

**Explanation of role of Expert Groups.**

Expert Groups consist of industry representatives and are facilitated by FSA staff. The Expert Groups provide outputs for discussion at the Credit Risk Standing Group with the overall aim of providing proposals for the FSA to consider.

## **The procyclicality stress test Statement of expert group opinion**

### **1. This document**

#### **1.1. Introduction**

This document states the opinion of the expert group on the FSA's proposed implementation of the CRD Procyclicality stress test requirements (CRD, Annex Part 4, Para 42 Para 435). The document does not seek to address the general Pillar II stress tests. In Sections 1 and 2 below we outline some of the FSA's own views on procyclicality, Sections 3 and 4 refer to the views of the Expert Group, and then in Sections 5 to 7 we include the relevant text from the CRD, the FSA's CP 05/03, and a previously unpublished FSA paper.

#### **1.2. What is procyclicality?**

Section 7 contains a description of procyclicality taken from an unpublished FSA document entitled "PROCYCLICALITY OF CAPITAL REQUIREMENTS UNDER BASEL II: AIDE MEMOIRE", dated July 2004. This description identifies a *cause*, rising capital requirements in economic downturns, and two possible undesirable *effects*, namely deleterious economic effects resulting from banks' concerted attempts to manage their increasing capital requirements, and individual capital breaches by any banks that prove unable to successfully manage those requirements.

***Question 1: Does this definition reflect the FSA's current views on procyclicality?***

### **2. FSA and comparative implementation proposals**

#### **2.1. The stress test in the CRD**

The procyclicality stress test is intended to assess the potential for increases in a bank's capital requirement due to an economic downturn. The form of the test is described in Annex VII, Part 4, Para 42, reproduced below in Section 5. CRD Annex XI, (1) subjects the test to a supervisory review. The CRD does not link the results of the test to capital requirements, but rather includes the test within the broader regime of Pillar II stress tests, allowing regulators to take a holistic view.

Additionally, in Article 156 (also included in Section 5 below), the CRD contains a commitment to revisit procyclicality periodically, so allowing a seasoned review once the CRD is operational.

#### **2.2. FSA proposed implementation**

The FSA's current version of the stress test and its relation to capital requirements is at BIPRU 4.3.34/5, in Section 6.2 below. The FSA propose at 4.3.35(5) to require banks to hold additional capital where the test indicates that more capital will be required. The FSA acknowledges that this would be super-equivalent to the CRD.

**Question 2: What is the FSA's rationale for being super-equivalent here? Has additional Cost/benefit analysis, beyond that carried out by LECG (on behalf of the FSA) in January 2005 (quoted below), been conducted? What is the current estimate for the size of the capital add-on, and what are the competitive implications of the proposals for the UK?**

### 3. Expert group positions

#### 3.1. Summary

The expert group were tasked with designing a stress test which, in conjunction with the FSA's super-equivalent proposals, would be effective in reducing procyclicality.

*Our views are summarised in positions A – C below.*

**Key messages:** *We insist that the FSA justify its super-equivalent stance automatically linking capital requirements to the results of the procyclicality stress test. We strongly advise against any super-equivalent capital floors or covert measures with the same intended effect. Instead we would ask the FSA to consider the views of the EU Commission and conduct an ex-post review based on experience, and one that would reflect the existence of the capital floors. With this in mind, and in order to make any further progress, we therefore seek a proper dialogue between industry experts and the FSA at the appropriate level.*

**Question 3: Does the CRSG support these recommendations?**

#### 3.2. Summary of Positions

**Position A. It is not possible to successfully implement the FSA's proposals<sup>1</sup>.**

1. The stress test is not exempted from the requirement to be conducted in a manner that does not vary systematically with the business cycle (Accord para 503, also CRD, Annex VII, part 4, para 112, "methods shall be..consistent through time"). That is, the stress test must be designed to prudently assess possible requirements on a consistent basis over time. That the stress test will be subject to review and will be on the usual basis that the FSA expects to be convinced of, rather than taking for granted, the validity of any assumptions used is to be seen from BIPRU 4.3.35 G (9) and (10). (see Section 6 below)

2. To mitigate procyclicality, a stress test is needed the *outcome* of which *does* vary systematically with the economic cycle by definition. No method for accurately predicting the economy so as to know with confidence when capital requirements will not increase in future is known and the pursuit of such methods is widely regarded as hopeless.

