Commentary

Christine M. Cumming

In commenting on the three thought-provoking papers in this session, I would like to consider the first two papers together and then turn to the third.

From the standpoint of methodology, the first two papers could not be more different. The Estrella paper blends analytical and historical methodologies, with attention to supervisors' own understanding of their policies and practices, to consider the appropriate role of formulas and judgment in the supervisory assessment of capital adequacy. The Kupiec and O'Brien paper considers a series of results in the literature in the context of a more general model. Paul Kupiec and Jim O'Brien have done a great service in their paper by bringing these strands of the academic literature into a common framework. They help us to understand better the role of capital requirements and the interaction of capital requirements with risk management, the public safety net, and the short- and long-run optimization problems of firms, where franchise value is interpreted as capturing the long-run value of the firm as an ongoing concern.

The themes in the two papers, however, are very similar. Estrella emphasizes the dynamism and complexity of the financial system and, more particularly, of the rules and conventions that guide financial institution and supervisory behavior. In doing so, he draws on literature beyond economics that discusses the phenomenon of reliance on judgment and interpretation in the crafting and execution of rules and conventions. Reliance on simple quantitative rules applicable to all institutions—in Estrella's language, formulas—cannot work as supervisors would like them to.

In their paper, Kupiec and O'Brien make much the same point by generalizing the models used in the literature on capital requirements and deposit insurance pricing. Well-known policy prescriptions developed in models with certain assumptions change markedly with the relaxation of even one or two assumptions. In particular, for banks with different strategies or different investment opportunities, the "optimal" capital requirement—the requirement that shareholder value is maximized but moral hazard is minimized—is bank-specific. No two capital requirements are likely to be the same.

In both the Estrella and the Kupiec and O'Brien papers, the development of bank-specific requirements entails large amounts of information and a degree of precision that is not reasonable to expect of anyone, except the owners of the firm. As the world becomes more analytical, precise, and complex, it becomes all the more difficult to specify simple and hard-and-fast regulatory rules.

Christine M. Cumming is a senior vice president at the Federal Reserve Bank of New York.

Yet both papers see a role for capital requirements—to limit moral hazard, to benchmark information, and to provide a cushion to limit the social costs of a bank liquidation. If we look beyond these papers to actual practice, formulas such as minimum capital requirements appear to have additional purposes. Such requirements shorten the negotiation time to agreement between firm and supervisor on appropriate capital levels by providing a lower bound to the possible outcomes. A related consideration is transparency. Since the regulator has statutory powers to enforce capital adequacy, the considerations influencing its evaluation should be known to the financial firm, and the government should be able to demonstrate capital inadequacy in setting out any remedial action.

What, then, do the conclusions in these papers mean for supervisors?

First, capital requirements will necessarily be imperfect and have only temporary effectiveness. Second, the increasing sophistication and complexity of risk management in financial institutions call for more judgment in assessing capital adequacy. Third, capital cannot be considered in isolation, but has to be understood in the context of strategy, investment opportunities, risk management, and the cost of equity issuance. Capital requirements need to be seen in the broad context of supervisory activity, and capital adequacy supervision must necessarily involve some elements of supervisory judgment. Fourth, the conclusions in these papers help explain why we increasingly see a link between the quality of risk management and various supervisory rules and permissions. For example, the internal models approach includes both qualitative and quantitative criteria. With prompt corrective action and under the recently revised Regulation Y in the United States, limitations on activities and requirements to seek regulatory permission to conduct activities can be triggered by supervisory judgments, as reflected in the CAMEL or Management ratings given by U.S. supervisors during a bank examination. Finally, the results also help to explain the appeal of "hybrid" approaches described by Daripa and Varotto and by Parkinson; the supervisory approach described in Estrella's 1995 paper, "A Prolegomenon to Future Capital Requirements"; and the approach described in the Shepheard-Walwyn and Litterman paper.

In reading the Frankel paper, I found myself surprised. After the breadth of perspective in the previous two papers, Frankel moves the point of perspective higher and further back to survey the broad global scene, and generates the shock of the unexpected—the problems we just considered in Estrella and in Kupiec and O'Brien are yet more complex. The shock is reinforced by the contrast between the elegance of the two earlier papers and Frankel's candid observations.

Frankel's paper considers two sets of issues. First, he points out that certain preconditions have to be met for financial supervision to have any meaningful role. These preconditions include meaningful financial statements, publicly available on a timely basis, and a clear set of rules determining what happens when debtors cannot pay. In other words, we need to have adequate accounting, disclosure and bankruptcy principles established and applied in every country active in the international financial markets.

No one in this room is likely to disagree openly with his point. Frankel argues that the absence of these preconditions in some countries contributed to and exacerbated the recent crisis in Asia. Moreover, that crisis does seem to have created a defining moment for G-10 supervisors and central banks. The G-10 official community shows every sign that it agrees on the need to strengthen global accounting, disclosure, and bankruptcy rules and practices. What makes the moment defining is that these issues are not new—efforts have already been made to address them within the G-10 countries with mixed success, and the need for genuine success is all the greater.

That brings me to Frankel's second set of issues. I did not fully understand his arguments, but the issue of the respective roles of authorities in the G-10 and the emerging market countries in creating these preconditions is important. In my view, there is no question where leadership should come from. In the context of capital regulation, leadership from the G-10 countries—rooted in a perspective that encompasses the emerging market countries—suggests some considerations in evaluating possible approaches to twenty-first-century capital requirements. In

particular, we might look for approaches that provide evolutionary paths for capital requirements, with financial institutions proceeding along the path at their own pace and consistent with the nature of their business strategy and risk management and internal control processes. The 1996 Market Risk Amendment to the Basle Accord, with its standardized and internal models approaches, represented one example of the creation of an evolutionary path.

One caution, however. The path concept cannot be seen as a reason to avoid moving expeditiously down the path or failing to put the preconditions described by Frankel in place. When you drive on the Autobahn, you cannot drive at 25 kilometers per hour or operate a car in need of repair.

The substantive issues raised by Frankel's paper are, what changes to the national and the international financial systems do we want and how much do we want them? The other issues he raises—who is a signatory to international agreements and whether and how to have some international enforcement mechanism to ensure minimum standards among participants in the international financial markets—are issues of process. We first have to work on agreeing on the substantive issues. The very process of forging a consensus is by its nature inclusive, and that suggests some clear considerations for the process issues.

The views expressed in this article are those of the author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System. The Federal Reserve Bank of New York provides no warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, or fitness for any particular purpose of any information contained in documents produced and provided by the Federal Reserve Bank of New York in any form or manner whatsoever.