Book Review

REGULATION OF FINANCIAL INTERMEDIARIES IN EMERGING MARKETS, T.T.Ram Mohan, Rupa Rege Nitsure and Mathew Joseph (eds.), Response Books, New Delhi, 2005, Hardbound.

The financial sector has undergone a rapid transformation during the last 10 years. Unlike the period between 1951 and 1991, today's financial sector is grappling with three major challenges, globalization, democratization and increasing competition. In this backdrop, the Indian financial sector is in the process of formulating a vision for 2020. In any such exercise, it has to take on questions such as 'where does it stand now?', 'where it would like to be' and 'why and how could it get there?' It should also take a clear stand on views such as 'finance promotes growth', 'finance follows growth', 'finance does not matter', 'finance hurts growth' and 'finance matters for crises'.

The volume is a collection of papers discussed at an International Conference on 'Regulation of Financial Intermediaries in Emerging Markets' held in March 2002. the conference was jointly organised by ICICI Research Centre and Indian Institute of Management, Ahemadabad's (IIMA). Besides an introductory note from Rupa Rege Nitsure, Mathew Joseph and T.T.Ram Mohan, the volume comprises eight chapters covering themes such as critical issues in banking sector, cross country analysis of external governance and bank profitability, regulation of banks, regulation of financial conglomerates, and nonperforming assets.

The introductory note summarises the discussions on the theme of the conference and presents a bird's eye view of the papers presented. T. T. Ram Mohan identifies some critical issues such as re-capitalisation of domestic banks, corporate governance in the financial sector, bank privatisation and nonperforming assets situation in banks.

James. R. Barth and Susanne Trimbarth observe that there is a significant positive correlation between the size of a country's financial system and its real GDP per capita.

They identify a number of 'best practice' areas that financial institutions should be focusing on. These areas include the power of the bank, it's market entry policies, capital adequacy, managerial supervisory power, the extent of autonomy enjoyed by line managers, deposit insurance, loan classification, provisioning, asset allocation, internal management and state ownership issue. They have also discussed bond and derivatives market, off-balance sheet activities of banks, role of venture capital, comparative advantage and absolute advantage in financial services and e-finance from a global perspective.

James R.Barth, Valentina Hartarska, Daniel E.Nolle and Triphon Phuminwasana observe that a healthy banking system requires more insightful regulation and supervision. In their view, efficient functioning of financial systems requires both corporate governance and external governance. They, however, say that very little attention have been paid to the corporate governance of banks. Quoting Caprio and Levine, they identify four sources of governance for banks, viz., Shareholders, debt-holders, the competitive discipline of output markets and governments. They recognise the importance of accountability standards, strength of external audits, financial statement transparency, and external rating and credit monitoring as the sub-component of external governance. Empirical results of their study indicate that external governance does indeed matter for a bank's profitability. The magnitude of the effects of external governance measures is also economically significant.

Uwe Neumann and Philip Turner take up questions about the desirability of a market–orientated, risk sensitive framework for banks in emerging market economies. They warn that capital requirements and acquisitions without considering the relevant risk factors will increasingly become unsustainable. They conclude that the cost of credit will primarily be driven by the bank's internal risk measures.

V. Sundararajan and Barbara Baldwin, while providing their distilled wisdom trace on the question of 'single versus multiple' regulators, conclude that the most limited option would be to leave the existing regulatory structure in place, but to overlay it with a newly established oversight board. Amar Gande, Kose Jhon, and Lemma W.Senber present different perspective on the role of incentives in the prevention of financial crises in

emerging economies. They reject the most established approaches which debate the determinants of financial crises and on *ex-post* resolution of a crisis. They have suggested an approach focusing on the prevention of financial crises. They look at the role of incentives in mitigating the vulnerability of such crises. They show that the distorted risk incentives in investment decisions by corporation and in loan decisions by banks as a result of implicit or explicit bailouts can lead to an increased probability of precipitating financial crises.

Abhay Pethe and Rupa Rege Nitsure look at the activities of development financing institutions such as Industrial Credit Investment Corporation of India(ICICI) and Scheduled Commercial Banks of India to find out their subsidy dependence and conclude that ICICI is out of the subsidy dependent net whereas, the State Bank of India continues to thrive on subsidies and the authors term it as a case in 'in-perfections in Indian regulation'.

Samaresh Bardhan and Sugata Marjit have tried to formalise an attempt to advance an understanding of the implications of the tolerable limit of NPAs. They have tried to address the question, what is the critically maximum or the permissible level of NPAs that a bank can tolerate, given its portfolio of various assets? The study points out that it is largely the personal cost which is highly significant in explaining the 'severity of NPAs'. The recovery ratio in banks is found to be significant to the severity of NPAs. In the case of private and foreign banks, price competition has the positive and significant coefficient in explaining the severity of NPAs. Interestingly, in the case of public sector banks this factor appears to be insignificant.

This edited volume is a significant addition to the literature on the regulation of financial intermediaries and emerging markets. As it is a collection of papers, it deprives the reader of the continuity of the thought and implications of the various conclusions as related to the financial system of a particular country. Most of the papers have carried an extensive literature review. However, the paper by V. Sundararajan and Barbara Baldwin is a departure as they have copiously quoted from the various official reports. The volume raises a number of questions that need to be answered by policy makers, practitioners and researchers: should financial systems be bank-based or market-based? Does size matter in

the case of the various components of a financial system? Could financial crises be prevented in future? We hope that the volume would provide a better understanding of this intricate but interesting area of study to policymakers, practitioners and researchers.

Reviewed by Professor R.K.Mishra, Director, Institute of Public Enterprise, Osmania University Campus, Hyderabad 500007, Andrha Pradesh, India.