

Cheaper Debt or Weaker Guardrail? The Barclays Proposal Splitting the Bank of England

Introduction

The UK government will spend close to £111.2bn servicing its debt this year, more than the entire schools budget. With 30-year gilt yields at their highest since 1998 and the Chancellor's fiscal headroom at just £23.6bn, the pressure on the public finances is not letting up. A proposal sitting with the Bank of England's (BoE) regulators claims to offer £2.5bn of annual relief and doing so without raising a single tax or cutting a single service.

When Chancellor Reeves delivered her Spring Forecast in March, the headline figures offered some relief, with the OBR forecasting borrowing would fall from 4.3% of GDP in 2025-26 to 1.6% by 2030-31, with fiscal headroom rising to almost £24bn. But the underlying position is more precarious, with public sector net debt representing 94.3% of GDP, and with thirty-year gilt yields having recently climbed to 5.78%, their highest since 1998. According to OBR sensitivity analysis every 25bps rise in government borrowing costs add ~£2.5bn to the annual debt-servicing bill, the same figure Barclays claims its proposal can save. Compounding the pressure, the traditional base of long-dated gilt buyers was pension schemes using liability-driven investment strategies, and in the last decade, there has been a structural decline in their demand for gilts. With declining structural demand, a central bank still actively selling, and a nation faced with large financing requirements, the question of who buys Britain's debt is becoming as important as how much of it there is.

Last month, Barclays proposed the BoE and the Prudential Regulation Authority should adjust the way the leverage ratio, a capital rule applied to the UK's largest banks, treats holdings of UK government bonds. Barclays argues that gilts held by banks purely for liquidity and hedging purposes, not those pledged as collateral, also known as unencumbered gilts, should be excluded from the leverage ratio denominator. If these unencumbered gilts were excluded from the leverage ratio, Barclays argue demand for UK gilts will increase by ~£150bn, estimating a reduced government spending for debt servicing by £2.5bn annually.

Understanding the Leverage Ratio

To grasp the implications behind this proposal, it is important to understand the purpose of bank capital regulations, which is to ensure banks hold enough equity to absorb losses before they fall on depositors or creditors. The modern framework for bank capital regulation is Basel I, introducing the concept of risk-weighted assets and it is based on the fundamental concept that banks hold more capital against risky assets (RWAs). Under Basel III, banks are required to hold a minimum quantity of high-quality capital, such as retained earnings and common equity, measured as Common Equity Tier 1 (CET1), as a proportion of their RWAs, giving a CET1 ratio. CET1 is the highest quality of capital that can absorb losses during a going concern scenario. The Basel III accord introduced a regulation for commercial banks to hold a minimum CET1 ratio of 4.5%, with banks also required to hold a buffer of a further 2.5%, bringing the effective minimum to 7%.

Such risk is assigned to each asset class based on the credit risk, with cash and claims on central banks carry a 0% risk weight, likewise does sovereign debt denominated and funding in the country's home currency. Moving up the risk spectrum, interbank exposures to well-rated institutions have risk weights anywhere between 20-30%, with residential mortgages and investment-grade corporates exposures being higher. At the far end of the spectrum, subordinated debt carries 150%, while equity exposures can be weighted at 250% for standard holdings and 400%

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for speculative positions. The practical implication is under risk-weighted rules, a UK bank holding gilts requires almost no capital against that position.

Building up to the 2008 financial crisis, many banks looked well capitalised on paper, with healthy CET1 ratios, however following the financial crisis it became apparent these banks had built excessive off-balance sheet leverage. In response, Basel III introduced a non-risk sensitive 'backstop' alongside the risk-weighted framework, called the leverage ratio. It is Tier 1 capital, divided by the total balance sheet exposures, with no risk adjustment, treating every asset the same regardless of credit quality, meaning a Gilt would be treated the same as a leveraged loan. Tier 1 Capital mostly consists of CET1, alongside some additional hybrid instruments, such as Contingent Convertible bonds (CoCos), designed to absorb losses before the bank fails. The Financial Policy Committee (FPC), a body within the BoE, set the UK minimum at 3.25%, implying a maximum leverage of ~31 times Tier 1 capital, with the logic that it can constrain excessive leverage, but isn't so binding to displace risk-sensitive. As a result, UK banks operate under two distinct capital constraints system, with the CET1 ratio governing the risk-sensitive dimension, asking how much high-quality equity a bank holds relative to the riskiness of what it has lent and invested, whereas the leverage ratio is an absolute dimension.

