to enable it to respond to economic circumstances. Certainty and stability remain the hallmarks of good tax policy, however. The Chancellor should, as far as reasonably possible, set out his strategy for fuel duty over a rolling five-year period. (Paragraph 125)

The Government has introduced a fair fuel stabiliser which guarantees that fuel duty will increase by no more than inflation in years when oil prices are above £45, consistent with the Government's overall approach of ensuring fuel duty policy responds to wider pressures on pump prices. As the Committee has acknowledged, it is important that the Government retains the flexibility to respond to economic circumstances to support households and businesses with the high cost of fuel. This approach has enabled the Government to ease the burden on motorists by £21.5 billion over the Parliament to 2015–16.

Energy policy

12. The Committee is concerned that the competitiveness of UK business is being undermined by high energy costs, in particular in manufacturing and energy intensive industries. This is a matter of significant concern, especially in the current economic circumstances. To this end, the Committee welcomes the Chancellor's promise of additional support for such firms and will examine closely the support package put in place. However, over the longer-term, the Government must address the underlying causes of competitive disadvantage on energy-intensive businesses, rather than merely seeking to mitigate the impact of its energy policies on a case by case basis. (Paragraph 192)

The competitiveness of UK business is a key issue for the Government and is at the heart of the Government's plan to support growth. The Government recognises the cumulative impact of energy and climate change polices on the most energy intensive industries, which are critical to the UK's growth, and will continue to monitor the impacts of energy policies.

The measures announced to support energy-intensive industries, worth £250 million over the current Spending Review period with further details on compensation in 2015–16 to be announced in June, represents a targeted package that addresses the needs of those whose competitiveness is most affected by government policies. The Government is are also helping energy-intensives through relief from the costs of Electricity Market Reform, subject to state aid, and exemption from the climate change levy (CCL) for metallurgical and mineralogical processes, announced at Budget.

In addition, the Government has announced measures to support the development of the shale gas industry, including fiscal measures to incentivise exploration and technical guidance to provide greater clarity around planning for shale gas projects. Maintaining levels of domestic production is good for the UK's security of energy supply and can be expected to lead to economic benefits, such as the development of the supply chain and a reduced need for energy imports.

The Government is also taking action to support the competitiveness of all UK businesses through, for instance, a further reduction in Corporation Tax to 20% by 2015, and the introduction of a £2,000 per year Employment Allowance for businesses and charities from April 2014 to reduce their employment and NICs bill.

13. The tension between the Treasury and the Department for Energy and Climate Change, and lack of clarity over which department is in the lead on energy policy, has created uncertainty. This must be addressed. It must not be allowed to undermine business and investor confidence. The two departments need to clarify, as a matter of priority, their respective responsibilities. (Paragraph 195)

The Energy Bill is currently making its way through Parliament, as planned, with cross-government support. The Government's Electricity Market Reform introduces the mechanism of Contracts for Difference, providing price certainty for low-carbon investors. These contracts will help developers secure the large upfront amounts of capital investment required for low carbon infrastructure and set the framework for investment in the coming years.

In November 2012 the Government announced the level of funding available for low-carbon infrastructure through the Levy Control Framework out to 2020–21. Spending will rise to up to £7.6 billion in real terms in the final year. This will allow generators to invest with confidence, as they are clear that support is sustainable and affordable, and provide protection for consumers.

Premature disclosure of Budget information

14. Last year we were highly critical of leaks of parts of the 2012 Budget. We recommended then that the Government review its practices for preserving Budget confidentiality. This year a newspaper prematurely released Budget information provided to it by the Treasury. This was extremely serious. The Committee welcomes the Chancellor's recognition that the present Budget briefing arrangements cannot continue. However, the Chancellor also suggested to us that the Permanent Secretary's review might draw on the experience of arrangements of the sort used by the Office for National Statistics when releasing market sensitive material. (Paragraph 203)

15. The ONS says that its 'lock-in' arrangements for the release of market sensitive information allow the media to absorb and understand the significance of a given statistic before it is officially released. This arrangement seeks to ensure that all market participants have access to the same accurate information at the same time through the newswire agencies. When considering the pre-release of ONS data in 2010, the Statistics Authority acknowledged that it might on occasion be helpful for journalists to have extra time to absorb the substance of a statistical release, which might then result in more balanced and considered reporting. But it was also aware of the risks of creating a perception of collusion between the Government and the press, and acknowledged too that Parliament might reasonably expect information at the same time as the press. For these reasons, the only sort of pre-release that it supported was the 'lock-in'. (Paragraph 204)