3. Therefore no test can be designed which satisfies the operational requirements of the CRD and yet has a countercyclical<sup>2</sup> outcome. The only way to obtain a countercyclical outcome is to take a directly countercyclical point of view, contrary to the requirements of the CRD and indeed contrary to common sense as an actual point of view about the economy.

4. BIPRU text suggests situations where additional requirements might not arise (4.3.35(7), see Section 6.2). But these mere suggestions cannot override the requirement at 4.3.35(5). We have explained above that due to the context of the stress test, the resulting additional requirement ought always to be positive, so the examples are ineffective and might as well be struck out.

5. A measure which results in positive additional requirements at all times is not mitigation for procyclicality. Moreover BIPRU 4.3 is damaging to the conceptual clarity of the framework.

**Question 4: Is the justification for position A clear? Does the CRSG agree with the rationale**

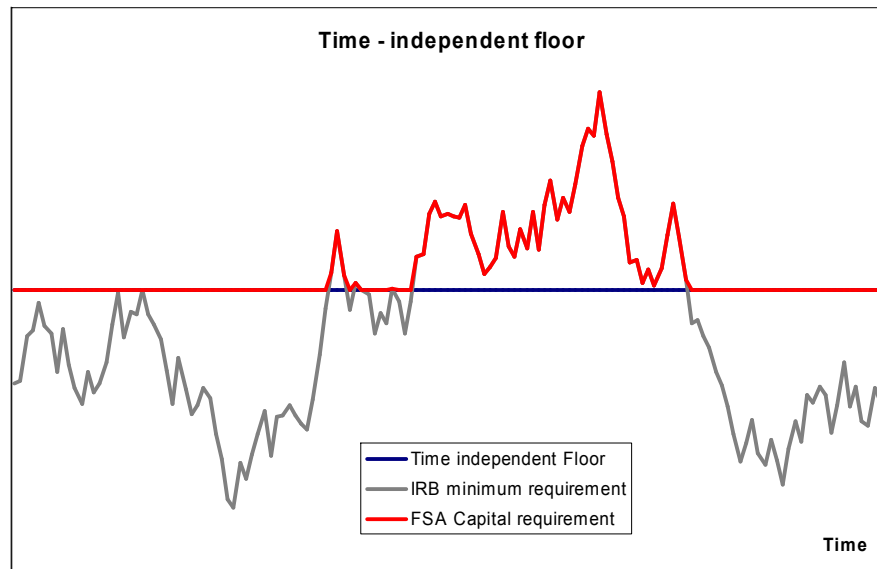
<sup>1</sup> "Successful" means that the implementation can be reasonably expected to achieve its objective. An implementation, for example, that merely results in consistently higher capital requirements, is not successful.

<sup>2</sup> A number is pro/countercyclical if that number is larger/smaller in economic downturn.

*outlined in position A?*

**Position B. The FSA's intention is to create floors to capital requirements, but to do so without introducing any explicit floors.**

1. As explained at Position A, the FSA's implementation of CRD as written will simply result in additional capital requirements at all times.
2. However the expert group believe that what the FSA think will be achieved is a *floor*, or system of floors on capital requirements, which do not vary over time:



3. This objective *could* be achieved by implementing a system of floors (perhaps depending on product type, and higher than the floors already present in Basel II). No stress test is needed.
4. However an explicit system of floors is wholly unacceptable to the Expert Group members and any system, whose real aim is to produce this result, whether stated explicitly or not, is unlikely to get any industry support whether from members of the Expert Group or from the CRSG as a whole.

