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cial role of the government, is how the bu-
reaucrats in charge remained immune from
corruption. Recent evidence suggests more
corruption than hinted at in the book, but it is
still small by the standards of other develop-
ning and transforming economies. One won-
ders then whether the earlier documented
virtues of the system can be replicated in
other countries. For instance, Bhatt argues
the lead bank system in India was far less suc-
cessful, even though the system was designed
with similar intent. Why did it not work in
India? Was it because of excessive govern-
ment interference or less competent and
more venal bureaucrats in India? If so, how
should developing countries guard against
this? Finally, the book, while documenting
the value of banks when an economy has
young and growing firms, also hints at the op-
position banks pose to liberalization when
firms become mature enough to tap the mar-
kets themselves. Will the transition to a more
market based form of finance be delayed if
banks are given too much power when an
economy is young? If so, how should the re-
sulting costs be weighed against the benefits
of the system? While these questions all sug-
gest more research before the Japanese sys-
tem is advocated for other economies, the
authors in this book have done a splendid job
in educating the reader about it.

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*The prudential regulation of banks.* By MATHIAS
DEWATRIPONT AND JEAN TIROLE. Translation.

JEL 95–1562

After the Savings and Loans debacle and
the solvency problems of banks in a host of
countries the book by Dewatripont and Tirole
comes to illuminate the thorny issues associ-
ated with the prudential regulation of finan-
cial institutions using an insightful and coher-
ent analysis.

The authors argue that the main goal of
regulation is the protection of small deposi-
tors and that the main tool to accomplish it is
to bring about an efficient corporate govern-
ance structure for banks. According to De-
watripont and Tirole the distinguishing fea-
ture of banks is that their debt is held by
small investors who are not able or willing to
monitor banks’ activity. Hence, depositors
need to be represented by a public or private
agent. Aside from this, banking regulation
must deal with essentially the same issues
that arise in connection with the control of
firms by large creditors.

The starting point of Dewatripont and Ti-
role is to consider a bank as a managerial
firm. Then, they confront the challenge of ex-
plaining why the capital structure of banks,
that is, their solvency or debt/equity ratio,
matters from the point of view of a manager’s
performance. Indeed, we know from the
Modigliani-Miller theorem that if complete
contracts between owners and managers
could be written then financial structure
would be irrelevant. To get around this the
authors turn to the incomplete contract para-
digm to build their model.

A key assumption is that external interven-
tion, which is crucial to affect managerial in-
centives, is “noncontractible.” The view is
that the incentives that can be offered to
managers are limited by problems of verifying
the bank’s performance. Dewatripont and Ti-
role’s basic model is extremely simple. They
consider a manager whose unobservable ef-
fort affects the quality of the bank’s loan port-
folio and whose only objective is to preserve
the private rents (perks and so on) of staying
in the job. Furthermore, the party who has
control over the bank (be it shareholders or
debtholders), can choose only between a risky
“continue” and a conservative “stop” action
(involving possibly a reorganization, cancella-
tion of projects, . . . ). Efficiency then re-
quires that there should be more interference
with management when the (verifiable) per-
formance of the bank is poor. The optimal
managerial incentive scheme can be imple-
mented in a variety of ways, including contin-
gent control mechanisms, net worth adjust-
ments, and a recapitalization scheme. The
basic idea is always the same: When perfor-
ance is good, control should stay with share-
holders who have a tendency to be “pas-
sume”—that is, to continue with the risky
course. This is so because shareholders have a
convex return structure due to limited liabil-
ity. When performance is poor, control has to change to debtholders/depositors, who have a tendency to be "interventionist," that is, to choose a conservative course for the bank. This is so because this group has a concave return structure. The threshold for the change in control can be interpreted as a minimum solvency requirement. This can be complemented with recapitalization following a bad performance and an extra allowance for dividend distribution when performance is good.

These ideas constitute the core of the book and are nicely presented in Part III. Before that, Part I provides a truly remarkable description of banking regulation institutions with particular attention to the Basle Accords (1988) and U.S. regulations. This part also includes a description of the U.S. S&L crisis. Part II contains background material on some theoretical models of banking and an outline of the main argument. Part IV of the book contains the application to regulation of the ideas developed in Part II. It provides a penetrating analysis of the strengths and weaknesses of the Basle Accords, and discusses also the role of securitization, the political economy of regulation, and the tradeoffs associated with private remedies such as rating agencies, private deposit insurance, and the role of uninsured subordinated debt. The implications for regulatory practice are gathered in Part V. The authors conclude that market value accounting should be introduced when feasible, with net worth adjustments to compensate for macroeconomic shocks, that solvency measures should take account of interest rate and market risk, and not only credit risk (which should be handled at the portfolio level), and that private rating agencies should be used with caution. Furthermore, it is argued that a broad deposit insurance system is preferable, and that the Basle Accords on solvency roughly approximate the optimal governance structure except that account should be taken of macroeconomic shocks. In good times they should be offset with dividend distributions and in bad times with recapitalization complemented perhaps with a subsidy scheme.

All this makes good economic sense and some recommendations coincide with those derived from other approaches to banking regulation like the classical portfolio approach. In this sense it would have been nice if the authors had devoted some more space to contrasting their recommendations with the received results in the literature.

Both the strength and the weakness of the book lie in its adoption of a definite point of view. According to the authors the prudential regulation of banks is a matter of finding the optimal governance structure in a context where depositors need to be represented (and protected). The advantage of the approach is that it provides a coherent framework, based in incomplete contract theory, in which to understand regulation (and this is exploited magnificently by the authors). A disadvantage is that it obviates a (and for some the) major concern of banking regulation: systemic risk and the preservation of the stability and smooth functioning of the banking and payments system. On the methodological front, the model presented by the authors is very streamlined and several aspects of it may be open to question. However, it must be acknowledged that, as of today, there is still no well established foundation for why contracts may be incomplete and therefore the assumptions made by the authors are not uncommon in the literature.

All in all this book has more than accomplished its self-imposed task of contributing to the foundations of a theory of regulation of financial intermediaries. The book is a must both for academics and for practitioners interested in the prudential regulation of banks.

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This excellent book is based on a series of lectures in honor of Erik Lindahl, given by Professor Atkinson in 1989 at the University