



BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
London
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26 November 2013

Dear Chancellor,

Thank you for your letter of 26 November requesting that the Financial Policy Committee (FPC) undertakes a review of the role for the leverage ratio within the capital framework for UK banks, building societies and large investment firms.

I agree that the time is now right to commission such a review. A judgement on the appropriate calibration for a leverage standard cannot be made until the exact definitions for the leverage ratio are finalised. These definitions are due to be agreed internationally by the Basel Committee on Banking Supervision early in the New Year. In light of that, the European Union will finalise its rules on the disclosure of leverage ratios, ahead of their coming into effect on 1 January 2015. Important elements of the resolution regime for systemic banks will also fall into place during 2014: the rules to introduce a Recovery and Resolution Directive within the European Union are set to be finalised; the Financial Stability Board is due to publish proposals on the quantum and location of gone concern loss absorbing capacity required to support resolvability; and the implementation of national structural reform measures, following the recommendations of the Independent Commission on Banking, are due to be assessed. These decisions on resolution will form part of the overall capital framework, of which the leverage ratio is also part.

My view has been that a minimum leverage ratio is a vital component of the overall capital framework. As I said to the Treasury Committee in February, if I were to choose just one reason why Canadian banks fared as well as they did through the crisis, it would be because they were subject to a leverage standard. It is, therefore, crucial that we have an appropriately calibrated minimum leverage ratio for UK banks. There is also a compelling logic to being able to move that minimum in the light of any variations in the corresponding risk-weighted standards. Were the FPC to direct the regulators to increase risk-weighted standards without a proportionate increase in the leverage standard, there would be an incentive for banks to concentrate their balance sheets in apparently low-risk assets, or to understate the risks on existing assets. For similar reasons, the Independent Commission on Banking recommended that ring-fenced banks be subject to a proportionally higher leverage ratio requirement, in line with the higher-risk weighted minimum requirements they will face.

As you suggest, once the Basel work on the definition of leverage is complete, Bank staff will be able to finalise the terms of reference for the FPC's review. As well as considering the leverage standard required to ensure the system is sufficiently resilient, the review will also need to assess how this standard should apply to ring-fenced banks. The Committee will need to assess the impact of leverage standards on lending generally, and on those businesses with high concentrations in low-risk-weight assets, where a leverage constraint could be more likely to bind, in particular. I would expect that the FPC would be able to complete its review within a twelve month period.

The FPC will publish some high-level considerations, along similar lines, on the role of the leverage ratio within the overall capital framework in a box within its *Financial Stability Report*, on Thursday 28 November.

Yours,
