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The reform of international banking: some remaining challenges - speech by Paul Tucker

In a speech to the Oliver Wyman Institute Conference in London on Tuesday, Paul Tucker discusses three issues that standard setters and regulators will need to address as they complete the reform of international banking.

The first area is that while the international regime sets a requirement for banks to have a minimum equity cushion, it does not ensure that banks have in issue debt that enables an effective reconstruction in resolution : 'gone concern loss absorbing capacity' (GCLAC), which can be used to smoothly absorb losses in resolution or liquidation. The recent G20 Leaders Summit called on the Financial Stability Board (FSB) to produce plans over the coming year. He believes that "in time the Basel Capital Accord could usefully be recast so that it has distinct components for going concern and gone concern requirements. That would replace what to my mind is the fuzzy distinction between what are termed 'Common equity tier 1', 'Additional tier 1' and 'Tier 2' capital – not all of which is capital in the ordinary sense of the term that it can absorb losses outside of liquidation."

The second area, also being addressed by the FSB, is ensuring an adequate distribution of equity and gone-concern loss-absorbing capacity across the different legal entities in a banking group. Paul Tucker identifies this as an important gap in the international regime for international banking. He says, "From a resolution perspective, the distribution of loss-absorbing capacity (the sum of going concern and gone concern loss absorbency) is crucial. Yet, from a regulatory and supervisory perspective, there is as yet no international standard that requires a banking group to ensure a sensible distribution of equity and debt within the group. The international standards on banking will need to catch up."

Paul Tucker explains that "the choice of how equity and gone-concern loss-absorbing capacity should be distributed across a group is part and parcel of deciding its preferred resolution strategy." Resolution strategies will either need to be Single Point of Entry – a top-down approach where a whole-group resolution is executed from the top - or Multiple Point of Entry, where a group is split into parts which, as necessary, are resolved separately. He concludes that, "There is a clear way forward on resolution. But there will be some consequential recasting of the regulatory rulebook."

Finally, Paul Tucker explores how a clear framework for stress testing banks and other key financial institutions can help micro- and macro-prudential regulators. He draws attention to the discussion paper published by the Bank today which outlines plans for a stress testing regime in the United Kingdom. Each year, the FPC would design a set of common scenarios that it judges the banking system needs to be able to survive given prevailing threats to stability. The PRA would apply that scenario to the major banks, dealers and building societies alongside more firm-specific scenarios. The regime would be transparent.

Paul Tucker argues that a “stress-testing regime can enhance the quality of the Bank’s macro and micro prudential supervision, and, over time, underpin confidence in the banking system”. It could also represent a “quantum leap” in the public accountability of both the Financial Policy Committee and the PRA Board: “we need to engage society – public, Parliament – in debates about the resilience of the financial system and how we are supervising it in the good times as well as in the bad times.”