16. By its practice of briefing media organisations with advance details of the Budget, the Treasury has now fallen into the very trap that the Statistics Authority foresaw—that of creating a perception of collusion between Government and press. The Treasury briefed selected media organisations about the Budget in advance in order to influence media coverage. The 'lock-in' practice of the Office for National Statistics (ONS) seeks to eliminate the scope for market abuse, and allow markets to function; the purpose of the Treasury's actions may have included a desire to obtain better coverage. If so, the two practices are therefore wholly different in purpose and effect. The Committee recommends that there should be no Treasury pre-releasing of Budget information, even in secure conditions. (Paragraph 205)

As the Chancellor has made clear, it is completely unacceptable for details of the Budget to be made public before Parliament is properly informed. The Evening Standard accepted full responsibility for this serious error. As the Committee notes, the Permanent Secretary of the Treasury, Sir Nicholas Macpherson, is conducting a review into the practice of the proactive pre-releasing of Budget information under embargo on Budget day. Sir Nicholas will carefully take into account the Committee's views on this matter when determining the conclusions of his review.

17. Despite our requests the Treasury has not yet had a clear or adequate explanation from the Government for the unacceptable scheduling of this year's or last year's Finance Bills. That is probably because no acceptable explanation can be provided. It gives the appearance of an attempt to close down meaningful scrutiny. We also reiterate our previous recommendation that the Government schedule a longer gap between the publication of the Finance Bill and its Second Reading and between Second Reading and Committee of the Whole House. There should be at least a weekend between Second Reading and the beginning of Committee of the Whole House. (Paragraph 211)

The Government remains committed to enabling full scrutiny of its legislative proposals, and has taken significant steps to improve opportunities for scrutiny, including publishing the majority of the Finance Bill in draft at least three months before the final Bill is published. The Government will continue to look for opportunities to improve scrutiny within the constraints of the Parliamentary calendar.

The Government recognises that the interval between publication of the Finance Bill and Second Reading, and between Second Reading and Committee of the Whole House, has been shorter than in the recent past. However, as the Committee has itself noted, this is largely a consequence of the new pattern of Prorogation and State Opening of Parliament.

Housing

18. The mortgage guarantee scheme, which is due to be introduced in 2014, will result in the state partially guaranteeing the mortgages of people spending less than £600,000 on their homes with a deposit of between 5 per cent and 20 per cent. The pledge will cover a portion of any losses suffered by the lender. This represents a sizeable intervention in the UK mortgage market. (Paragraph 156)

Since the financial crisis, larger deposit requirements and falling equity values mean many credit-worthy households cannot get a mortgage, or are trapped in their existing homes unable to take the next step. A key contributor to this issue is a sharp reduction in the availability of high Loan-To-Value (LTV) mortgages. At the beginning of 2008 there were 754 mortgage products available at 95 per cent LTV, compared with 70 products in February 2013.

Budget 2013 announced Help to Buy, a major new package of measures to increase the supply of low-deposit mortgages for credit-worthy households, increase the supply of new housing and contribute to economic growth. The Help to Buy: equity loan provides a loan worth up to 20 per cent of the value of a new build home, interest free for the first 5 years. Under Help to Buy: mortgage guarantee, the Government will offer lenders the option to purchase a guarantee on mortgages between 80 and 95 per cent LTV, encouraging them to offer more mortgages to borrowers with small deposits.

The Help to Buy scheme sits alongside housing measures to support new development and affordable housing, as well as ambitious reforms to the planning system to encourage sustainable housing development. This combination of measures will help ensure the increased demand from Help to Buy is complemented by an increase in supply.

In designing the scheme, HM Treasury will bear in mind the questions raised by the Treasury Select Committee.

