Demystifying RBI – from inflation to inclusion

Nani Palkhiwala, in whose honour this series of lectures is being organized, said “To my countrymen who gave unto themselves the constitution but not the ability to keep it, who inherited resplendent heritage but not the wisdom to cherish it, who suffer and endure in pain without the perception of their potential.” In today's context of strife between different segments in society, we would do well to remember these words and acquire the capacity to keep our constitution. Mr Palkhiwala’s annual budget speech attracted as many as 100000 persons in Mumbai’s Brabourne stadium. He felt that the educated youth should be involved in informed debate on matters of public interest. Hence this series of lectures would have succeeded if it results in debate and discussion within the IIMs and IITs on some of the public policy issues raised in these talks.

In my talk today, I want to give you a flavour of what the RBI does and why – what is so unique about the RBI as a central bank? What are the challenges it faces currently? What is the institutional framework –the relationship between RBI and the Government –that serves best the public interest? Can there be an informed debate about whether the RBI has delivered on its goals and public expectations and what are the factors critical for good governance of the monetary and financial system?

Monetary policy

The first and foremost role of any central bank is conduct of monetary policy. In fact any central bank owes its existence to its ability to create money. This seems to be naturally something a government ought to be doing and in fact in India till 1935 the Government did precisely that. But till the world was on gold standard a government only printed as much money as was proportional to the gold it had. All this was given up following the First World War and today a country

decides how much money it needs to ensure that there is steady non-inflationary growth and employment. While growth is usually the role of the Government, the central bank has to ensure price stability. The separation of this function is considered desirable to safeguard against a politically motivated executive who may try and exploit the short-run trade-off between employment and inflation. Nevertheless, in many jurisdictions the central bank has been given both growth and price stability as it's objectives.

After the global financial crisis of 2008, financial stability has been included as an additional objective for most central banks. Monetary policy through pumping in of money was used to stimulate the economy. In some countries such as US this was supported and supplemented by fiscal policy –in others like UK there was fiscal rectitude while having accommodative monetary policy. Despite having a practically zero interest policy and quantitative easing in developed economies for so many years, growth is yet to return to many of these countries some of which have two-digit unemployment rates. Hence one wonders whether the world has put too much responsibility on central banks –too many objectives for which they do not have sufficient tools. This is why today it is seen that government and central banks have to act in sync to achieve the growth and stability objectives together. Structural reform, productivity improvements, labour market changes, more mobility in many developed markets have to go hand in hand with monetary stimulus for growth to return. In India for example unless the government manages the prices of food articles through supply management, the RBI will not be able to deliver on its objective of price stability. It is in this context that the current and ever present debate on independence and autonomy of central banks has to be seen.

The relationship between the political authority and the central bank is always a delicate one and post the World Wars when the scourge of hyperinflation was experienced, the independence of the Central bank was emphasised.

In his 2001 talk here in IIM Indore, the then Deputy Governor Dr Reddy (later became Governor in 2003) talked about central bank autonomy. He pointed out

that in the early post independence period, the RBI enjoyed some autonomy in monetary policy which essentially went away as the proportional reserve system was given up in the mid 50s and the RBI had to finance the Government's fiscal deficits which were incurred for national economic development. From then, till 1994, fiscal dominance of monetary policy was pronounced, leaving the RBI with very little autonomy. In fact the 1991 crisis was because of fiscal profligacy. Post 1994, the agreement for stopping the automatic financing of Government by RBI and the passing of the Fiscal Responsibility Act finally making it illegal for the RBI to contribute to Government financing by subscribing to the primary issuance of Government securities gave the RBI some degree of autonomy to pursue monetary policy.

Governor Subbarao in his recent book "Who moved my interest rate", articulates the challenges of conducting monetary policy in a real world where the political executive tries to influence the central bank in veering towards lower interest rates to stimulate growth. In recent interviews in the context of the release of his book Subbarao has asked the government and the RBI to keep their differences "behind the closed doors", and has said the central bank must prevail when it comes to the monetary policy and any disagreement should not matter as long as it exerts its autonomy. Governor Rajan has also said the same thing "Criticism of the central bank using arguments unsupported by evidence is not just an Indian phenomenon. The Bank of England was criticized for laying out the economic costs of Brexit, the ECB has been criticized for doing too much to restore health to troubled peripheral economy financial sectors, and the Fed is under fire for departing from the Taylor Rule. Criticism comes with the territory, and central banks need to make the case for their policies. At the same time, it is important that governments around the world look beyond sometimes uninformed and motivated public criticism and protect the independence of their central bank to act. That is essential for stable sustainable growth."

