# 1. RBI's Balance Sheet -Assets and Liabilities

RBI's balance sheets show its assets and liabilities. Total Assets of the RBI Rs 41.02 lakh crores (trillion) in fiscal year 2019. Asset and liabilities are equal for the central bank.

**A. Assets of the RBI (as on end June 2019)**

| No | Assets of the Banking Department | Value (Rs)* |
|---|---|---|
| 1. | Balances of Notes, and coins with the RBI | 9 crores |
| 2. | Gold Coin and Bullion (BD) | **0.882** lakh crores |
| 3. | Bills purchased and Discounted tojo | Nil |
| 4. | Foreign Currency Assets (BD) | **6.964** lakh crores |
| 5. | Investment in Domestic Securities (BD) | **9.89** lakh crores |
| 6. | Loans and Advances | **0.9** lakh crores |
| | **Assets of the Issue Department** | |
| 7. | Gold Coin and Bullion (as backing for Note issue) | 0.79 lakh crores |
| | Investment inf Foreign Securities (ID) | 20.87 lakh crores |
| | Investments Domestic Securities (ID) | 0.00 |
| 8. | Other assets | Negligible |
| | **Total** | **41.029 lakh crores**** |

* Figures are approximated to make it simple (**total figures may not add up as some insignificant components are not entered).

**Notes:**

**2. Gold Coin and Bullion** (566 metric tonnes of gold with the RBI); Value Rs **1.67 lakh crores**.

- 292 metric tonne is with the issue department; value Rs 0.79 lakh crores cores as on end June 2019.

- 274 tonnes is with the Banking Department (held abroad); value **0.882** lakh crores crores as on end June 2019.

**4. Foreign Currency Assets** (approximately **Rs 27 lakh crores.** Of these, Rs 20.87 lakh crores is with Issue Department and Rs **6.964** lakh crores is with the Banking Department)

The FCA include – deposit with other central banks, deposit with BIS, balances with branches of foreign commercial banks, investment in foreign treasury bills and securities, SDRs, and NAB (IMF).

**B. Liabilities of the RBI (end June 2019)**

| No | Category of Liability | Value (Rs)* |
|---|---|---|
| 1. | Capital (paid-up capital by the government) | Rs 5 crores |
| 2. | Reserve Fund | Rs 6500 crores |
| 3. | Other reserves | Negligible |
| 4. | Deposits held by governments, banks and other financial institutions in the RBI | **Rs 7.6** lakh crores |
| 5. | Other Liabilities and Provisions (CF, ADF, CGRA, IRA, FCVA etc.) **(Contingency Fund – Rs 1,96344 crores, ADF Rs 22875 crores**, CGRA Rs 6,64480 crores, IRA- (Rs 65285 crores), FCVA – Rs 1304 as on end June 2019).<br><br>(Contingency Fund Rs 232108 1,96344 crores, ADF – Rs 22811 crores, CGRA Rs 691641, IRA- Rs 13285, FCVA – Rs 3262 as on end June 2018). | **Rs 11.62** lakh crores |
| 6. | Liabilities of the Issue Department (currency in circulation) | **Rs 21.68 lakh crores** |
| | **Total Liabilities** | **41.02 lakh crores** |

*Figures are approximated to make it simple.

**5. Investment in Domestic Securities (DCs) –** with the Banking Department – Rs **9.89 crores.** DCs comprises Dated Government Rupee Securities, Treasury Bills and Special Oil Bonds. As on end June 2019, no treasury bill is held as investments.

**6. Loans and Advances –** RBI Loans to Central and State governments, Commercial and Cooperative banks, NABARD and others. **Rs 0.9 lakh crores** as on end June 2019**.**

**4. Deposits held by Governments, banks and other institutions with the RBI.**

These represent the balances maintained with the Reserve Bank, by banks, the Central and State Governments (cash balances, MSS etc.), All India Financial Institutions, such as, Export Import Bank (EXIM Bank), NABARD *etc*., Foreign Central Banks, International Financial Institutions, balances in Employees' Provident Fund, Depositor Education and Awareness Fund (DEA Fund), amount outstanding against Reverse Repo, Medical Assistance Fund (MAF) *etc*. The deposits amounted to **Rs 7.6** lakh crores as on end June 2019.

