

## BOOK REVIEWS

### **Perspectives on Safe and Sound Banking: Past, Present and Future**

George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz,  
Edward J. Kane, and George G. Kaufman

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358 pp.

This is an important book. Commissioned by the American Bankers Association (ABA), George Benston, Robert Eisenbeis, Paul Horvitz, Edward Kane, and George Kaufman conduct a stimulating examination of the industry. Their work is much more than a set of loosely related essays brought together by an editor, however; it is a fully integrated book. The drafts of each chapter were circulated to the entire team for comments and reconciliation of views. Their perspectives provide a sound, frequently innovative, and persuasively argued analysis of bank stability.

The authors cover a wide range of topics: the lack of diversification in bank portfolios (Chapter 1), excessive risk-taking associated with mispriced deposit insurance (Chapter 3), the role of the lender of last resort (Chapter 5), the expansion of bank powers (Chapter 6), the value and probable efficacy of various kinds of market discipline as a tool for controlling bank risk (Chapter 7), the potential advantages of introducing risk-based deposit insurance premiums (Chapter 9), the high cost and misdirection of the standard bank field examinations (Chapter 10), and past and present proposals for reforming the bank regulatory system (Chapter 11). In addition to describing the current state of the industry and the nature of the debate over banking regulation, there are many important new contributions made to the discussion of the proper role of government regulation.

In Chapter 2, "The Consequences of Bank Failure," for example, George Kaufman provides some bracing analysis against sloppily based fears of bank runs. Kaufman shows that except during the years of the Great Depression, bank failures have been less common and have imposed smaller losses on depositors than is generally supposed.

Kaufman is somewhat ambivalent, however, about the relationship between the extent of branching and concentration in the banking system and the system's stability. While he follows W. F. Spahr in attributing Canada's escape from bank failures during the 1930s to its nationwide branching system (p. 68), Kaufman also ascribes the fears of banking contagion expressed by 19th century British writers Henry Thornton and Walter Bagehot to the highly concentrated nature of British banking.<sup>1</sup> He argues that the large "number of banks in the United States, and the unit banking structure" insulate the United States from a contagious "public loss of confidence in the banking system" (p. 71). It is unclear, therefore, whether Kaufman believes branching and concentration promote or impede bank safety.

In Chapter 4, Horvitz addresses "Alternative Ways to Resolve Insolvencies." He describes the many methods for failure resolution used by the Federal Deposit Insurance Corporation (FDIC) in the past. The authors adopt a recommendation proposed elsewhere by Kaufman—that of a modified trusteeship program. The insurer would act promptly when a bank reaches insolvency, writing down uninsured deposits overnight by a "haircut" that would represent the agency's estimated maximum loss. Next day the bank would reopen, administered by the insurers pending a more permanent resolution. Stockholders and management would be more severely penalized than at present in order to discourage risk taking. The study might have, but unfortunately did not, recommend regularly giving taxpayers equity shares in rescued institutions. No doubt the authors want to avoid nationalization, but this can, and should, be precluded by other means.

In Chapter 5, Edward Kane and George Kaufman discuss the role of "The Lender of Last Resort." Surprisingly these authors state that a "threat of simultaneous insolvencies at a large number of sizable institutions" which "might cause systemwide difficulties" could justify lender of last resort (LLR) assistance to insolvent institutions (p. 116).

Widespread simultaneous insolvencies would be unlikely if monetary policy were always conducted correctly. Unfortunately, that is not the case. The impact of recent disinflation, for example, on the agricultural, energy, old manufacturing, and international debt portfolios of banks is portentous. The challenge facing the savings and loan (S&L) industry for the past five years has been widespread insolvencies. Are the authors, in fact, recommending prolonged and widespread LLR assistance to banks and S&Ls facing current difficulties?

In Chapter 8 on "Market-Value Reporting," Kane makes a vigorous appeal for using market value accounting (MVA) measures instead of book values. He argues the change would improve management and benefit stockholders, the public, and the regulators. Kane acknowledges the practical difficulties—the lack of secondary market data—but he recommends an industry self-regulatory body to help resolve the problems. His enthusiasm evidently is not shared by all team members, however, as the team's final recommenda-

<sup>1</sup>The British system was much less concentrated in the 19th century than it is now, but still appeared compact in comparison with the U.S. system.

tion (in the appendix) is to permit, but not require, MVA both for internal use and public disclosure. MVA is recommended for insurance purposes, representing a significant departure from present practice.

Rather like an old soldier, the book fades away in Chapter 11. But it is surprisingly resurrected in a vigorous appendix that provides the authors' recommendations for "Improving Efficiency, Safety and Soundness of the Banking System."

