ABSTRACT

The Government of India, Ministry of Finance (MoF), constituted the Financial Sector Legislative Reforms Commission (FSLRC) in March 2011. The Commission was set up with an objective of reviewing the legal and institutional structures of the financial sector in India and reorganizing it to meet the modern-day requirements of the sector. According to the Commission, the current regulatory architecture is fragmented and is full of regulatory gaps, overlaps and inconsistencies. To address this, the Commission has submitted its report to MoF (in March 2013 and a revised draft in October 2014) containing an analysis of the current regulatory architecture. As a part of this reorganization, the Commission has proposed a draft Indian Financial Code to replace the various existing financial laws. This paper would like to evaluate the recommendations of the Committee focused on the scope of RBI in governing the systemic risk in India.

Keywords: RBI, Systemic Risk, Financial Sector Legislative Reforms Commission, Financial Stability, Monetary Policy

INTRODUCTION

Monetary policy refers to a regulatory policy framed by the central monetary authority. In India, the central monetary authority is the Reserve Bank of India (RBI). The RBI began operations on April 1, 1935 and was nationalized with effect from January 1, 1949. It formulates and implements the monetary policy with the intent of achieving and maintaining its primary objective.

Over the years, India has experienced periodic economic challenges, urging changes in the way RBI designs its monetary policy objectives. The Preamble to the RBI Act, 1934, describes the basic functions of Reserve Bank as ‘to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.’ According to Y. V. Reddy (1999), the objectives of monetary policy in India have evolved as maintaining price stability and ensuring an adequate flow of credit to the productive sectors of the economy. Since 2004, RBI has added financial stability as an additional objective in view of the fast growing size and importance of the Indian financial sector. In 2014, an expert committee headed by the RBI Deputy Governor Urjit Patel, opined that subject to the establishment and achievement of the nominal anchor, monetary policy conduct should be consistent with a sustainable growth path and financial stability. It can thus be derived that governments and central banks have the responsibility of upholding price and financial stability through proper supervision and regulation. However, the 2008 financial crisis has raised a question as to what extent price-stability-oriented monetary policy frameworks should take into account financial stability objectives?
Post 2008 crisis, the government of India progressively started adapting the lessons of the crisis to its macroeconomic policies. For instance, the MoF constituted the FSLRC in March 2011. The Commission has recognized nine components that the new regulation needs to address. One of the nine components is systemic risk. The Commission has proposed that the existing Financial Stability & Development Council will become a statutory agency, and have modified functions in the fields of systemic risk and development.

So, while developed countries in the West are busy giving their central banks more authority and regulatory powers following the 2008 financial crisis, let us try to comprehend why India is proposing a system whereby the RBI is rendered a pale shadow of its former self.

**OBJECTIVES OF THE STUDY**

i. Understand systemic risk and financial stability  
ii. Determine the involvement of various central banks in maintaining financial stability  
iii. Understand the recommendations of FSLRC towards governance of systemic risk  
iv. Determine whether financial stability should be governed by a separate body or by the central bank.

**REVIEW OF LITERATURE**

According to T. Padoa-Schioppa (2003) the financial crisis in South-East Asia in the late 1990s, established that financial stability is an important objective in its own right and that central banks should give it due weight in their policy decisions.

Michael Koetter, Kasper Roszbach and Giancarlo Spagnolo (2014) study how the crisis in the sub-prime mortgage market and the subsequent financial crisis ignited a debate about the past and future role of central banks and financial supervisory agencies. They conclude that in several countries, new laws have been or are being adopted that alter the objectives of central banks, change the allocation of prudential supervisory authority, or change the governance structure of central banks.

**Systemic risk and financial stability**

Mainstream economics traditionally viewed the financial system as an intermediary that was not in itself a source of economic risk. Asset bubbles were deemed important only when they affected the real economy. At worst, financial institutions were channels through which economic shocks might be passed or amplified, rather than the source of the shocks themselves. Much of the regulations in place before the financial crisis was targeted at protecting investors or assuring institutions' soundness. Very little attention was paid to risks that might build up across or between institutions, what we now call systemic risk. Systemic risk was a major contributor to the financial crisis of 2008. It refers to the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer substantially.

