BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
London
SW1A 2HQ

31 October 2014

Dear Chancellor,

I am pleased to send you the Financial Policy Committee's *Review of the Leverage Ratio.*

The document is the culmination of a year's work since you asked the FPC to review the role for the leverage ratio within the capital framework for UK banks. You also asked the Committee to assess the full set of powers that it would need in relation to a leverage ratio, including ahead of the introduction of any common international standard, in order to meet its primary objective of promoting financial stability in the UK and, subject to that, supporting the economic policy of HM Government.

Following its review, the Committee has concluded that there is a strong case for introducing a leverage ratio in the UK ahead of an internationally-agreed standard and that it should apply to global systemically important banks and other major domestic UK banks and building societies. The number of systemically-important institutions present in the United Kingdom and the size of the UK banking system relative to the domestic economy reinforce the importance of building a complementary and robust supplementary leverage requirement to address risks that are not adequately dealt with by the risk-weighted capital framework and to respond to risks to financial stability that might emerge before any international standard on leverage is agreed and implemented. Authorities in some other major jurisdictions have already implemented leverage ratio regimes recently with similar considerations in mind.

In carrying out its review, the Committee has considered the responses to its public consultation and assessed the impact of the leverage ratio framework on capital levels for different types of financial institution, on the financial system, and on economic growth. The Committee believes that its proposals for the design and calibration of the framework will lead to prudent and efficient leverage ratio requirements for the UK financial system.

The Committee's proposals include a minimum leverage ratio requirement; a supplementary leverage ratio buffer for systemically important firms, whose failure would be most destabilising for the UK financial system; and a countercyclical leverage ratio buffer. The FPC judges that this strikes the right balance between ensuring the simplicity of leverage ratio requirements, establishing a framework that protects and enhances financial stability, and the FPC's secondary objective to support growth and employment.

It is critical that our proposal is seen in its entirety and as part of a broader capital framework that will, in due course, include requirements for the total loss absorbing capacity that globally systemic banks must have.

The Committee's judgement is that the minimum leverage ratio would be set at 3% which - taken together with the ability to impose supplementary buffers in response to risks posed by systemically important firms and the credit cycle - is consistent with historic loss experiences and the Basel standardised approach to risk weights. The Committee was mindful that 3% leverage is consistent with the minimum Tier 1 risk-weighted capital required against mortgage lending under the Basel Standardised Approach.

The Committee judges that leverage ratio buffers should be set in proportion to corresponding risk-weighted capital buffers. In this way, the relationship between leverage and risk-weighted regimes will be fixed: the leverage requirement of each institution will be 35% of its pillar 1 risk-weighted capital requirement.

Each systemically important institution will therefore face a supplementary leverage ratio buffer of 35% of its corresponding risk-weighted systemic risk buffer. Similarly, as a guiding principle, the Committee expects to set the countercyclical leverage ratio buffer at 35% of the risk-weighted countercyclical capital buffer (CCB) rate. As you know, the Committee sets the CCB each quarter, and it is currently set at zero. The ability to vary the leverage ratio with the CCB is critical to the calibration of the baseline requirement. Without it, the appropriate baseline would be materially higher.

While the FPC has agreed the relationship between the risk-weighted and leverage regimes, the precise calibration of the leverage requirements for some firms will depend on the finalisation of the risk-weighted requirements on which they will be based. In particular, the risk-weighted supplementary capital buffer for large domestic UK banks and building societies, including ring fenced banks - 'the 'systemic risk buffer' (SRB) - has not yet been set and the legislation establishing it will soon be considered by Parliament. Once the legislation is in place, it will fall to the FPC and the PRA to set the SRB. We would consult on the appropriate design and calibration of the SRB as part of establishing the framework.

Given the continuing international debate, the FPC will review progress towards an international standard for a minimum leverage requirement in 2017 and consider the implications for the UK leverage framework.

Yours sincerely,