Closer integration of the recommendations into the book would have strengthened it substantially. As it is, some of the recommendations come as a surprise to the reader. For example, the recommendation concerning risk-based capital requirements involves a subject virtually omitted from the book.

A second odd thing about the book is its focus on banking. Can the stability of the whole financial system be equated with that of banks? Since the 1980 and 1982 deregulation acts, banks have become less "special," so that a broader discussion of thrift issues, at least, would have been appropriate. The concentration on banking is acknowledged in the book's title, however, and it is understandable given the ABA's role.

There is at least one mistaken policy recommendation caused in part by the failure to consider the problems facing S&Ls, however. The authors recommend that the insuring agency, instead of the Federal Reserve, should lend to institutions experiencing liquidity problems (p. 313). The intention is to prevent "insolvent institutions from being subsidized and imposing losses on the insurance funds." But the Federal Savings and Loan Insurance Corporation (FSLIC) has not followed its own rules and closed failed thrifts. Instead the Federal Home Loan Banks have lent heavily to insolvent S&Ls, allowing them to continue incurring losses that add to the future burdens of the FSLIC, the industry, and the taxpayer.

The reader also may be unconvinced by the assertion that "a system of risk-related premiums needs not be actuarially perfect in order to be a useful constraint on risk-taking" (p. xix). Are the authors of this book fully convinced that even inappropriate premiums could make the future situation no worse than the present? Or do they believe the regulators are unlikely to make mistakes in setting insurance premiums and that appropriate premiums can be costlessly determined? Or do they think that *ex post* settlement will offset any undesirable incentives?

Readers who favor deregulation may be disturbed by the basic premise of the book that the central bank, the systems of deposit insurance, examination, supervision, and regulation are all necessary. Indeed, the authors do not debate this issue; they merely state at the outset that "the efficient functioning of the financial system benefits from appropriate government intervention" (p. xv). Nevertheless, the authors take a relatively free-market position: "[M]uch of this report considers the means of increasing the effectiveness and minimizing the extent of such intervention, and of harnessing market forces and incentives to maintain bank stability" (p. xv).

There are some notable omissions from the book. No mention is made of international banking and the developing nations' debt crises. Nor is there

any real discussion of the rapid growth and increasing risk of off-balance sheet liabilities. Finally, a brief discussion of the securitization of bank portfolios, the bundling and selling of bank loans in secondary markets, and their corresponding impact on liquidity and the need for market value accounting would have strengthened the book.

In summary, this is an authoritative, vigorous, albeit not exhaustive, study that results in a wealth of recommendations whose implementation could greatly ease the present situation and prevent it from deteriorating further. Students, practitioners, and scholars will all benefit by reading it.

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### Superfairness

William J. Baumol

Cambridge, Mass.: MIT Press, 1986, 266 pp.

We have long been familiar with fairness as a normative concept. As such, its application was capricious and its implications acceptable only to the extent one accepted the analyst's definition. In this book, William Baumol extends the works of Duncan Foley, E. A. Pazner and David Schmeidler, and Hal R. Varian to provide a positive, analytically useful theory of fairness.<sup>1</sup>

The book, essentially, has two sections; one presenting the theory and the other presenting applications. Chapters 1 through 3 contain the positive theory of superfairness. A distribution of commodities is said to be "superfair" if no participant prefers another's share to his own, that is, if each participant (strictly) prefers his share to that of all other participants. For purposes of application, these definitions are extended. "Incremental superfairness" implies a change in distribution in which no participant prefers another's increments to his own. "Partial superfairness" and "partial incremental superfairness" apply the above definitions to proper subsets of all commodities.

Chapters 4 through 12 contain the applications of the theory of fairness. In Chapter 4, "On Rationing of Scarce Commodities," Baumol draws from a previous article to present an extensive and appealing application of the fairness criterion. Other applications include compensation in the face of negative externalities (Chapter 5), pricing in multiproduct firms (Chapters 6 and 7), peak and off-peak pricing (Chapter 8), taxation and subsidization (Chapter 9), and arbitration (Chapter 12). Baumol also suggests the application of fairness theory to divorce settlements (Chapter 11). Chapter 10 deals with the prevalence of economic illusion.

<sup>1</sup>See Duncan Foley, "Resource Allocation and the Public Sector," *Yale Economic Essays* 7 (Spring 1967): 45-98; E. A. Pazner and David Schmeidler, "A Difficulty in the Concept of Fairness," *Review of Economic Studies* 41 (July 1974): 441-43; and Hal R. Varian, "Equity, Envy and Efficiency," *Journal of Economic Theory* 9 (September 1974): 63-91.