**5. Other Liabilities and Provisions –** includes CF, ADF, CGRA, IRA, FCVA etc. Other Liabilities and Provisions amounted to around **Rs Rs 11.62** lakh crores as on end June 2019. **(CF – Rs 1,96344 crores, ADF – Rs 22875 crores, CGRA Rs 6,64480, IRA- Rs 65285, FCVA – Rs 1304 as on end June 2019).**

Table: Components of Capital Reserves of the RBI as on end June 2019 (included under Other liabilities and provisions in the liability table).

| **Component** | **2019 (Amount in Rs crores)** | **2018 (Amount in Rs crores)** |
|---|---|---|
| **Contingency Fund (CF)** | **1,96344** | **232108** |
| **Asset Development Fund (ADF)** | **22875** | **22811** |
| Currency and Gold Revaluation Account (CGRA) | 6,64480 | 691641 |
| Investment Revaluation Account (IRA) and | 65285 | 13285 |
| Foreign Exchange Forward Contracts Valuation Account (FCVA). | 1304 | 3262 |
| **Total** | **11,624.51** | **949822** |

Source: RBI Annual Reports

## 2. Staggered Surplus Distribution Policy of the Bank

To reduce the impact of cyclicality in the Bank's economic capital levels on the surplus transferable to the Government of India, a rule-based Staggered Surplus Distribution Policy (SSDP) has been put in place.

## 3. RBI's Capital Reserve –Components

Capital reserve of the central bank is the fund available with it to face any financial contingency. Liquidity emergencies like the Global Financial Crisis, IL&FS liquidity situation etc. points towards the strengthening of such a reserve to manage contingencies.

RBI's capital reserve is estimated to be about 11.6 lakh crores or 28.30% of the total assets as on end June 2019. It is a buffer for the RBI to meet financial contingencies while facing the any potential financial crisis situation in the economy.

In recent months, there occurred a controversy that the RBI has excess capital reserves and it has to be used for specific purposes. Later, on 19th of November, the RBI Central Board decided to create a Committee to decide on an Economic Capital Framework. Such a Framework is expected to determine the right volume of capital reserve for the RBI.

**What is the purpose of the Capital Reserve?**

The main purpose of the capital reserve is to enable the RBI to meet any financial emergency situation out of liquidity crisis etc., - on its own. Capital actually indicate the ready funds available with the RBI to manage own business.

For example, the most important component of the Capital Reserve – the Contingency Fund is expected to help the central bank to meet risks from sudden liquidity shortages in the market, steep exchange rate movements, fall in the value of government securities held by the RBI etc.

Similarly, the Asset Development Fund is expected to give support to the associates of the RBI (like the NHB) when the latter is facing crisis.

**What are the components of the capital reserve?**

There are five components in the RBI's capital reserve. The first two (CF and ADF) are Funds created to meet specific purposes and provisions are made yearly to add money to these funds.

The other three (CGRA, IRA and FCVA) are valuation accounts just shows the gain or losses in foreign exchange, government securities or foreign currency contracts handled by the RBI.

Following are the five components of the RBI's capital reserve.

1. **Contingency Fund (CF)**
2. **Asset Development Fund (ADF)**
3. Currency and Gold Revaluation Account (CGRA)
4. Investment Revaluation Account (IRA) and
5. Foreign Exchange Forward Contracts Valuation Account (FCVA).

All these five components are recorded in the liability side of the RBI's balance sheet.

**1. What is Contingency Fund (CF)?**

The CF is a fund set apart for meeting the unforeseen contingencies, including depreciation in the value of securities, risks arising out of monetary/exchange rate policy operations, systemic risks and any risk arising on account of the special responsibilities enjoined upon the Bank.

**2. What is Asset Development Fund?**

The Asset Development Fund (ADF) has been set aside for investment in subsidiaries and associates and internal capital expenditure.

**How DF and ADF are financed?**

From 2014 onwards, both CF and ADF are financed through provisioning. Meaning of the word provisioning is that an estimated amount is allocated from a given source.

Hence, the allocation to the CF and ADF may is not shown in the final income statement of the RBI. Income is estimated after making the provisioning to the DF and ADF.

On the other hand, before 2014, deductions to DF and ADF were made after estimating the income. After making allocations to DF and ADF from Income, transfer to the government was made.

The practice of provisioning instead of allocating from income seems to be made after the recommendations of the Y H Malegam Committee recommendations (2013). Report of the Committee is not available in the public domain.

