Kishori J Udeshi: The pursuit of financial stability

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The references for the speech can be found on the Reserve Bank of India's website.

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It gives me great pleasure to address this gathering at the 7th Annual Conference on Money and Finance in the Indian economy organised by the Indira Gandhi Institute of Development Research (IGIDR). Issues related to monetary policy and financial sector continue to attract a lot of research interest all over the world and this is all the more true for emerging economies like India which are gradually integrating with the rest of the world. Accordingly, the initiatives taken by the IGIDR to hold annual conferences on the topic of Money and Finance to bring together researchers and policymakers are indeed welcome.

With growing financial openness, globalisation and liberalisation, financial stability issues have come to the forefront. These issues have ranged from discussions on basic issues of the definition of financial stability itself to issues of measurement, issues of choice of instruments to achieve the objective of financial stability and even issues on the degree of activism that central banks should adopt in pursuing this objective.

Traditionally, it has been believed that monetary stability leads to financial stability. However, as the events of the 1990s show, it need not necessarily be the case. While there are complementarities between these two objectives, especially in the long run, the same need not hold in the short-run. A stable macroeconomic environment - low and stable inflation, sustained growth and low interest rates - can generate excessive optimism about the future economic prospects and often the risks are downplayed. Accordingly, episodes of financial instability often have their origins in environment of macroeconomic stability. Thus, macro economic stability need not necessarily always place an economy in financial stability in the medium/long term and central banks, therefore, now bestow a more focussed attention to the objective of maintaining financial stability. Historically, central banks have been concerned with both price stability and financial stability, albeit not at the same time (Crockett, 2004). What is rather unique since the 1990s has been a simultaneous pursuit of price and financial stability by central banks.

Forces affecting financial stability

The basic forces affecting financial stability are the quickening pace of technological innovation and the growing acceptance of market processes as basic determinant of resource allocation. Due to sectoral distinctions getting blurred, financial intermediaries have the ability to effectively compete in sectors beyond their domain by deconstructing and recombining risks. Further, the source of financial disturbances has become more unpredictable mainly due to integration of financial markets. Financial liberalisation has led to the emergence of financial conglomerates, cutting across not only various financial sectors such as banking and insurance, but also a number of countries. Therefore, a contagion means the problems of distant economies can become problems of our own. The progressive opening up of the economies to external flows since 1990s has led to massive cross-border capital flows and volatile exchange rates. Sharp movements in exchange rates can have an adverse impact upon the balance sheets of both financial and non-financial entities. This is especially true for emerging economies as they usually need to resort to borrowing in foreign currencies.

If we recall the banking crisis and the resultant financial crisis of Latin America (IMF 2004), we can broadly categorise the trigger points as:

- A boom in credit to the private sector, for both investment and consumption (Mexico, 1994; and Colombia, 1999). A particular form of boom and bust cycle is generated by the end of hyperinflationary episodes (Bolivia, 1986);

- Wholesale liberalization in the absence of an appropriate and effective prudential regulatory framework (Mexico, 1994; and Chile, 1984). It is worth stressing, however, that highly regulated systems have also suffered crises (Peru, 1987);
- Direct effects of fiscal difficulties on the domestic banking system, a factor that seems to have become an increasingly important source of strain on Latin American banks (Argentina, 2001);
- Contagion and spillovers, where a crisis in one country induces economic agents to reassess their expectations and thus reduce investment in other countries (Argentina, 1995), or where a crisis in one country has a direct effect on economic conditions in another country (Uruguay, 2001);
- Terms of trade shocks and movements in real exchange rates (Venezuela, 1994; and Ecuador, 1998); and
- Political instability, unrest, and, in some cases, civil conflict.

Deficiencies in the following areas have detracted from good banking practices and increased vulnerability to crisis in some Latin American countries:

- Inappropriate and ineffective prudential regulation and supervision;
- Inefficacy of bank intervention and resolution;
- Policy-induced distortions, and, in particular, government influence over public sector banks;
- Poor structure and composition of government finances;
- Inadequate accounting practices, property rights, and corporate governance; and
- Inefficiency of the judicial system and poor observance and enforcement of laws.

