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Column: Influence from the ivory tower

Rajesh Chakrabarti

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In [December](#) 2008, at the height of the financial turmoil, the finance faculty at Stern produced a timely and useful collective document analysing the reasons behind the crisis and sketching the broad reform agenda to be followed to fix it. A year later they have followed it up with an e-book initiating a serious debate about the ongoing developments in the US financial system. The scale and reach of the current crisis and the extent of regulatory thought and action it has spawned, particularly the two landmark Bills currently in the US Congress—the recent Wall Street Reform and Consumer Protection Act of 2009 passed by the House and the Restoring American Financial Stability Act in the Senate—have been overwhelming for most observers.

The e-book*—a form particularly appropriate for ‘real-time’ dynamic inputs, given the evolving and continuous nature of the discussion—is an extremely useful resource to evaluate the regulatory reaction and anticipate its outcomes.

The legislations in Congress, like all US law-making, are already the result of much compromise and support-shopping. They cover aspects of the market and the economy ranging from consumer protection to derivative trading. The Stern group rightly points out that within this motley baggage, it is the management of systemic risks that should be of the highest concern.

Here the two Bills seem to be at odds. The first Bill, passed by the House, seems to reaffirm the Fed’s powers in dealing with such firms while the second appears to emasculate the Fed. The Stern group recommends setting up a new regulator for Large Complex Financial Institutions (LCFIs) that create such risks. If you think beyond the knee-jerk ‘Yet another one?’ response, this makes perfect sense. None of the segment regulators—the Fed, SEC, FDIC etc—are really equipped to handle cross-segment risks, and ‘coordination’ among regulators rarely works. The unified regulator approach of the UK has hardly fared better. A cross-segment regulator for a specific set of large firms is the most practical compromise. The debate is of singular significance for India, which has a fragmented regulatory environment like the US.

Notwithstanding their difference of opinion on who should bell the cat, both the House and Senate Bills rely largely on simple systemic risk criteria for the identification of LCFIs. These include, broadly speaking, size, leverage and interconnectedness. However, real-time monitoring and management of systemic risks would be served better by continuously variable market-based measures. Also, given the imperfections in measuring these variables, hiving off systemic risk-creating activities away from the

'implicit guarantee' *may* be a good idea. Both proposals suggest taxing the too-big-to-fail institutions and create an insurance fund of sorts. This is a good idea in principle but application *may* have its challenges, particularly in identification and assessment of taxes. The group identifies several other lacunae in the proposals and implementation challenges implicit in them. But it is not exclusively critical or disapproving of the endeavours. It readily acknowledges merit where it finds it.

Apart from providing valuable input in a key debate, the Stern Working Group approach sets an example of how responsible academia can contribute to better policymaking. As distinct from individual research or commentary, the papers in the e-book are collaborative output of multiple experts. Together they add to the quality of the discussion and enhance the pool of ideas dealing with a contemporary problem at hand, instead of flawlessly dissecting the problems of the previous decade. This approach is of relevance to all parts of the world, but particularly India, which has no dearth of capable economists. While clearly the role of an academic is different from that of a policy advisor or commentator, it would not hurt if major research institutions adopted this approach to carry out a conscious, collaborative effort to discuss current issues.

Of course, directors and deans would be ill-advised to create another 'policy advice committee' and draft faculty into it to achieve this end. Policy advice given under duress can cause more harm than good. Being informed in current affairs and carefully arguing about them requires time and effort, particularly if the pursuit is away from one's normal research interests. Faculty must have suitable incentives to voluntarily participate in such an activity. In turn, institutes need to have incentives from, not obligations to, the government and civil society to take up such initiatives.

The author teaches finance at the Indian School of Business, Hyderabad

* <http://govtpolicyrecs.stern.nyu.edu/home.html>

Rajesh Chakrabarti, Ph.D.

Assistant Professor of Finance,

Indian School of Business,

Gachibowli, Hyderabad 500 032, India

Tel: +91-40-2318-7167; Fax: 91-40-2300-7032

E-mail: rajesh_chakrabarti@isb.edu

Home Page: <http://www.isb.edu/faculty/RajeshChakrabarti/>

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