



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

31 October 2014

Dr Mark Carney
Governor
Bank of England
Threadneedle Street
London
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Dear Mark,

THE FPC'S REVIEW OF THE LEVERAGE RATIO

Just under a year ago, I wrote to you requesting that the FPC undertake a review of the leverage ratio. Today, I welcome the publication of the Financial Policy Committee's (FPC) response, the *Review of the Leverage Ratio*. The *Review* is the culmination of almost a year's work by the Committee and is another step towards providing greater certainty on the medium term capital framework for UK banks. The *Review* also marks another step towards a safer, more resilient financial system that provides the services and lending vital to a growing economy, while also protecting taxpayers from the costs of financial crises.

Reform of the UK's financial sector regulation and a strong and stable financial system are key elements of the government's long-term economic plan. This government has undertaken a wide-ranging programme of fundamental reforms to the UK's financial regulation as set out in the Financial Services Act 2012. We have learnt from the mistakes of the past and established focused regulators with clear objectives. The FPC is a vital part of this system: ensuring that risks to financial stability at a system-wide level are identified, monitored and addressed.

The government's reforms are based on four years of analysis, consultation and legislation to reform the UK's financial sector. They represent the biggest ever overhaul of Britain's banking system. In 2010, I asked Sir John Vickers to lead the Independent Commission on Banking which made recommendations for fundamental reform of banking, including the creation of ring-fenced banks to protect the essential functions of retail banking. In 2012, in response to the LIBOR scandal, I recommended to Parliament the creation of the Parliamentary Commission on Banking Standards. The Banking Reform Act 2013 implemented the key recommendations of the ICB and the PCBS. The work to raise the standards of conduct in the financial system is continued by the Fair and Effective Markets Review that I announced in June 2014.

Both the ICB and the PCBS recommended introducing a leverage ratio to strengthen the capitalisation of our major banks. I believe that the leverage ratio is a key part of the new, framework that the government and the Bank of England are putting in place to strengthen

the UK banking sector. That is why I requested that the FPC undertake a review of the leverage ratio and its role in the regulatory framework.

The *Review* makes a strong, evidence-based argument for the implementation of a leverage ratio framework as a complement to the existing risk-based capital requirements. I am pleased that the final proposals are clear and simple and include an indication of the proposed level of calibration. This was a strong message from the feedback to the FPC's consultation process.

I accept the recommendations made to the Treasury in the *Review*. Consistent with my commitment to complete in this Parliament all the legislation required to implement the government's overhaul of the banking system, I will take forward legislation to grant the FPC new powers of direction over the Prudential Regulation Authority (PRA) in this Parliament.

Specifically, I will propose to Parliament that the FPC be granted powers of direction regarding:

- a minimum leverage ratio that will apply to all PRA-regulated institutions; this will apply to G-SIBs and other major domestic UK banks and building societies with immediate effect and to all PRA-regulated institutions from 2018;
- a supplementary leverage ratio buffer for Globally Systemically Important Banks, ring-fenced banks and large building societies; the G-SIB leverage buffer will be phased in in parallel with the G-SIB risk-weighted systemic buffers as from 2016 and the leverage buffer for ring-fenced banks and large building societies will apply from 2019; and
- a countercyclical leverage ratio buffer that will apply to all institutions subject to the minimum; this will come into force to the same timescale as the minimum requirement.

Once the legislation is in force, the PRA will need to consult on any rules used to implement the countercyclical leverage ratio buffer prior to its first use.


You have provided a clear indication of the level of calibration for the leverage ratio framework. This is a matter for the FPC and not for HM Treasury or for Parliament. However, it is extremely helpful for me and for Parliament to understand the FPC's thinking on calibration. You are proposing a minimum leverage ratio of 3% which is consistent with the de facto international standard. For G-SIBs, you are proposing that the leverage buffer rate is set at 35% of the risk-based G-SIB buffer which results in static leverage ratio requirements including supplementary buffers in the range of 3.3% to 3.9% for the UK's four G-SIBs. For ring-fenced banks and large building societies, you also propose a relationship of 35% between the Systemic Risk Buffer (SRB) and the leverage ratio. However, as the *Review* notes, once the government has legislated to implement the SRB in the UK, the FPC and PRA will then need to finalise the framework for applying the SRB to ring-fenced banks and large building societies. The government intends to lay the SRB

legislation in Parliament before the end of this year, and the SRB framework will then be set as part of your work on the medium term capital framework in 2015. Until that framework is set, it is not possible to say what the static leverage ratio requirements, including supplementary buffers, will be for individual ring-fenced banks and large building societies, though as the *Review* sets out, they will fall within a range of 3.0% to 4.05%.

While I fully accept the logic for establishing the relationship between the SRB and the leverage buffer at 35%, I believe that more work is required to understand the impact of the resulting leverage ratios on individual ring-fenced banks and large building societies once the SRB framework is set. I am encouraged therefore that you plan to consult extensively next year on the FPC's and PRA's proposals for the SRB framework. That consultation should address the impact of different levels of calibration for the SRB on important factors such as: the levels of lending to the real economy; the degree of competition in retail banking; the impact on lenders with low average risk weights; and the maintenance of a diverse set of business models in the banking industry. I would be grateful if Bank staff could consult with HMT officials in finalising the terms of reference for the consultation on the SRB framework. Given the importance of these issues, I believe that a consultation of 2-3 months will be necessary to provide firms with adequate opportunity to feed in their views and to shape the conclusions of the FPC and PRA Board.

I note that the FPC intends to require that leverage ratio requirements be met using a minimum amount of Core Equity Tier 1 (CET1) capital (at least 75 per cent) for the minimum requirement and that all leverage ratio buffers should be met using CET1 exclusively. The Basel agreement currently requires banks to disclose their leverage ratios using a total Tier 1 definition of capital with no restrictions on the use of Additional Tier 1 (AT1). The Basel Committee on Banking Supervision will undertake a review of leverage ratio capital standards in 2017 and I would like your assurance that the FPC will review its own approach in the light of the Basel Committee's conclusions. I remain keen, as I know you are, for the UK's approach to be consistent with international standards and definitions for the leverage ratio.

I thank the Committee for their excellent work in preparing this report and providing me with a strong set of proposals that I can present to Parliament for approval.

A handwritten signature in black ink, appearing to read "George Osborne". The signature is fluid and cursive, with a period at the end.

GEORGE OSBORNE