BANK OF ENGLAND

Mark Carney
Governor

Mario Draghi
Chair of ESRB General Board
Kaiserstrasse 29
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Germany

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Dear Mario,

UK countercyclical capital buffer rate

In accordance with Article 136 of Directive 2013/36/EU (CRD IV), I am writing to notify the European Systemic Risk Board that the UK countercyclical capital buffer (CCB) rate has been set at 0 per cent, as announced in the Bank of *England's Financial Stability Report* which was published today. More information on the UK's approach to setting the CCB rate is provided in the annex to this letter.

Yours sincerely,

Annex: Further information on setting of the UK CCB rate

Information required to be published under CRDIV	Latest data
Applicable countercyclical buffer rate	0%
Credit-to-GDP ratio	162.9%
Deviation of credit-to-GDP from long-term trend	-18.7%
Buffer guide	0%

<u>Justification for the buffer rate</u> (source: June 2014 *Financial Stability Report*)

As part of its discussions, the Financial Policy Committee considered the so-called 'buffer guide' – a simple metric identified in Basel III and EU legislation, which provides a guide for the CCB rate based on the gap between the ratio of credit to GDP and its long-term trend. Legislation requires the Committee to calculate and consider this guide although there is no simple mechanical link between the guide and the setting of the CCB. As the Committee has stated in its Policy Statement on the CCB, it will use its judgement in setting the CCB, looking beyond the guide at a wider set of core indicators, other relevant metrics, supervisory and market intelligence and information from stress tests.

At over 160% of GDP, the level of aggregate credit in the UK economy remains very high, and at a sectoral level, household and corporate debt levels remain high relative to income. But weak credit growth since the peak of the crisis means that the credit gap has been strongly negative recently, and so the buffer guide has been at 0%.

The Committee's core indicators look at aspects of balance sheet stretch in banks and other sectors and terms and conditions in markets. With regards to bank balance sheet stretch, most of the core indicators on bank resilience – such as capital, leverage ratios, and dependence on short-term wholesale funding – have improved recently. Though further improvements are still required, levels of resilience are markedly higher than before the crisis.

In terms of non-bank balance sheet risks, most aggregate indicators of UK imbalances outside the banking sector – such as the UK net foreign asset position – have fallen over the past year. An exception, however, is the current account deficit, which at 5.4% of GDP in 2013 Q4 is close to historical highs.

The core indicators point to an easing of terms and conditions in markets, with some signs of increased risk-taking. Indicators of volatility are close to pre-crisis lows, for example, and corporate bond spreads have narrowed. Insights from market intelligence and non-price data not covered by the indicators also provide further evidence of search for yield activity in some financial markets.

As discussed above, some aspects of the financial system might be vulnerable to shocks. But the Committee also noted that actions by banks, including in response to increased regulatory requirements, were leading to increased capital ratios. The Committee did not currently have detailed information on how banks' capital positions might evolve through a period of stress. But the 2014 stress test, which includes shocks to interest rates and the housing market, should help to identify any weaknesses in UK banks' capital resilience.