The mortgage guarantee scheme will be designed in a way that does not incentivise irresponsible lending and contains the level of risk borne by the Government. The scheme will be self-financing; lenders will pay a fee which compensates the Government for the excepted losses under the scheme, the cost of capital of providing the guarantee and the administrative costs of the scheme. There will be a cap of £12 billion on the contingent liabilities under the scheme and lenders' losses will be subject to a guarantee cap. The scheme will have robust eligibility criteria to ensure that the scheme is focussed on helping people buy their first home or move home to meet their family circumstances, and to guard against irresponsible lending practices.

The Help to Buy mortgage guarantee scheme is a temporary measure designed to support the market in the aftermath of the financial crisis and will last for three years. After three years, the Government will ask the Financial Policy Committee (FPC) to assess the impact of this scheme on financial stability and advise whether, in light of this assessment, it should be continued. The Government will work with the Governor of the Bank of England and the FPC to finalise the details of the lock mechanism.

19. The Government has justified it on the grounds that first time buyers and others who wish to move properties are unable to do so because of lenders' requirements for large deposits following the financial crisis. The Government says this represents a market failure which it is seeking to address through the mortgage guarantee scheme. The route which the Government has taken to help such people would provide taxpayer compensation for the mortgage lender for a portion of any net losses suffered in the event of repossession. The appropriateness of the taxpayer amassing contingent liabilities in this way needs careful scrutiny. The Chancellor says that expected losses under the scheme will be covered by the commercial fee charged to participating lenders. No details of the proposed level of the fee nor how it will be structured in practice are yet available. Nor has a date been given. (Paragraph 157)

20. The Committee is therefore unable to assess the likelihood that the Chancellor will be correct when he says that expected losses under the mortgage guarantee scheme will be covered by the commercial fee. Furthermore, recent history tells us that the housing market is volatile and the level of repossessions difficult to calculate. We therefore believe that the Government will find it extremely difficult to price the fee in such a way that sharply curtails Exchequer risk. (Paragraph 158)

- The Government will receive a commercial fee from lenders who participate in the guarantee scheme. How will the fee be determined? Will the fee be subject to alteration? (Paragraph 182)

The Government will require lenders to pay a commercial fee for each mortgage in the scheme. This fee will be set so that the scheme is self-financing, and will be set in line with the European Commission's guidance on setting fees for guarantees. To that end, the fee will include: an estimation of the expected losses the Government will incur under the scheme; an adequate remuneration of capital; and administration costs. In order to limit the contingent liability to the taxpayer, this will be capped at £12 billion for the three year scheme.

The fee amount will be calculated following modelling of expected losses and will be subject to regular review, so that it accurately reflects any changes to the expected losses, cost of capital or administrative costs of the scheme. The timing of the fee, and in particular whether it will be charged up-front or on an annual basis, will be determined following more detailed discussions. There is likely to be differentiated pricing for the fee, to reflect the varying levels of risk mitigation offered by the scheme according to the mortgage loan-to-value.

21. The mortgage guarantee scheme also makes the Government an active player in the mortgage market. The Committee is concerned that the Treasury now has a financial interest in maintaining house prices to limit losses to the taxpayer. (Paragraph 159)

The scheme will be self-financing; the commercial fee will cover expected losses.

22. There is a risk that if mortgage lenders begin to exercise reduced levels of forbearance, repossessions may rise and house prices subsequently be lower than they would otherwise. If this happened, and unless this risk was fully priced into the fee, then the Treasury could end up facing large losses on those mortgages it has guaranteed. (Paragraph 160)

In order to participate in the scheme, lenders will be required to comply with the regulator's rules around responsible lending and arrears management. The Mortgage Conduct of Business (MCOB) rules on arrears and repossessions set out by the Financial Conduct Authority (FCA), along with the Pre-Action Protocol rules set out by the Ministry of Justice (MoJ) state that a lender may not repossess a property unless all other reasonable attempts to resolve the position have failed. This includes considering, at a minimum, whether it is appropriate to; extend the mortgage term, change its type, defer payment of interest due on the mortgage, add the payment shortfall to the original mortgage amount or make use of any government forbearance initiatives in which the firm chooses to participate. Each lender must also be able to justify which of these it chooses and explain the actions they have taken to comply with these rules. The lender must also provide the customer with a reasonable period of time to consider proposals for dealing with payment difficulties.

The scheme design will ensure compliance with these rules by setting out clear eligibility criteria for lender participation in the scheme and robust audit mechanisms. The Government is working closely with the FCA and lenders to ensure the scheme design complements these rules.

