Preserving the independence of the RBI

In part 1 of a series, the author says if proposals to set up an appellate body to review RBI's regulatory and supervisory decisions were to be implemented, the whole supervisory process would get mired in constant litigation

RAKESH MOHAN

The last decade has witnessed an almost constant attack on the Reserve Bank of India (RBI), emanating sometimes from within the government, sometimes from expert committees appointed by the government, and otherwise from independent analysts, researchers, commentators and economists. That this has happened is quite curious, particularly since the RBI is generally acknowledged to have negotiated very well the vicissitudes of financial markets, both global and domestic, resulting from the Asian financial crisis 1996-97, the north Atlantic financial crisis (NAFC) of 2008-09, and the taper tantrum of 2013. Its otherwise consistent performance has, however, been marred in recent years by the high inflation of 2010-13, the current ongoing emergence of some large frauds and excessive non-performing assets in the banking and non-banking financial sectors, and a couple of episodes of excessive volatility in the exchange rate.

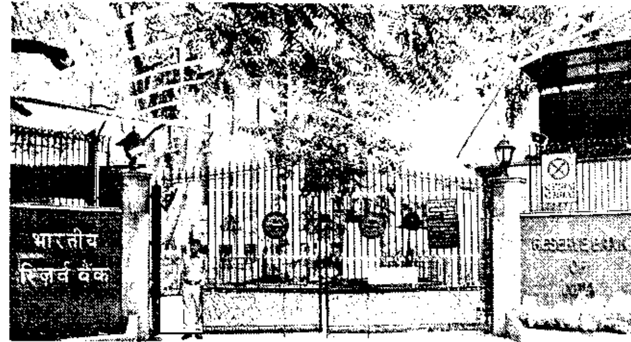
The saving grace has been that wiser counsel seems to have prevailed most of the time, and most of the recommendations that would have adversely affected the functions of the RBI were eventually not implemented.

RBI performance pre-NAFC

During the period before the eruption of the NAFC in 2008-09, the RBI suffered substantial criticism for being excessively conservative in its approach to the regulation and supervision of the banking and non-banking financial sectors, and in being excessively cautious in permitting introduction of then-popular financial innovations. Similarly, there was withering criticism of its monetary policy-making, which did not conform to the internationally popular inflation targeting framework often characterised as the gold standard in monetary policy-making. There was also a view that its approach to external sector management, consisting of forex intervention to achieve a managed float of the exchange rate, accumulation of foreign exchange reserves, combined with capital account management, was too cautious and inimical to Indian financial market development. Such views were then reflected in the observations of various committees such as the High Powered Expert Committee on Making Mumbai an International Financial Centre (HPEC, 2007; Chairman Percy Mistry), Committee for Financial Sector Reforms (CFSR, 2009; Chairman: Raghuram Rajan), and the Financial Sector Legislative Reforms Commission (FSLRC, 2013; Chairman B N Srikrishna).

Although there were differences in the specific recommendations of these committees, there were broad commonalities, which essentially proposed the dilution of RBI functions as a full-service central bank. On the monetary policy side, even though the RBI had practiced a multiple indicators approach, its inflation management record between the mid-1990s and the late 2000s had been exemplary and not different from other central banks that did practice inflation targeting. The average inflation between 1995 and 2008 was around 5.5 per cent. It is, therefore, surprising that each of these committees proposed a simpler single-objective, single-instrument market policy framework centered on inflation targeting.

Similarly, between the early 2000s and 2008, the RBI had successfully managed the external sector and maintained financial stability despite consistent and excessive capital inflows that reached a peak of almost 10 per cent of GDP in 2007-08. The capital account had been opened incrementally and the exchange rate allowed to fluctuate in response to market fundamentals while curbing excessive unwarranted fluctuation. A whole range of instruments had to be used to accomplish relatively successful sterilisation, which involved the introduction of the market stabilisation scheme (MSS), changes in the cash reserve ratio (CRR), the use of open market operations (OMO), and the judicious operation of the liquidity adjustment facility (LAF), along with corresponding monetary policy changes. Foreign exchange reserves were augmented substantially through consistent forex intervention, thereby providing a significant degree of forex buffers to cope with the high degree of volatility that characterises international capital flows. The utility of such reserves was demonstrated in the aftermath of the NAFC and the taper tantrum. Yet the general recommendations from these committees (and the IMF) proposed much greater capital account opening towards a liberalisation of both inflows and outflows, a reduction in forex intervention, greater participation of foreign investors in both the domestic bond and stock markets, and the elimination of restrictions on both sovereign and corporate foreign borrowing. It is ironic that these recommendations were being made just when international financial markets, particularly in advanced economies, were demonstrating the severe problems that can arise from excessive financial innovation, excessive global capital flows, and lack of capital account management. In effect, these recommendations amounted to a significant reduction in RBI roles related to the pursuit of financial stability through external management.



