This article sheds new light on the important debate about the choice of risk weights in regulatory capital ratios for banks. Several academics including Kim and Santomero (1988) and Rochet (1992), had criticized the first Basel Accord (1988) for being too coarse. Basically the message of these papers was that when regulatory risk weights differ from markets’ assessments of risks, there will be a distortion in the portfolio choices of banks. In some extreme cases, the risk of default of some banks might actually be increased (!) by regulation, which is of course exactly the opposite of what prudential regulation is supposed to do.

Interestingly, Glasserman and Kang suggest that if the regulator’s objective is to minimize the risk in banks’ portfolios, the appropriate risk weights should be related to the expected profitability, not to the risk of the assets. Of course, if financial markets are reasonably efficient, the two should be closely related but there are many reasons to think that this is not always the case. Given that expected profitability might be difficult to evaluate by regulators, Glasserman and Kang proceed by advocating for a recursive method whereby regulators would adjust their risk weights over time and hopefully converge towards the “right” risk weights, provided that the environment is sufficiently stationary. Then they use recent data on U.S. banks to illustrate how such an adaptive method might work in practice. The end of the paper is dedicated to a very interesting discussion of related issues such as the use of complementary regulations such as an equally weighted leverage ratio and countercyclical capital add-ons to limit the excessive fluctuations of bank credit over the business cycle.

This paper is very timely, as the authors provide a very clear and rigorous discussion of policy issues that are currently hotly debated. I basically agree with most of the authors’ conclusions, as they concord a lot with my previous work on the topic (Rochet 1992). My comments will therefore bear on two slight points of disagreement I have with the authors.

First, I do not subscribe anymore to the view that regulation should be complex enough to take care of the complexities of banks’ activities. I rather think that supervision (implying possible regulatory action) is more important and therefore that rules (regulation) should be simple. The Subprime Crisis has shown that complex regulations always fail because big banks are able to bypass them and supervisors cannot do much about this, even if they are well intentioned. Contrarily to what I thought in 1992, the role of bank regulation is not to steer bank portfolio decisions towards some “social optimum” (which is always unattainable) but rather to allow supervisors to detect deviant behaviors before it is too late, in the spirit of stress tests. The supervisors do not have the staff and the expertise to control in continuous time what all banks are doing. They should concentrate on the

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1 Incidentally I suggest that the authors refer to the original publication of my work as a journal article in 1992, rather than to the book of reprints that was published much later in 2008.
ones that are susceptible of creating problems for the financial system. Capital requirements should be viewed as an “early warning indicator”, among others.

Second, I am not in favor of adjusting regulatory weights too often, because it adds regulatory uncertainty to fundamental uncertainty, which is already huge. To make a parallel with monetary policy, it would not be a good idea to adjust inflation targets on a regular basis to take care of changes of the economic environment. The actual target is less important than the credibility that the monetary authorities will stick to it. This is why I do not believe that the adaptive method recommended by the authors at the end of the paper would really work.

Jean-Charles Rochet

Swiss Finance Chair, University of Zürich

and Toulouse School of Economics.