The Lord Livermore and The Lord Sharkey
House of Lords
London
SW1A 0PW

21 December 2023

Dear Spencer and John,

FINANCIAL SERVICES AND MARKETS ACT 2023 (BENCHMARKS AND CAPITAL REQUIREMENTS) (AMENDMENT) REGULATIONS 2023

Thank you for your contributions during the Parliamentary debate on the Benchmarks and Capital Requirements Statutory Instrument. During the debate on 13 December, Lord Livermore asked for further information about the interaction between the instrument and the implementation of Basel 3.1. Lord Livermore also asked what impact Basel 3.1 and the increase in capital requirements would have on SME lending. While Lord Sharkey asked for more information on what the formula does in the context of the credit valuation adjustment (CVA) capital requirements.

Relationship between Credit Valuation Adjustment discount factor and Basel 3.1

Basel 3.1 is a wider set of reforms which are due to be implemented from July 2025. The Prudential Regulation Authority (PRA) is responsible for implementing Basel 3.1 under the UK's approach to financial services regulation. Following the implementation of Basel 3.1, the capital requirements for credit valuation adjustment will be moved to the PRA's rules, in line with the Government's Smarter Regulatory Framework for financial services. The Government's reinstatement of the discount factor now is to ensure it is in place for the intervening period. The PRA have included a discount factor in its near final rules which they published on 12 December.

SME Supporting Factor

The discount factor debated last week lowers the amount of capital firms have to hold against particular trading activity that is more straightforward e.g., for exchange products and does not relate to SME lending.

The SME supporting factor forms part of the changes to capital requirements being implemented under Basel 3.1. HM Government has delegated responsibility for implementing Basel 3.1 in the UK to the PRA, who are still finalising its proposals. The PRA has been clear that its final requirements will be guided by the evidence and that it would particularly welcome evidence on the impact on SME lending so it can get its final proposals right. The PRA will publish its second policy statement in Q2 next year which will contain more information on the potential rules in relation to SME lending.

Discount factor

The discount factor calculation is designed to reflect the present value of banks' future cashflows from their derivative exposures. The discount factor applies a discount rate of 5%, hence '0.05' in the formula. 'Mi' is the effective maturity of the transactions. The use of e, the natural logarithm exponent, is part of the longstanding formulation for this discount factor.

Thank you again for your contributions during the debate. A copy of this letter will be deposited in the library of the House.

Yours,
Charlotte

BARONESS VERE OF NORBITON