Table: RBI's CF and ADF and the transfer of income to the government – the two phases (amount is in Rs billion except for 2018-19).

| **Item** | **2011-12** | **2012-13** | **2013-14** | **2014-15** | **2015-16** | **2016-17** | **2017-18** | **2018-19 (figures are in Rs crores** |
|---|---|---|---|---|---|---|---|---|
| | **Amount in Rs billion** | | | | | | | **Rs crores** |
| Income of the RBI | 531 | 743 | 646 | 792 | 808 | 618 | 782 | 193000 |
| Transfer/Provisioning to CF and ADF | **Transfer** | | **Provisioning** | | | | | |
| | 271 | 287 | 0 | 9 | -4 | 81 | 39 | -35800 |
| Transfer to the Govt. | 160 | 330 | 526 | 659 | 658 | 306 | 500 | 175987 |

Source: Compiled from different Annual Reports of the RBI.

Provisioning was almost nil for 2018-19 after the recommendations of the Committee on Economic Capital Framework (Bimal Jalan Committee). The Committee observed that RBI is well capitalized. It has also found excess capital with the RBI. Hence the RBI Board decided to transfer all net income to the RBI besides transferring the newly discovered excess capital.

"As financial resilience was within the desired range, the entire net income of ₹1,234.14 billion for the year 2018-19, of which an amount of ₹280 billion has already been paid as interim dividend, will be transferred to the Government of India. This is in addition to the ₹526.37 billion of excess risk provisions which has been written back and consequently will be transferred to the Government." – RBI Annual Report 2019.

**What is happening to the DF and the DF over the last few years?**

At the same time, the proportion of the DF and the ADF are declining since the last few years. Especially, they have shown a rapid decline since the launch of provisioning instead of allocation from declared income. The table below shows that the combined value of the DF and the ADF are showing a decline since 2014.

| **Year (as on June 30)** | **Balance Amount in CF and ADF together (Rs crores)** | **CF+ADF as a % of total assets of the RBI.** |
|---|---|---|
| 2014 | 242413 | 9.2 |
| 2015 | 243375 | 8.4 |
| 2016 | 242944 | 7.5 |
| 2017 | 251018 | 7.6 |
| 2018 | 254919 | 7.05 |
| 2019 | 219219 | 5.34 |

Source: Estimated from RBI Annual Report 2019

Understandably, the RBI's CF and ADF – the two critical funds have registered decline due to high transfer to the government in the background of provisioning adoption

**What are Revaluation Accounts?**

The RBI holds several accounts for its holding and handling of the foreign currencies and foreign currency assets (for example US Securities), government securities (Central government), Gold, Forward Contracts to10 etc. Simply, these assets (foreign currencies, gold, foreign currencies, government securities etc.,) may change values with market changes. Hence, the values of these assets with the RBI also may change. A revaluation is to be made with respect to their values. Such changes are accommodated in the three respective revaluation/valuation accounts. Following are the revaluation/valuation accounts of the RBI. Remembers since they are part of the Capital Reserves (after CF and ADF), continuous numbering after CF and ADF is given.

**3. Currency and Gold Revaluation Account (CGRA)**

The CGRA shows fund that is available to compensate RBI's loss in the value of gold and foreign exchange reserve holdings. Gains and losses of the values of Gold and Foreign Currency Assets decreases or increases the CGRA money.

Thus, changes in the market value of gold and forex assets (like the US Government securities where the RBI invested its foreign exchange reserves) is reflected in the CGRA.

CGRA provides a buffer against exchange rate/gold price fluctuations. When CGRA is not enough to fully meet exchange losses, it is replenished from the contingency fund.

Increase in gold price and depreciation of the rupee increases the CGRA fund.

**4. Investment Revaluation Account (IRA)**

The investment Revaluation Account shows the buffer amount available with the RBI to compensate losses and to accommodate gains in (i) foreign securities and (ii) domestic securities. RBI holds significant portion of foreign securities and domestic securities (government of India). Under IRA, the marked to market gains and losses are measured.

**5. Foreign Exchange Forward Contracts Valuation Account (FCVA)**

The FCVA measures marked to market (periodic) gains and losses for the RBI from foreign exchange forward contracts.

**Central bank balance sheet purpose**

The purpose of central bank balance sheet is not to yield profit; though central banks can earn profit. Now, the main fact is that it has to maintain enough funds to manage emergencies. Dr SS Tarapore (late) in his September 3, 2015 article (the Hindu Business Line) pointed out that central banks should maintain its balance sheet by focusing on wider interest of the economy.

