Swaminathan J: Central banks and financial stability

Address by Mr Swaminathan J, Deputy Governor of the Reserve Bank of India, at the RBI@90 High Level Conference "Central Banking at Crossroads", organised by the Reserve Bank of India, New Delhi, 14 October 2024.

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Distinguished panellists - Prof. Randall S. Kroszner, Professor, University of Chicago and Former Governor, Federal Reserve Board; Ms. Emmanuelle Assouan, Director General, Financial Stability and Operations, Banque de France; Ms. Sarah Breeden, Deputy Governor for Financial Stability, Bank of England; Dr. Sajjid Chinoy, Managing Director and Chief Economist India, JP Morgan; esteemed delegates and colleagues from the Reserve Bank. A very good afternoon to all of you.

It is an honour to open this discussion on this very important and pertinent topic in today's financial world - "Central Banks and Financial Stability: Assessing Risks and Building Resilience."

The financial sector is the backbone of the economy, enabling efficient allocation of resources, managing risks through various instruments, and ensuring smooth payments and settlements. It performs crucial functions that support investments and drives economic growth. Therefore, the financial sector becomes the cornerstone of a well-functioning economy.

The financial sector is vulnerable to risks-especially systemic ones that, which if left unchecked, can have far-reaching consequences. As you are aware these systemic risks manifest across two dimensions: time and interconnectedness. On the one hand, financial risks can build up over time, especially in periods of economic euphoria. On the other, the growing interconnections between financial institutions, markets, and the broader economy make the system more open to shocks.

In today's world, challenges are more complex and unpredictable than ever. Traditional risks, like credit and liquidity risks, now have new and faster drivers. For example, bank runs that once unfolded over days, giving regulators time to respond, can now occur within hours due to the speed of internet and mobile banking. The increasing reliance on technology also introduces vulnerabilities, such as dependence on third-party service providers and heightened cybersecurity threats, all while customers expect uninterrupted services. Additionally, we face emerging risks, such as climate risk.

In this increasingly volatile environment, building resilience is crucial to maintaining financial stability. However, resilience is a balancing act-too much emphasis on safeguarding can stifle innovation and growth, while too little can expose the system to significant vulnerabilities. Finding that right balance so that we can have a robust financial system that can weather crises without constraining economic progress is one of the key challenges that we face today.

Indeed, central banks are much like wicketkeepers in cricket or goalkeepers in football-often unnoticed in success but always in the spotlight during failure. When everything works seamlessly, their efforts remain behind the scenes, often taken for granted.

However, when a crisis occurs, they are asked as to how they could allow the ball to slip through their fingers! In addition, Central Bankers are also tasked with preventing further damage and restoring stability quickly.

Let me offer an analogy: imagine a person teetering on the edge of a cliff, seemingly about to fall, only to be pulled back just in time by a watchful observer. When central banks intervene in such a manner to prevent a potential crisis, those they protect may claim they didn't need saving at all. This highlights a common paradox-while regulators work tirelessly to maintain stability and avert disasters, their successes often go unnoticed, and their actions are sometimes viewed as unnecessary, intrusive or excessive by those unaware of the risks. Yet it is precisely this proactive oversight that ensures the safety and soundness of the financial system, allowing it to function smoothly even in times of uncertainty.

Over the years, the role of central banks has significantly evolved. Initially seen as the lender of last resort, today, central banks are equipped with a broad range of tools-regulatory, supervisory, and monetary-to ensure the stability of the financial system. In some countries, central banks do not have supervisory roles, with the supervision being carried out by a separate agency, but a coordinated approach is essential. Governments, central banks, financial regulators, and the industry must all work together to ensure appropriate and timely action is taken to safeguard financial stability.

In India, the Financial Stability and Development Council (FSDC), chaired by the Union Finance Minister, along with its sub-committee led by the Governor of the Reserve Bank, has been effectively facilitating discussions and enhanced understanding of risks across the financial sector. Biannually, Reserve Bank publishes Financial Stability Reports that deliver a thorough risk assessment of India's financial landscape. These reports utilise macro stress tests, sensitivity analyses, network and contagion assessments, and systemic risk surveys to provide valuable insights into potential vulnerabilities that affect the financial sector. Apart from inter-regulatory coordination, RBI also actively engages with the industry through regular engagements/ interactions including conferences with the Boards of supervised entities, periodic meetings with the MDs & CEOs, Heads of Assurance functions as well as interactions with auditors.

Having discussed the importance of domestic coordination, I would also like to emphasise the significance of global supervisory cooperation. Historically, crises have acted as catalysts for bringing supervisors together to address shared challenges. For instance, the Basel Committee on Banking Supervision was formed in the aftermath of the Herstatt Bank failure, highlighting the necessity for a coordinated response to systemic risks. However, we should not wait for crises to play out before strengthening international collaboration. Greater engagement for proactive horizon scanning of potential risks and vulnerabilities, along with discussions on strategies to mitigate and address these challenges, can enhance our collective resilience and crisis preparedness.

Indeed, as a part of our agenda for the next decade, RBI@100, the Reserve Bank intends to engage more with the central banks of the global south. The Reserve Bank also aims to establish a global model of risk-focused supervision by fostering a strong risk discovery and compliance culture, building a "through-the-cycle" risk assessment framework. Reserve Bank is working to create a comprehensive data analytics ecosystem to support its supervisory functions.

With these thoughts in mind, I look forward to a rich and insightful panel discussion on how central banks can continue to enhance financial stability and build a resilient global financial system. Thank you!