Till recently, the RBI while accepting that price stability was a paramount objective of monetary policy, emphasised the role of monetary and credit policy for growth, financial stability and financial inclusion. Implicit inflation targets

were articulated in the monetary policies. In February 2015, the agreement between the RBI and Government clearly places price stability as the objective of monetary policy and adopts an explicit inflation target of 4 plus or minus 2 per cent in terms of CPI. The agreement says that RBI Governor would set the interest rate to achieve this target. The Government has since then approved the setting up of a six member Monetary Policy Committee (MPC), three members of which will be from the and three will be independent persons appointed by the Government. Under this arrangement it will be the MPC that will set interest rates. While there is no veto for the Governor, he has a casting vote. The main reason why Governor Rajan and Subbarao have supported the MPC is to broad base the decision-making rather than being of one individual.

Hence the autonomy issue is whether this MPC can and will act in an independent (of the political short term objective) and unbiased manner in the interest of the economy? What does this depend upon? A related issue is to what extent the CPI inflation can actually be targeted through the policy rate. So are the tools available to the MPC sufficient to influence the CPI inflation? These are issues you may like to debate and set up a mock MPC in your debating fora.

What does all this mean for the common person? Monetary policy has implications for how much interest you earn on your savings and how much interest you have to pay on your loans. For most of the younger generation, the lower the interest rates the better, as you would be most likely borrowers than savers. But the interest of both savers and borrowers has to be delicately balanced in the interest of having sufficient savings in the financial sector to support growth and employment.

Banking or financial sector regulation and supervision

I have so far touched only on the monetary policy role of the RBI –no doubt the most important one and affecting the entire economy. A second and very important role of the RBI is its regulatory role. The RBI is the regulator and

supervisor of all banks and non-banking financial companies in the economy under the Banking Regulation Act and the RBI Act. It is also the regulator of payments system under the Payment and Settlement Act 2007. It is also the regulator of the money credit forex and government securities markets and their derivatives in terms of the RBI Act. It administers foreign exchange controls through the FEMA. It is also the regulator responsible for consumer protection in banks and other entities regulated by it.

What does this mean in simple language?

As a regulator of banks that accept public deposits, the RBI tries to ensure through regulation and supervision that the deposits are safe and the interest of savers who have put their money in these banks is protected. Protection is against bank failure which people saw in the crisis period was not a near impossible scenario. Banks regulated by the RBI include commercial banks, cooperative banks, regional rural banks, local area banks and more recently the newly licensed payments banks and small finance banks. In case of other entities that accept public funds either directly like some NBFCs or indirectly through borrowing from other banks and in the markets, the RBI regulation tries to protect the safety of the public funds mobilised by them. But banks are special because they are highly leveraged institutions and have the ability to create money. No bank can repay at one time all the deposits mobilised by it as these are deployed in assets like loans and investments which are contracted out for longer period and cannot be recalled at once. Also there can be bad business decisions and some investments or loans can turn bad. It is for all this that banks are required to make adequate provisions for NPAs and also have capital to protect the losses from eroding the depositor's funds. Also banks need liquidity that is needed to meet its liabilities as and when they arise. Liquidity and solvency are the two parameters the RBI constantly looks at for individual banks.

The RBI as regulator of banks and other non-banking entities is also responsible for consumer protection in banks to see that customers are treated fairly.

Financial stability has emerged as one of the important objectives of financial sector regulation after the crisis. Hence even if the regulator was earlier focusing on the solvency and liquidity of individual institutions and these were found to be ok, there were trends in the markets due to globalisation, interconnectedness and huge leverage that did not reflect the risks that were being built up till the Lehman Bros crisis happened. Subsequent to 2008, the international club of regulators- the Basle committee has brought in regulations for ensuring systemic stability. In many countries that had located banking regulation in an entity outside the central bank have after the crisis brought the oversight of systemically important entities under the central bank. Also because the bailout of banks had to be borne by the budget and the fisc, governments have now taken a role in ensuring financial stability in addition to the regulator. This is why today in most countries there is a financial stability council or committee.

Since the financial sector reform of 1990s, the RBI has applied all the international prudential norms to banks relating to capital adequacy, provisioning, asset classification, liquidity and more recently leverage. Supervision is both off site and on site and is risk based –by devoting more supervisory time and resources to riskier areas and entities. Regulation and supervision also focuses on better governance practices in banks, ensuring that those who run banks are fit and proper, proper accounting disclosure audit practices and policies, and developing risk management and compliance as part of organisational culture.