Table: Accretion to Contingency Fund and Asset Development Fund as on end June between 2011 and 2019 (Rs Billion)

| | | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Transfer to CF & ADF | | | Provisioning to CF and ADF | | | | | |
| CF | Outstanding | 1707 | 1954 | 2216 | 2216 | 2216 | 2201 | 2282 | 2321 | 1,963 |
| | Addition | 122 | 247 | 262 | 0 | 0 | -15 | 81 | 39 | -358 |
| ADF | Outstanding | 158 | 182 | 207 | 207 | 217 | 227 | 228 | 228 | 228 |
| | Addition | 12 | 24 | 25 | 0 | 9 | 10 | 1 | 0 | 0.1 |
| Total (CF+ADF) | Outstanding | 1865 | 2136 | 2424 | 2424 | 2433 | 2429 | 2510 | 2549 | 2191 |
| | **Addition** | **134** | **271** | **287** | **0** | **09** | **-4** | **81** | **39** | **-358** |

Estimated from different Annual Reports of the RBI (2013 to 2019). CF is Contingency Fund and ADF is Asset Development Fund. Deviation by 1 occurred for few years due to fraction adjustments (e.g., 2017 total is recorded as 81 instead of 82).

## 4. RBI Capital Reserve and surplus transfer to the government

On August 26, 2019, the RBI's Central Board decided to transfer Rs 52,637 crore to the government along with the RBI's net income of Rs 1,23,414 crore for the year 2018-19. The Central Board of Directors (CBD) is the administrative body of the RBI. Total transfer comprising of this excess reserve and the net income share is around Rs 1.76 lakh crores.

Regarding the net income transfer (Rs 123414 crore), it is the share of the government in the RBI's net income. Since government is the sole shareholder of the RBI, it is customary to transfer the amount to the government. Net income is effectively the profit of the RBI that has been occurred after meeting all expenses. But the interesting fact is that nearly 99% of the RBI's profit is transferred to the government. This is the practice over the last five years.

### The surplus capital reserves

Now, the second amount that is the Rs 52637 crore is the curious one. Here, the RBI is transferring this amount as it has been found excess or surplus in its capital reserve.

The capital reserve in simple terms is the money procured by the RBI out of its income and kept with itself to meet emergency situations. Though the capital reserves are not directly deployed to fight any emergency situation, it can be considered as a sound base for the RBI to make its actions.

Over the last few years, there is a debate that whether the RBI has surplus capital reserves or not. Those who are in the government were suggesting that the RBI is one of the highest capitalised central banks in the world.

**The Bimal Jalan Committee and the discovery of surplus capital reserve**

People in the government argue that the surplus reserve must be identified and should be transferred to the government. As per this idea, a Committee on Economic Capital Framework under the Chairmanship of former RBI Governor Dr Bimal Jalan was constituted. The Committee's final report has been published on August 29, 2019 and the Central Board of Directors (CBD) decided to transfer Rs 52637 crores to the government as the surplus capital reserve. This means that the Bimal Jalan Committee has identified this amount as excess reserve with the RBI.

The RBI has around Rs 9.5 lakh crore as capital with it. Total assets of the RBI are around Rs 36 lakh crores as per the 2018 Annual Report of the RBI. Remember, the 2019 Annual Report that gives an updated details of the RBI's balance sheet including the capital reserves is ratified by the August 26 CBD, but that is not published.

Practically, the surplus capital reserve of Rs 52,637 crore should be taken out of the Contingency Fund of the RBI. This is because the other components of the capital are just revaluation that occurred in stocks of foreign currency, gold and government securities that are kept with the RBI. The Contingency Fund is the more of a cash form of capital reserve.

Capital reserve of the central bank is the fund available with it to face any financial contingency. Liquidity emergencies like the Global Financial Crisis, IL&FS liquidity situation etc. points towards the strengthening of such a reserve to manage contingencies.

**What is the purpose of the Capital Reserve?**

The main purpose of the capital reserve is to enable the RBI to meet any financial emergency situation out of liquidity crisis etc., – on its own. Capital actually indicate the ready funds available with the RBI to manage own business. The RBI can consider this as a financial capacity while delivering some action like liquidity injection. When your purse is big or assets are strong, your readiness to provide funds during a crisis also will be big.

Liquidity emergencies like the Global Financial Crisis, IL&FS liquidity situation etc. points towards the strengthening of such a reserve to manage contingencies.

For example, the most important component of the Capital Reserve – the Contingency Fund is expected to help the central bank to meet risks from sudden liquidity shortages in the market, steep exchange rate movements, fall in the value of government securities held by the RBI etc.

Similarly, the Asset Development Fund is expected to give support to the associates of the RBI (like the NHB) when the latter is facing crisis.