There seems to be little understanding of the continuous process that characterises regulation and supervision of banks and other financial institutions

A full-service central bank

The RBI has been a full-service central bank since its inception in 1935, encompassing its role, inter alia, as a monetary authority, a banking regulator, the lender of last resort, a foreign exchange and exchange rate manager, and a sovereign debt manager, apart from other functions such as currency issuer and payment system regulator and facilitator. The 1990s and 2000s had seen a general movement in some countries towards making the central bank a pure monetary authority, while separating out its related functions to a separate agency. This movement was led by the UK when it made the Bank of England (BoE) a pure monetary authority, set up a separate debt management office (DMO), and shifted all financial sector regulation to the newly created Financial Services Authority (FSA) in the late 1990s. In India, the various committees recommended similar action, proposing the shifting of some of these roles from the RBI, though they did shy away (reluctantly) from taking away the banking regulation function. Once again, some of these recommendations were being made just when global expert opinion had begun to change after the NAFC.

Ironically, the FSA in the UK has been abolished since, and its financial regulatory and supervisory functions have been brought back to the BoE. In addition, a financial stability objective has been added explicitly to the functions of the BoE, with a formal Financial Policy Committee established within the BoE. Similarly, while the European Central Bank (ECB) was originally established as a pure monetary authority, in the wake of the NAFC, it is now entrusted with bank supervisory responsibilities as well.

That having been said, new questions have arisen with regard to the RBI's functioning in regulation and supervision of both banks and non-bank financial institutions. After continuous and substantial improvement in the performance of public sector banks in the 2000s, they have exhibited significant deterioration with the emergence of large non-performing assets in recent years. Governance issues have arisen in some private sector banks as well. Most recently, one of the most significant non-bank financial institutions has suddenly begun to default on its debt obligations.

The collective impact of each of the developments is serious for the Indian financial sector. In view of the increasing size, complexity and interconnectivity in India's financial sector, the RBI's regulatory and supervisory apparatus clearly needs to be re-examined and modernised, along with technical strengthening and expansion of its personnel. That would include an organised programme for greater lateral entry into the RBI. Separating out this function from the RBI would not be a solution. One approach would be greater formalisation and strengthening of the existing Board of Financial Supervision within the RBI, which already meets on a monthly basis. There also needs to be a greater clarity on the supervision of systemically important financial institutions as the inter-linkages between different segments of the financial sector become more complex. This includes arrangements for regulatory cooperation where there are overlapping regulatory responsibilities. Indeed, central banks, as monetary and regulatory authorities and lenders of last resort, are almost universally seen as critical to the maintenance of financial stability.

In the wake of the NAFC, in other countries, the financial stability and macro-prudential regulatory function has now been specifically entrusted to the central bank. By contrast, in India the Financial Stability and Development Council (FSDC) was established in 2010 with this explicit responsibility. In fact, when the FSDC was first proposed to be created, the RBI governor was placed on par with the other regulators on the board of the FSDC. Good sense, however, prevailed and the governor is now designated as the vice-chair of this committee, consistent with the key role of the central bank in financial stability and macro prudential policy.

There have also been puzzling proposals to set up an appellate body to review the RBI's regulatory and supervisory decisions, as there are for other regulatory authorities. There seems to be little understanding of the continuous process that characterises regulation and supervision of banks and other financial institutions. If such decisions could be appealed, the whole supervisory process would get mired in constant litigation with resultant chaos in the system. This is the reason why such provisions for appeals against banking regulation and supervision do not exist in any other major jurisdictions either. There have been other more recent developments that have also been somewhat disturbing.

