WHY #RBIVSGOVT IS A VIRAL STORM IN A TEACUP

RBI remains one of the most unreformed central banks in the world. The present rift could be a turning point

In happier times, finance minister Arun Jaitley and RBI governor Urjit Patel at an RBI board meeting last year. MOHD ZAKIR/HT

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LONG STORY

Central bank deputy governor Viral Acharya's speech on the issues between Reserve Bank of India (RBI) and government has brought the rift between the two into public domain more visibly than perhaps ever before. One reason for the fissures seems to be that in the board meeting of the RBI there was a debate on some items listed on the agenda. There are reported to be differences of opinion between the independent directors and the management of the RBI on these items.

At first blush this seems rather strange because it is the job of the board of a regulator to discuss regulations. Regulations require board approvals. That such approvals should be given after a detailed cost benefit analysis of each regulation is to be expected. It should be quite normal, for example, to discuss what impact these regulations would have for the health of the banks and the economy, for small and big firms, for consumers and other stakeholders. It should be equally normal to have differences in opinion on such complex issues.

Why then did a discussion in the board turn into such a public storm? It seems that in the normal course of affairs the RBI board did not hold discussions on agenda items and merely approved what the management brought to it. Regulations were made by the Central Committee of the

lation making processes by regulatory boards were accepted by all members of the Financial Stability and Development Council, these were not followed by some regulators. But there was no serious follow up by government. Now at this stage, after publicly airing differences between the management and other board members, if the government uses Section 7 to give directions to the RBI on regulations, it is not a step towards improving the functioning of RBI governance. It would be a step backward in the reform process.

A MATTER OF RESERVES

Another question in the speech is that of RBI reserves and its transfer to government. Acharya's speech begins with how a transfer of excess reserves from a central bank to government can be catastrophic, as was in the case of Argentina. The RBI Act requires RBI to create a Reserve Fund of ₹5 crore. In addition, RBI board can make regulations governing the manner and form in which the balance-sheet of the Bank shall be drawn up. But this requires the previous sanction of the Central Government.

In the past under Section 47 of the RBI Act, 1934, the RBI board created discretionary operational reserves and revaluation accounts to account for fluctuations on its assets side and unforeseeable expenses. For the year ending June 2018, RBI's reserves, at ₹9.63 trillion, constituted 28% of its total assets (See box for details). This is higher than almost all central banks in the world.

The board should discuss if it wishes to achieve compliance with the law and what should be done with the remaining reserves. In principle, this money should have been paid to government in the years the profit was generated as is done else-

independent as well as more accountable. For example, it proposed to do away with the government's power to give directions, while it sought to make boards of regulators more accountable and transparent with agenda and minutes of board

Long term reform can only be undertaken when there is no crisis. If the board members are discussing short term solutions to the credit crunch for small firms, the RBI management cannot absolve itself of the responsibility for the situation coming to

At the same time, even though the RBI was independent and free to give out commercial bank licences, it only gave out two bank licences in more than a decade. This failed to create a competitive environment where banks were competing to give

MINT SHORT STORY

WHAT

The rift between the Urjit Patel-led RBI and the Narendra Modi government has come out in the open. The trigger was a speech by the RBI's Viral Acharya that warned of a "full-blown crisis" if its autonomy was attacked.

BUT

One issue was discussions in the RBI board, but a healthy functioning board which debates on important issues should have been the norm. Moreover, RBI has massive reserves, which should by law have been paid to government.

WHAT NEXT

If the government uses this opportunity to improve governance at RBI, it would be a move in the right direction. If it merely asserts its powers by giving directions, it could well turn into a catastrophe as predicted by Acharya.

The math behind RBI's massive reserves

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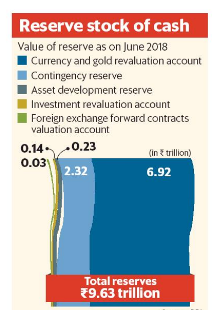
The total reserves of the RBI is the sum of its capital (statutory reserves of ₹5 crore) and a variety of contingency and revaluation accounts. In the balance-sheet of the RBI, these components are shown as Schedule 3 under the head "Other liabilities and provisions". The current total amounts to ₹9.63 trillion. These "reserves" are not foreign exchange reserves that we often talk about. These are provisions made by the RBI for various uses. Sometimes, they are also called equity capital or risk capital.

Central banks normally make profits. RBI has two main sources of income. RBI gets seigniorage income, which is the difference between the face value of money and the cost to produce and distribute it. The second source of income is from the banking department, wherein, the RBI earns interest and revaluation from its portfolio of securities—both domestic and foreign. RBI's



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expenditure is primarily on account of three heads: establishment expenses, agency charges, and security printing.

As per Section 47 of the RBI Act, the central bank "after making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and for all other matters for which provision is to be made" shall transfer the balance of the profits to the central government. At the same time, Section 58 requires the RBI's central board to make regulations "to provide for all matters for which provision is necessary."

However, there are currently no rules regarding the purpose for which these reserve funds may be created; the proportion of profits that may be transferred to these reserve funds; the proportion of profits that may be distributed to the government.

In 1996-97, a group was set up to recommend guidelines for the allocation of RBI's capital and profits. It suggested a target of 12% of total assets to be set aside for reserves. In 2013-14, a technical panel of the RBI Board reviewed the adequacy of reserves and the surplus distribution policy and found the available reserves to be in excess of needs.

made by the Central Committee of the Board (CCB) to which the board had delegated all its functions. This meant that CCB could take decisions on any of the matters that the board should have deliberated upon. It resulted in a subset of the board, with largely RBI management, getting practically all the powers of the board.

