Rt Hon Pat McFadden MP

House of Commons

London

SW1A 0AA

26 November 2020

Dear Pat,

**Financial Services Bill – Committee debate**

During the Committee session on the Financial Services Bill on 24 November, I committed to write to you and the Committee on several issues raised in that debate. These were the nature and effect of the changes to the Credit Rating Agencies Regulation, the effect of the Bill on risk weightings under the prudential regulatory regime, and the effect of Government Amendment 32 on leverage ratios.

Credit Rating Agencies

The Credit Rating Agencies Regulation (CRAR) was introduced by the EU in 2009 following the financial crisis and provides for regulatory oversight of credit rating agencies (CRAs). Only credit ratings that fulfil CRAR’s requirements can be used for regulatory purposes in the EU. From the end of the Transition Period, the CRAR will be ‘onshored’ to the UK statute book, and will continue to have effect, so that only credit ratings that fulfil CRAR’s requirements can be used in the UK.

You raised a concern around potential conflicts of interest in relation to CRAs. Concerns about potential conflicts of interest in the provision of credit ratings were a key reason the Regulation was proposed following the 2008 financial crisis, given the issuer-pays model (i.e. where the entity requiring a rating is the one that pays for this rating). Although this model is not directly prohibited, the Regulation addresses these concerns by imposing requirements for avoiding conflicts of interests in such circumstances. For example, CRAR sets requirements for CRAs to ensure that the issuing of a credit rating is not affected by any existing or potential conflicts of interest or business relationship involving the CRA.

You also asked how Clause 6 of the Financial Services Bill will change the CRAR. Some amendments are required to ensure that CRAR is consistent with the latest Basel standards, which the PRA will implement in line with the provisions in the Bill. Clause 6 will enable HM Treasury to amend the CRAR while having regard to the Basel standards. HM Treasury intends to use this power to make only those amendments needed to update this Regulation in line with the latest Basel standards, and therefore to promote financial stability.

Risk Weightings (and the scope of the Basel 3.1 measure)

The purpose of Clause 3 is to enable implementation of the outstanding Basel standards. The specific standards, which contain the relevant risk weightings, are set out in Clause 4 of the Bill.

More specifically, Clause 3 will enable HM Treasury to delete sections of the Capital Requirements Regulation (CRR) related to the matters listed in Clause (3)(2). This list of matters is based on HM Treasury’s analysis of areas that need to be updated in order to implement the outstanding Basel standards. Deleting these sections will allow the PRA to then ‘fill the space’ made by these deletions with their rules, reflecting the latest Basel standards. The list also acts as a constraint on the actions of HM Treasury and the PRA to only use these powers to allow for the implementation of the remaining Basel standards, and not to make unrelated policy changes.

In implementing these standards and the risk weights that go with them, the PRA will have to have regard to these Basel standards, so we are not giving the PRA broad discretion to implement risk weights in a different way to Basel. However, the Basel framework does provide within it a degree of flexibility to allow the relevant authorities of each jurisdiction to ensure their framework can be tailored to the specificities of how their own markets operate.  The framework recognises that there is not one single solution that is appropriate for every jurisdiction, so it is right that we ask the regulators to balance their implementation against various other considerations.

In terms of guarding against the risk of reducing risk weightings, I want to note that the PRA’s primary objective as set in the Financial Services and Markets Act 2000 is to promote the safety and soundness of financial institutions. This underpins how the PRA carries out all its duties and functions, including its rulemaking.

Leverage Ratios

Government Amendment 32 removes a temporary time limit of 27 June 2021 attached to a derogation from the calculation of the leverage ratio applying to all firms subject to the Capital Requirements Regulation (CRR). This leverage ratio is relevant for reporting and disclosure purposes for all such firms, and to the total loss-absorbing capacity (TLAC) capital requirement, which only applies to globally significant institutions (G-SIIs) under the same Regulation.

The derogation was introduced by the EU into the CRR as a response to the Covid pandemic and it brings forward a method of calculating the leverage ratio already provided for in the latest Basel standards. In other words, the effect of the derogation is to ensure that CRR firms have to comply with the most up-to-date calculation recommended by the Basel Committee.

This derogation is time-limited in the EU to 27 June 2021 as that is when the relevant provisions in the Second EU Capital Requirements Regulation (CRR2) (which amends EU CRR to reflect the latest Basel standards) come into force.

However, because the end of the Transition Period falls between the period on which the derogation took effect, and the date on which the EU CRR2 will take effect, the relevant CRR2 provisions will not be retained EU law and therefore will not take effect in the UK.

As you know, the UK’s changes to CRR will be made through the provisions in this Bill, and subsequent PRA rules. The Bill does not set a deadline for implementation, but we expect the PRA’s rules to go live in January 2022.

Without this amendment, there would be approximately a 6 month period from June 2021 to January 2022 where the UK CRR would revert to the old calculation, since the derogation will have expired. This amendment will avoid that outcome by ensuring that the derogation (which reflects the latest Basel rules) remains in place until the new permanent regime is in place.

This is not about watering down standards. In 2016, the UK was one of the first jurisdictions in the world to set a minimum leverage ratio requirement for banks and building societies with retail deposits equal to or greater than £50 billion on an individual or consolidated basis. The UK’s leverage ratio is stronger than the ratio to be introduced in the EU through CRR2 next June, as it must be met with substantially higher quality of capital and has additional buffer requirements.

I hope that this provides more detail on the questions you asked, and addresses your concerns. I look forward to further discussion of these important issues with you in future, and to continuing the Committee’s scrutiny of the Financial Services Bill.

I am copying this letter to the Chairs and members of the Financial Services Bill Committee, and I am also depositing a copy of this letter in the Library of the House.



#### JOHN GLEN