To further incentivise lenders to exercise forbearance where possible, the lender will retain 5 per cent of the liability of the guarantee amount under the scheme, for example if 15 per cent of the property value is guaranteed, then the Government will pay a maximum of 14.25 per cent. Further to this, there will be a total cap on the scheme of £12 billion over the three year period of the scheme.

23. Professor Nickell of the Budget Responsibility Committee, as well as independent commentators, have argued that the mortgage guarantee scheme will increase demand for housing, but that existing constraints on the supply of new housing—largely as a result of planning laws—will mean that the primary effect of easier credit, at least in the short-to-medium-term may be to raise house prices. It is by no means clear that a scheme, whose primary outcome may be to support house prices, will ultimately be in the interests of first time buyers. This is the group the Government says it wants to help. (Paragraph 170)

The Help to Buy: mortgage guarantee is aimed at making high loan-to-value mortgages available to those who can afford to pay them but who are unable to save the high deposits required by banks in the wake of the financial crisis. According to the Council of Mortgage Lenders (CML), the number of first time buyers has fallen to its lowest rate in 25 years from an average of around 470,000 a year in the early 2000s to only 220,000 in 2012. Further analysis by HM Treasury of CML data shows that the average deposit now makes up 79 per cent of a First Time Buyer's annual income compared to only 36 per cent in the early 2000s. By making available more mortgages at high LTV, this scheme will support the aspirations of first time buyers.

The Help to Buy equity loan scheme is designed to support first time buyers as well as those already on the housing ladder looking to move up. The scheme will provide buyers, who have a minimum 5 per cent deposit, with a maximum 20 per cent equity loan, which they can use to purchase a new build home worth up to £600,000. The equity loan scheme will support credit worthy first time buyers who aspire to own a new build home, but struggle to access or afford the repayments on a low deposit mortgage. Equity loan builds on the successful First Buy scheme, which specifically targeted First Time Buyers.

24. The Committee finds the Chancellor's assertion that increased demand for home ownership and rising prices, resulting from the mortgage guarantee scheme, will trigger a corresponding supply response, unconvincing, at least for the short term. In the longer-term there may be an effect. This would be likely in a well-functioning market. However, the housing market contains severe supply constraints. The Government argues that new supply will be encouraged by the equity loan component of First Buy. This may be the case, but the size of the equity loan scheme, which at £3.5 billion, is dwarfed by the size of the mortgage guarantee scheme—which will make available up to £12 billion of government guarantees, sufficient to support £130 billion of high loan-to-value mortgages. Overall, though, if the Government's priority was housing supply, its housing measures should have concentrated there. (Paragraph 171)

- What are the principal constraints on increasing the supply of housing in the UK? (Paragraph 182)

The Government is taking action to increase housing supply. The Government has undertaken significant reform of the planning system in order to better support sustainable economic growth. The UK has suffered from a longstanding mismatch between housing demand and supply. Under the National Planning Policy Framework (NPPF), local authorities are required to assess and then meet the need for new housing, with a strong presumption in favour of sustainable development underpinning all local plans and decisions. The NPPF has been welcomed by business and house builders and is already having positive results.

The Government has also invested significant funds specifically into supporting new supply. This includes:

- Help to Buy: Equity Loan announced at Budget 2013;
- Get Britain Building scheme to support stalled housing sites;
- Build to Rent, which will lead to £1 billion being invested alongside the private sector to support homes for private rent;
- a new debt guarantee scheme for new build affordable and private rented housing; and
- the New Buy guarantee scheme, for new build housing.

However, supply also responds to demand and builders need to be confident of demand in order to increase supply, so it is important to tackle both sides of the problem. The Help to Buy: Mortgage Guarantee scheme will help to increase demand and provide confidence to builders. The measures announced in Budget 2013 have also been welcomed by house builders, who have confirmed that increasing the availability of mortgages will support housing supply for example Tony Pidgley, chair of Berkeley has said "The biggest problem has always been the mortgages and this is a meaningful number. We will be able to build extra homes because of this."

