Comments on "Is the New Basel Accord Incentive Compatible?"

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Outline

- Review the paper
- Discuss the results
- Propose future research

Basic model

- Consider the effect of capital requirements in presence of deposit insurance
- Compare:
  - 1988 Accord
  - New Basel Accord
    - The Standardised Approach
    - The Foundation Internal Rating Based Approach
    - The Advanced Internal Rating Based Approach

Results

How about other incentives?

- Banks self-select their regulatory structure.
- Non rated borrowers have lower standardized risk weight than below BB- borrowers
- Role of the rating agencies and equilibrium effect in the market.

Is there any solution?

A philosophical answer:

- to avoid regulatory arbitrage the "optimal risk-weighting" system should be based on the "true" risk measures of the risks.
- May be a detailed externally imposed risk weighting system is then a contradiction.
- Role of the rating agencies and equilibrium effect in the market
- Is an internal rating approach a viable alternative? Carey and Hrycay (2000) report that officially reported default rates for a given rating can be made as low as half the bank's private estimate.

Is there a solution?

Does the market have a role?

- In this static model, capital requirement has an effect on the behavior of the banks only if it is binding. In practice, shareholders may want to have higher solvency ratios to appeal to non insured investors.
- In the new accord the role of market discipline is limited to information disclosure. Information disclosure per se does not enhance market discipline. The market should be able to value the information and impose costs on banks that releases negative information. As long as depositors are insured discipline will not happen.
- The current approach discriminate against the use of subordinated debt in satisfying the capital requirement.

Is there a solution?

Is the role of regulation limited to impose the solvency ratios?

- The solvency regulation of banks brings in a rule specifying under what conditions the shareholders remain in control, and under what conditions the regulator is in control (Dewatripont and Tirole (1994))