Subbarao (2009) stated that post crisis it has become clear that financial stability could be endangered even if there is price stability and macroeconomic stability. So what do we understand by financial stability? The definition of financial stability is yet in its developing stage. The European Central Bank has explained financial stability as “a condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unraveling of financial imbalances in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities”.

The following table summarizes the definition of financial stability used by some central banks.
Table 1: Selected Central Bank’s Definitions of Financial Stability

<table>
<thead>
<tr>
<th>Central Bank</th>
<th>Definition</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve Bank of Australia</td>
<td>“A stable financial system is one in which financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors and by doing so, helps promote growth in economic activity.”</td>
<td><a href="http://www.rba.gov.au">http://www.rba.gov.au</a></td>
</tr>
<tr>
<td>Deutsche Bundesbank</td>
<td>“The Bundesbank defines financial stability as the financial system’s ability to perform its key macroeconomic functions well, even in stress situations and during periods of structural adjustment.”</td>
<td><a href="http://www.bundesbank.de">http://www.bundesbank.de</a></td>
</tr>
<tr>
<td>Bank of Japan</td>
<td>“Financial system stability” refers to a state in which the financial system functions properly, and participants, such as firms and individuals, have confidence in the system.”</td>
<td><a href="http://www.boj.or.jp">http://www.boj.or.jp</a></td>
</tr>
<tr>
<td>Reserve Bank of South Africa</td>
<td>“Financial stability can be described as the absence of the macroeconomic costs of disturbances in the system of financial exchange between households, businesses and financial-service firms.”</td>
<td><a href="http://www.reservebank.co.za/">http://www.reservebank.co.za/</a></td>
</tr>
<tr>
<td>Central Bank of Sri Lanka</td>
<td>“Financial system stability means a safe and secure financial system which is able to withstand external and internal shocks”.</td>
<td><a href="http://www.cbsl.gov.lk">http://www.cbsl.gov.lk</a></td>
</tr>
<tr>
<td>Swiss National Bank</td>
<td>“A stable financial system can be defined as a system whose individual components – financial intermediaries and the financial market infrastructure – fulfill their respective functions and prove resistant to potential shocks.”</td>
<td><a href="http://www.snb.ch/">http://www.snb.ch/</a></td>
</tr>
</tbody>
</table>

The above table abridges to financial stability broadly being the stability of the important institutions and markets forming a part of the financial system.

**RBI and financial stability**

Reserve Bank of India has been using macro prudential polices, more notably the countercyclical policies, since 2004 as a tool for ensuring financial stability. The Financial Stability Report of March 2010 states that ‘the nature and intensity of the impact of the global crisis on India was very different
from those in some of the developed economies. The financial sector remained resilient and functioning, despite of some volatility\(^2\). There was no material stress on the balance sheets of banks and non-banking financial companies on account of toxic financial instruments\(^3\). There were no solvency issues with any of the financial institutions requiring direct financial support from the Government.’ This was made possible on account of the synergies between the twin roles of the Reserve Bank as the monetary authority as well as the regulator of banks, financial institutions, NBFCs and key financial markets.

Table 2 below depicts the involvement of selected central banks in the financial stability function of their country.

### Table 2: Selected Central Banks’ Involvement in Financial Stability Functions

<table>
<thead>
<tr>
<th>Central Bank</th>
<th>Institutions</th>
<th>Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bank Supervision</td>
<td>Non-bank Supervision</td>
</tr>
<tr>
<td>Reserve Bank of Australia</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Bank of Canada</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Sveriges Riks bank</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Banque de France</td>
<td>Y</td>
<td>Y (Shared)</td>
</tr>
<tr>
<td>Federal Reserve</td>
<td>Y (Shared)</td>
<td>Y (Shared)</td>
</tr>
<tr>
<td>RBI</td>
<td>Y</td>
<td>Y</td>
</tr>
</tbody>
</table>

Y: Involvement of the Central Bank; N: No Involvement of the Central Bank.

Financial stability is not an explicitly stated objective under the Reserve Bank’s statute. However, as observed above, RBI has been involved in undertaking various measures to strengthen financial stability in the system. This involvement particularly developed since the liberalization of the economy and the introduction of the financial sector reforms in 1991\(^4\).

**Monetary policy and financial stability**

We have mentioned above that the main purpose of monetary policy is to manage liquidity for achieving the general economic goals. So with price stability being the focal purpose of monetary policy, can it accommodate financial stability too?

