Opinion | RBI and the government: stepping back from the brink

While the RBI can be faulted for having allowed the NPL problem to develop and fester in the first place, it has been making up for its past negligence

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The Reserve Bank of India (RBI) and the ministry of finance (MoF) are once again making headlines for all the wrong reasons. It is expected that matters will come to a head at the RBI central board meeting on 19 November. My own expectation is that both parties will step back from the brink. If they don't, the impact on the financial markets will be very costly as deputy governor Viral Acharya recently warned. Of course, his public reference to the ongoing tensions didn't exactly help to calm the markets.

Tensions between central banks and finance ministries are neither new nor unique to India. Such tensions often arise between the finance ministries and central banks in advanced economies as well as emerging market economies. In India, RBI governor Urjit Patel's predecessor Raghuram Rajan is known to have had his differences with the present government and former governors D. Subbarao and Y.V. Reddy had their differences with P. Chidambaram, the then finance minister.

Such tensions are partly structural, embedded in the different roles of the institutions. Central banks are primarily responsible for monetary policy and maintaining a low rate of inflation. The finance ministries are responsible for fiscal policy and ensuring a high rate of growth and employment. Fiscal and monetary policies interact and the policy requirements of these competing goals often pull in opposite directions. Hence the embedded tension. Of course the tensions between the RBI and the MoF are not always healthy tensions embedded in their different policy roles. As a seasoned campaigner wryly remarked, "it is often just a clash between the arrogance of power and the arrogance of expertise".

In the past, such differences have typically been resolved in discreet discussions away from the public gaze. This time the differences have unfortunately been aired in the full glaze of the media. Why is it different this time? A possible reason is that several contentious issues have come together at the same time.

First, there is the Allahabad high court suggestion that the central government should consider giving directions to the RBI regarding the highly indebted independent power producers who fell foul of the Insolvency and Bankruptcy Code (IBC). The government is authorised to give such directions if it considers necessary in public interest, after consultations with the governor, under clause 7(1) of the RBI Act.

Then there is the issue of the RBI's surplus after provisioning for reserves. Clause 47 of the RBI Act requires that all the surplus profits of the RBI, after making adequate provision for reserves under various heads corresponding to different risks, should be transferred to the central government. The size of the surplus thus depends on the provisioning for reserves and the computation of the RBI's deployable capital base. Y. H. Malegam, a reputed chartered accountant and by far the longest serving member of the RBI

central board, indicated in a recent television interview that a committee headed by him had recommended that the old policy of maintaining reserves equal to 12% of net worth be replaced by a policy which links the required level of reserves to the nature of the risks for which provisions are to be made.

The tricky issue here is the treatment of foreign currency reserves. According to some estimates, the RBI's capital base is as much as 27% of its assets. But two-thirds of this consists of foreign currency reserves that increase or decrease in value according to changes in the exchange rate. Setting this component aside, the deployable capital base would be only around 7% of assets, one of the lowest among central banks. MoF now wants to discuss a proper framework for establishing the RBI's capital base, the requirements for provisioning, and hence the surplus to be transferred to the government.

A third bone of contention is the set of prompt corrective action (PCA) norms currently in place for commercial banks to recognise stressed assets and take corrective action before those assets turn into non-performing loans (NPL) that will further erode their balance sheets. The PCA regime is a key policy tool the RBI has deployed to gradually clean up the balance sheet of commercial banks. The NPL problem is widely recognised as the critical factor that has constricted the credit cycle and constrained growth.

As a regulator, the RBI can be faulted for having allowed the NPL problem to develop and fester in the first place. But it has been making up for its past negligence during the last couple of years. On 13 April 2017, it announced the amended PCA norms. This has helped revive the credit cycle, which had remained constricted at well below 10% credit growth for a couple of years. It started recovering from around December 2017 and credit is now growing at over 12% per year. However, the credit growth has come entirely from banks with relatively strong balance sheets. Twelve banks presently under the PCA regime, including 11 public sector banks, are unable to increase their lending. The RBI is doing what it should be doing as the regulator. But the MoF which had earlier approved the amended PCA norms is now wanting these norms to be eased, presumably to help the public sector banks which the government owns.

A fourth area of disagreement that has surfaced after the loan defaults by Infrastructure Leasing & Financial Services (IL&FS) is the RBI's liquidity management for non-bank finance companies (NBFCs). NBFCs have been

increasingly relying on short-term commercial paper, and the modest increase in commercial paper rates does not suggest a liquidity crisis for NBFCs. But MoF believes that NBFCs are facing a severe liquidity crunch and wants the RBI to open a special loan window to ease the crunch. The RBI is reluctant to create such a window to give relief to NBFCs.

As the IL&FS fiasco suggests, the challenge here is not liquidity but solvency. Again, the RBI as the regulator can be faulted, along with the NBFC boards, for having allowed the problem to fester for this long. But at least it is now trying to tighten its regulations. The government also took swift action in replacing the IL&FS board once the defaults started, and the new board has moved with remarkable speed to establish a resolution plan for this mammoth NBFC. It is disappointing that the MoF is now pressing the RBI to create a crutch for NBFCs.

The issues listed above, and others such as the demand for easing Basel norms for banks without substantial international transactions, point to a distinct pattern. The RBI, past regulatory failures notwithstanding, is now diligently applying itself to cleaning up and strengthening the financial sector. In passing the IBC and then constituting the National Company Law Tribunal, the MoF has been very much a partner in this effort. However, it now seems to be pulling in the opposite direction. Perhaps the MoF itself is under pressure from special interest groups to lean on the RBI to loosen its regulatory framework.

Whatever might be the underlying drivers, what matters is that substantial differences persist between MoF and RBI. This inevitably raises the question of RBI's autonomy. The reasons for ring fencing the autonomy of central banks are well known. It enables them to conduct monetary policy professionally, without the short-term political compulsions of elected governments. However, it must be recognised that this protection of the RBI's autonomy is by convention, not by law.

Legally, there is no ambiguity that the central government is the sovereign. The entire central board of the RBI, including the governor, is appointed by the central government under article 8 of the RBI Act. Further, article 30 empowers the government to supersede the board and take over its management according to a laid down procedure for informing parliament. Finally, as noted earlier, under article 7(1), the government may from time

to time give directions to the RBI, after discussions with the governor, should it so decide in the public interest. It is again a matter of healthy convention, not law, that the autonomy of the RBI has been respected and this article has not been invoked until now.

In the television interview cited earlier, Malegam correctly made the point that unlike chief executive officers in corporate boards, the RBI governor does not report to the central board but has the same powers as the board. They are like equal partners. He went on to say that the central board has a decision-making role on administrative matters and only an advisory role on policy matters, which are to be decided by professional RBI management, i.e., the governor and his/her deputies. On this, I must respectfully disagree with Malegam. Under articles 7(2) and 7(3) of the RBI Act, the powers of the central board and the governor are the same with regard to all affairs of the RBI, whether related to administration or policy. The wording of the two clauses are identical. If policy matters have generally been left to the RBI management, then that too is a matter of convention, not law.

Given that legal background, if differences between the RBI and the central government remain irreconcilable, then only two courses of action are possible: Either the governor resigns or the central government removes the governor as per laid down procedure. The consequences of either course of action for the financial markets would be disastrous, especially in the present economic context when India remains vulnerable externally, despite the recent easing of oil prices, the fisc is under great pressure and the financial sector is still fraught with many risks.

Fortunately, we are nowhere near such a disaster. Both the MoF and the RBI are seeking compromises and stepping back from the brink. The 19 November meeting of the central board is likely to see a reasonably harmonious resolution of the major differences prevailing between the two institutions.

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