25. Both Help to Buy schemes are intended as temporary measures. The mortgage guarantee scheme will be open from January 2014 and will run for three years. The temporary nature of this scheme reflects the Government's view that the current scarcity of high loan-to-value lending is primarily a cyclical issue rather than a symptom of a longer-term structural change in the mortgage market. The Government has provided little analysis to support this assertion. Indeed the Council of Mortgage Lenders, who have warmly welcomed the scheme, have attributed the scarcity of such loans in part to higher capital requirements for high loan-to-value mortgages. This could well be justified by assessments of the increased riskiness of such mortgages. Our concern is that, should the current scarcity of high loan-to value mortgages reflect structural rather than cyclical factors, the pressure for Government to extend the scheme in three years time will be immense. The unintended and unwelcome outcome could well be that a scheme designed to deal with a supposedly temporary problem in the UK housing market becomes a permanent feature of the UK housing market. (Paragraph 175)

As set out in the scheme outline document, the Government's view is that the current scarcity of high loan-to-value lending is primarily a cyclical issue rather than a symptom of a longer-term structural change in the mortgage market.

The availability of high loan to value lending has seen a sharp reduction in the wake of the financial crisis. At the same time, the average deposit required for first-time buyers has risen from around 35 per cent of average incomes in 2006 to just under 80 per cent in 2012. It is not just first time buyers who have been affected by the lack of high LTV mortgages.

Across the housing market, residential property transactions fell by around 50 per cent after 2007.

High LTV mortgages have been a long-standing feature of the UK mortgage market, but availability of these mortgages fell sharply following the financial crisis. At the beginning of 2008 there were 754 mortgage products available at 95 per cent LTV, compared with just 70 products in February 2013. The nature of this reduction indicates that the current limited availability of high LTV mortgages is a cyclical issue, directly linked to the financial crisis.

Mortgage lending conditions have had dramatic effects on the wider housing market. Current housing market conditions do not appear to be sustainable into the long-term. The level of property transactions is equivalent to a house selling every 25 years on average. This is around double the long-run average and impractical for a well functioning market. The CML have estimated that the large majority of first-time buyer purchases now require parental assistance – in contrast to conditions before the financial crisis. This is indicative of a market that has not reached a long-term steady-state. The Help to Buy: mortgage guarantee scheme is a temporary measure designed to support the market in the aftermath of the crisis. After the planned three year term of the scheme, the Government will ask the FPC to assess the impact of this scheme on financial stability and advise whether, in light of this assessment, it should be continued.

26. The decision to out-source to the FPC whether to continue with the scheme may be a recognition that curtailing the scheme after three years will be politically difficult, as has been the case with housing support and subsidy programmes in previous decades. However, it is not clear that, given its remit, the FPC is best-placed to take this decision, nor that the decision should be out-sourced at all. (Paragraph 176)

27. As far as can be understood from the Chancellor's evidence, the initiative to seek continuance, or require discontinuance, of the scheme appears to lie both with the FPC and the Government. The Chancellor should clarify whether the above interpretation of his evidence is correct. The FPC was created with a statutory duty of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the Government. The new task given to the FPC is an onerous one, but is particularly so given that it is a new body, and given the current economic and financial climate. The new responsibility for Help to Buy: mortgage guarantee is an extension of the FPC's responsibility beyond its current remit, and one with considerable political implications. Given the considerable challenge already faced by the FPC in creating and implementing new macro-prudential tools in the conduct of its central role, this new responsibility may prove a distraction or burdensome. (Paragraph 177)

- Why was the FPC chosen to make the decision on the continuation of the mortgage guarantee scheme after 2017? (Paragraph 182)

- If the FPC is given responsibility for terminating the mortgage guarantee scheme, will this require a change in remit? (Paragraph 182)

- Against what criteria does the Government expect the FPC to make a decision on continuation of the guarantee scheme? To what extent would the FPC be expected to take into account factors other than those related to financial stability? (Paragraph 182)

- The decision as to whether to continue the guarantee scheme after 2017 could be politically controversial. Does the Government accept that giving this decision to the FPC could affect its ability to perform its core role, namely the pursuit of financial stability? (Paragraph 182)

The FPC was set up to monitor the financial system and take action where it identifies risks to financial stability, for example from conditions in the housing market. The Government will ask the FPC to assess the impact of the scheme on financial stability.