Loretta J. Mester on June 4, 2016, gave five points about monetary policy and financial stability in Sveriges Riks bank Conference on Rethinking the Central Bank’s Mandate. In one of her points, she mentioned that ‘financial stability matters to central banks because the goals of monetary policy and financial stability are interconnected and complementary. For instance, price stability helps businesses, households, and financial institutions make better decisions, thereby fostering the stability of the financial system. And a stable financial system allows for more effective transmission of monetary policy throughout the economy’. However, she moved on to say that ‘financial stability should not be added as another goal for monetary policy, but monetary policymakers need to remain cognizant of the linkages between financial stability and monetary policy goals’.

Contrary to this, Sarat Dhal, Purnendu Kumar and Jugnu Ansari (2011) studied the crucial issues relating to the linkages of financial stability with economic growth and inflation in the Indian context. Their conclusions were as follows:

1. Financial stability, growth and inflation could share a medium to longer-term relationship.
2. Financial stability can promote growth without posing much threat to price stability.
3. Financial stability can enhance the effectiveness of monetary transmission mechanism.
4. Economic growth can have positive influence on financial stability. But inflation can adversely affect financial stability.

5. With financial stability, growth could be more persistent and inflation less persistent. Thus, they established that financial stability goal could be pursued along with conventional objectives in the Indian context.

**Key recommendations of FSLRC concerning financial stability**

The institutional framework governing the financial sector in India has been built up over a century. There are over sixty acts and manifold regulations that manage the financial sector. Many of the financial sector laws date back several decades, when the financial backdrop was very different from that seen today. Therefore, the responsibility of the Commission is to comprehensively review and rework the statutes governing India’s financial system.

The following charts 2 and 3 reflect that there has been a transformation in the focus of financial regulation in India–

**Chart 2: Focus of Traditional Financial Regulation**

**Chart 3: Focus of Recent Financial Regulation**

A commanding aspect of systemic risk has been added to the focus of financial regulations in India. To uphold this, the Commission has evolved a common set of principles for governance of financial sector regulatory institutions. As part of it, the following Financial Agencies are established to exercise the powers and discharge the functions assigned to them–

(a) Financial Authority;
(b) Reserve Bank of India;
(c) Financial Redress Agency;
The following table depicts the revisions proposed by FSLRC in the regulatory functions of the financial agencies-

**Table 3**: FSLRC’s Proposed Regulatory Framework Compared with the Present

<table>
<thead>
<tr>
<th>Functions</th>
<th>Current Regulators/Agencies</th>
<th>Proposed Regulators/Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary policy; regulation and supervision of banks; regulation</td>
<td>RBI</td>
<td>RBI</td>
</tr>
<tr>
<td>and supervision of payments system.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation and supervision of all non-bank and payments related</td>
<td>SEBI, FMC, IRDA and PFRDA</td>
<td>UFA</td>
</tr>
<tr>
<td>markets.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hear appeals against RBI, the</td>
<td>SAT</td>
<td>FSAT</td>
</tr>
<tr>
<td>UFA and FRA.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resolution work across the entire financial system.</td>
<td>DICGC</td>
<td>Resolution Corporation</td>
</tr>
<tr>
<td>Statutory agency for systemic risk and development.</td>
<td>FSDC</td>
<td>FSDC</td>
</tr>
<tr>
<td>Debt management role.</td>
<td>RBI</td>
<td>Debt Management Agency (A new body that will be independent)</td>
</tr>
<tr>
<td>Consumer complaints against all financial firms.</td>
<td>-</td>
<td>Financial Redressal Agency (a new body for complaints against all financial firms)</td>
</tr>
</tbody>
</table>

As seen above, some major changes have been advised by FSLRC in our regulatory framework.

The Commission advocates that these changes are a step towards reducing the probability of a breakdown of the financial system. It believes that understanding the financial system, as a whole will reduce the possibility of a collapse of the financial system. Currently each financial regulator tends to focus only on regulating and monitoring some components of the financial system. What is of essence in the field of systemic risk is avoiding the view of any one sector, and understanding the overall financial system. Therefore, apart from rearranging the roles of financial agencies, the Commission foresees a five-part process to preserve systemic risk. This five-part process is represented in the following chart-

Four out of the below five elements of the systemic risk process mentioned above, involve a leadership role at FSDC. The Commission envisages that FSDC would be a new statutory agency, in contrast with its relatively informal existence at present.

