

To: Representatives of the Financial Services Roundtable, GAC, Public Affairs Council, Research Council, All Staff

Fast Facts: PROCYCLICAL vs. COUNTERCYCLICAL POLICIES

On August 17, 2011, the Financial Services Roundtable released a study commissioned through the Cluff Fund and authored by Drs. Bill Longbrake and Clifford Rossi, entitled: "The Procyclical versus Countercyclical Policy Effects on Financial Markets." Below are key takeaways from the report.

FACT: Markets are inherently cyclical. There are booms and busts.

- Procyclical policies exaggerate the ups and downs of business cycles (e.g. the good times are really good, the bad times are really bad).
- Countercyclical policies reduce the length and extent of business cycle contractions.

FACT: One of the most significant procyclical forces is financial regulation, which can negatively impact economic growth and innovation.

FACT: During economic downturns, regulators are more apt to implement procyclical (vs. countercyclical) policies.

- "Reflecting the losses and recriminations of the bust, regulators are afraid of being criticized themselves, afraid of making further mistakes, and trying to rebuild their deposit insurance fund which has shrunk to negative net worth. Reacting to the painful mistakes already made, they clamp down forcefully. This contracts credit further than the crisis already has," *Alex Pollock, Senior Fellow at the American Enterprise Institute, writes in his foreword to the report.*

FACT: Examples of procyclical policies that may have contributed to worsening and deepening the financial crisis include: loan loss reserving accounting rules; supervisory implementation of regulatory policy; regulatory capital requirements; liquidity requirements; deposit insurance premiums; and fair value accounting rules.

FACT: Drs. Bill Longbrake and Clifford Rossi examine these procyclical policies and offer countercyclical alternatives and key recommendations:

- **Coordination.** Regulators should *coordinate* to mitigate procyclical impacts.
- **Accountability.** Regulators should *be accountable* for mitigating procyclical impacts.
- **Regulatory Capital Requirements.** Regulators should study the potential consequences of the proposed Basel III capital requirements for lending and economic growth and analyze countercyclical alternatives.
- **Liquidity Requirements.** The Basel Committee on Banking Supervision and U.S. regulators should evaluate potential significant unintended consequences of the two

proposed required liquidity ratios and should either revise the ratios to mitigate such consequences or replace the ratios with supervisory guidelines.

- **Fair Value Accounting Rules.** The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should continue to work toward harmonizing US and international fair value accounting (FVA) principles, and in doing so, should be attentive to mitigating potential procyclical impacts.

A full copy of the report is available here:

<http://www.fsround.org/fsr/pdfs/cluff/CountercyclicalPE.pdf>

If you have questions, please do not hesitate to contact Abby McCloskey, Director of Research at the Financial Services Roundtable, at Abby@fsround.org, or Scott Talbott, Senior Vice President of Government Affairs, at Scott@fsround.org.