BOOK REVIEW:

Rethinking Bank Regulation: Till Angels Govern

by James R. Barth, Gerard Caprio, Jr. and Ross Levine, (Cambridge University Press, 2006)

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Rethinking Bank Regulation presents a compilation of research by the authors, who submitted a comprehensive questionnaire to banking and government authorities in over 150 countries. They examine the results of the questionnaire in connection with the recommendations of the Basel Committee on Bank Supervision contained in Basel II and attempt to harmonize the information with best banking practices. The authors, respectively professors at Auburn University, Williams College, and Brown University, have published extensively—together, with others, or individually—on subjects relating to the economics of banking and its social and governmental impact. This book contrasts the different approaches of the major variants of bank supervision and regulation with their economic results. It is highly technical and written, at least the first four chapters, in very technical terms. (Just what is heteroskedasticity? See http://en.wikipedia.org/wik/Heteroscedasticity. [note: the spelling is somewhat in dispute])

So, you may properly ask, what is a person who had difficulty making the supply and demand curves cross in Econ 101 doing reviewing a technical economics text? The authors go beyond the technical to explain the outcomes of their research and their analysis of the best practices in banking and its supervision and regulation. For more than 40 years I have had the opportunity to observe and to wonder at the vagaries of the United States approach. This book puts our system into context with world systems and provides economic insight into which practices provide the greatest benefits to the constituencies of banks and their governors. Its conclusions are not limited to the most beneficial forms of organization, capital structure, and supervision for emerging economies, they also apply to limitations on the business which can be conducted by banks in developed countries.

Banks have a unique place in every society. They are entrusted to accept society's currently unneeded funds and make decisions as to whom and for what purposes that money will be loaned. Government has the ability, at each step of the bank's business decision tree, to dictate or affect how the decisions will be made, thus affecting the use of the communities' surplus funds. In almost every modern case, government controls the entry of organizations into banking, the capital requirements for entry, the reserve requirements in relation to impeded loans, and the capital requirements for continuing in business. In addition, and perhaps even more importantly to the possibility of ultimate success in the banking business, government determines what that business is. Is it simply the acceptance of deposits and lending those funds? Or, can it encompass investments for the bank's own account in other businesses or real estate, or conducting securities sales or underwriting? Can a bank underwrite or sell insurance, and, if so, what lines? The answers to these and other line-of-business questions can determine the profitability of the banking industry and its impact (for good or evil) on the community.

The authors discuss the results of their research in the context of the recommendations of Basel II. They describe the three "pillars" of the Basel II guidelines: established minimum capital requirements, enhanced and more universal supervision and regulation requirements, and improved market mechanisms for providing oversight of banks by their customers, that is, depositors and loan recipients. The authors analyze each of these goals against the results of their research and conclude that the most effective means of keeping banks' activities aligned with societal goals is market scrutiny of banks' activities and financial positions. They criticize the existence of high coverage deposit insurance as depriving depositors of the incentive to analyze the safety and soundness of their banks and encouraging moral hazard on the part of bankers to take greater than prudent risks, i.e., if a risky transaction pays off, it will result in greater profit to the owners/managers; if it doesn't, deposit insurance will rescue the depositors. The authors recommend the use of subordinated debt in a bank's capital structure since it is likely that the holders of such debt will be hawk-like in monitoring the activities of the bank. They conclude that the best supervision and regulation is that which maintains some regulatory balance among banks, but otherwise governs lightly.

The book opens with a quotation from James Madison:

"But what is government itself, but the greatest of all reflections on human nature. If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

—Federalist Papers, number 51

The authors do well in expanding upon this thesis.

TAKEAWAY

One of the lasting contributions of this work will be the effort to collect comparative data on banks and the banking business worldwide and to develop methods to compare and contrast it. The development of statistical analyses over the database will allow these authors and others to continue, harmonize, and enlarge the study.

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