Comments on
"The Political Economy of Financial Regulation" by Rainer Haselmann, Arkodipta Sarkar, Shikhar Singha, and Vikrant Vig

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Summary

- Examines the rulemaking process of the BCBS (Basel Committee on Banking Supervision), and finds:

1. A regulator is more likely to oppose the regulation proposed by the working group if the big banks of the regulator's country (national champions) express opposition to the proposal. The tendency is especially strong when the opposition is not shared by the national champions in other member countries.
2. Tones of the speeches on financial regulation given by regulators become more negative when the national champions (NCs) express negative opinions on the current BCBS proposals.
3. The alignment of positions between regulators and NCs are observed equally for countries with high shares of small banks and those with low shares.
4. Tones of the speeches by regulators who have past experience in large bank are more aligned with the position of the NCs
5. Proposals that are opposed by some NCs (but not all) are more likely to be delayed, diluted, or stalled altogether.

Interpretation of the Results

- More consistent with regulatory capture (suggested by the influence of regulator's experience in large banks) than national interest (the result does not differ according to the importance of large banks in the country)
- Regulatory capture by large banks makes international harmonization more difficult and may jeopardize the financial stability

Comments

- I like the paper very much!
- Important questions, new data, innovative techniques to analyze text data, robust results
- New data: from Risk.net, text mining at Factiva and LexisNexis, comments by banks and lobbying groups on the consultative documents, 1500 speeches by regulators collected by BIS
- Innovative techniques: Latent Dirichlet Allocation (LDA) topic modeling to estimate the sentiment from sentences

Comments focus on interpretation of results

- Paper’s interpretation: Many regulators are captured by national champions (NCs) and oppose the regulations that would help financial stability at the global level but would hurt NCs. This leads to watering down of finally implemented regulation. We should “question whether the current international standard setting via the Basel agency really provides optimal outcomes.”
- Comments:

1. Is this really “regulatory capture”? Any alternative interpretation? (other than national public interest)
2. Should we really call this “watering down”? Can it be “correction”?
3. Even if it is really “watering down”, is that bad?
4. This may be interpreted as an evidence that suggests “the current international standard setting via the Basel agency really provides optimal outcomes”

1. Is this really “regulatory capture”?

- Alternative that has not been really tested: Information story
- Nobody knows the exact impacts of the proposed regulation, so each stakeholder goes out and get relevant information. This is actually the rationale for the consultative process at BCBS.
- Regulators and NCs tend to get similar information, and they independently make decisions to oppose the proposed regulation.
- Evidence that shows that regulators’ reactions to the same information differ depending on where the information comes from
- Maybe a clever experimental survey?

2. Is this really “watering down”?

- If it was clear that all the proposed regulations add to financial stability at global level without side effects, this would be the case.
- In reality, we don’t know whether a proposed regulation will be effective. Reasonable people can disagree on the benefit and the cost of the proposed regulation.
- For example, capital floors: trade-off between model errors (or manipulations) in the internal model-based approach and perverse incentives (to choose highest risk in a risk-weight bucket) in the standardized approach
- In some cases, “watering down” may be welfare (stability) enhancing “correction”

3. Is “watering down” really bad?

- Given other problems of the current system, making the standard less stringent may be good
- For example, as the paper points out, in the current system, the standard is set by a small number of large countries. This may impose cost on smaller countries, and less stringent standard may reduce the cost.
- The problem can happen among member countries (now 28) as well
- In some cases, the proposed regulation, if not watered down, might have *increased* systemic risk by reducing the diversity of business models of the banks. This is an important problem that Romano (2014) raised.
- Romano (2014) proposes the mechanism to allow departures from the Basel standard with a process to monitor if the departures have not increased the systemic risk
- Given the absence of such a mechanism, “watering down” or blocking proposed regulation with large disagreement may be the best outcome.

4. Is this the evidence that the system is working?

- Disagreement often comes from the difference in the business models.
- The paper makes a similar point. “Given that the US and European banking markets fundamentally differ in terms of the proportion of banks do investment banking and corporate credit lending, reforms particular impacting one of these two business lines have a high likelihood of getting an adverse position by a regulator.” (p.14)
- The paper shows these proposed regulations are more likely to be opposed by some regulators and are not approved, given the requirement of unanimous decision making.
- The paper may be providing an evidence that the current system with the unanimous decision making does a good job protecting diversity from the potentially harmful standardization or at least getting buy-ins from all the member countries so that they implement the regulations seriously.