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Discords between the Reserve Bank of India and the Government over Financial Supervision

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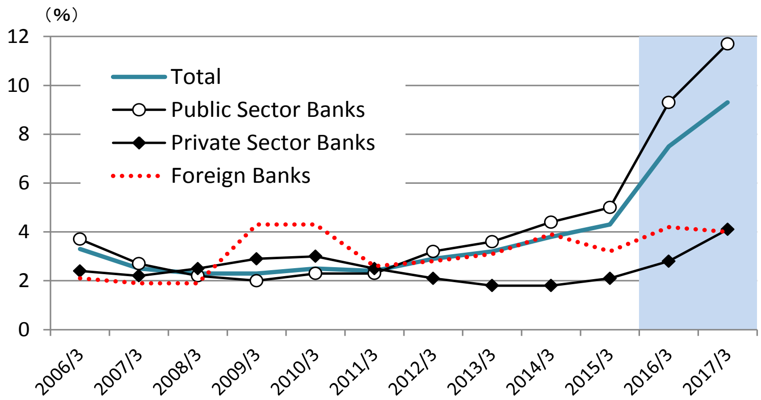
In 2018, confrontation of opinions became conspicuous between the central bank and the government. In late October, the situation was feared to worsen when Dr. Viral Acharya, Deputy Governor of the Reserve Bank of India (hereinafter referred to as RBI), a central bank, expressed a concern in his lecture over the threatened independence of the central bank, and the media reported a possible resignation of its Governor Urjit Patel. The key issue in the disputes between RBI and the government over the independence of the central bank is on the supervision power of financial institutions that includes disposal of bad banking loans and handling of financial difficulties of nonbank institutions. It differs from the case in the United States or Turkey where the maintenance of independence over monetary policies is an issue in the environment of interventions in the rate hikes by the president.

The ratio of non-performing loans in India continued to rise moderately since the point of March 2012 with a sharp increase at the point of March 2016, which was partly prompted by the start of stricter asset assessments implemented by RBI in FY2015 and the ratio remains high since. The breakdown by sector shows that the ratio of non-performing loans at private sector banks and foreign banks continues to rise relatively slowly while that at public sector banks is rising markedly, pushing the aggregate ratio higher (Figure)

Figure：Non-performing Loan Ratio in Commercial Banks in India



(Note) Ratios of non-performing assets in total lending at the point of end-March every year.
(Source) Reserve Bank of India（RBI）

The reasons why the non-performing assets increased especially in public sector banks include their weak credit decisions of individual banks and concentration of default companies in the infrastructure-related construction sector which public sector banks have mainly financed. Since 2015, RBI that supervises credit provision of financial institutions has taken supportive measures including capital injections to deal with the increase of bad loans, reducing the risks for the banking sector to fall into a credit crunch.

However, as the banking sector continued to fail to recover the soundness as a whole, RBI started to review the Prompt Corrective Action framework it had introduced in 2017, and put a ban on public sector banks from making new loans or establishing branch offices unless they met certain standards. As a result, the lending, especially to small and medium enterprises, stagnated, and severity in lending was further aggravated by the deterioration of management of major nonbanks which had difficulty in their fund raising. The government took the situation seriously and demanded RBI to relax the strict Prompt Corrective Action framework on public sector banks and provide liquidity to nonbanks. RBI, however, perceived them as pressure on the bank and insisted on the maintenance of independence of the central bank, deepening the confrontations between the two.

Later, the government and RBI had consultations and their confrontation is going to be cooled down for now, as RBI showed an attitude to respect the government by relaxing the Prompt Corrective Action framework. However, since the demand of the government on RBI over financial supervision can be considered as part of an election strategy to win more votes in the general election to be held in the spring of 2019 by creating an environment to increase the lending, it is highly unlikely that this would end their confrontation. Going forward, it is feared that the government may again strengthen its intervention in the RBI's financial supervision if the ruling party had an increased sense of crisis over winning enough votes in the expected heating up of the election campaign. An unpredictable situation will continue for some time to come.