Financial markets are different from other markets and therefore, greater liberalisation goes along with deeper supervision and higher degree of regulation. This is because in financial markets the herd mentality catches up fast making markets volatile. Any destabilisation in financial markets affects even those who are not in financial markets. On the other hand, financial markets can drive the real economy. Central banks, therefore, need to pursue a multifaceted approach towards ensuring financial stability through (i) payments system oversight, (ii) contingency planning against market disruption, (iii) lender of last resort (LOLR), (iv) share in procedures for financial regulation and (v) analysis and communication through reports such as Financial Stability Reviews (FSRs) (Goodhart, 2004). The importance assigned by central banks nowadays to the objective of financial stability is evident from the fact that a number of central banks have started publishing FSRs, giving their assessment of the health of the financial sector and its ability to withstand various shocks. The European Central Bank is a recent addition to this growing list of central banks that come out with regular FSR-type reports.

At the global level, crisis prevention initiatives have prominently centred around strengthened IMF surveillance and include a number of aspects: data dissemination, greater transparency, development of standards and codes, constructive involvement of the private sector, Sovereign Debt Restructuring Mechanism (SDRM) and introduction of facilities like Contingent Credit Line (CCL).

Financial stability: an Indian perspective

In India too, financial stability has emerged as a key consideration in the conduct of monetary policy since the 1990s, consequent to the structural reforms initiated in the early 1990s, the gradual opening up of the Indian economy and the transformation of the financial system from a planned and administered regime to a market-oriented financial system. As observed by Governor Dr. Reddy, contextually, financial stability in India would mean (a) ensuring uninterrupted settlements of financial transactions (both internal and external), (b) maintenance of a level of confidence in the financial system amongst all the participants and stakeholders and (c) absence of excess volatility that unduly and adversely affects real economic activity (Reddy, 2004b).

The overall approach of the Reserve Bank to maintain financial stability is three-pronged: maintenance of overall macroeconomic balance; improvement in the macro-prudential functioning of institutions and markets; and strengthening micro-prudential institutional soundness through regulation and supervision. Monetary stability is an important precondition for financial stability and, therefore, the most significant contribution that monetary policy can make to financial stability is through maintaining low and stable inflation. Since the second half of the 1990s, inflation has been brought down to an average of five per cent per annum compared to an average of around 8-9 per cent per annum in the preceding two and a half decades. The reduction in inflation since the early 1990s has also enabled inflation expectations to stabilise. Low and stable inflation expectations increase confidence in the domestic financial system and, thereby contribute in an important way to the stability of the domestic financial system.

Second, a number of measures have been taken to widen, deepen and integrate various segments of the financial markets in order to strengthen price discovery mechanism, lower the transaction costs and enhance the liquidity in the markets. At the same time, it is recognised that the capacity of economic agents in developing economies to manage volatility in all prices, goods or foreign exchange is highly constrained and there is a legitimate role for non-volatility as a public good (Reddy, 2004a). Accordingly, ensuring orderly conditions in the financial markets is an important aspect of the Reserve Bank's approach towards maintaining financial stability. Operating procedures and instruments of monetary policy have evolved over time to meet these objectives. For instance, with persistent capital flows, a new facility in the form of Market Stabilisation Scheme (MSS) was put in place effective April 2004. The MSS has provided the Reserve Bank greater flexibility in its market operations. Similarly, India's exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way has stood the test of time. Prudent external sector management with a cautious approach to capital account liberalisation has been an important component of macroeconomic policies to ensure financial stability. Overall, the Reserve Bank's approach is to minimise volatility in the financial markets and minimise knee-jerk reactions, while focusing on price stability and the underlying inflation. The objective has been to ensure that there are no avoidable uncertainties in policy, while mitigating undue pressures on the functioning of markets without undermining market efficiency.