**How capital reserves are obtained?**

Funds to the capital reserves are added out of the net income or profit of the RBI. Every year, such allocation from the net income is made to the capital reserve. This addition is made mostly to the *Contingency Fund* of the RBI.

But over the last five years, no major fund injection is made out of the net income to the capital reserves. Rather, the entire net income is transferred to the government as profit share (during 2018-19, profit share is Rs 1,23,414 crore).

## 5. RBI Capital transfer FAQ

The RBI's Central Board of Directors (CBD) which is the administrative body of the RBI, in a meeting on August 26, decided to transfer Rs 1.76 lakh crore to the government. The transfer amount is comprised of two components; first transfer of net income of the RBI and second, transfer of surplus reserves. Here is the division:

(1) the entire net income of **Rs 1,23,414** crore for the year 2018-19,

(2) there is an excess (surplus) reserve of ***Rs 52,637*** crore that has been written back and consequently will be transferred to the Government.

The first one is the transfer of RBI's income (read profit) to the government as the government is the single shared holder of the RBI. Over the last five years, the government is withdrawing nearly 100% of the RBI's net income.

But the second component ie., the surplus capital is the interesting one. This is not the one that the government gets from the RBI usually. Rather this is the first time that the government is getting surplus capital from the RBI.

It indicates that the RBI has surplus capital over the risk situation requires and hence it should be transferred to the government. According to the CBD, the Committee on Economic Capital Framework of the RBI (Chairman Bimal Jalan) has discovered this surplus capital (of Rs 52,637 crore) and hence the RBI is transferring it to the government. The Committee report was published on August 28, 2019.

Out of this Rs 1.76 lakh crores, Rs 28000 crore has been already transferred to the government.

Now, to understand the significance of the RBI decision especially that related to the identification of excess reserves (52,637 crore), we have to go through the basic concepts related to capital reserves from a central bank angle.

**1. What is the capital reserves of the RBI?**

Capital reserve of the RBI is the fund available with it to face any financial contingency in the economy. It is considered as own money of the RBI to manage the central bank operations. Capital in a literary sense implies the money put by the owner to run the business.

**2. Why a central bank like the RBI need capital reserves?**

During emergency financial situation like a liquidity crisis, the RBI can support with the supply of money only if it has some credible assets. Capital reserves simply indicate the financial capacity of the central bank. It is a buffer for the RBI to meet financial contingencies while facing the any potential financial crisis situation in the economy.

Usually, it is the commercial banks habit to keep own money or capital to meet financial contingencies. You may be heard about Capital Adequacy Ratio (Proportion of capital as a percentage of the loans given by the bank). But central banks also behave like commercial banks and the central bank faces lot of risk related to the management of the economy.

**3. How the capital reserves are acquired by the RBI?**

The RBI accumulates reserves out of its own income. Several of the RBI functions like giving loans to commercial banks (repo) gives interest income to the RBI. As per the statute, this income has to be transferred to the government as the government is the single owner of the RBI. At the same time, a certain proportion of the income is kept apart as Contingency Fund, Asset Development Fund etc. to strengthen the RBI operations. These funds and the valuation gains of the RBI in the form of gold, foreign currencies etc are indicated as Capital Reserve.

**4. What is the amount of capital reserves with the RBI?**

In the last few years, people in the government were pointing out that the RBI has higher capital compared to its assets. As per the August 26th, 2019 intimation of the RBI Central Board, as on June 30, 2019 the RBI's capital reserve lies within the range of 24.5 per cent to 20.0 per cent of balance sheet. The central board concluded that with this level of capital reserve, the RBI is supposed to be one of the highest capitalised central banks in the world. Or in other words, its capital reserves is more than enough. Earlier data for June 2018 indicates RBI capital reserve at around Rs 9.5 lakh crores or 26.25% of the total assets.

**5. What is the meaning of surplus capital reserve or excess provisions?**
Surplus capital reserve or excess capital reserve or excess provisions means the RBI is stocking excess own funds over what actually requires facing contingency situations. The reserve addition is called provisions as these funds are made through provisioning (fund transfer from RBI's income) by the RBI to its capital reserves.

**6. Whether there is a surplus reserve for the RBI?**

Several analysts especially from the government side view that the RBI is one of the highly capitalized central banks in the world. Its' capital reserves are nearly 29 % of its assets. Hence, they argued that a part of this reserves has to be transferred to the government.

