EUROPEAN CENTRAL BANK

EUROSYSTEM

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European Central Bank

Discussion of "The Bank of England's Approach to Stress Testing the UK Banking System"

London

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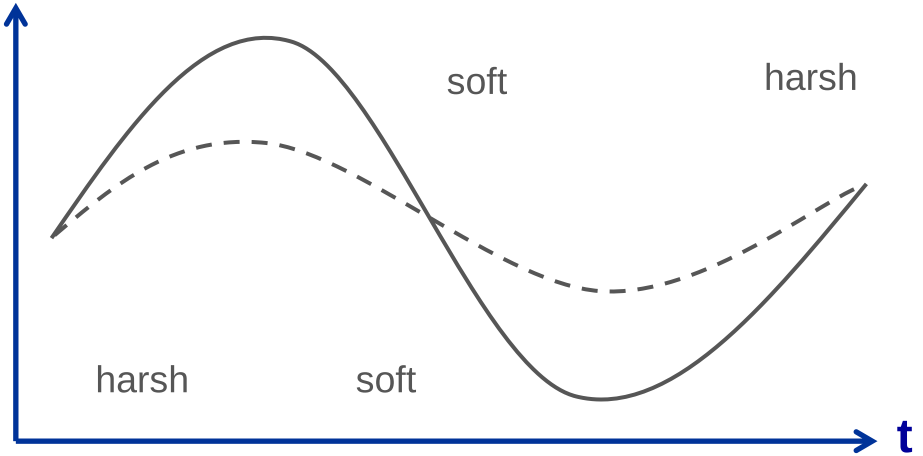
Two versions of the macro-prudential policy objective

- **Asymmetric**
  - Ensure systemic financial stability
  - Avoid financial crises
  - “Prudential” taken literally (ex ante perspective)
- **Symmetric**
  - Ensure the smooth flow of financial intermediation services (ex ante and ex post perspective)
  - Smoothen the financial cycle, both in the upturn and in the downturn
  - More like a third aggregate stabilisation policy (in addition to monetary and fiscal policy)
  - More ambitious

Annual stress test with "cyclical scenario"

- **Countercyclical design of stress test**
- **Upturn of financial cycle: "harsher" scenario**
  - Rapid growth of credit and asset prices
  - Compressed risk premia
  - Effective instability low but underlying risks growing (emerging imbalances?)
- **Downturn of financial cycle: "softer" scenario**
  - Correction of credit provision and asset prices
  - High risk premia
  - Effective instability large
- **Some steps towards symmetric approach**
- **Rules versus discretion: Constrained discretion**



Policy responses and challenges

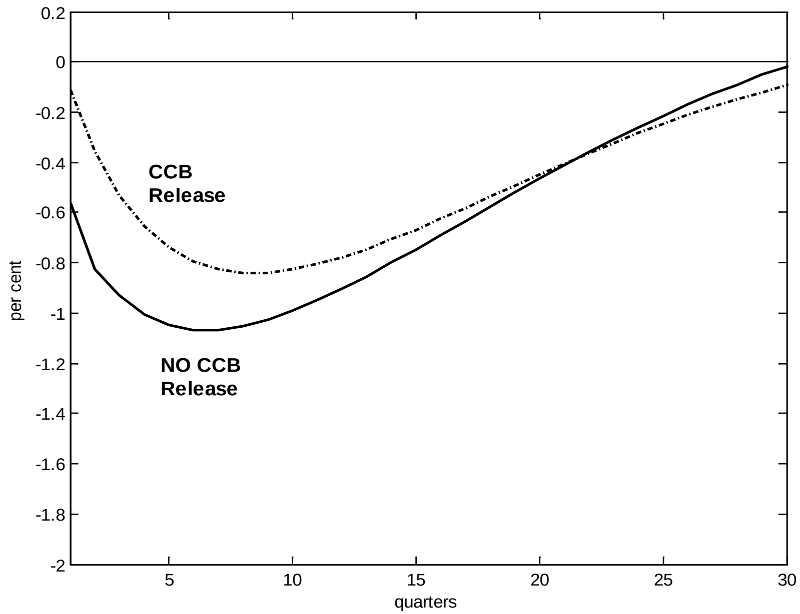
- **If the stress test results suggest changes of capital**
  1) Financial Policy Committee considers system-wide buffers
  2) Prudential Regulation Authority considers individual banks' buffers

