FSA approach to stress testing

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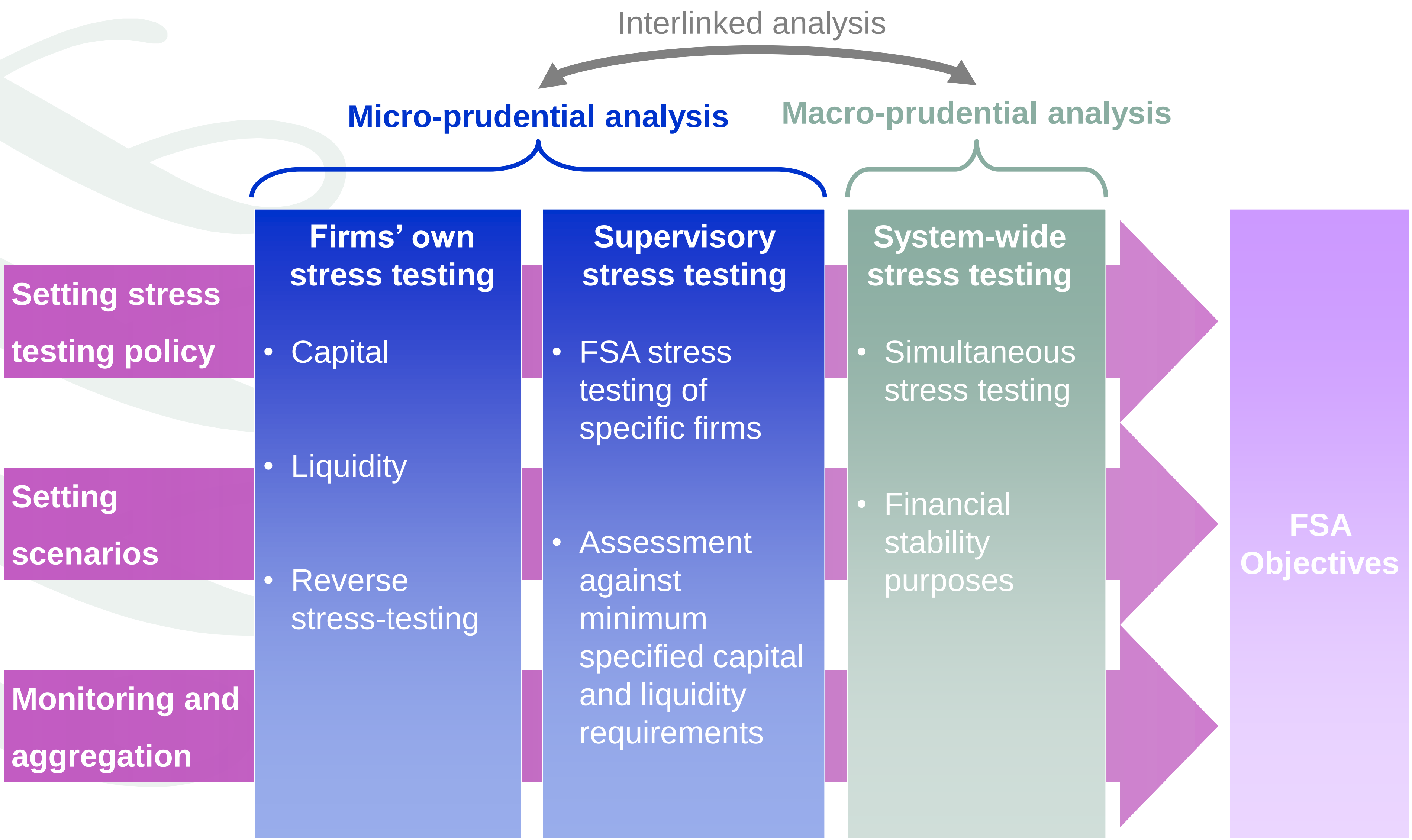
FSA integrated stress testing framework