A robust financial system is often characterised by smooth and secure payment systems and a word here about the several initiatives undertaken by RBI towards lifting the Indian payment system to global standards would be in order. While clearing houses were strengthened with MICR clearing processes, electronic clearing initiatives were undertaken through promotion of Electronic Clearing Services (ECS), Electronic Funds Transfer (EFT), establishment of an exclusive secured private network (INFINET) which serves as private geteway to the Indian financial system. A Real Time Gross Settlement System (RTGS) has been operationalised as an effective, quick and secure system for inter bank funds transfers. Introduction of Negotiated Dealing System (NDS), a Centralised Funds Management System (CFMS) and the Structured Financial Messaging System (SFMS) are other key components that were put into the payment system. All these measures have quickened the settlement processes, reduced risks in settlements and built confidence in the payment and settlement systems.

In the pursuit of financial stability, effective regulatory and supervisory initiatives along with a calibrated approach to financial sector liberalisation have a critical role to play. The Indian approach towards financial sector reforms has been based on pancha sutra or five principles (Reddy, 1998): (a) cautious and appropriate sequencing of reform measures; (b) introduction of norms that are mutually reinforcing; (c) introduction of complementary reforms across sectors (most importantly, monetary, fiscal and external sector); (d) development of financial institutions; and, (e) development of financial markets. The reforms have aimed at enhancing productivity and efficiency of the financial sector, improving the transparency of operations and ensuring that it is capable of withstanding idiosyncratic shocks.

Regulatory measures

Keeping in pace with times, various regulatory prescriptions were being issued by the central bank from time to time. These steps are taken to basically ensure banking stability vis-à-vis exposures and risks. I shall outline some of the key measures:

- Capital adequacy norms at 9% which is higher than the 8% international norm
- Income Recognition and Asset Classification (IRAC) norms

- Exposure norms – individual and group norms 15% and 40%, respectively with additional 10% in case of infrastructure funding.
- Cap on foreign currency borrowing and lending as well as policy measures on hedging of such foreign currency loans
- Cap on Capital market and sensitive sector exposures
- Building up of Investment Fluctuation Reserve (IFR) to a minimum of 5% by March 2006.

As a result of improvements in the regulatory and supervisory framework, the degree of compliance with Basel Core Principles has generally been high, and observed areas of weaknesses, primarily with respect to country risk guidelines have been addressed. Consolidated accounting for banks has been introduced along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities. A scheme of Prompt Corrective Action (PCA) was introduced effective December 2002 to undertake 'structured' and 'discretionary' actions against banks exhibiting vulnerabilities in certain prudential/financial parameters. With liberalisation, financial conglomerates are emerging. Banks have accordingly been advised to prepare and disclose consolidated financial statements and prepare consolidated prudential reports. The inter-regulatory coordination has also been streamlined with the establishment of a monitoring system in respect of Systemically Important Financial Intermediaries (SIFIs), coupled with the establishment of three Standing Technical Committees constituted by the High Level Coordination Committee on Financial and Capital Markets (HLCCFCM) to provide a more focused inter-agency forum for sharing of information and intelligence.

A major initiative towards preventing crisis has been the strengthening of the effectiveness of surveillance and incorporating a fresh perspective to its analysis and policy recommendations. To identify the strengths and vulnerabilities of the financial system (which includes banks, financial institutions, NBFCs, Primary dealers, and markets – forex, debt, money/call, and capital), a half yearly review based on financial soundness indicators (also known as macro-prudential indicators MPI) is undertaken. The MPI review comprises both aggregated micro-prudential indicators (AMPIs) of the health of individual financial institutions and macroeconomic indicators (MEIs) associated with financial system soundness.

This macro approach to financial supervision has helped the policy makers to refine their regulatory stance so as to achieve the fine balance between growth and financial stability. For instance, thanks to exhaustive data being collected under off-site surveillance, Reserve Bank could closely monitor the ratio of gross non-performing loans (NPL) to total loans which was at a high of 15.7 per cent for schedule commercial banks (SCBs) at end-March 1997. This ratio witnessed a marked decline to 7.2 per cent at end-March 2004. Net NPLs also witnessed a significant decline, driven by the improvements in loan loss provisioning, which comprises over half of the total provisions and contingencies. Also, based on the data on the maturity patterns of banks' assets and liabilities and on the unrealised gains on the investment portfolios, RBI could regularly gauge the impact of rising bond yields on the banks' balance sheets after taking into account the cushion available, both for the system as a whole and for the individual banks. We thus identified the outliers in the system on the basis of their capacity to withstand interest rate shock and sensitized them to take corrective steps.