Other regulators in the financial sector are the SEBI for capital markets, IRDA for insurance sector PFRDA for the pension sector and all these regulators are members of the FSDC, which is headed by the FM.

Legitimately, at this stage, you should be asking two sets of questions. The first set of questions could be: does the present high level of NPAs and capital position of banks represent a collapse of RBI regulation and supervision? Why are so many bad loans being written off? Have banks colluded with promoters in

siphoning away funds? What was the supervisor doing? What about auditors? Who is accountable? The second set of questions relate to scams like Saradha. How can so many companies mobilise public funds and not return what they have promised? How can such amounts run into millions and crores affecting so many people?

Let me try and answer both sets of questions.

In the first instance, let me talk about the NPA problem in banks. Stressed advances in public sector banks (gross NPAs plus restructured standard assets) rose from almost 9 per cent in March 2012 to 14.5 per cent in March 2016. In case of private sector and foreign banks, the stressed advances ratio was 4.5 per cent in March 2016. Subsequent to the Asset Quality Review undertaken by RBI, the gross NPAs rose y-o-y nearly 80 per cent in March 2016.

The high level of NPAs reflects a combination of factors.

- Aggressive lending to certain sectors, like infrastructure, in the post crisis period partly as a result of the stimulus pushed by the Government. These sectors encountered implementation problems and the loans got stressed.
- Weakening of credit standards by banks in the post 2008 period when liquidity was plenty and repos rates had been reduced from 9 per cent in July 2008 to just 4.75 in March 2009. Rates remained low for a fairly long time moving to a more neutral rate of 6.5 only in Jan 2011. This was also a time when there was a lot of euphoria about growth and that India had decoupled.
- Certain concessions in recognition of stressed accounts now termed as regulatory forbearance in order to allow banks to restructure accounts under corporate debt restructuring (CDR) in the wake of crisis. This got exploited by promoters and allowed banks to postpone recognition of the NPAs- although this concession was available for a small window it got interpreted for longer time.
- The lending to the State Electricity Boards and the power companies that had entered into PPA agreements with such Boards got stressed due to

losses of the State Electricity Boards

- Global conditions including slowing down of the Chinese economy creating stress in the textiles and steel (and metal) sectors
- Huge leveraging by some companies which as a group incurred excessive debt to finance expansion, which could not be sustained once the slowing down started
- The bad experience in recovery of loans through courts have also influenced banks to agree for restructuring as a better option taking into account the time value of money etc. The delayed court recovery has also in turn encouraged promoters to force banks to write off etc.

There is a view that the RBI has taken too tough a stand on the banking system and this has made banks freeze into in action reluctant to lend afresh and this is one of the reasons the economy is not picking up. In banking while in conditions of recession (negative growth) slowing down prudential action can be counter cyclical, in conditions where there is at least 7 percent growth, such as in India, any delay in recognition of the asset quality delays action by the borrowers and bankers in correcting the weaknesses and this can only compound the problem as debt cannot be wished away. Either it has to be repaid through asset sales infusion of new capital or resize it through restructuring. The earlier this is done the better it is for the economy even if it means pain for a while. With the action by the Government through the Banking Bureau in the matter of the governance in pubic sector banks, actions to expedite recovery by banks through legal process and the bankruptcy code, hopefully the situation will improve all around. A clear capital infusion plan for public sector banks with incentives and disincentives to use capital efficiently needs also to be brought in quickly.

As regards Ponzi schemes like Saradha , SEBI has been given significant powers over collective investment schemes and other such schemes aimed at the vulnerable depositor. But there is no alternate for continued vigilance by local State level authorities – the announcement of a platform Sachet by the regulators where names of all entities authorised by any regulator to accept public funds recognised is displayed and through wider education of the common person

through financial literacy, media etc., gullible investors could be prevented from investing their money with fly by night operators who promise high return on their savings.

Another role of the RBI is deposit insurance-, which it does through its subsidiary the Deposit Insurance, and Credit Guarantee Corporation (DICGCI) that guarantees the safety of small depositors in banks. This has proved to be of real value in the urban cooperative banking structure which has undergone a clean up in the last decade or so.

Other related functions of the RBI

Management of foreign exchange reserves to ensure that these are safely invested with adequate liquidity to serve the needs when needed is a very important function. So also the RBI manages the debt of the Central and State government - this is a function many central banks do not perform and even in India the intention is to carve this function to a separate agency. There are pros and cons on whether this should be done and at what stage of economy but I will not get into that debate here. Another role of which many people are aware are the exchange control functions the rules that under the FEMA are applicable for transactions resident undertake with the rest of the world - how much foreign exchange can be taken for studies abroad, what can you as a businessman or an individual receive from non resident investors by way of equity or loan, can you invest abroad - all these are covered by the RBI regulations which are administered through banks called authorised dealers and for most of the needs people do not have to go to the RBI. But there are some areas where the RBI still exercises controls mostly on the capital account and hence quite a few people in the RBI are working in this area.