**Question 5: Is this interpretation of the FSA's position accurate? If not, can the FSA explain what the current requirements will mean in practice? What are the views of the CRSG in relation to additional regulatory floors?**

**Position C: There is a clear consensus that procyclicality is not an urgent issue.**

- 1 The survey commissioned by the FSA (BIPRU, Annex 2: "Cost benefit and market failure analysis"), concludes "On balance, our opinion is that any pro-cyclical effects from CRD implementation are likely to be very muted" (8.5 copied at Annex 6.1). The survey did not find any supporting evidence for particular concern over the impact of procyclicality.
2. It is also worth noting the generally relaxed view of procyclicality taken by most regulators outside the UK.
3. CRD Article 156 (copied in Section 5), by committing to revisit procyclicality after the implementation of the new framework, implicitly acknowledges that whatever the ultimate risk of procyclicality, severe effects are unlikely in the first few years of Basel II implementation at least, due in part to the existence of Basel I related floors in the first two years. An additional implication of this is that the question of procyclicality cannot be conclusively answered at present, and hence is best addressed once the framework has been operative for a few years.
4. The US ANPR does not address procyclicality.
5. We believe that in practice, banks will cope with capital volatility using a variety of means already available to them and summarised in Section 4. The proper place of stress tests is to give

an idea of the amount or scale of volatility, against which the “size” of the measures available (i.e. the amount of capital they generate) can be compared to assess overall comfort.

Note that we do not rely on position C. Whether procyclicality is an urgent issue or not, our view is that *the FSA have created a situation in which it is not possible to address this issue.*

***Question 6: What evidence is there to suggest that procyclicality in the UK under Basel II is an urgent issue that needs to be addressed? What are the views of the CRSG?***

#### **4. How banks will manage their capital under Basel II**

The expert group have identified the following types of action exhibited by banks as they manage their capital requirements. In the opinion of the expert group, these measures are sufficient for banks to manage capital volatility today, and will probably continue to be sufficient in the modestly more volatile world of Basel II (unaided by overt or covert countercyclical amendments).

- **Raising Capital** – capital planning can take advantage of the global markets and currencies available to multinational banks. For example, in the event of a mild recession in the UK, an international bank might plan to tap non-UK investors for more capital.
- **Use of subsidiaries to raise capital** – large banks typically have rated subsidiaries with their own power to raise capital. The capital requirements and the credit ratings of these subsidiaries may react differently to changing economic circumstances, so that according to the nature of the change it may be appropriate to use different subsidiaries to raise capital in the most efficient manner.
- **Halting or delaying capital repayments** – banks typically have repayment plans for capital which in the case of certain capital instruments, can be delayed at the option of the issuer in the event of any pressure on capital ratios. A similar comment applies to share buyback programs which are regularly undertaken by large UK banks.
- **Sale or securitisation of assets** – depending on the severity of the recessionary impact on the bank, banks can sell assets to reduce capital requirements. Suitable assets for sale would include holdings in foreign subsidiaries which may be treated a deduction to total capital, or other assets whose capital treatment is such as to generate a capital benefit on sale, such as leasing portfolios. Discretionary trading activity could also be run down quite quickly to reduce capital usage. A bank could also sell peripheral businesses or other discrete business units without affecting its core strength.
- **Refraining from acquisition** At any time, banks may have a number of acquisition plans which require additional capital planning. In general, refraining from undertaking these plans might be expected to have less effect than selling existing assets.
- **Reduction in Non-financial entities funding** – intra group lending to deconsolidated entities could be reduced by asking these subsidiaries to raise funds in their own name.
- **Retaining current year earnings** –banks have some discretion to alter their dividend policy or otherwise retain current year earnings where necessary.
- **Reduction in general capital buffers** – banks typically, and for a variety of reasons, maintain capital well above the Basel 8% minimum. This buffer is often connected to acquisition activity and is not demanded by rating agencies or regulators, and so is available for use in the event of an increase in core capital requirements.