(Tomorrow: Responsibility fulfilled)

The author is senior fellow, Jackson Institute for Global Affairs, Yale University, and distinguished fellow, Brookings India

2

BUSINESS STANDARD, 4TH OCTOBER 2018

Responsibility fulfilled

In part 2 of the series, the author argues that some changes made to the RBI board lack merit and examines the role of the central bank in regulating the payment and settlement system

RAKESH MOHAN

Some changes have been made to the Reserve Bank of India (RBI) board without adequate discussion. Since the inception of the RBI in 1935, the Act provided for only one government director on its board. It had also been specified that this director would be a nonvoting position. This provision is more important symbolically than in actual practice; in fact, votes are seldom resorted to in the functioning of RBI's board. Even without a formal vote the reality is that the government's representative always has an influential and effective voice in the board. The intention of this provision was to provide a strong signal in favour of independence of the central bank. After the Department of Financial Services was carved out from the Department of Economic Affairs in the Ministry of Finance, provision has been made for a second nonvoting government director on the RBI board.

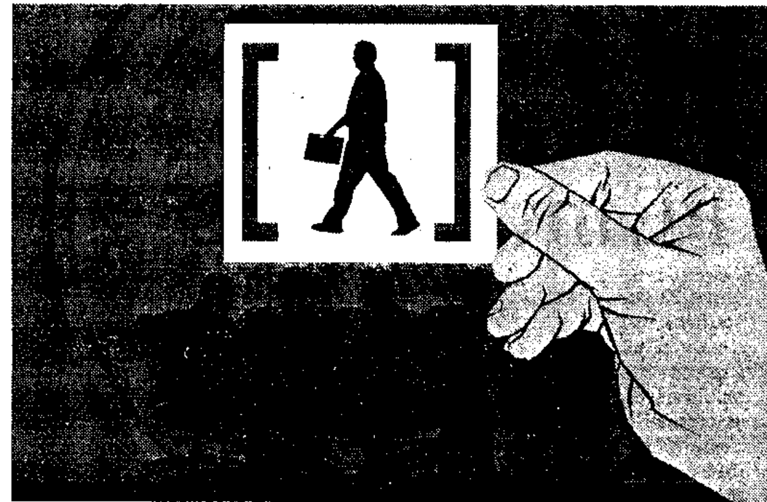
This provision amending the RBI Act was quietly inserted in 2012 as a clause in the Factoring Regulation Act (!) with almost no discussion in Parliament. A second amendment was carried out in 2013 as part of the Banking Amendment Act. Prior to this amendment, although members of the RBI board were appointed for periods of four years, the Act provided for them to continue as members of the board until their successors were appointed. Consequently, the membership of the RBI board was always full and continuous.

This amendment has removed this provision so members of the board now have to demit office after their four-year term is over even if their successors have not yet been appointed. As a result, because of delays in the appointment process, positions on the RBI board have often remained vacant ever since this amendment was adopted. At present, for example, four out of the 14 independent director positions are vacant on the central board; and as many as eight were vacant when the momentous decision on demonetisation was made in November 2016.

Inflation targeting & MPC

Second, the preamble to the RBI Act was amended in 2016 to give statutory status to the Monetary Policy Committee (MPC), and to mandate inflation targeting as the primary objective of India's monetary policy framework. This move implemented the recommendations of the various committees mentioned earlier and has been widely welcomed as a major monetary policy reform. The composition of the MPC has, however, received little discussion in India. Unlike other major central banks where, in general, all the deputy governors are represented in the MPC, three of the four in the RBI have been excluded. This is particularly unfortunate in a full-service central bank where it is important to derive the benefits of knowledge, information and expertise that the other deputy governors bring from their financial market and banking portfolios and experience. As the NAFC demonstrated all too clearly, monetary policy decisions can depend on assessments of market and banking conditions, and monetary policy can have important implications for other central bank activities. It is critical that central bank activities not take place in "silos"; rather, information and expertise should be brought to bear on decision making across the institution. Thus, the current composition of the MPC effectively weakens the functioning of the RBI as a full-service central bank cum monetary authority.

ILLUSTRATION BY BINAY SINHA



Payment & settlement system

Third, and most recently, there is a proposal to move the responsibility for governing the payment and settlement system out of the RBI. The Payment and Settlement Systems Act, which currently prescribes the governance of this system, was promulgated as recently as 2007. It formally designated the RBI as the authority for regulation and supervision of payment and settlement systems. It further prescribed that the central board of the RBI should set up a committee for exercising this responsibility conferred on it by this Act. The Act provided for the rationalisation and modernisation of the various payment and settlement systems that existed in the country.