The RBI is banker to the government and banks. It also issues fresh currency into the system and withdraws soiled currency. Quite a few people in the RBI are performing these functions of note distribution, providing banking facilities to banks and government - these roles naturally extend into the role as regulator of

the payment system. For example Paytm or any other entity like MPesa which offers to make payments for you need RBI approval - the underlying objective of regulation is to ensure that these are credible entities who can be trusted to do this function without any discontinuity or leakages. I finally turn to an important role of the RBI role viz. financial inclusion.

Financial inclusion

The ultimate objective of financial inclusion is to ensure that the financial system gives a fair opportunity and access to all persons especially the common person. Such opportunity includes access to a bank account, to affordable payments facility, savings, loan, insurance and pension products. In any household's life cycle there are a variety of financial requirements - ranging from a safe place to save money, to getting a loan for a business or housing or higher education. Finance can either release a human being from distress or place him or her in distress. The objective of financial inclusion is financial empowerment. Financial empowerment goes beyond financial inclusion. It encompasses efforts on the demand and supply side to ensure the financial security of low-income households. Financial security is not possible without economic security. Hence efforts for enhancing health education, skills and linkage to markets need to go hand in hand with measures on supply side to provide easy and affordable access to financial services such as savings, loans, insurance, payments and remittances. In all this, the role of infrastructure – road, power, telecom- and other measures like UID credit information and technology backbone are critical.

In many countries it is the Government, which takes the lead on financial inclusion. In India too with the nationalisation of banks, government steered the public sector banks into extending their presence to the backward areas and to the sectors that were not receiving bank credit such as agriculture, small-scale industry, self-employment etc. The current approach to financial inclusion started in 2005 under the leadership of Governor Reddy. His focus was not so much on the very poor as the Aam Aadmi. Again his focus was not on loans or the

purpose of these loans as agriculture or self-employment. The Aam Aadmi needed a convenient, safe and accessible place to save, a facility to which the Aam Aurat will not have access, some consumption smoothening loans and safe remittance facility. More stringent KYC norms /AML after 9/11, also meant that he/she needed to have some identity proof. It was clear that the banks, while fulfilling their priority sector lending targets, were not really making any special effort to provide banking services, especially opening of a bank account for the Aam Aadmi. In fact, be it private or public sector banks, there was a general reluctance to open bank accounts for such persons especially from the informal sector. Governor Reddy then crafted a strategy based on basic banking or no frills accounts to be mandatorily offered by all banks, simple overdrafts facility, IT driven solutions to make the banking services accessible and low cost, simplified KYC for no fills customers relying on introduction, use of agents or business correspondents for providing basic banking facilities, free withdrawal at ATMs. RBI encouraged its institution IDRBT at Hyderabad to undertake a pilot using hand held biometric device for 'government to person' in collaboration with the AP Government. Starting from one district in Kerala to achieve 100 per cent financial inclusion and in the entire Union Territory of Puduchery, there was enthusiasm in each State to achieve 100 percent inclusion. But as in many cases, there was many a slip between the cup and the lip. While accounts were opened, their usage was limited. IT failure, delay in integrating the basic banking accounts with general banking and in evolving a proper compensation model for the BCs were challenges. Overdrafts and simplified credit cards were hardly extended. In the area of remittance, till the Aadhar seeding was more widespread, the challenges of KYC and regulatory restrictions inhibited the banks. Mobile banking did not take off even though mobiles took off, as the policy makers feared that KYC checks by telecom companies were not so reliable. Moreover the RBI's view was that financial inclusion needed services other than just payments that could only be provided by well-regulated banks. Moreover, there were regulatory issues if telecom companies were allowed to offer banking like services. Hence RBI pushed for a bank led model even in mobile banking.

Financial Literacy and Credit Counseling were made an integral part of the

strategy. Financial literacy in local languages was promoted. Banks used local NGOs to act as a bridge between the bank and the Aam Aadmi who found accessing formal banking somewhat daunting. Financial Literacy was introduced in schools. Apart from Aadhar, the most important market infrastructure put in place was credit information through licensing specialised companies to provide data on the repayment record of borrowers.

