2008/9 FSA Stress Tests: Background

Banking Recapitalization Package

10/8/08: Tripartite authorities (Treasury, BoE, FSA) unveiled 3 part package:

1. Provide sufficient liquidity
2. Recapitalize banks should they need it
3. Guarantee certain new wholesale debt of certain banks

Within Tripartite structure, FSA responsible for determining the appropriate capital levels for each involved institution, considering:

1. That the amount of capital would sustain confidence in that institution, and
2. Ensure the institution would have enough capital in excess of minimum requirements to both absorb losses in a recession and also to continue lending on normal commercial criteria

Initial Stress Test Statement

11/14/08: FSA releases vague methodology, **essentially declining to publicly describe specifics of the test or when the results would be announced (if at all)**.

What they did say:

- "[T]he process included utilisation[sic] of a stress test based on some standard assumptions but with weightings tailored to the specific institutions"
- Targeted 8% Tier 1 Capital and Core Tier 1 Capital of at least 4% in the stressed scenario
- Noted this method did not set new minimum capital ratios

Useful to compare to U.S. SCAP stress tests, which were announced 3 months later. SCAP disclosed much more detail in methodology (discussed later).

January-April 2009: Basically No Disclosures

1/19/09 Statement, But Still Vague

FSA provided additional clarification, in the context of a counter cyclical regime:

- Expected participating banks to have minimum core Tier 1 of 4%
- At time of recapitalization, Tier 1 ratio of 8% used to determine appropriate level of buffer
- "Estimate 6-7% to be comparable post stress to Tier 1 number to the core Tier 1 at 4%"
- Emphasized the tests were existing part of the supervisory framework, "not a new set of rules"

To ensure implementation of Basel would not create any unnecessary or unintended procyclical effects, FSA reduced the requirement for additional capital from the procyclical effect by changing variable scalar method of converting internal credit risk models.[1]

[1] Changed from point-in-time to through-the-cycle

So where did information come from?

Answer: *Financial Times* sources, usually

- There was no formal or consistent information published about the stress tests (until May, but unexpected)
- After Lloyds and RBS, attention shifted to Barclays
- Results effectively released via the *FT*:

  "The Financial Times has learnt that the FSA will conclude its detailed trawl through the banks books in the next few days and it has indicated that Barclays does not need any fresh capital." (3/27/09)

By "passing" Barclays, the FSA indicated it had confidence Barclays would maintain core Tier 1 capital of 4% without taxpayer help via government's insurance scheme for toxic assets.

May 2009: Some Disclosures

Before May 28

US results released on May 7 → stark contrast with UK disclosure approach

Unclear which banks had been tested, and which had passed. Barclays had passed[2], but no word on RBS and Lloyds

HM Treasury rejected Freedom of Information request for the results on May 20

Rumors: test scenarios of 50% fall in home prices, 16%(!) fall in GDP[3]

Why not disclose?

- Difficult to explain differences with US approach
- Because observers might see the stress scenarios as an official forecast (and rumors suggested particularly gloomy scenarios)

May 28 Disclosures

FSA released a more detailed note describing the test methodology, but no results. Main points:

- "The UK authorities have not applied stress testing in the same way as in the US"
- Broadly parsed as an "integral element" of the regular supervisory approach
- Provided some numbers behind their scenarios → turned out to be less stressful than rumors suggested

> *"Since the FSAs tests are embedded in their regular,* ***routine supervisory processes the FSA will not, as a matter of practice, be publishing details of the stress test results****."* [Emphasis added]

[2] Known via the *FT*

[3] US ultimately had 4.2% drop in GDP peak to trough; UK 4.9%

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Comparing "Crisis Intervention" Stress Tests

	UK/FSA 2008/9	US/SCAP 2009	EBA 2011
Purpose	Inform policy decisions such as access to CGS and APS and begin the process of embedding revised testing approach in the supervisory regime	Estimate losses, revenues, and reserve need for the large BHCs, and evaluated the size of governmental capital injections contingent on results	Examine the resilience of banking system, inform policymakers the ability of the banks to absorb shocks and the banking system's dependence on public support.
Scenario Severity, Cumulative GDP Loss	6%	2.8% (but at peak of crisis)	3.1%
Disclosures	Limited	Substantial; firm and loan product specific publicly released	Substantial; firm-specific
Capital Backstop	Yes, APS or CGS	Yes, CPP	Not explicitly
Successful?	Yes, eventually	Yes; viewed as credible with clearly communicated backstop measures in place ahead of time.	Not really. Scenario wasn't seen as sufficiently stressful (soverign risk issue). Backstop was ambiguous as well.
Coverage	9(?) banks and building societies	19 BHCs	21 countries/24 national supervisors/12 European institutions/91 banks/19 languages/7 currencies

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