From financial stability perspective, issues of ownership, size and governance in banks are extremely relevant. In view of the importance of corporate governance in banks, we issued guidelines for effective corporate governance and also identified the criteria for determining the fit and proper status of owners and directors. It was also considered necessary to lay down a comprehensive framework of policy on ownership and governance in banks in a transparent manner. Accordingly, we have placed in public domain a draft paper on 'A comprehensive policy framework for ownership and governance in private sector banks'. The Reserve Bank has adopted a consultative approach, encouraging a debate on this issue and the draft is being reviewed on the basis of the feedback received from various quarters.

The stability of a financial system can be achieved only when institutions and markets function on the basis of informed decisions. In India, the banking system has witnessed greater levels of transparency and standards of disclosure. The range of disclosures have gradually been expanded over the years and presently includes a host of indicators relating to capital adequacy (Tier I and Tier II capital separately), NPAs, Government shareholding, movements in NPAs, exposure to sensitive sectors (capital market, real estate and commodities), movements in provisions for NPAs and investments as also information on corporate debt restructuring. These are being further enhanced to incorporate asset-liability management, risk management policies, concentrations, connected lending, evaluation of investment in subsidiaries, various performance measures and indicators thereof. Banks are providing information on various indicators in the form of notes to accounts and schedules in their balance sheets. Guidelines in regard to Fair Practices Code for Lenders were framed and the banks/all-India FIs have been advised to adopt these guidelines. The Reserve Bank has been taking several steps from time to time to enhance the transparency in banks' operations by prescribing comprehensive requirements for disclosure in tune with the international best practices. In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks have been advised on October 19, 2004 that all cases of penalty imposed by the Reserve Bank as also strictures/directions on specific matters including those arising out of inspection will be placed in the public domain with effect from November 1, 2004.

Conclusion

To conclude, ensuring an acceptable degree of financial stability is a never-ending process.

Looking ahead, the vulnerability to real sector shocks has the potential to significantly affect financial stability in India. The major sources of shocks in India are very sharp increases in oil prices and extraordinary monsoon failures and other natural calamities with consequent impact on the agricultural sector, spilling over to other sectors of the economy. Therefore, the weight to financial stability in India is higher than in many other countries.

Financial stability has moved to centre-stage nationally as well as in discussions relating to the future of the global monetary and financial system. Several factors have brought this about: the disturbing intensity and frequency of financial crises in the decade gone, the move to strengthen domestic financial systems under Basel II and the unfinished quest for the appropriate international financial architecture for crisis prevention and management. Unlike in some countries where the responsibility for financial stability has been located in an independent authority, our approach has been to exploit the synergies that exist between the conduct of monetary policy and the function of financial regulation. Accordingly, financial stability in India is an integral responsibility of the Reserve Bank. Appropriate governance has enabled us to mitigate areas of conflict of interest even as we have reaped the benefits of (i) a deep understanding of the dynamics of India's financial sector – which, in essence, has evolved around the Reserve Bank over the years – (ii) oversight of money, debt and foreign exchange markets and (iii) the accumulation of the technical skills associated with regulation and supervision. The experience with the tumultuous 1990s has shown that our approach has stood the test of time in ensuring a stable, vibrant and well-functioning financial system in the country. We have a well-capitalised financial system even by international standards, with low levels of loan delinquency despite our prudential standards being set tighter than international standards. Our financial markets are orderly and smoothly functioning and the ability of our financial intermediaries to deal in various segments of the financial market spectrum is improving almost continuously. Periodic monitoring and self-assessment of the quality of financial supervision is buttressed by external audits, including by the IMF. In the years ahead, we will continue to vigorously pursue the objective of financial stability by developing and refining our approach, modulating the pace and sequencing of regulatory function with the financial dynamics and benchmarking ourselves against international best practices so that our financial institutions emerge as global players and India becomes the international financial centre of the new millennium.