Though, the Commission claims a strong combination of independence and accountability for RBI in its conduct of monetary policy, it has proposed only a narrow role for the Reserve Bank. These are- (a) formulate and implement monetary policy; and (b) carry on other activities of a central bank, including – (i) to issue currency of India; (ii) to transact certain business of the Central Government and the State Government; and (iii) to act as banker to banks.
Thus it is evident that the Commission insinuates that systemic risk should primarily be overseen by FSDC.

**Chart 4:** Five-Part Process Proposed by the Commission

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**Guardianship of financial stability**

In the US and UK, macro prudential regulation and supervision are a mandate of the central bank. There, the central bank, being the monetary policy authority and the only lender of last resort, is the natural choice for being the systemic regulator. The U. K. had a unified regulator when the crisis hit it. But as it emerged out of the crisis, the Financial Services Authority (FSA) has been brought back under the Bank of England. Similar banking supervision moves have been made in the U.S. with regard to the Federal Reserve.

So what are the pros of maintaining the guardianship of financial stability with the central bank?

1. When the same institution looks after price stability and financial stability, there is a lesser requirement of coordination.
2. Financial stability can sometimes require prompt and politically sensitive actions, in situations of great uncertainty. At such times, an institution that is at arms’ length from the political cycle would be able to take balanced decisions.

However, there are also certain pluses of maintaining the guardianship of financial stability with a separate body (as suggested by FSLRC):

1. When a separate institution maintains a strong macro prudential policy framework, it can reduce the conflicts in the pursuit of monetary policy. This in turn creates more room for maneuver for monetary policy to pursue price stability.
2. When macro prudential policy is assigned to a separate institution, it reduces the burden of the central bank. The central bank will then be in a better position to address the undesired side effects of monetary policy.

**CONCLUSION**

It is quite evident that conserving financial stability requires harmonization among regulators, and between regulators and governments. So the recommended role of FSDC is of immense importance. However, FSDC is chaired by the Finance Minister and only assisted by a sub-committee that is chaired by the Governor of the Reserve Bank. There could be plausible consensus problems as we are currently facing with the MPC.

Commercial banks are dominant institutions in the Indian financial landscape accounting for around 60 per cent of its total assets. They also hold high linkage with other segments in the Indian financial landscape.
Since RBI is the regulator and supervisor of the Indian banking system, a complete disunion of financial stability from the RBI is not advisable. In fact RBI should have a further empowered role in the FSDC. Also, currently the goal of monetary policy is being narrowed to controlling inflation over the short run. Rather, it must also take into account credit growth and asset information, with the aim of promoting financial and macroeconomic stability over the medium term.

RBI should hence be endowed with a substantive, although not exclusive, responsibility of maintaining financial stability.

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1. Select Episodes of Financial Instability

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Main Feature</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>Latin America</td>
<td>Debt Crisis</td>
</tr>
<tr>
<td>1995</td>
<td>Mexican</td>
<td>Banking Crisis</td>
</tr>
<tr>
<td>1997</td>
<td>Asia</td>
<td>Bank Failures</td>
</tr>
<tr>
<td>2000</td>
<td>Argentina</td>
<td>Bank Runs</td>
</tr>
<tr>
<td>2007</td>
<td>U.S.A.</td>
<td>Sub-Prime Crisis</td>
</tr>
<tr>
<td>2009</td>
<td>Greece</td>
<td>Sovereign Debt Default</td>
</tr>
</tbody>
</table>

2. GDP Growth- India and the World

![GDP Graph](Image)

Source: Financial Stability Report, March 2010

3. Financial Stress Indicator- India

![Stress Indicator](Image)

Source: Financial Stability Report, March 2010
4. Asset Quality- International Comparison- BRIC Countries

5. Background of FSDC

The Financial Stability & Development Council (FSDC) was set up in December 2010 to strengthen and institutionalize the mechanism for maintaining financial stability, and enhancing inter-regulatory coordination and promoting financial sector development. The chairman of FSDC is the finance minister, with all the sectoral regulators as members. FSDC also focuses on financial literacy and financial inclusion as part of its developmental activities. The proposals of the Commission aim to place the FSDC on a sound legal footing by sharply defining its powers and tasking it with achieving objectives in relation to monitoring and addressing systemic risk concerns.