**7. What the government has done to examine whether the RBI is keeping excess (surplus) reserves?**

The RBI in November 2018 appointed a Committee called Committee on Economic Capital Framework under former RBI Governor Bimal Jalan to examine whether the RBI is holding excess capital reserves.

**8. What is the meaning and significance of the Economic Capital level?**

Economic Capital simply indicate the amount of capital to be kept by an institution (here RBI) to manage its risk. The economic capital goes up with the risk incidence. From the RBI angle, the significance of Economic Capital is that the RBI has to limit its capital reserve only around the Economic Capital level. (More than that amount can be called as excess reserve and it has to be transferred by the RBI to the government).

**9. What was the responsibility of the Committee on Economic Capital Framework?**

Though there were several responsibilities to the Bimal Jalan led committee, two of them were more important. First, the Committee has to examine whether the reserves and buffers (capital) of the RBI are in surplus or deficit compared to the required level. Secondly, the Committee has to propose a suitable profit distribution policy for the RBI. This means the amount of profit to be transferred by the RBI to the government. By considering all situations of the RBI, the Committee has to find whether the RBI is holding more provisions (capital) than required or whether the RBI holding less provisions (capital) than required.

**10. What is the level of Economic capital suggested by the Committee?**

The detailed report of the Committee is yet to be published. At the same time, important views of the committee were mentioned in the RBI Director Board report. Here, the Director Board news brief says that " While the revised framework technically would allow the RBI's economic capital levels as on June 30, 2019 to lie within the range of 24.5 per cent to 20.0 per cent of balance sheet, the economic capital as on June 30, 2019 stood at 23.3 per cent of balance sheet."

This means that based on the current situation, the Committee advocated a minimum reserve of 20 % (maximum 24%). But as on June 2019, the RBI has an economic capital of 23.3%. So, the Committee identified Rs 52,637 crore excess reserves and recommended its transfer to the government.

**11. What is the logic behind the transfer of Recommendations of the committee based on?**

According to the RBI's Director Board meeting, the Committee's recommendations were guided by monetary policy, financial and external stability considerations. "The Committee's recommendations were based on the consideration of the role of central banks' financial resilience, cross-country practices, statutory provisions and the impact of the RBI's public policy mandate and operating environment on its balance sheet and the risks involved."

**12. What is the justification for the discovery of capital surplus and its transfer to the government?**

This is an important question. Ultimately what is the justification for the transfer of excess reserves to the government than keeping it with the RBI? The Committee here highlighted that any shortfall in reserves when market risk goes up, could be met through increased allocation from net income to capital reserves. Or in other words, whenever the market risk increases, the RBI adds money from its income to capital reserves.

In the same way, whenever the capital reserves are excess, it has to be returned back as income and thus has to be transferred to the government (implication).

**13. How important is this transfer of Rs 1.76 lakh crore to the government?**

The transfer is like an energy drink for a starving government that need tremendous money to overcome the current slowdown. Remember, the size of the transfer is huge. Government anticipated nearly Rs 90000 crores but is getting Rs 1.76 lakh crore. In the current year, tax revenues are expected to be lower than the estimate because of the slowdown in the economy. Whenever there is slowdown, tax revenue will be hit. Here, the government will be in trouble with low revenues. On the other side, the government has the responsibility to spend more to stimulate the economy. In this context, the high transfer from the RBI to the government is a blessing in disguise for the government.

## 5. Major Recommendations of the Committee on Economic Capital Framework of the RBI

The Reserve Bank of India (RBI) has developed an Economic Capital Framework (ECF) for determining the allocation of funds to its capital reserves so that any risk contingency can be met and as well as to transfer the profit of the RBI to the government.

There are two clear objectives for the ECF. First, the RBI as a macroeconomic institution has the responsibility to fight any disorder especially a crisis in the financial system. Here, to meet such a crisis, the RBI should have adequate funds attached under the capital reserve.

Second is transferring the remaining part of the net income to the government.

The process of adding funds to the capital reserve is a yearly one where the RBI allots money out of its net income to the capital reserve. How much funds shall be added to the capital reserve each year depends upon the risky situation in the financial system and the economy. The process of allocation of funds is technically called as *provisioning* (risk provisioning etc.,) to the reserves.

After allotting money to the capital reserve, the remaining net income of the RBI is transferred to the government as profit. Since the government is the shareholder of the RBI, the latter's' income (means profit) should be transferred to the Government (Section 47 of the RBI Act).

