Addressing the procyclicality of IRB requirements – Pillar 1 or Pillar 2?

1. ‘Procyclicality’ is a rather complex subject. Those members who do not feel sufficiently versed in the issues are encouraged to read the attached paper. That is a reasonably comprehensive factual note, prepared as background for the deliberations we expect to have on the subject over the next few months.
2. **The question on which the Sub-board is asked to opine is a however a relatively narrow one; namely whether we should pursue Pillar 1 or Pillar 2 treatments for the procyclicality impact of the IRB framework.** This extends to both our domestic implementation and the stance to be taken in future international negotiations.
3. In this context, the ‘Pillar 1 approach’ may be seen as adjusting the output of allowed rating methodologies to produce Pillar 1 regulatory capital requirements that are less procyclical than would otherwise be the case. ‘Pillar 2’ involves relying on the results of the so-called procyclicality stress test and the action to be taken by supervisors in reaction to the shortfall identified. In practice the same basic techniques may be used to carry out the initial calculation. But there can be important differences in the final result with Pillar 2 having a greater ability for that result to be adjusted or even ignored.
4. This note seeks to identify the pro’s and con’s of the two alternatives. As is usually the case, a pro for one approach is often a con of the other.
5. In CP189, as described in the attached paper, we put forward a specific proposal for a Pillar 1 treatment. However the sub-board is **not** being asked whether we should proceed with that particular proposal – but instead the more basic question of whether we should be pursuing a Pillar 1 treatment at all.
6. In addition to seeing Pillar 1 and Pillar 2 as either/or alternatives, it is also possible to view them as complementary, i.e. that Pillar 1 provides a partial solution which is then supplemented by Pillar 2. Furthermore, credible initiatives to pursue Pillar 1 approaches can be seen as useful tools to make it more likely that more work is done to better understand the extent of the procyclicality problem, and that serious efforts are made to implement Pillar 2 properly.

Arguments in favour of Pillar 1

7. It is **intrinsically more appropriate.** The risk that we are trying to address is that derived from volatility in the Pillar 1 IRB capital requirements, not something that is a different form of risk which is usually the case with the risks covered by Pillar 2. It is really a Pillar 1 capital requirement disguised as Pillar 2. Nor does it sit well with the philosophical approach to Pillar 2 of a firm assessing the risk and the supervisor judging if he is in agreement. What we are fundamentally focused upon is the factual question of what the Pillar 1 requirement would be in a given set of circumstances. The amounts are large and the techniques are not well-established. Consistency of the treatment applied to different firms is important. Accommodating different firms’ specific ways of measuring the impact may be dangerous.

8. A Pillar 1 treatment aims to **eliminate forbearance** by supervisors. Under Pillar 2 the correct calculation of a figure does not necessarily lead to it resulting in a capital requirement. It may instead be followed by an argument as to why it is not important. Especially in the upswings in the cycle, there will otherwise be a tendency to easily accept arguments by firms that do not reflect what will actually happen in practice; as opposed to managing the problem.
9. A connected point is that a Pillar 1 approach provides automatic reduction of the 'add-ons' as the cycle worsens. (One of the criticisms by the industry is that supervisors will get cautious in those circumstances and not allow this to happen).
10. A Pillar 1 treatment would allow/facilitate the procyclicality impact to be included in the **'overall capital requirement'** calibration. This is desirable if the procyclicality requirement is to bite, as this will prevent the overall capital requirements being too high at an industry level.

Arguments in favour of Pillar 2

11. Even if **Pillar 1 is preferable in principle, it is too late** to have an internationally-agreed treatment based on it. The subject has been discussed before and people will not change their minds at this late stage with both the Basel June document and the Draft Directive published. (Although the counter to this may be that a number of the players have changed and politicians may be more interested in the procyclicality issue.)
12. Accordingly if the UK (even with a few others) were to try to implement a Pillar 1 approach, we would be **superequivalent.** (Although the sub-board's recent decision on equity risk weights has provided a precedent in terms of 'superequivalent Pillar 1'.) And there is an increasing amount of focus on **consistency of international implementation.** (But no guarantee that this could be achieved through the Pillar 2 route either).
13. Although the impact of procyclicality is on Pillar 1 IRB requirements, it is **technically difficult to make adjustments to the Pillar 1 calculations.** As we are unlikely to require a firm do carry out individual re-ratings at an asset level, implementation possibilities seem likely to be limited to top-down portfolio adjustments, which seem more of a Pillar 2 concept.
14. In order to guard against forbearance, **Pillar 1 treatments seem also to deny flexibility where it is warranted.** We should be able to take account of **dynamic effects,** and **diversification** is important in reducing the procyclical impact. Even allowing for the judgemental nature of IRB estimates, it does not seem that either of these can be allowed under Pillar 1.
15. The arguments in favour of the Pillar 1 approach may unrealistically overstate the position. It is **not impossible for the Pillar 2 approach to be implemented in a way that bites. It is also debateable whether we should want to include the procyclical impact in the overall capital requirement** given the industry's ability to reduce this by switching to more acyclical approaches.