***Question 7: Does the CRSG agree that the above list is an appropriate representation of the range of actions available for firms during an economic downturn?***

#### **5. CRD text on procyclicality**

##### **5.1. Article 156 – Review of macroeconomic effects**

*Article 156* The Commission, in cooperation with Member States, and taking into account the

contribution of the European Central Bank, shall periodically monitor whether this Directive taken as a whole, together with Directive [93/6/EEC], has significant effects on the economic cycle and, in the light of that examination, shall consider whether any remedial measures are justified.

Based on that analysis and taking into account the contribution of the European Central Bank, the Commission shall draw up a biennial report and submit it to the European Parliament and to the Council, together with any appropriate proposals..

## 5.2. Annexes

### *Annex VII, Part 4, Para 42*

A credit institution shall regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test to be employed shall be one chosen by the credit institution, subject to supervisory review. The test to be employed shall be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. A credit institution shall assess migration in its ratings under the stress test scenarios. Stressed portfolios shall contain the vast majority of a credit institution's total exposure.

### *Annex XI Technical criteria on the review and evaluation by the competent authorities [Excerpt]*

1. In addition to credit, market and operational risk, the review and evaluation performed by competent authorities pursuant to Article 124 shall include the following:

(a) the results of the *stress test* carried out by the credit institutions applying an IRB approach;

(b) *etc*

## 6. CP05/03 text on Procyclicality

This is a summary of relevant BIPRU and other text. The key BIPRU provision is 4.3.35 G.

### 6.1. CP05/03 Annex 2 (Cost benefit and market failure analysis)

7.10 *Impact of CRD on cyclicity - conclusion* “Procyclicality is an issue about which there is considerable uncertainty, both in the literature and amongst our survey respondents. We are struck, however, by the insistence of the large banks that they have been using sophisticated risk based pricing for some time. They do not believe that these techniques have a pro-cyclical impact, nor have they seen pro-cyclical effects in their own businesses. Similarly, we have not found any other commentators suggesting that such effects have arisen from large bank risk management techniques over the past few years. **The balance of the survey evidence in our view, therefore, is that CRD will not significantly exacerbate the business cycle<sup>3</sup>.**

8.5 *Costs and benefits of CRD – procyclicality* Procyclicality has been extensively debated as a potential negative effect of CRD. LECG’s research found evidence both for and against the notional of a pro-cyclical effect. Large banks already using sophisticated risk-based pricing did not believe procyclicality to be a major issue, and we are aware of no evidence that the actions they have already taken in their risk management activities have had any cyclical effects. **On balance, our opinion is that any pro-cyclical effects from CRD implementation are likely to be very muted.**

### 6.2. CP05/03 Appendix 1 (I.e. Draft BIPRU text)

2.2.29 G A firm’s CRR may vary as business cycles and economic conditions fluctuate over time. Deterioration in business or economic conditions could require a firm to raise capital or, alternatively, to contract its businesses, at a time when market conditions are most unfavourable to raising capital. Such an effect is known as procyclicality.

2.2.30 G To reduce the impact of cyclical effects, a firm should aim to maintain an adequate capital buffer during an upturn in business and economic cycles such that it has sufficient capital

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<sup>3</sup> Here and next para. Expert group bold.

available to protect itself in unfavourable market conditions.

2.2.31 G To assess its expected capital requirements over the economic and business cycles, a firm may wish to project forward its financial position taking account of its business strategy and expected growth according to a range of assumptions as to the state of the economic or business environment which it faces. For example, an ICAAP should include an analysis of the impact that the actions of a firm's competitors might have on its performance, in order to see what changes in its environment the firm could sustain. Projections over a three to five year period would be appropriate in most circumstances. A firm may then calculate its projected CRR and assess whether it could be met from expected financial resources.