This is unlike most boards which delegate specific functions to sub-committees of the board. The board would rarely question the decisions of the CCB. A normal healthy tension that should exist between the management and the board did not exist. A question arising from Acharya's speech is whether a discussion by board members in the RBI board constitutes interference in the job of the RBI and reduces its independence?

For its part, until now, the government did not pay adequate attention to the functioning of the RBI board. A healthy functioning board with discussions and debates on important issues and a more accountable RBI should have been the norm. Debates in board meetings should not have kicked off storms.

The government's overall commitment to financial sector reform was also weak when it rolled back bills like the Public Debt Management Agency (PDMA) and Financial Resolution and Deposit Insurance (FRDI).

In 2015, when new guidelines for regu... tral banks in the world.

A central bank is not a normal bank. It is not a commercial bank—so it bears negligible credit risk. As a consequence, there is no clear framework, as there is for commercial banks, on the reserves or equity capital required to be held by a central bank. It is not correct to use the Basel framework to compute the equity capital required in a central bank. In fact, as former chief economist of the IMF, Prof Olivier Blanchard, has emphasised, it's perfectly feasible for a central bank to run on negative equity capital. A central bank could have negative values of `equity capital' and this does not induce any stress.

If the government uses Section 7 to give directions to the RBI on regulations, it would be a step backward in the reform process

The reserves with the RBI have been created by the board of the RBI. However, these funds were not created with the prior permission of the central government, as required by the law. Further, the RBI board has not made rules about how much should go into each reserve. In its 2015 Annual Report it said that it would come up with a framework for equity capital, but has not done that so far. As noted before, the present RBI Act requires only one Reserve Fund of ₹5 crore.

... the profit was generated as is done elsewhere by most central banks. Today the discussion must involve the pros and cons of transferring it to government or holding it back. If it is transferred, then the inflationary or other effects must be discussed. If it is held back or more is to be accumulated, then the board should put in place a framework and set of rules about each of the funds.

PROTECTING THE FORT

A third issue raised by Acharya is that governments have a short term view while central banks have a longer term view. But is this always true? Let us look at the case of RBI reform. Based on difficulties in the financial sector, a reading of India's archaic laws and learning lessons from the global financial crisis, the Financial Sector Legislative Reforms Commission (FSLRC) highlighted the need for reform. In its report submitted in 2013, it recommended changes in India's financial sector laws to provide the rapidly growing Indian economy a new financial regulatory architecture.

The Commission based its work on a number of RBI and government committee reports which had recommended changes, but it was the first to propose legal changes in the form of the Indian Financial Code. It sought to modernize governance and make regulators more ... parent with agenda and minutes of board meetings to be public, and with boards having the responsibility of approving all regulations after due process.

The government's attempts at reform following the FSLRC report over the last 5 years have, in general, been opposed by the RBI. The exception, also mentioned in Acharya's speech, was FSLRC's proposal for making RBI an inflation targeting central bank. Media reported RBI as opposing the larger number of external members proposed by FSLRC, as it would undermine its independence. The government compromised. Even when three external and three internal members were to constitute the committee, the new law gave the RBI governor a casting vote. This tilted the balance in favour of RBI.

On other reform, including governance reform, reform of the regulation making process, appeals on RBI orders, etc RBI consistently opposed reforms. Then RBI governor Raghuram Rajan's speech titled, "Financial Sector Legislative Reforms Committee Report (FSLRC) - what to do and when?" famously argued "If it ain't broke, don't fix it".

It seems that as the economy grew rapidly, RBI's capacity to evolve and reform did not keep pace. RBI failed to recognize that if we wait to fix things when they get broken, then the short term solutions that need to be provided are rarely optimal.

... responsibility for the situation coming to this point. There is little doubt that the proposal to let weak banks lend more is a risky one, but there is also little doubt that poor supervision by RBI management failed to arrest the slide early on.

LENDING BLAME GAME

Why is India's banking sector not lending to small companies? The RBI has been an important stumbling block in the attempt to develop deep and liquid bond markets. It has kept a stronghold over the government bond market, which is an integral part of the bond market, by allowing limited participation in its market infrastructure—the exchange (NDS-OM) and the depository (SGL). While most major central banks in the world stopped trying to manage government debt after being given an inflation target, RBI protected its turf and forced the government to withdraw the bill that proposed to reform the bond market. This created a financial system in which large firms with better ratings and collateral accessed the banking sector at the cost of small firms.

The proposal to let weak banks lend more is a risky one, but poor supervision by RBI management failed to arrest the slide early on

... ment where banks were competing to give loans to small firms. For its part, no government over the last 15 years addressed the issue of the lack of competition in the banking sector either.

The DG's speech is peppered with the usual fear mongering and buzz words RBI often uses whenever there is an attempt at RBI reform—"hyper-inflation", "full-blown crisis", "asset-price crashes", "financial crisis", "sudden-stops", "collapse", "unchecked financial fragility" and so on. Needless to say, many a country has undertaken central bank reforms without leading to a crisis. In India, fear mongering has often resulted in governments backing off on the question of reform. As a consequence RBI remains one of the most unreformed central banks in the world.

The present rift is a turning point. If the government uses this opportunity to improve governance, initiate changes in laws and regulations that strengthen India's financial regulatory architecture, it would be a move in the right direction. If it merely asserts its powers by giving directions or imposing its will by other means, it could well turn into a catastrophe as predicted by Acharya.

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