Book Review

Guardians of Finance

Making Regulators Work for Us

By James R. Barth, Gerard Caprio Jr, and Ross Levin, MIT Press

■*Guardians of Finance* is a rare book which addresses the question of where were the regulators, Guardians, when the financial crisis occurred in a clear and balanced manner. The Guardians have largely escaped criticism by cloaking themselves behind a convenient narrative. Under this view, the Guardians were powerless to stop the crisis which represented an accidental event. Furthermore, they allege if only granted additional powers, for example the Dodd Frank Act (DFA), future accidents would be eliminated. Even though it is difficult to envision what powers regulators lacked that could have stopped the crisis. The often blamed Glass-Steagall Act repeal is shown to be a red herring as the crisis occurred in countries which did not have a Glass-Steagall to repeal. This book, like their 2006 book *Rethinking Bank Regulation: Till Angels Govern* may be uncomfortable for both those on the right and left given its balance. The book, however, is not about blame, but about the accountability needed to achieve real progress. Essentially, you cannot learn if you do not understand.

The premise is the Guardians, Federal Reserve, FDIC, SEC, FSA, inter ialia, failed to protect us against the crisis by encouraging financial institutions to take excessive risk. Their failure was as much as cause of the crisis as banks and other participants. The crisis did not happen to them. Rather, it happened because of them. Far from being impartial guardians of the public trust- the Guardians were, in fact, captured by special interests they sought to regulate, based on three factors. The factors include large scale industry lobbying, bias in believing the industry's opinion and the revolving door factor. The movement between financial institutions and the regulatory agencies, the revolving door, perverts financial regulation. Thus, their interests deviated from the public just as economists Macur Olsen and James Buchannan have predicted for elected officials. Unlike politicians, the Guardians are unelected, unaccountable officials with an information monopoly who are largely unchallenged. As the crisis demonstrated, empowering the Guardians without adequate checks and balance leads to ruinous results.

The authors then outline the difficulties with financial regulation and its various approaches. The underlying problem is the opaque and amorphous nature of risk. We never see risk beforehand. Rather, it is seen only after an event occurs. Consequently, regulators are always playing catch-up. Next, regulations change the dynamics and incentives among management, shareholders and other stakeholders in unintended and not fully understood ways. This is a problem whenever a simple system, government, attempts to control a complex system like markets. Therefore, we cannot assume institutions will act prudently despite incentives to do otherwise.

The book recognizes market imperfections such as externalities, economies of scale and scope and asymmetric information. The government, however, suffers from inadequate incentives and capabilities. The authors note Adam Smith's warning that while markets may not know best, imperfect governments may cause more harm than perceived market imperfections. This is clearly the case with recent financial regulations and the existing regulatory approach.

The current crisis driven regulation system is defective and stagnant. It crowds out private sector responses and protects the status quo. Furthermore, it converted bank risk management into regulatory compliance. The Guardians, however, have escaped accountability. Politicians needed to show action to offset the public anger at the on sequences of the crisis. This is reflected in the DFA which increased the Guardians authority and power. It adds additional complexities to already bewildering complex regulatory system. The result is confusing set of rules often running at cross purposes and froth with dangers. At a minimum, politicians should adapt a zero based regulatory approach which deletes unneeded prior regulation before adding another layer of regulations.

The book proposes an independent group called the Sentinel to challenge the Guardian's information monopoly. It would deliver annual reports assessing the safety and soundness of regulations and grade the Guardians performance. This increased accountability is unlikely to be welcomed by the Guardians. The Sentinel members would be appointed by the President for long staggered terms to enhance their independence. Additionally, they could not be employed by the industry for at least five years after leaving office to reduce the revolving door effect. This proposal may seem too modest by some. Rather, it realistically recognizes there are no quick fixes – only useful first steps.

The financial crisis was not the result of too little regulation, but of inefficient regulation and poor regulatory oversight. Regulation that facilities market forces, provides reliable information and encourages private sector monitoring is needed. Instead of safety and soundness to benefit the public, we frequently get regulations which benefit private interest of governmental officials and bankers by repressing competition and increasing subsidies. The Guardians had responsibility for the soundness of the financial system, and failed us. Increased regulatory accountability is needed to ensure history does not repeat again. I encourage reading this excellent thought provoking book. It addresses the important question of who watches the watchers. You will be rewarded by becoming forewarned and hence forearmed to deal with the next crisis.■

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