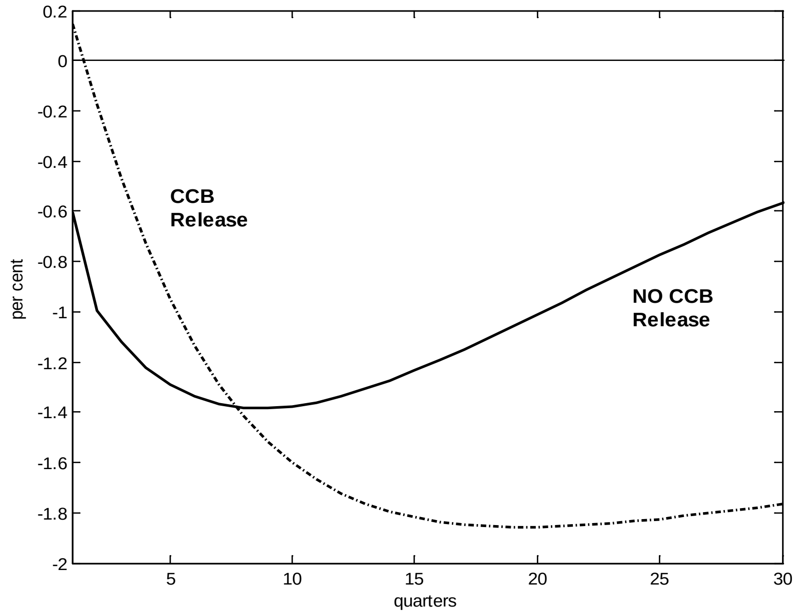
  Question: Can PRA also reduce some individual buffers or creates the FPC a hard floor?

- **Challenges**
  - How to determine the state of the financial cycle and be consistent over time? Indicators may point in different directions → Judgement
  - Design may work better in regular financial cycles than in crisis cycles: In a severe financial crisis it may sometimes be necessary to re-establish supervisory credibility and market confidence by generating a larger capital increase (e.g. if minimum requirements are violated)
  - Probably many more…

Risk in a severe crisis: Illustration from 3D model

Effects of a persistent reduction in home prices and firm valuations on GDP





- <u>Higher capital requirements</u> (10.5%)
  - Release attenuates shock propagation for the first 1.5 years

- <u>Lower capital requirements</u> (8%)
  - Release attenuates shock propagation early on
  - But when capital becomes too low excessive defaults may also worsen the situation

Source: Clerc, Derviz, Mendicino, Nikolov, Moyen, Stracca, Suarez and Vardoulakis (2015), Capital regulation in a macroeconomic model with three layers of default, *International Journal of Central Banking*, 11(3), pp. 9-63. Novel approach for assessing the benefits and costs of macro-prudential regulatory policies developed under the ESCB Macro-prudential Research Network (MaRs).

Other comments

- **Capital policies may not be the most effective regulatory instrument against the sources of financial imbalances**
  - Evidence that borrower based instruments more effective than lender based instruments (Claessens, Gosh and Mihet 2014)
  - Capital may not “lean” as much against the financial cycle as LTVs, DTIs and the like
- **Did the FPC’s secondary objective play a role in excluding (for the moment) medium-sized banks? (box 1)**
  - Less burden on them
  - Easier to innovate and grow to compete with the large ones in the future?
- **Work with home supervisor that the parent group supports the UK investment banking subsidiary of a foreign-owned bank? (p. 24)**
- **We agree that it should be explored how stress tests can be extended to the wider financial system (box 5)**