See. Spot. Catch. Frisbee. (… or Behold the Simple Elegance of Bank Capital, Upside-Down)

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Heidi Mandanis Schooner, *Top-Down Bank Capital Regulation*, 55 **Washburn L.J.** 327 (2016).

In the words of one younger and wiser colleague, "prescriptions are empty calories for law review editors."[1] Many fabulous articles uncover new histories, new facts, new frames … only to fizzle around the obligatory Part V, with its half-hearted defense of a model law or regulatory gimmick, that orphan child born of perfunctory comments in faculty workshops.

The latest article by Heidi Mandanis Schooner, based on her endowed lecture at Washburn Law School, is a rare counterexample—a stunningly simple reform idea that would literally upend the paradigm of bank capital adequacy, dispensing with some of today's most urgent and intractable financial regulatory debates. The Washburn Law Journal symposium issue (which includes insightful commentary on Schooner's lecture) and her spinoff testimony before the Senate Banking Committee are rich food for legal, economic, and policy thought—but are not very well-packaged, and could easily get lost in the buzz and dazzle of the fast-growing scholarly field.

Here are the problem and the fix, in a nutshell.

Under the existing regime, banks and a growing set of other financial firms must keep a minimum cushion of regulatory capital (roughly meaning equity and certain junior liabilities) to absorb losses in the event their assets decline in value. If its cushion is too small, a firm might fail, depositors and other senior creditors might lose money, and other firms and markets might succumb to contagion. To prevent or contain a financial crisis, the state might step in with a bailout.

The proper size of the capital cushion is the subject of a huge, nasty, and mostly unresolved academic and policy debate, which Schooner recounts briefly in her piece. The "consensus" range is somewhere between 4 percent and 40 percent, reflecting different methodologies and normative perspectives. In practice, the floor has been set by international agreement: since the late 1980s, the successive Basel Accords have articulated global norms for bank capital adequacy, and ever more convoluted ways of measuring it. Basel I, II, and III reflect technocratic and political accommodation among regulators who oversee the world's largest financial institutions and markets.

Crucially, the burden of going above the floor is on the state. U.S. officials have successfully used administrative discretion for decades to raise the effective capital requirements for most banks above the absolute minima—but failures and crises came anyway, leading many to argue that capital cushions were still too small.

In a delightfully legal move, Schooner would simply flip the burden. Instead of starting with, say, 8 percent and working up to, say, 15 percent, using a host of complex formulas and byzantine administrative procedures—regulations might start at 20 percent and give regulated firms a chance to argue it down to 15 percent. As she puts it towards the end of her Senate testimony, "[c]onceptually, capital regulation would be set … as 'prudent' capital as opposed to 'minimum' capital."

This is ingenious because it flips two arguments at once—the argument over math, and the argument about its normative underpinnings. When the standard is "minimum," the market failure paradigm dominates. In contrast, "prudent" could be defined in terms of banks' public functions and the risk preferences of the taxpaying public.[2]

Schooner's prescription is broadly in line with the precautionary trend in financial regulatory scholarship – a rich crop of proposals to limit and license financial products and activities, reflecting a healthy skepticism about financial innovation and post-crisis risk aversion on the part of the public. Hers stands out for its radical simplicity. It would require no new administrative apparatus, and, if anything, might do away with some of the complexity that has come to define financial regulation.

As Erik Gerding notes in his comment, the upside-down capital idea follows another regulatory precept—captured in Andrew Haldane's metaphor of the dog and the Frisbee—to fight complexity with simplicity. Top economists have shown that identifying the right minimum level of capital against financial crises is incredibly hard, perhaps even harder than finding a formula for consistently catching a Frisbee. Dogs learn to catch Frisbees without formulas. Flipping capital regulation on its head might dispense with a few formulas as well.

As Gerding and Brett McDonnell rightly note in the symposium, Schooner's inspired concept does not escape the essential criticisms directed at *all* bank capital regulation – namely, that regulating some firms more stringently, or more effectively, could drive finance beyond the regulatory perimeter, and spawn new regulatory arbitrage strategies. McDonnell also notes that there are risks to firms and to society from setting capital thresholds too high. Both critiques are fair, but they are not particular to Schooner's argument. If you are going to regulate bank capital at all, it is hard to see why you wouldn't do it upside down.

My own frustration with the article is that the absolutely brilliant core contribution is buried way too deeply for most readers to reach, and takes up much less of the text than it should. I am also uneasy about Schooner's term for the proposal, "Top-Down Capital Regulation," which to me connotes a clunky *dirigisme*, potentially overshadowing the subtle elegance of her idea.[3]

In the grand scheme of things, these are quibbles, perhaps pointing to an opportunity for the author to expand on her insight in another article or two.

1. The colleague's name is withheld until such time as he no longer need care what the editors think. [?]
2. To align incentives, Schooner also argues that managers should have personal liability in the event they successfully argue for a cushion that turns out to be too low—although she does not fully develop the idea. [?]
3. The existing regulatory paradigm is called "Bottom-Up," which I associate with people power, in a world that is anything but. [?]

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