Here, the determination of the amount of money to be provisioned or allocated to the capital reserve (out of the RBI income) is a difficult task. The risk scenario in the economy, the size of the current capital reserve with the RBI including the contingency fund etc are critical in deciding the size of provisioning to the capital reserve. For adjusting or determining the central banks' capital reserve in accordance with its needs, central banks have a methodology called Economic Capital Framework.

**What is Economic Capital Framework?**

The ECF is an objective, rule-based, transparent methodology for determining the appropriate level of risk provisions (fund allocation to capital reserve) that is to be made under Section 47 of the Reserve Bank of India Act.

Previously, there were several attempts to frame an ECF for the RBI. But under the changed circumstances, the RBI central board constituted a new committee (under Bimal Jalan) to design an ECF in 2018.

**Expert Committee on Economic Capital Framework**

The Central Board of the RBI in its meeting held on November 19, 2018, in consultation with the Government of India (Government), constituted an Expert Committee to review the extant ECF of the RBI. The Committee was chaired by former Governor Bimal Jalan. RBI has a sophisticated practice of upgrading capital framework. In the past the Subramanyam Group (1997), Malegam Committee (2014), ECF (2015) and the Usha Thorat Committee (2004) were appointed to make recommendations on the ECF.

**Recommendations of the Bimal Jalan Committee on ECF for the RBI**

The Expert Committee to Review the Extant Economic Capital Framework was appointed at a time when the transfer of RBI's net income to the RBI touched 99% for several years. Similarly, several observers opined that the RBI is having surplus capital as it is one of the highest capitalized central banks in the world. The Committee was appointed in November 19 and its report was published on August 28th, 2019.

Following are the main recommendations of the Committee on ECF.

1. **There should be harmony between the interests of the government and the RBI on the design of the ECF.**

In its report, the committee stressed the need for aligning the interests of the government and the RBI. The Committee opines that "there always needs to be harmony in the objectives of the Government and the RBI."

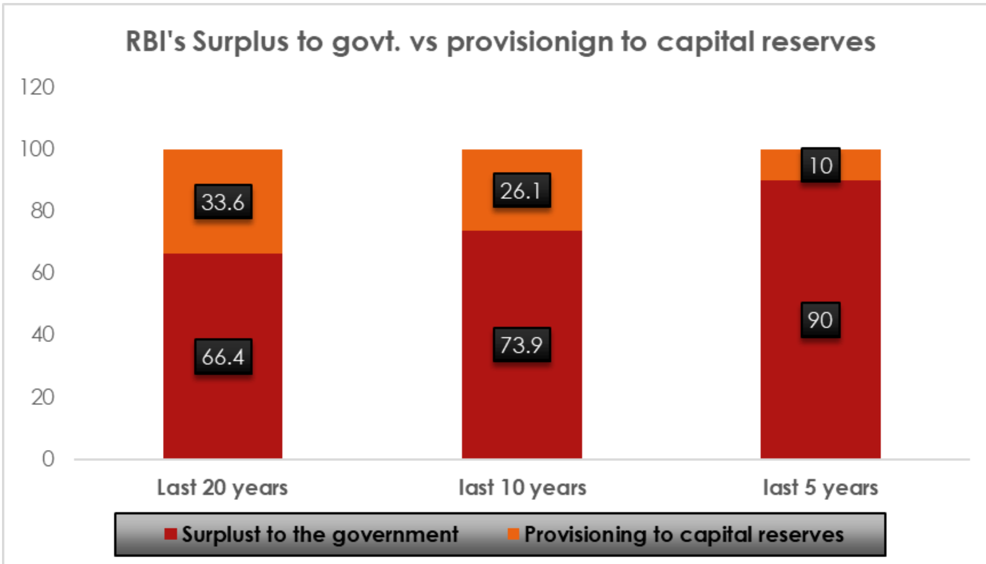
The financial resilience of the RBI should be kept as one of the central banks of the emerging world: "the Committee was of the view that the financial resilience of the RBI needs to be maintained above the level of peer central banks, as would be expected of the central bank of one of the fastest growing economies of the world."

2. **Whether the RBI's capital reserve is enough or whether there is a surplus capital reserve with the RBI?**

Here, after devising a new methodology, the Committee on ECF found that the available risk buffers (capital available with the RBI) is around 26.8% of the assets. What is required is 20. 8% to 25.4%. Hence, there is a surplus capital reserve with the RBI.

The Committee identified that there is excess realized equity and it ranges from Rs 26280 crores to Rs 62456 cores, as on June 30, 2018.

