To Our Readers

There has been a silent revolution in the banking industry in the past decade. Banks are much more than banks, and non-banking financial institutions are more like banks. This has been accompanied by increased geographical reach of banks - added to by banks registered in cyberspace - and the introduction of new financial instruments and the implementation of new financial strategies made possible by advances in finance theory. Falling interest rates and falling credit off-take in a large number of countries have also contributed to a general tendency to adopt more risk based practices. These changes in turn have now created new opportunities and risks for financial institutions and new challenges for supervisors and regulators.

There are three ways in which recent developments have put pressure on legislation, regulatory standards and supervisory practice. First, the job of supervision has simply become more challenging as a result of the increased size, geographic scope, complexity, globalization and diversity of banking organizations. Second, the effectiveness of one of the foundations of the current regulatory framework, the risk-based capital rules, has eroded as improvements in credit risk measurement facilitated increased use of securitization and credit derivatives to arbitrage those capital rules. These innovations have allowed banks to reduce the capital charges for a given set of risks, making reported risk-based capital ratios increasingly less meaningful and the current standards progressively less effective. Third, banks and other financial institutions, often with the help of their regulators, have found ways, albeit within statutory limits, to expand not only the activities in which they engage, but also to compete more effectively with one another. Market developments and regulatory actions have created tensions within the existing legislative framework of banking and financial services.

We can all agree that, in India, reform of our legal framework for banking regulation and supervision has been on the slow track. In the meantime, all the identified pressures on the legislative system have been working overtime. The need to remain competitive through a relentless search for newer activities which can somehow be absorbed within one's charter, has been the prime mover even for Indian banks. The point to ponder is that this process is not only inefficient, but creates new inequities. What the process also does is encourage institutions to overlook some risks, and allow misallocation of resources. The effect of all this on the macro economy is potentially devastating.

There is no doubt that the increased synergies provided by banks and financial services firms promise important benefits to consumers. Simultaneously however, the challenge of managing and of regulating and supervising banks has increased. On their own, even Indian Banks have responded by developing new approaches to measuring and managing risk. Now it is time for regulatory standards and supervisory practice to catch up. This catching up must involve updating the legislative framework underlying banking. It must also involve updating the international capital standards that have been the foundation of the regulatory framework. And it may also be useful to reinforce the role of market discipline. Only by working together, can the markets, the political process, and the regulators ensure that we optimize our advantage while maintaining the safety and soundness of our banking system.

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