Under the standardised approach to credit risk, as previously mentioned, the risk weighted framework includes a national discretion that allows jurisdictions to apply a 0% risk weight for sovereign exposures denominated and funded in domestic currency. In practical terms, a UK bank holding £1bn in gilts is required to hold no additional capital against that position, treated as if they carry zero credit risk. This means a bank can grow its gilt portfolio without limit and its CET1 ratio will be entirely unaffected, making gilts an attractive asset for UK banks.

However, the leverage ratio dismantles this preferential treatment entirely, because every asset on a bank's balance sheet uses up an identical amount of Tier 1 capital relative to its size, thus a £1bn gilt position and a £1bn portfolio of risky corporate loans makes identical demands on Tier 1 capital. This creates an economic disincentive for banks, where they could seek higher returns on other assets. As mentioned above, banks operate under two parallel capital constraint regimes, so for a bank whose leverage ratio is comfortably above its minimum requirement and the CET1 ratio is the constraint, the zero risk weight on gilts remain advantageous, so such a problem only arises when the leverage ratio is the binding constraint.

The BoE December 2025 Financial Stability Report noted that the leverage ratio is now the binding capital constraint for three of the seven major UK banks (Barclays, HSBC, Lloyds Banking Group, Nationwide, NatWest Group, Santander UK and Standard Chartered). This implies that as the banking system has shifted to safer assets with lower risk weight, the leverage ratio is no longer a backstop as designed, but instead a binding constraint which is impacting capital allocation. Average risk weights across major UK banks have declined from ~37% to ~30% in the last decade, with BoE estimating this is a fall in required capital of ~£60bn relative to what would have been the case had risk weights remained unchanged. Thus banks with low average risk weights are more constrained by leverage ratio requirements. As this leverage ratio is becoming a growing constraint, expanding a gilt portfolio carries an identical capital cost to writing a leveraged corporate loan, thus limiting capital available for low risk-weight activities, as banks optimising return on Tier 1 capital with favour higher-yielding assets over gilts.

The UK as an Outlier

The leverage ratio disincentive for government bond holdings is not unique to the UK, however the UK's framework around the backstop does make it more binding than elsewhere in the developed world. The UK's minimum leverage ratio, set by the Financial Policy Committee and implemented by the PRA, requires in-scope firms to hold Tier 1 capital of at least 3.25% of their total leverage exposure measure at all times, with at least 75%

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of that minimum met with Common Equity Tier 1 capital. This minimum is already above the Basel III international standard of 3%, and consists of an additional two layers, a Countercyclical Leverage Ratio Buffer (CCLB) and for systematically important firms, an Additional Leverage Ratio Buffer (ALRB). The CCLB is at 25% of their institution-specific countercyclical capital buffer rate, while the ALRB at 35% of the higher of the firms buffer rates, and both must be met entirely with CET1 Capital. These additional requirements have created a total capital stock which can sit comfortably above the 3.25% headline for most major banks.

The consequence of these additional requirements is notable when comparing to the EU, with the EU imposing no equivalent leverage buffers beyond the Basel minimum. The treatment of central bank reserves in the leverage ratio denominator is also unique for the UK, with the typical denominator of the leverage ratio capturing the total balance sheet, the UK applies a conditional exclusion for central bank claims, with the Leverage Exposure Measure excluding assets with claims on central banks when matched by liabilities denominated in the same currency and for the similar or longer maturities. This exclusion rule is a fundamental component to Barclays proposal for gilts, arguing if the most liquid sovereign-adjacent asset, central bank reserves, are excluded, why not the most liquid ones as well?

The European Contrast

EU banks are subject to a minimum Tier 1 leverage ratio requirement of 3%, with some individual banks subject to a specific Pillar 2 leverage ratio add-on imposed by their supervisors. Unlike the UK, the EU has introduced no CCL or ALR buffers. Thus, the aggregate effective requirement is materially lower than in the UK. Additionally, while the UK permanently excludes central bank reserves from the leverage ratio denominator, the ECB granted relief on central bank exposures from 2020 to early 2022 in response to the pandemic, but allowed it to expire, this today, European banks report leverage ratios today against a denominator that fully includes their central bank reserve holdings, a larger denominator than their UK equivalents face. Despite this, the EU clears its minimum with substantial room to spare, with the weighted average leverage ratio across institutions stood at 5.9% in Q2 2025, representing a headroom of ~290bps.