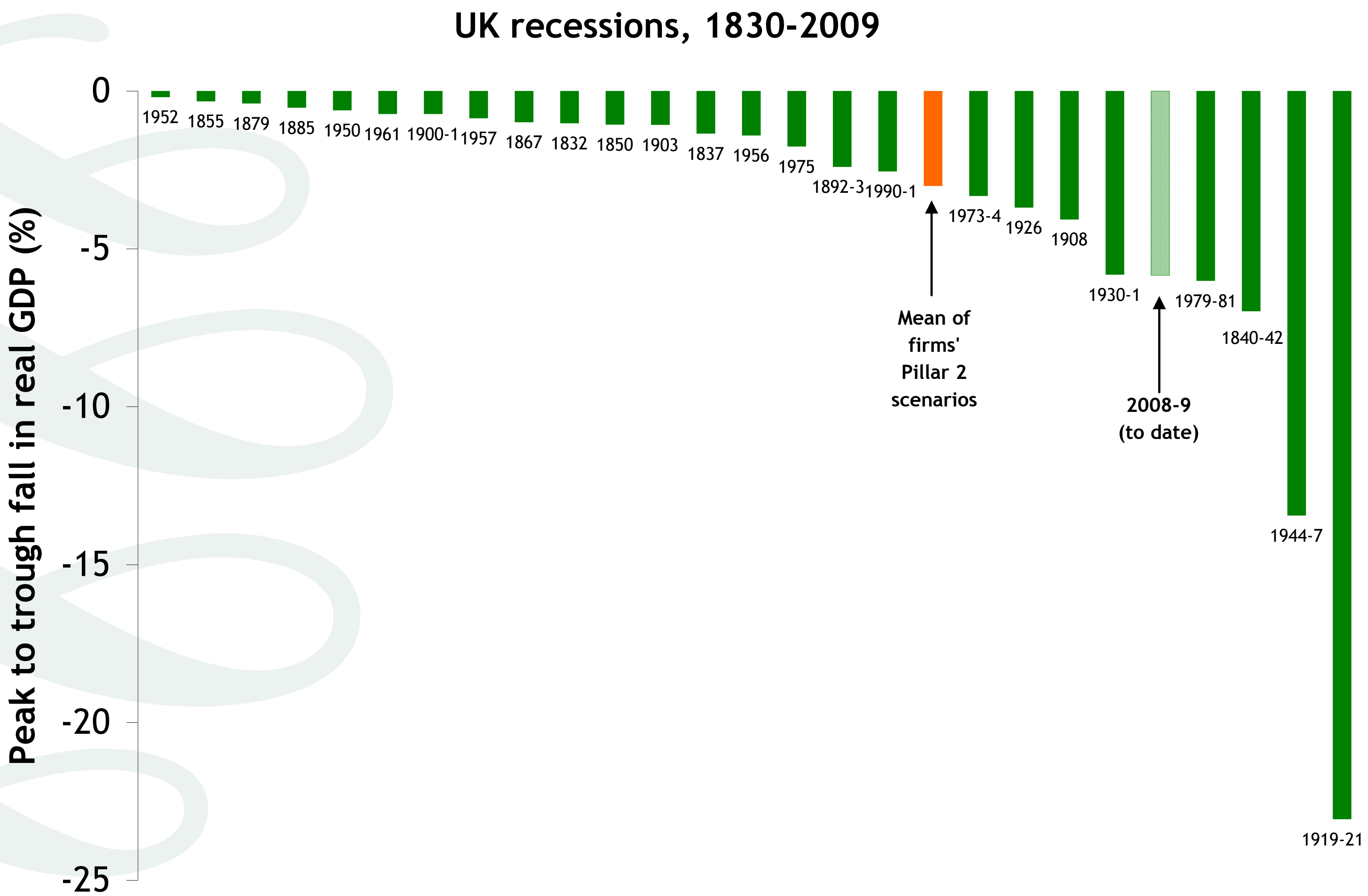
Stress testing: pillar 2 capital

- Guidance PS09/20:

  'In their Pillar 2 capital planning, firms should consider a range of scenarios. They should include a severe downturn scenario based on forward-looking hypothetical events that are calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.'