The FPC will provide advice to the Government based on whether or not the scheme should be continued. This is fully consistent with the FPC's primary objective to identify, monitor and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. As such, the Government is not imposing any additional responsibility on the FPC. The Government will work with the Governor of the Bank of England and the FPC to finalise the details of the lock mechanism. The Government will engage with the Treasury Select Committee on this issue ahead of scheme launch.

28. The lack of clarity over whether the mortgage guarantee scheme will be open to those wishing to purchase a second home is concerning on two grounds. First, it is a reflection of the need to think schemes through carefully before announcing them. Second, whilst the Committee is aware of the complexity which may come with an exclusion, we struggle to see the rationale for the taxpayer to stand behind loans for people wishing to own a second property, especially given that the Chancellor has repeatedly stated that the scheme is primarily designed to help people onto the property ladder as well as those who wish to move property. (Paragraph 181)

- Why have second homes not been explicitly excluded from the scheme—is it on grounds of complexity or does the Government wish the guarantee scheme to encourage the acquisition of second homes? (Paragraph 182)

The intention of the Help to Buy package is to help people get a first home or get a bigger home for their family, not a second home. At Budget 2013 the Government stated that the details of the Help to Buy: mortgage guarantee scheme and how it is expected to work will be discussed in detail with industry. The Government is now working closely with lenders to develop the scheme design, including the exclusion of second homes. More details on the scheme will be set out at the Spending Review.

29. The Government's latest intervention in the housing market raises many questions. These questions require answers to allay concerns that the scheme may have unintended and unwelcome consequences:

- The Government has asserted that the current scarcity of high loan-to-value mortgages—whether for cyclical or structural reasons—represents a market failure. What is the Government's assessment of the likely duration of this market failure?

- Does the reduction in the availability of high loan-to-value mortgages reflect temporary/cyclical factors or does it represent a longer-term move by lenders away from such provision?

- If the former, does the Government believe that the availability of high loan to-value mortgages will increase after three years, rendering the scheme unnecessary?

- If the latter, should the Government be trying to reverse the move by lenders away from potentially riskier forms of high loan-to-value mortgage provision? (Paragraph 182)

The housing market has not been functioning well. Housing transactions remain close to half their long-run average, equivalent to houses selling almost once every 25 years. The housing measures, taken together, look to support an increase in activity and a better functioning market. The mortgage guarantee is a time-limited, targeted intervention to meet the specific challenges following the financial crisis. The scheme will help increase availability of high Loan to value (LTV) mortgages bringing more lenders into this market. We believe that this will help increase lender confidence in supporting high LTV mortgages, which will mean government support can then be withdrawn.

The scheme is intended as a temporary measure and will run for three years. This is in line with the Government's view that the current scarcity of high loan-to-value lending is primarily a cyclical issue rather than a symptom of a longer-term structural change in the mortgage market.

- What is the Government's estimate of the number of home owners it expects to be supported by the mortgage guarantee scheme and what estimate, if any, has been made of the number of first-time home owners who will be assisted via the scheme? (Paragraph 182)

The mortgage guarantee will be available on mortgages on homes across the UK. Depending on its final design, it will be sufficient to support £130 billion worth of mortgages, which could benefit up to 190,000 households per year. Bank of England research suggests that around 65 per cent of households in rented accommodation between the ages of 25 and 34 would like to buy a house but cannot afford a deposit. The average deposit now makes up 79 per cent of a first time buyer's annual income compared to only 36 per cent in the early 2000s. The Help to Buy: mortgage guarantee and equity loan schemes will reduce the amount of equity first-time buyers will require.

- What is the Government's estimate of the likely dead–weight costs of the guarantee scheme? (Paragraph 182)

The scheme will be self-financing, thereby covering any potential dead-weight costs.

- What is the Government's estimate of the effect of the guarantee scheme after three years on house prices?

Has any estimate been made of how much higher house prices would be relative to the likely level of house prices in the absence of such a scheme being in place?

- What is the size of the supply response the Government expects as a result of the introduction specifically of the mortgage guarantee scheme?

Over what period does the Government expect any tangible supply response to emerge? (Paragraph 182)

The impact of the scheme will depend on take-up, which will be determined by the design of the scheme. The Treasury is working to develop detailed scheme rules to govern the scheme, which will be shared with the Committee in due course.