By and large, this arrangement has functioned very well and it has facilitated the many digital-technology-related changes that have characterised the transformation of the Indian payment and settlement systems in recent years. It is therefore very surprising that a government appointed official committee has now come out with recommendations for sweeping changes to be made in the legal framework governing payments and settlements in the country. The panel has apparently proposed the creation of an independent Payments Regulatory Board (PRB) and suggested replacing the central bank governor as chairperson with a person appointed by the government in consultation with RBI.

The governance of payment and settlement systems have long been among the core responsibilities of central banks all over the world. A review of the current institutional arrangements in major countries in this area is available with the Bank for International Settlements (BIS). A careful examination of these BIS documents reveals that the legal responsibility for governing payment and settlement systems in the 20 largest systems rests with their respective central banks, except for the United States (where the Federal Reserve has substantial, but not unique authority) and Canada. It is not clear what the provocation has been for proposing such a far-reaching change in this area, which is at variance with established global practice.

I hope that in this case also wiser counsel will prevail and the recent recommendations for setting up an independent payments regulatory board outside the RBI will not be implemented. What is certainly desirable, however, is that the current oversight committee, which is entirely internal to the RBI, should be more broadbased so that other stake holders are adequately represented in governance of the payment system.

(Tomorrow: Protect RBI's balance sheet)

The author is senior fellow, Jackson Institute for Global Affairs, Yale University, and distinguished fellow, Brookings India

Protect the RBI's balance sheet

In the concluding part of the series, the author says the continued pressure on the RBI might have been successfully resisted but it has taken a toll on the reputation of the institution built up painstakingly over its long existence

RAKESH MOHAN

The most disturbing developments in recent years have been formal suggestions emanating from the government's official statutory Economic Survey proposing a raid on the RBI's balance sheet, with the purpose of funding the recapitalisation of public sector banks. The proposal was to transfer a portion of the stock of securities held in the RBIs balance sheet to public sector banks. It was argued that the RBI has excess capital in its balance sheet.

As it happens, the composition of central banks' balance sheets remains an arcane subject for discussion. Regardless of conclusions on how such balance sheets should be structured, it should be understood that the idea of using central bank capital to fund government expenditures of any kind is a bad one in almost any circumstances, and essentially shortsighted.

First, what are the practical consequences of making such a transfer? In the short run, the central bank balance sheet would contract and the government would receive an equivalent lumpsum. As it is, the RBI transfers to the government the profits it makes from its interest income from its portfolio of securities, both foreign as well as domestic, after accounting for its expenses. But with the contraction of the central bank stock of government securities, it will suffer a reduction in the future stream of income from the interest that would have emanated from the securities it transferred or sold to fund the government. The longer-term fiscal consequence would be the same if the government issued new securities today to fund the same expenditure. Thus, raiding the RBI's capital creates no new government revenue on a net basis over time, and only provides an illusion of free money in the short term.

Second, such funding of the government from the RBI goes against the letter and spirit of the FRBM Act that prohibits the RBI from subscribing directly to government securities in the primary market. The use of such a transfer would erode whatever confidence that exists in the government's intention to practice fiscal prudence.

Third, we need to examine whether the RBI's capital is indeed excessive. In theory, a central bank can implement monetary policy appropriately with a wide range of capital levels, including levels below zero. In practice, the danger is that it may lose credibility with the financial markets and public at large, and may then be unable to attain its objectives if it has substantial losses and is seen as having insufficient capital.

As it happens, the RBI's total assets have been around 20 per cent of GDP for a long period. Such a proportion is similar at the current time to those of the Euro area, the UK, the US, and lower than that of Japan. The proportion is much higher than that of a host of emerging market central banks. On the liability side, how much capital does a central bank need and why? In principle, the RBI needs adequate capital reserves for:

- Monetary policy operations;
- Appreciation of the rupee against currencies held as part of foreign currency assets (FCA) and a possible fall in gold prices with respect to the rupee. FCA currently constitute more than 70 per cent of RBIs total assets;
- A possible fall in the value of bonds, both denominated in foreign currency and those in rupees, on account of rising bond yields;
- Sterilisation costs related to open-market operations and other innovative means;
- Credit risks arising from the lender of last resort function;
- Other risks arising from unexpected increases in expenditure, such as those that arose from demonetisation.