The second stage of financial inclusion –from around 2009- involved extending coverage of the population through branchless banking or through micro branches to all locations with more than 2000 population. The Jan Dhan Yojana launched in 2014 broadened and widened the financial inclusion program by increasing the outreach massively, made Aadhar the basis of the program and also deepened it by making bank accounts, savings, remittance, credit, insurance and pension an integral part. This is the current phase. It is a bank led program unlike in Kenya and Philippines where it is a telecom led model.

Dramatic changes in the payments system have taken place in recent times. The setting up of the NPCI, the recent steps taken for financial messaging viz UPI without internet access will make mobile banking for the common person a reality - it should soon be possible for every person who has a basic banking account to get all the basic products under the JDY through his or her mobile. This can unleash a huge opportunity, as the younger generation is very comfortable with the mobile devices.

Payment banks small finance banks and Post Office Bank will further the efforts by providing institutions, whose business model itself depends on making financial inclusion a viable business and hence can be expected to be more nimble footed customer focused and provide completion to the mainstream banks.

In the drive to adopt the best technology we should not forget the cultural and anthropological aspects, which define relationships exemplified in this story I will tell you. I had visited an NGO in Ajmer many years ago. The NGO had

catalysed groups that consist of poor Muslim women and trained them in making crochet caps for the nearby dargah. The groups then started supplying caps and other items to distant places. Initially the women were neither taken seriously nor supported by their men folk, but after successive drought years when they found that the supplementary income from the women enabled the families to be free from starvation, the SHGs gained credibility and won the support of the men folk. The SHG leaders become so empowered that they started going to Ajmer and even to Jaipur for procurement of yarn and marketing the produce. In the process of empowerment the women actively encouraged their children especially the girls to be regular in school and they themselves have showed active interest in adult literacy classes. They even wanted to learn how to keep their accounts on the computer. There was much more consciousness on sanitation issues and preventive health care. These women were also prepared to travel as far as Kutch for exchange of experiences with other women SHGs involved with craft production. Banks and NABARD supported the SHG under the SHG bank linkage program. To me, this represents a real case of financial empowerment, economic empowerment and social empowerment!

Conclusion

How has being a multifaceted entity helped the RBI or has it hindered its functioning? In many countries prudential regulation is given to a separate entity, consumer protection to another and monetary policy only to be with the central bank. The global crisis has actually reiterated the need for the central bank, which provides last resort liquidity to also be concerned with at least the oversight of systemically important financial institutions. And that is what has happened in UK and US. Consumer interest can be in a separate regulator as also securities market pension and insurance regulation. The FSLRC has made a number of wider ranging suggestions for changes in the regulatory architecture for removing many of the regulatory functions from the RBI. The consensus that seems to be emerging is while debt management, consumer protection and resolution of financial institutions can be separated from the RBI, it is necessary that banking regulation and regulation of entities that lend using leveraged

money such as NBFCs, should be with the RBI. Also as long as there are capital controls, regulation of money forex and government securities markets should be with the RBI.

The next question, which I would like to answer, is - what has made the RBI tick? Has it ticked? One would think so looking at a fairly credible inflation record, hardly any cases of bank failure, good foreign exchange management reflected in the reserves level, a fairly efficient payments system, good debt management as reflected in the non disruptive manner in which huge market borrowing program of the a central and state governments have been carried out, sound market infrastructure organisations like the CCIL and NPCI. From another lens one can say the performance is not good, looking at the high NPA level, the inability for formal financial institutions to reach out to the small business or household, inefficient processes in banks especially in public sector, industry taking advantage of the banking system's inability to recover the loans and absence of a more widespread forum for redress of consumer complaints. It is for the public to judge the RBI. Both Governor Subbarao and Governor Rajan have stressed upon the need for the RBI Governor to make a suo moto deposition before the Parliament on its performance as a calendar event.

What has helped the RBI? Excellent governors who have been professionally highly competent and have been persons of high integrity and stature - these leaders have encouraged talent wherever they saw it within the organisation, they have not been afraid to bring in talent form outside in any area that was seen as lacking, gave huge opportunities to staff for self development and allowed the free expression of independent views even though such views may be different from the higher level authority. There is also a tremendous loyalty to the core values, which I believe are, highest respect for competence and objective unbiased expression of views orally and in writing. Despite attractions of a market outside that pay much higher, how has the RBI managed to attract and retain talent? The prestige and standing of this institution I believe makes people attracted to it and once they have entered the quality of the output expected and recognised makes people, put forward their very best.

I hope many of you would be encouraged to join the RBI and serve the nation.