To Our Readers

A major concern of the twenty-first century economies is the regulation of the financial system. Accepted wisdom in this area takes as its aim the application of a stable liberal regulatory environment, creation of a competitive market, and the provision of appropriate incentives for efficiency and innovation. Such an approach dispenses with arbitrary restrictions on entry, branching, and mergers. However, 'core' wisdom requires that risks be diversified (including limits on lending to related parties and large exposures to single groups), and accumulation of capital reserves to absorb losses.

Going by this theorem, regulators seek to set appropriate prudential norms and effective internal systems of risk management and control. The issue is, can one do better than this by having more regulations?

Again, going by conventional wisdom, elaborate regulatory rules on capital adequacy have been proposed by Central Banks, both in India as well as in other countries. Such steps, while they may improve incentives in a worked-out model for a few banks, are likely to fail in more complicated networked financial systems. Therefore, one may argue that it is necessary to apply caution before over-regulating.

One must remember that it is one thing to introduce regulations, and quite another to supervise the performance and solvency of the regulated institutions. One must be realistic about the information and expertise available to regulators. And one of the major factors in this is the blurring of boundaries between banking and other financial institutions. In their efforts to increase bank profitability, bank managements have ventured into areas traditionally not their own, just as non banking institutions have entered heavily into areas which were traditional banks' areas of operation. One example of this is the growing importance of management of portfolios in banks. In such cases the market price risk (interest rate, stock price or exchange rate changes) are more important than credit risk. Bandwagon effects in these speculative markets probably increase the degree of risk which in turn adds to the vulnerability of banks.

Generally speaking, because of the much wider variety of factors and situations which can have a material effect on the solvency of banks, it is harder to assess the capacity of each bank to face future risks. Nowadays, with highly leveraged and frequently traded contingent assets and liabilities in the picture, not to speak of the uncertainties of counterparty risk, maintaining an up to date evaluation of solvency seems almost impossible. This is true of the bank's management certainly, but doubly so of the supervisor if, as in many recorded cases, the bank's management sets out to deceive the supervisor.

The question then is, if in the era of highly networked financial systems, the above arguments draw the limits of supervision of the financial system, what *can* work? The answer probably is, nothing. Nothing, that is, except verification of the presence of effective internal information and management systems and early intervention to avoid heavy costs of forbearance. The rational and optimal approach is to make the cost of failure of banks and non banking financial institutions as small as possible for society at large.

It is for this reason that regulators need to look at the redundancies in the financial network. The higher the redundancies, the larger the capacity of the society to contain the effects of distortions caused by bank failures and bank shenanigans.

For the regulator, the essential thing is to assure the degree of financial prudence in actual practice, and the authenticity of information generated. Other than that, over regulation, or the imposition of arbitrary restrictions is unlikely to generate desired growth patterns. And that defines the role of the auditors also. The carrying out of the objectives of the supervisors, as we have stated, will reduce the social costs of bank failure to levels that are less than bubbles on an already turbulent sea.

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