The more fundamental European advantage however lies not in the leverage ratio at all, but in the risk-weighted framework that sits alongside it. Under Article 114 (4) of the CRR, exposures to EU Member States' central governments and central banks that are denominated and funded in the domestic currency are assigned a risk weight of 0%, and due to the common currency in the eurozone, the exemption applies to all banks in the area, extending the preferential treatment to cross-border sovereign holdings, ignoring differences in credit risk between Member States. Consequentially, the majority of the sector faces CET1 ratio as the binding constraint, and the leverage ratio still acts as a backstop. According to IMF data cited in the Barclays report, holdings of national sovereign debt by domestic banks are relatively low in the UK at 7% of total sovereign debt, compared to 13% in the US, 16% in France and 18% in Germany. This is clear indication that portfolio management is pushing UK banks away from gilts towards higher-yielding assets, generating the same leverage ratio capital cost at a better return.

Another dimension of the UK's outlier status is the divergence in the direction of regulatory activities. While the UK is receiving proposals whether to increase bank holding domestic sovereign debt by relaxing the leverage ratio, European regulators and policymakers are engaged in the opposite conversation, discussing how to reduce the concentration of domestic sovereign debt on European bank balance sheets. The origins of the European debate lie in the 2010-12 eurozone sovereign debt crisis which led to the "doom loop", a cycle where sovereign stress went into bank balance sheet losses, which damaged confidence in the sovereign's ability to backstop its own banking sector, pushing sovereign yields higher and completing the vicious circle. In response, a policy debate

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opened on whether the zero risk weight treatment of sovereign debt, the very feature that made European banks natural holders of government bonds, should be reformed or constrained.

Fiscal Relief Through Regulatory Reform: The Barclays Gilt Exemption Proposal

As previously discussed, Barclays is essentially arguing that since central bank reserves are already excluded due to their high liquidity and low risk, unencumbered gilts should be treated the same. The scale of this reform could be transformational for the UK banking system, as Barclays estimates that banks would absorb up to £150bn in additional government debt. For banks, aside from improving the leverage ratio headroom, they would also satisfy their liquidity requirements, would be reduced vulnerability to gilt market volatility, as this reform can attract a deeper investor base with structural reasons to hold gilts, and a reduction in gilt yields could also spill on the lowering the cost of a new fixed-rate mortgage for households, a politically significant benefit for the government.

In November 2024, the UK Chancellor challenged the BoE to consider how they could “enable informed and responsible risk-taking” while also adhering to their objectives around financial stability and growth. This led to the Financial Policy Committee (FPC) to launch a review of the UK’s bank capital requirements in December 2025, which reduced its benchmark for system-wide Tier 1 bank capital from 14% to 13%, and signalled that it is reviewing the effectiveness of leverage ratio as part of a broader assessment of the capital framework. Following this, on March 20th, 2026, the BoE hosted a debate to gather evidence from a range of stakeholders on the FPC’s assessment. There was a recurring theme of concern towards the fact that the leverage ratio may be operating as a binding constraint for lenders, rather than as a backstop. Others notes that if the FPC were to reduce the leverage ratio even further this would give an incentive to banks to conduct more low risk-weighted business, such as repo lending to non-bank financial institutions, rather than encouraging riskier, but growth supporting lending to the economy. The Barclay’s proposal now raises some questions; while it gives a solution to the current constraints facing the UK banks, it opens a debate about the role of the leverage ratio and the balance between financial stability and economic efficiency.

The Bank will summarise the evidence received at the debate and also written evidence submitted by stakeholders on issues identified in the review from December, and the FPC will provide and update on the next steps in its assessment of the capital framework in the July 2026 Financial Stability Report (FSR).

The counterargument: Is the guardrail being dismantled?

One key criticism of Barclays proposal is the conflict of interest. As one of the largest banks in the UK, Barclays would directly benefit from looser leverage constraints, gaining balance sheet flexibility and potentially increasing their revenue. This raises questions on whether the proposal was motivated by self-interest or systematic efficiency.