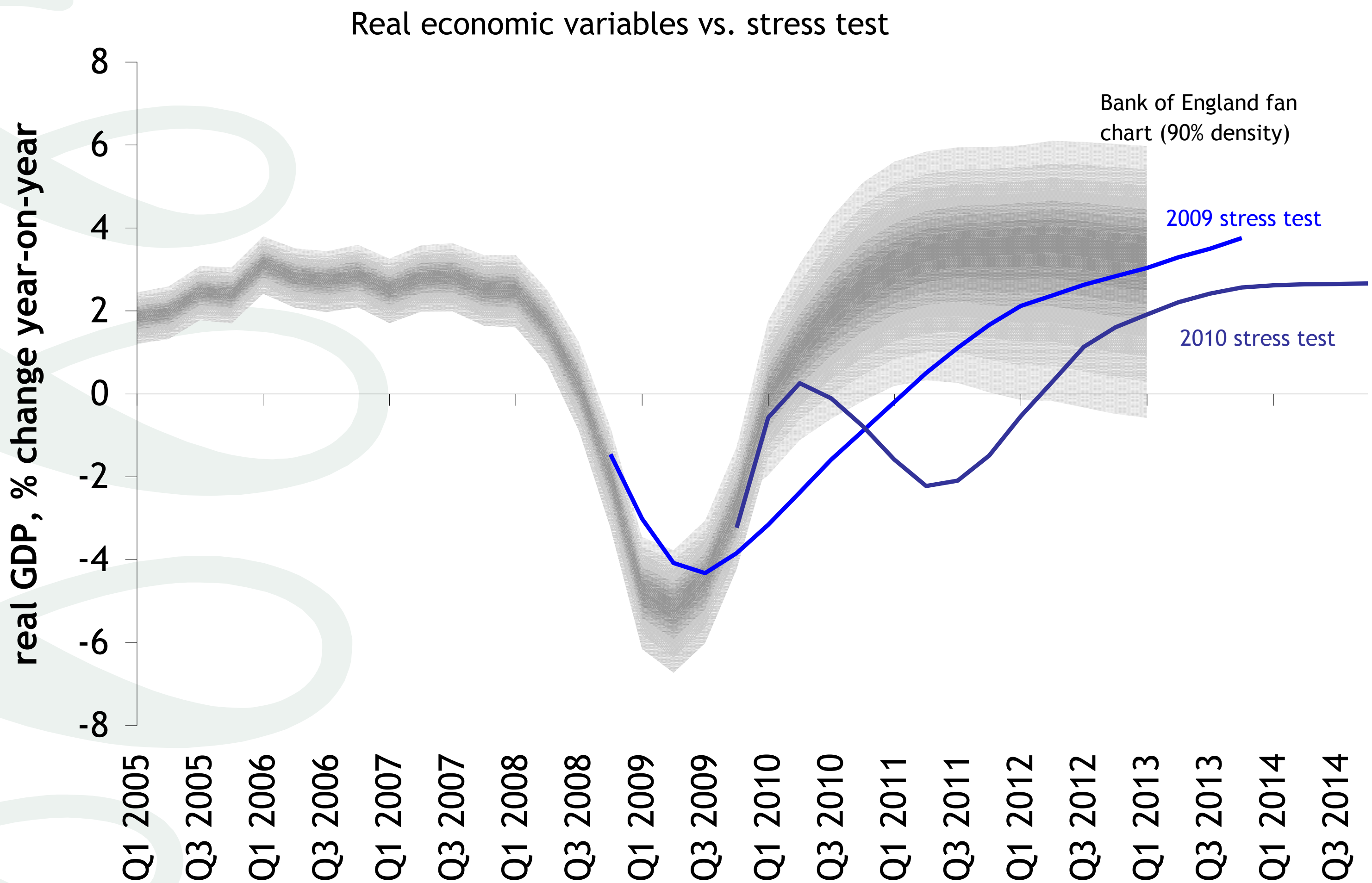
  FSA publishes an 'anchor' macro scenario against which firms can benchmark severity of own scenarios
- Stress test results used to size capital planning buffer – additional capital (pillar 2) held above minimum capital requirements to absorb losses in adverse circumstances
- CP09/30 describes a capital planning buffer as:
- *"…the amount of capital that should be held now, so that it is available to absorb losses and meet higher capital requirements during adverse external circumstances after allowing for realistic management actions."*

UK banks previously misunderstood FSA risk appetite



Sources: Maddison (1830 - 1954); ONS (1955 - Q3 2009); selected major firms' ICAAPs (2008-2009)

2010 anchor scenario: UK GDP growth



Source: Bank of England, ONS, FSA

Note: For an explanation of the fan, see the Bank of England *Inflation Report* , February 2010, page 6, Chart 1.

2010 anchor scenario: key variables

	2009 scenario	2010 scenario
Period covered by scenario	2009-2013	2010-2014
GDP fall (peak-to-trough, %)	-6.9	-8.1
House prices, nominal (peak-to-trough, %)	-50	-36
Commercial property prices, nominal (peak-to-trough, %)	-60	-60
Unemployment rate (peak, %)	12.5	13.3

Note: Peaks – GDP peaked in Q1 2008; house prices peaked in Q3 2007; commercial property prices peaked in Q2 2007. Indices – The 2009 scenario used the DCLG house price index; the 2010 scenario uses the Halifax house price index. These peak-to-trough stresses cannot therefore be precisely compared.

Liquidity stress testing

- FSA liquidity policy: requirement to hold liquid assets in relation to potential net outflows in a stress scenario (Individual Liquidity Guidance)
- Stress scenario includes
  - Idiosyncratic, name-specific stress for 2 weeks
    - Inability to roll over credit sensitive wholesale funding
    - Outflow of retail deposits
    - Long-term rating downgrade
  - Market-wide stress for 3 months
    - Illiquid assets only realised at excessive costs
    - Asset price uncertainty
    - Risk aversion

Reverse stress-testing

- To be performed at least annually and be submitted to FSA
- To encourage firms to:
  - Explore more fully the vulnerabilities of their current and future business plans
  - Make decisions that better integrate business and capital planning
  - Improve their contingency planning
  - Inform and enhance existing stress testing framework

System-wide stress testing

- Common scenario, simultaneous and involving multiple firms
- To test resilience of system rather than individual firms
- Fast moving events/market stresses better than macro scenarios
- Explore feedback effects and interlinkages
- Possibly multi-round