4.3.34 G A firm should regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test to be employed should be one chosen by the firm. The test to be employed should be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. A firm should assess migration in its ratings under the stress test scenarios. Stressed portfolios should contain the vast majority of a firm's total exposures covered by the IRB approach.

4.3.35 G (1) This paragraph relates to the stress test referred to in *BIPRU* 4.3.34G.

(2) One of the purposes of the stress test should be the identification of the extent to which the capital requirements generated by the *firm's rating systems* vary with the state of the economic cycle.

(3) Where a *firm's* credit risk stress test does not cover all of the relevant *exposures* it should carry out other appropriate procedures in order to meet the requirement in *BIPRU* 4.3.34G and be able to demonstrate how it has met this requirement.

(4) An example of what a *firm* might do under (3) is to gross-up the result by the ratio of the total *risk-weighted exposures* in its portfolio to the *risk-weighted exposures* covered by the credit risk stress test.

(5) To the extent that the capital requirement that arises under the stress scenario is higher than the amount that arises under the non-stress scenario, a *firm* should, subject to (6), at all times have *capital resources* of the amount and type that it would have to hold if its *capital resources requirement* were increased by that excess.

(6) (5) does not apply to the extent that the capital requirement arising under the *firm's IRB waiver* apart from this paragraph already incorporates that excess.

(7) The *FSA* would not necessarily expect that the increase in the required level of capital in a scenario covered by a stress test as compared with the non-stressed scenario would always require the *firm* to increase the level of *capital resources* it actually holds. For example this might not be necessary if:

- (a) the *firm* already embeds conservatism into its estimates;
- (b) the *firm* is dealing with products or counterparties that are not affected by the economic cycle; or
- (c) if the economy is already in a mild recession.

(8) A *firm* should interpret mild recession as being equivalent to two quarters of zero growth.

(9) A *firm* need not assume that the result of the credit risk stress test at aggregate level is equal to the simple sum of stress tests applied at lower levels. Where it does not do so, the *firm* should be able to demonstrate to the *FSA* why it is appropriate to assume a degree of independence between the results of different business lines.

(10) A *firm's* stress tests will be subject to supervisory review.

## 7. An FSA description of procyclicality

The below is quoted from an unpublished FSA document entitled "PROCYCLICALITY OF

CAPITAL REQUIREMENTS UNDER BASEL II: AIDE MEMOIRE”, dated July 2004.

*“Procyclicality, in this context, is a term which refers to the **tendency for regulatory capital requirements to rise with downswings in the economy and to fall with upswings**. To avoid excessive repetition, this note tends to generally to focus on what happens in the downturn when capital requirements rise. However usually there is a complementary effect in the upturn. Given the perspective of prudential supervisors, this note does however tend to perceive those cases as sowing the seeds of future problems, as opposed to signifying 'opportunities'.. It is associated mainly with credit risk, as it is generally assumed that changes in operational risk are not correlated with the economic cycle; while in market risk the extent of procyclicality depends on the nature of the positions, e.g. whether a firm is habitually long in bonds and equities.*

*From the authorities' perspective procyclicality carries two major downside risks. First, and of most direct interest to us, is the possibility that a firm will breach its capital requirements in the downturn as a result of an increase in the Pillar 1 credit risk charge at a time when it is unwilling (typically because of the high cost) and/or unable to raise new capital. Secondly, there is the possibility that actions taken by individual firms to reduce their risk, e.g. by cutting back on lending, will magnify the downturn by causing a credit crunch. This would cause problems for the economy as a whole, as well as limiting the extent to which the firms are able to reduce their risk when they actually try to do so – there may be no replacement lenders to take on that risk.*

*Footnoted: It is often the case with Basel II that debate is obscured by different interpretations of different terms with the original meanings having been lost in translation. In this context, it may be justifiably argued that the variation in capital requirements is actually 'cyclicality', while the correct meaning of 'procyclicality' is how firms react to the changes in the cycle. However in this note, the term is used in the loose way defined above, and which reflects the way in which it is being used by the supervisory community.”*

ENDS.