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Banking reform and macroprudential regulation: implications for banks' capital structure and credit conditions - speech by Paul Tucker

Speaking in Helsinki today, Paul Tucker considers the implications of the reforms of banking for the credit system. He outlines the possible shape of a Capital Accord for the future, catering for banks in distress as well as in health; tries to dispel some commonly held misconceptions of how macroprudential variations of capital requirements will affect credit conditions; and outlines some thoughts on how the reforms might influence the shape of the financial system.

Paul Tucker looks first at changes in the micro-regulatory regime and banks' capital structure. The micro-level reforms have two important components, he says: a step change in regulatory requirements on capital, leverage and liquidity; and the establishment of credible and effective resolution regimes. "Separately and in combination, they will change how the risks in banks' portfolios are distributed across shareholders, bondholders, depositors and, perhaps most important, taxpayers".

Paul Tucker makes the case for a "richer regulatory Capital Accord for the future – one that distinguishes more carefully between the different phases of a bank's life and death". He says the core purpose of the existing Basel 3 Accord, to set a minimum level of equity to provide sufficient going-concern loss absorbency, is not enough. "We also need to regulate for a minimum level of term bonded debt to provide gone-concern loss absorbency", mandating bond issuance of a minimum quantity from prescribed parts of banking groups in order to make resolution feasible. While "that might be enough", a richer Accord might go further still, in providing for the stages prior to resolution, "mandating so-called 'high-trigger' CoCos, so as to encode recovery measures into a bank's capital structure. And it might even include low-trigger instruments to aid resurrection when a bank had seriously impaired equity but was not on the brink of bankruptcy."

Yet even a more complete Accord along such lines is, Paul Tucker says, not sufficient, as revealed by the authorities' creation of macroprudential regimes. In the UK, he notes, the primary objective of the new FPC is to protect and enhance the resilience of the financial system, with a subordinate objective of supporting growth and employment.He underlines that the authorities need to be able to respond to the system's evolving structure, or temporarily tighten capital requirements in especially threatening circumstances.

Paul Tucker reasons that the primary objective of macroprudential regulation – improving financial system resilience - can be advanced even if a credit boom itself is not always tempered. Whether macroprudential interventions could quell a credit boom turns largely on the effects of the cost of finance, he says. But he expresses concern that too much of the analysis in this area is oversimplified. “A required substitution to more expensive equity finance will, indeed, tend to push up banks’ funding costs, but the effect on overall funding costs will depend on whether, and by how much, debt financing costs fall due to a lower probability of bankruptcy … Where there are question marks over the system’s capital adequacy, the reverse [i.e. a fall, rather than a rise, in overall funding costs] can sometimes be true. More generally, the effects on credit conditions will depend on whether the policymaker’s actions revealed information about the state of the system and its approach to policy, and on whether the market regarded the actions as warranted, insufficient or too much. Overall, this underlines the importance of transparency – from banks and from the macroprudential policymaker.”

Paul Tucker says that it would be surprising if the crisis and regulatory response did not induce structural changes in the system; “the shape of some can perhaps be discerned”. Actions to remove the subsidy from banking will he says, amongst other things, create conditions in which the relative role of unlevered capital market investors, probably crowded out in the past, can grow. “Some of that might come through securitisation, although a mature and resilient market in ABS of loans to SMEs might well require initiatives to produce rich data sets on credit histories. The time may have come to evaluate the utility of the central credit registers that have long existed in some continental European and Asian countries.” He says that, as deposit takers, banks will always be levered and they will always have somewhat risky asset portfolios. But “only sound banks can make a credible promise to repay or lend money on demand”. And he highlights that there may be greater value in longer-term bonds, which can absorb losses, helping to recapitalise the firm in resolution, and can thus be a source of market discipline through price and rationing, than in short-term debt, often seen as a disciplining mechanism on the basis that it can run. "Not all forms of leverage are the same."