Sam Woods, then chief executive of the PRA and deputy governor of the BoE, who described granting banks and building societies capital relief on their gilt holdings, as “profound and highly risk” as it would allow a very large increase in bank leverage given the size of the banks’ sovereign holdings. The FPC’s primary focus remains financial stability, and it may be cautious about any move that could be perceived as weakening a key backstop.

These concerns are reinforced by changes in the compositions of the bank’s balance sheets over the years. The National Institute of Economic and Social Research (NIESR) stated that banks have shifted towards lower-risk business models, most obviously sovereign holdings and large volumes of secured financing and intermediation activity. This reduced the average risk weights across the system from around 37% to 30% over the past decade. Bank staff estimated that this equates to a fall in required capital of around £60bn for the major UK banks. As a

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result, the leverage ratio has become a more binding constraint; not because banks are taking on more risk, but because the importance of the non-risk-based measure has increased.

Additionally, if UK banks dramatically increase their gilt holdings, and a scenario triggering gilt yields to spike occurs, banks would face a simultaneous mark-to-market losses as funding conditions tighten, and the government would find its new primary buyers impaired, and due to the UK's weak fiscal position, one could argue they are particularly vulnerable to this. SVB also demonstrated in 2023, government bonds are not risk-free when held in large quantities in a rising rate environment, and a bank holding a large unencumbered gilt portfolio that is subject to a depositor run or liquidity squeeze, must liquidate those bonds in the market. If several banks in the UK do this simultaneously, a fire sale pressure could push yields higher and in fact worsen the government's borrowing cost. Thus, once these banks have expanded their gilt holdings under the new framework, reversing this policy becomes extremely difficult to unwind, so such a proposal should be examined carefully and only implemented with a high degree of confidence.

Conclusion: Three Roads and One Decision

The July 2026 Financial Stability Report will be the moment when the FPC takes the findings of its capital framework review and turns them into an actual decision. Three broad outcomes are on the table, and which one materialises will depend on how the FPC answers a question that runs through the entire debate: is the leverage ratio malfunctioning, or is it doing its job in conditions that were not anticipated when it was designed?

The first is that the Committee follows the Barclays proposal and excludes unencumbered gilts from the leverage ratio denominator. This would unlock the roughly £150bn of additional gilt-buying capacity Barclays identifies, and the £2.5bn of annual debt servicing savings that follows. For a government spending more on debt interest than its entire schools budget, with 30-year gilt yields at their highest since 1998, the appeal of a change that costs nothing on the fiscal scorecard is obvious. The price is a leverage ratio that no longer applies equally to every asset on a bank's balance sheet, weakening the original post-2008 logic of the rule, and once that exemption exists, the logic that created it is available to every future applicant for similar treatment.

The second is that the framework is kept intact but the underlying problem is addressed from the other side, by recalibrating risk weights in the areas where they have drifted lowest, particularly repo and secured intermediation activity. This sits closer to the NIESR's diagnosis and the Bank's own data, which show that system-wide risk weights have fallen by around seven percentage points over the past decade. The leverage ratio backstop remains untouched, and the disincentive for banks to hold gilts is eased indirectly. The downside is that this route is slower, and any fiscal benefit takes considerably longer to feed through to government borrowing costs.

The third is that nothing material changes, leaving UK banks caught between two capital regimes and the gilt market still dependent on a narrower pool of buyers than it once had. Given how divided the March evidence-gathering event was, and the general institutional caution of a body whose primary mandate is financial stability, this remains a plausible outcome.

Whichever path the FPC takes, the underlying trade-off is the same one that runs through the whole debate. On one side sits cheaper government borrowing, more room on bank balance sheets, and a more competitive domestic gilt market. On the other sits the integrity of a rule introduced precisely to prevent a repeat of 2008. With fiscal headroom of just £23.6bn and gilt yields at multi-decade highs, the cost of doing nothing is real, but so is the cost of dismantling a guardrail that, as the NIESR argues, is arguably working as intended. The FPC's answer in July will define not just the future of the leverage ratio, but how the UK chooses to balance financial stability against fiscal relief at one of the most constrained moments in its recent economic history.

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