Furthermore, the OBR is responsible for producing the official economic and fiscal forecasts. Its *Economic and Fiscal Outlook* sets out the key assumptions, conventions and projections underpinning the forecast, including the forecast for house prices. We expect the OBR to scrutinise a costing of the scheme in due course. The OBR will also set out its updated forecast in due course.

- Will the fee income be 'ring-fenced' or treated as general Government revenues? How will the fee income and the contingent liabilities resulting from the guarantee scheme be treated and reported in national accounts and whole of government accounts? (Paragraph 182)

The financial reporting treatment of the Help to Buy transactions will be determined by the Financial Reporting Manual and the International Financial Reporting Standards.

30. Whatever the merits of its Help to Buy proposals, we note that the Government has focussed on correcting what it sees as market failure in mortgage lending. However, the Budget measures appeared to emphasise less the more serious economic problem: the dysfunctional market for business lending, which it is widely held is causing difficulties for small firms (Paragraph 183)

The Government is also taking action on SME lending. On 13 July 2012, the Government and Bank of England launched the FLS. The Scheme works by reducing those pressures on UK banks in return for increased lending to businesses and households. The FLS creates strong incentives for banks to increase lending to UK households and businesses by lowering interest rates and increasing access to credit.

The Government and the Bank of England recently announced extensions to the scheme to strengthen the incentives for banks to lend to SMEs by putting more weight on SME lending. The Bank is also broadening the reach of the FLS by allowing a wider range of non-bank credit providers to benefit from the Scheme, who in turn lend to the real economy including many small businesses.

Finally the scheme will be extended for one year through to the end of January 2015, beyond the end of the current drawdown window of 31 January 2014. This ensures the Scheme continues to support credit supply by providing insurance against a recurrence of stress in bank funding markets, giving banks and building societies certainty around the cost and availability of funding in 2014. This will ensure banks can continue to provide credit to the real economy if stresses do recur.

The Autumn Statement also confirmed the introduction of a Business Bank to support the development of diverse finance markets for businesses and bring together the management of existing schemes into a single, commercially-minded institution. The bank will manage over £2.9 billion of existing schemes and deploy a further £1 billion of capital. £75 million will be used to invest in support for venture capital, £300 million will be co-invested to encourage new entrants and the growth of smaller providers in the SME lending market.

The Government is also taking action to increase the lending to businesses from non-bank lending channels. The £1.2 billion Business Finance Partnership aims to diversify the sources of finance available to smaller and mid-sized firms and reduce their dependence on bank finance, with the first loans now being arranged.

The Government has also incentivised lenders to lend more to SMEs under the Enterprise Finance Guarantee (EFG) scheme which provides additional lending to viable SMEs lacking adequate security or a proven track record for a normal commercial loan. In 2012–13, 2,500 businesses benefitted from more than £250 million of lending under EFG. The FLS complements the existing government schemes. FLS can be used alongside the EFG, providing lending to viable businesses lacking collateral and can support a range of non-bank lenders building on the diversification of non-bank finance through the Business Finance Partnership.

June 2013

Appendix 2: Letter from the Office for Budget Responsibility

Re: Treasury Select Committee report on Budget 2013

I am writing to respond to some of the recommendations and observations the Committee made in the above report, related to the work of the OBR.

Forecasting and uncertainty

You rightly highlight the considerable uncertainty the surrounds all economic and fiscal forecasts. We have always taken care to emphasise this uncertainty in our publications and in our evidence to the committee. For example, in each of our Economic and Fiscal Outlooks we point out the confidence that should be placed in our central forecast given the accuracy of past official forecasts, through the use of 'fan charts'. We use sensitivity and scenario analysis to show how the public finances are likely to be affected by alternative economic outcomes. And we also set out a detailed comparison of our central forecast with those of other economic forecasters. You urged us to do more to highlight the role and limitations of forecasting. I addressed this issue as part of my spring lecture to Institute and Faculty of Actuaries in May and we will have another opportunity to do so when we publish full details of the model that we use to help us in macroeconomic forecasting later in the year.

