2022 ANNUAL CYCLICAL SCENARIO (ACS): WHAT IS NEW?

On 26 September 2022, the Bank of England (BoE) published details of the return to its 2022 Annual Cyclical Scenario (ACS). The ACS was not performed over the past two years during Covid-19 and postponed in March 2022 due to Russia's invasion of Ukraine. The aim of this stress test is to test the resilience of the UK banking system to **deep simultaneous recessions** in the UK and global economies, **large falls in asset prices** and **higher global interest rates** over a **five-year** stress scenario. In addition, there is a separate stress test of **misconduct costs**.

- The Financial Policy Committee (FPC) and Prudential Regulation Committee (PRC) will use the test to assess bank balance sheets and the resilience of the UK banking system. This will help the bank to ensure the UK banking system is able to **adequately absorb**, rather than amplify shocks.
- The bank has made it clear that the stress applied under the ACS is not a forecast of any local or global macroeconomic conditions; however, it represents a **'tail risk'** scenario designed to be severe and broad enough to assess the resilience of UK banks to a range of adverse shocks.
- **Eight banks**, together accounting for around 75% of lending to the real UK economy, are participating in the 2022 ACS
- Empirical evidence shows that high debt burdens and credit booms tend to be associated with more severe recessions. In the real world, as these burdens grow, the risk of a more severe recession in an economy tends to grow with them. Sharp macroeconomic downturns in other countries will lead to a contagion effect being transmitted to the UK economy.
- The results of the ACS will be published in summer 2023 and will help inform the UK Countercyclical Capital Buffer (CCyB) rate and Prudential Regulation Authority (PRA) buffers.

WHAT'S DIFFERENT THIS TIME?

- Previously, ACS stress tests only incorporated the impact of higher interest rates in the **UK only**. This ACS will be the first time that UK banks' resilience to higher **global interest rates, cost shocks, and persistent global inflation** is tested.
- For the first time, the 2022 ACS will **assess ring-fenced subgroups** of banks on a standalone basis, where the ring-fenced banks **differ materially** from the group as a whole.

Implications for Clients

- Since the paper was published, the economic conditions in the UK have taken a turn for the worse. Rate hikes, soaring inflation and lower expected GDP levels have shown that this is not merely a hypothetical stress test, but rather a reality check for financial institutions to test if they can survive in periods of severe economic downturn.
- We see it as critical for firms to expand their internal stress tests to include impacts on their profitability and staff retention.
- It is especially critical for ring-fenced banks running simultaneous stress test exercises. There will be struggles for teams across banks to accommodate the workload usually associated with period of stress tests, especially during a period of high staff turnovers within banks.
- If a bank's capital ratio is projected to remain above its hurdle rate, the PRC may still require it to act to strengthen its capital position.

COMPONENTS OF THE STRESS TEST

1. UK and global macroeconomic stress, spanning a five-year period from Q3 2022 to S2 2027
2. Traded risk stress, linked to a financial market scenario consistent with the content and calibration of the macroeconomic stress
3. A misconduct costs stress

MACROECONOMIC STRESS-TEST SCENARIO

The stress scenario is broadly similar to the 2019 ACS, and more severe overall than the 2008 global financial crisis. The numbers extracted from the BoE publication are shown below: -

In %				
Variable	**2022 ACS**	**2019 ACS**	**More/less severe than 2019 ACS**	**Global financial crisis**
UK real GDP	-5.0	-4.7	**More**	-5.9
World real GDP	-2.5	-2.6	**Less**	-1.9
UK unemployment (change)	4.7	5.2	**Less**	3.2
UK unemployment (peak level)	8.5	9.2	**Less**	8.4
UK residential property prices	-31	-33	**Less**	-17
UK CRE prices	-45	-41	**More**	-42
UK Bank Rate	5.1	3.3	**More**	-5.2
UK Equity Prices	-45	-41	**More**	-40

Source: BoE

Unemployment:

- Unemployment rises 4.7% to peak at 8.5% by the end of 2023, the peak of which is less severe than the 2019 ACS.

Bank Rate & Credit Effects

- Bank rate increases to 5.1%, more severe than the 3.3% in 2019
- However, it is critical to consider the fact that bank rates were lower in 2019 (<1%), while it is at 3% today. Thus, the increase in 2019 was only marginally greater than the increase today.
- It is also interesting to note that the bank rate today is almost equal to the stressed scenario bank rate 2019, highlighting the importance of such stress tests on the preparation of banks to face statistically unlikely 'tail' risks.
- The spread between the yield on investment-grade corporate bonds and risk-free interest rates increases sharply from 171 bps in Q2 2022 to 419 bps in the UK.
- High-yield corporate bond spreads increase from 541 bps in Q2 2022 to 1953 bps in the UK. This reflects increased vulnerabilities in market-based finance, such as funds selling off corporate bond holdings at a discount (fire sales).

GDP

- The overall severity of the UK stress is broadly similar to that of the 2019 ACS, consistent with the FPC's judgment that UK debt vulnerabilities have remained at a standard level defined by the July 2022 Financial Stability Report, despite having risen lately.
- UK real GDP drops by 5%, compared to the 4.7% drop previously in 2019.
- Global real GDP drops by 2.5% vs. the 2.6% previously in 2019.
- The smaller drop in global GDP compared to UK is explained by the narrative that assumes the falls in China (-0.1%) and Hong Kong (-6.9%) are lower than variables used in the 2019 ACS scenario (-1.2% and -7.9% respectively). This is because some risks associated with financial conditions have started to crystallise and thus the magnitude of the remaining risks have diminished. In addition, China's growth trend still remains strong relative to other countries, specifically the UK.

Inflation

- Annual UK inflation averages around 11% in the first 3 years of the stressed period, peaking at 17% in early 2023. It only begins to fall in the second half of 2023 to 3.4% by end of 2024 and 2% by 2027.
- The sharp rise in UK inflation stems from the increases in global energy and food prices, as well as global supply chain issues distressing import and domestic prices.

Asset Prices

- UK residential property prices fall by 31%, which is less severe than the 2019 ACS. This is the tail of the historical distribution, and in line with comparable housing market downturns in other advanced economies. The downturn is sharper in regions of the UK which have seen more rapid house price growth since the pandemic. Commercial real estate (CRE) prices fall initially by 45% from start to trough, before recovering and ending the scenario 31% lower than their 2022 Q2 level.
- UK equities fall sharply by 45%, which is more severe than the fall assumed in the 2019 ACS.
- The fact that the fall in CRE is sharper than the fall in residential house prices reflects the historical notion that the demand for CRE is more cyclical, while the demand for residential property is more inelastic.

Misconduct Stress

- Banks will be assessed against stressed misconduct costs beyond those they have already paid or provisioned for. The methodology has not changed since previous tests.