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# The Debate on the Economic Capital Framework of the Reserve Bank of India

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*There has been significant debate surrounding the decision of the Reserve Bank of India Board to constitute a panel to determine the reserves that the bank maintains and to decide on a suitable profit distribution policy. The panel has been formed. It is very well constituted with a balanced representation. It is hoped that the panel will take a long-term view and decide the parameters which will serve as guidance for the future. This paper analyses the issues that it will have to address.*

## New Panel Formed

The issue regarding how much surplus capital the Reserve Bank of India (RBI) must maintain has come up for considerable debate. The RBI decided, in its meeting on 19 November 2018, to constitute an expert panel to examine the issue. It is reported that there were three earlier panels in 1997, 2004 and 2013 dealing with issues such as the adequacy of reserves and distribution, among others. However, there was never a government representative on these panels as the subject was considered to be within the remit of the RBI. To that extent, the decision to include a government representative in the panel proposed in the Board meeting of November 2018 did cause discomfiture within the RBI.

The panel has now been announced. A former governor, Bimal Jalan, is to head it and a former Deputy Governor, Rakesh Mohan, is to be the Vice Chairman. The other members include Bharat Doshi and Sudhir Mankad (both RBI Central Board members), S C Garg (Secretary of the Department of Economic Affairs) and N S Vishwanathan (Deputy Governor of the RBI). From all standpoints, the panel is balanced and has equal representation from the bank and the government. It has been mandated to review the justification for various provisions, reserves and buffers that the RBI maintains for contingency and other risk purposes. The panel will also propose a suitable profit distribution policy after factoring in situations which may arise as a consequence of holding more or less provisions, than are required.

There has been a feeling in the government that the RBI maintains reserves which are much higher at about 27 per cent of its total assets, as against about 14 per cent retained by other central banks.  As per the RBI Annual Report 2018, it has assets worth ₹36.2 trillion (S$707 billion) and its capital is ₹9.5 trillion (S$260 billion). The government holds the view that if the surplus capital is transferred, it could be used for other productive requirements such as recapitalising public sector banks. On the other hand, Raghuram Rajan, the former RBI Governor, feels that the transfer of excess reserves of the RBI may lower the central bank's rating. A higher capital base provides the RBI comfort in its operations such as liquidity adjustment facility or providing ways and means for advances to states.

## Types of Reserves

The RBI maintains two major types of reserves. The first is a revaluation fund, which keeps being adjusted with the changes in the value of the American dollar and gold portfolios it holds. An appreciation of the rupee or a fall in international gold prices will eat into these reserves. Thus, this is very much a standard accounting requirement as assets get revalued from time to time. Such asset revaluation does not generate money because to generate money from these assets, the assets have to be sold. It is merely an accounting entry. The RBI holds foreign exchange reserves of about US$400 billion (S$545 billion). It cannot generate money out of these reserves in rupee terms unless it sells the foreign exchange. The same holds true of its gold reserves, which are also revalued from time to time. Thus, a commonplace understanding of this 'reserve' as funds held by it, is rather illusory. About two-third of the reserves that RBI holds are in the form of revaluation reserves.

The second category of reserves is the contingency reserves fund. The RBI holds assets of a value equal to the reserves it holds. This amount is usually invested in government securities. Thus, if this has to be monetised to declare dividends to the government, the government will have to repay the loans.

## Lack of Legal Stipulation

Quite a few countries have laid down norms for maintaining the capital of its central bank. In Asia, for example, the Bank of Korea is legally bound to transfer 30 per cent of its annual profits to statutory reserves. It can seek further capital from the government in case of any requirement. The Singapore constitution stipulates that the Monetary Authority of Singapore has the responsibility to safeguard accumulated reserves which were not added during the term of the current government.

The RBI Act of 1934 does not have any such specific stipulation for the capital requirement of the bank. Under Section 47 of the Act, the RBI is required to transfer the surplus to the government after keeping all provisions and contingency buffers. The RBI generates surplus primarily from interest income that it earns from lending to commercial banks, from domestic and foreign government bonds that it holds, as well as from the purchase and sale of government securities. It has paid a dividend to the government of ₹500 billion (S$10 billion) in June 2018 as against ₹306 billion (S$6 billion) paid in 2016-17 and ₹658 billion (S$13 billion) in 2015-16.

It is hoped that the panel, now formed, will provide some guidance for the future, keeping in mind the RBI's long-term concerns in respect of economic growth, foreign exchange flows and the quantification of reserves.

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