How such risks should be provided for can be a subject of honest discussion with the possibility of different conclusions. The current practice in the RBI is to make provision for contingency reserves from the profits that accrue annually, before transferring the rest to the government. In recent years, there has also been questioning from the government whether there is need for such provisioning and on the magnitudes of provisioning that the RBI has been resorting to. Consequently, the RBI in some years has had to transfer its full profits under pressure from the government. For the first time, perhaps, in its history the RBI had to transfer an interim dividend to the government this past year to relieve some fiscal pressures. Once again the gain to the government was temporary since the transfer after the full fiscal year had to be reduced by exactly the same amount.

ILLUSTRATION BY BINAY SINHA

Are fears with regard to possible central bank losses illusory? According to the BIS 43 out of 108 central banks reported losses for at least one year between 1984 and 2005. So the maintenance of a prudent central bank balance sheet is a real issue. It may be recalled that the RBI's balance sheet contracted during 2008-09 due to the use of its foreign exchange reserves at the time of the NAFC. The contraction was due both to the use of reserves and a reduction in their US dollar value because of external exchange rate movements. Similarly, RBI expenditure increased significantly through absorption of excess liquidity following demonetisation, when currency deposited in banks increased rapidly for a time. There was, of course, the additional expenditure incurred in printing the new currency notes as well.

The governors and deputy governors in most central banks have tenures of greater than five years. All such appointments in India over the last decade or so have been restricted to three years

It is also argued by some that the government can always recapitalise a central bank when necessary. This is certainly true in principle but is practically difficult when the government itself suffers from fiscal pressures and maintains a relatively high debt-GDP ratio, as is the case in India. What is also important is the erosion of central bank independence both in reality and perhaps, even more importantly, in optics.

Once again, better sense has prevailed and the government has not raided the RBIs balance sheet.

The way forward

This continued decade-long pressure on the RBI may have been successfully resisted both by the RBI and by saner voices within the government. But it has taken its toll on the reputation of the RBI that has been built up painstakingly over its long existence. While there can be no doubt that the RBI has stumbled every now and then in its functioning, as in the excessive monetary stimulus after the NAFC, and somewhat lax regulation of the banking sector through continuing forbearance during the 2010-13 period, overall it has functioned with great credibility, probity and responsibility. It is among the few institutions in the country that can boast such a record over as long a period of time.

For most of its history, it has had a very cooperative and productive relationship with the government, which unfortunately has been vitiated over the last decade or so. These depredations have also had an impact on the functioning of its top management during this period and diluted morale down the line. Given the stage of India's development and the various uncertainties that now characterise the global economy and financial markets, it is of utmost importance that the government understands the need to strengthen its central bank and provide the kind of support that it deserves, so that the RBI can continue serving the country in the way it has throughout its history.

What would this entail? As a consequence of the various reports and panels suggesting curtailment of the RBI's functions, an impression has grown over the last decade that the government and the RBI function as adversaries, leading to decreasing confidence in the authority and competence of the RBI. Whereas actions must be taken to foster a more cooperative relationship between the government and the RBI, there is a simultaneous need for strengthening the latter's independence. Public airing of differences in key policy areas should be eschewed as far as possible. There will always be tensions between the government and the RBI in view of the different roles that they perform. Vigorous and contentious discussions between the two have always taken place but in an atmosphere of mutual trust and respect.

This must be restored. The public and markets need to be reassured that the RBI enjoys full confidence of the government. There should be clear articulation from the government of its continued support of the RBI as a full service central bank, and that it intends to strengthen its various functions as the key financial sector regulator and supervisor. This could, inter alia, include formalisation of the Board of Financial Supervision as the key body in charge of financial stability, continuation and strengthening of the Board for Payment and Settlement Systems as the key regulator for these systems, and continued functioning of the RBI as the government's fiscal agent and debt manager.

The governors and deputy governors in most central banks have tenures of greater than five years. All such appointments in India over the last decade or so have been restricted to three years, even though the RBI Act permits tenures of up to five years. Since monetary and regulatory authorities need to have longer time horizons longer tenures promote better decision-making and also more confident exercise of independence. On its part, the RBI must demonstrate improved technical competence and performance to earn the kind of independence of operation that it should have.

(Series concluded)

The author is senior fellow, Jackson Institute for Global Affairs, Yale University, and distinguished fellow, Brookings India