The Economist's Perspective: Comments on ARTURO ESTRELLA, «The Future of Regulatory Capital: General Principles and Specific Proposals» and TIM SHEPHEARD-WALWYN, «The Role of Precommitment in Future Capital Regulation – The Lessons of the New York Pilot Study»

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Let me begin by confessing that I do not consider myself to be an expert for the specific issues that have been discussed in the papers by ESTRELLA and SHEPHEARD-WALWYN. I will thus limit myself to commenting on some basic points.

Incentive issues are at the heart of the modern economic approach to the design of regulatory policy and have played a crucial role in past discussions of captial adequacy requirements. The mainstay of this approach is the presumption that the interests of banks and regulators diverge, with banks aiming to hold less than the socially optimal amount of capital. There is no need to dwell on the various reasons why such a divergence between privately optimal and socially optimal capital levels may arise. One consequence is immediate: to serve its purpose of aligning private decisions with social objectives regulation must interfere with the behavior of (some of the firms in) the financial sector. In this view regulation is supposed to benefit society by hurting firms. Of course, I do not mean to imply that a discussion of regulatory policy can proceed without a careful evaluation of costs and benefits. Quite to the contrary, I think we should be suspicious of any analysis which does not state explicitly which problem regulation is supposed to solve and how the specific proposal made will be successful in inducing the desired change in behavior.

In the «world of modern risk management» described by SHEPHEARD-WALWYN banks will find it in their own interest to have a «capital base which is well in excess of any likely or conceivable loss.» If this is so, I find it difficult to see why regulators should have reason to worry about banks holding insufficient capital. In fact, many of the arguments presented in the paper are quite consistent with this view. The author sees little (if any) real conflict of interest between the public sector and banks and proposes a regulatory approach which seems to be designed to avoid any interference with the well informed capital allocation decisions made by banks. From my perspective the trouble with this analysis is not only that a multitude of incentive issues are swept under the rug – for instance, I find it less than obvious that a well managed bank will find it in its in-

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terest to mark down the value of its loan book on the basis of expected (and presumably unverifiable) losses – but more fundamentally that it fails to address the question: if no one is supposed to be hurt by this regulation, then why do we need it? I suspect what the author has in mind is that not all banks can be trusted to partake in the new risk management techniques and that badly managed banks should be restrained. But then the discussion surely should have focussed on explaining how the «base-plus» approach provides the appropriate incentives for such banks to mend their ways.

To motivate a role for supervisory policy ESTRELLA notes that the «capital decisions of individual institutions may produce externalities and that an impartial public-sector supervisor with enforcement powers can play a useful monitoring role.» While this observation suggests that incentive issues should play a key role in the ensuing discussion of capital regulation, the author eliminates many of these considerations by assuming that «there is some level of capital that is consistent with the interests of the firm and the regulatory and supervisory objectives of safety and soundness.» ESTRELLA views the regulatory challenge as identifying the corresponding «optimal level» of capital in a world in which firms and supervisors may find it a difficult task to produce and evaluate the required information. Because the idea that binding restrictions might play a useful role in providing incentives is ignored, it is not surprising that «mechanical formulas» fare badly in the analysis: the argument is that such formulas will fail to take relevant information into account and thus produce distortions. Of course this does not settle the case against «mechanical formulas». The relevant question to ask is whether there are alternative approaches which do better in achieving the aim of identifying and implementing optimal capital levels. The author thinks that a «supervisory approach,» relying on informal constraints and conventions to ensure cooperation, provides a positive answer. I find this argument difficult to swallow. Which conventions evolve and how they affect behavior surely depends on the institutional environment in which they operate. Noting the importance of conventions thus does not absolve the economist from the task of paying careful attention to the design of institutions and rules – it just makes the task more difficult.