In thinking about the OBR's forecasting role it is also very important to remember that our primary duty is to assess the outlook for the public finances, where we have access to information and analysis that is not available easily or at all to outsiders. The path of real GDP—which most outside commentators focus on—is much less important in explaining the public finances than other variables: nominal GDP and its components; average earnings; inflation; labour market developments and interest rates, This was illustrated by the fact that in 2010–11 and 2011–12 the budget deficit shrank as a share of GDP much as the OBR had forecast in June 2010, even though real GDP growth was much weaker than expected. This was largely because nominal GDP and the labour market held up more strongly than we might have expected given the weakness of real GDP.

Fiscal multipliers

The committee noted that IL was sensible to keep estimates of the 'fiscal multipliers' under review. We reviewed the multiplier estimates that were used In the June 2010 forecast in our Forecast evaluation report last autumn, looking at the explanations for forecast errors against subsequent outturns. We will examine this issue again in our 2013 FER this autumn.

Contingent liabilities

The OBR aims to ensure maximum transparency in the reporting of contingent liabilities and other future liabilities, and uses them to assess potential risks to the public finances. In our Fiscal sustainability reports, we have provided analysis of the information on contingent liabilities and other future liabilities available from the Whole of Government Accounts (WGA). So far, for the first two years that the WGA accounts have been published, the greatest contingent liability has arisen from successive governments' financial stability interventions. We have reported on the current and future possible fiscal impact of these financial interventions in every EFO. As you noted, there is a significant delay before contingent liabilities are reported in the WGA. However in the FSRs we do try to look ahead to changes in future contingent liabilities reflecting latest policy developments. For instance in our 2012 FSR, we reported some limited information that was already available on how IIMRC's contingent liabilities for lost revenue on account of oil decommissioning policies would change in their 2011–12 accounts, following the March 2012 Budget measure that provided greater certainty on reliefs from decommissioning oil field assets.

We also considered the Bank of England's new Funding for lending scheme, which was announced in the preceding month, and commented that we thought that this was not likely to give rise to new contingent liabilities in future INCA accounts—because this was expected to involve exchanges of assets between the Bank of England and other banks.

We agree that it would also be useful for us to publish, with each Budget and Autumn Statement, a summary of the available information about the impact on future liabilities of policy measures in that Budget and Autumn Statement. So in future we propose, as a matter of course, to ask the Treasury to identify any changes to future liabilities that it expects from Budget and Autumn Statement measures and we will report them in the relevant EFO. However our Fiscal sustainability report is likely to continue to be our best opportunity to consider all future liabilities in detail.

4G spectrum auction and UK-Swiss tax agreement

We identified both the 4G spectrum auction and the UK-Swiss tax agreement as particularly uncertain policy costings in the 0 BR's annex to the Treasury's Autumn Statement Policy Castings document.

Our estimate for the proceeds from the 4G spectrum auction was based on two separate published analyses of the likely yield, drawing on the results of comparable spectrum auctions outside the UK. Assessing the economic value placed on the 4G spectrum by auction participants and the level of competition between them is inevitably difficult—if the appropriate price was self-evident then there would be no need for an auction.

The key uncertainties for the UK-Swiss tax agreement are the value of UK financial assets in Switzerland and the behavioural response of those individuals with funds in Switzerland. (Indeed, we made a lower estimate of the likely yield than that originally made public by ministers and HMRC because we preferred a lower central forecast for the pool of assets.) We will re-assess the yield from the agreement in our Autumn 2013 forecast and will also assess whether this has implications for the expected yield from the more recent tax agreements with Jersey, Guernsey and the Isle of Man.

Anti-avoidance measure

We agree that the yield from anti-avoidance measures is generally more uncertain than that from other policy measures and we have highlighted the particular uncertainty of such costings in our policy costings annexes. Key uncertainties include how much avoidance is currently taking place and the extent to which firms or individuals have opportunities for other avoidance routes. Many avoidance costings allow for attrition, in other words an expectation that revenue from the measure will decline over the forecast period as new avoidance routes are discovered. We are working with HMRC to improve the evaluation of anti-avoidance measures. We hope this will help improve future costings, for example the attrition rates adopted.

When we receive costings for anti-avoidance measures, we routinely ask whether there is evidence on the likely yield from similar measures in the past. But unfortunately there is a limit to what can be learned from examining past anti-avoidance measures, as there is always considerable uncertainty regarding what the path of receipts would have been in their absence.

Robert Chote, Chairman, Office for Budget Responsibility

6 June 2013