**Figure: RBI's surplus distribution vis a vis risks provisioning –last 5 years**




3. **Role of the CF: Contingency Fund is the real reserve to manage any financial crisis**

RBI's capital reserve has five components. The most important one is the Contingency Fund that is holding bulk of the yearly addition of money from the RBI through provisions. Other three components are just revaluation accounts whereas the remaining asset development fund is meagre. It is from the contingency Fund that the RBI is allocating funds to strengthen the revaluation accounts.

The Jalan Committee report recognizes that the Contingency Risk Buffer is the country's ***savings for a 'rainy day'*** (a financial stability crisis) which has been consciously maintained with RBI in view of its role as Lender of Last Resort (LoLR).

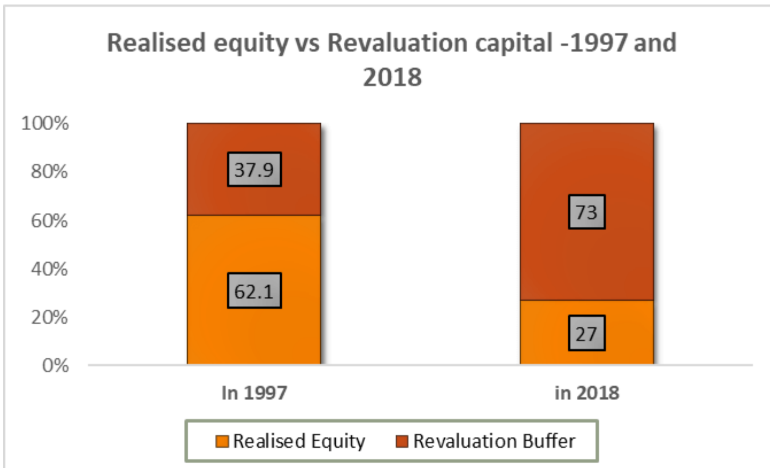
4. **Meeting financial stability risks need more money**

The financial stability risks like the Global Financial Crisis is the rarest of the rarest. Here, the Committee recommended that the risk buffer in the range of 5.5 per cent to 6.5 per cent of the RBI's balance sheet for meeting this risk. But at present, the available level is 2.4 per cent of balance sheet as on June 30, 2018.

5. **RBI's capital reserves seems to be bigger, because of the revaluation gains of gold, foreign currency etc., and not due to fund allocation to capital reserves from its own profit.**

Even if the RBI's economic capital could appear to be relatively higher, it is largely on account of the revaluation balances which are determined by exogenous factors such as market prices. Nearly 73% of the capital reserves are from revaluation gains and only the rest from equity injection from the government. This is a weak feature of the seemingly high capital reserves of the RBI.

Figure: Components of RBI's capital reserve




6. **There should be separate treatment for revaluation balances vis a vis equity contribution (realized equity) from the government.**

Out of the RBI's total buffer or capital reserves, nearly 73% comes from the high revaluation of its assets like foreign currency, gold etc. This valuation can fluctuate. On the other hand, the equity contribution from the government (this is actually, the provision of net income of the RBI to liquidity Contingency Fund and Asset Development Fund of the RBI) is the one that really matters (that is just around 27% of the total capital reserves).

7. **The Committee votes for inclusion of the unreliable revaluation accounts as part of risk buffer that can be used to meet contingency situations.**

The Committee recommended the inclusion of the revaluation balances (from valuation gains of gold holdings of the RBI etc.) as a part of RBI's overall risk buffers. At the same time, due recognition should be given to their volatility, limited usability, significant strategic and operational constraints on their ***monetization***.

The revaluation balances can't be used in an emergency situation since, the gold, foreign currency assets etc can't be sold overnight or their selling has strategic issues. Hence, the only component of the capital reserve is the Contingency Fund.

Measures to address the volatility of the revaluation accounts should be designed.

8. **What are the types of risks which the RBI should consider while determining the size of capital reserves?**

The Committee identified different types of risks for the RBI:

- Currency risks (since the RBI keeps huge volume of foreign currency assets),
- Gold Price Risk (RBI has gold reserves)
- Interest rate risk (RBI holds government securities)
- Credit risk (bonds and loans to the commercial banks)
- Operational risks (due to any potential operational problems)
- Monetary and Financial stability risks (due to weaknesses of the financial institutions like banks, liquidity problems

The Committee observed that there are no significant threats from some of the risks. Hence the Committee suggested keeping reserves to meet the following type of risks.

(i) Monetary and financial stability risks

(ii) Credit risk

(iii) Operational risk

(iv) A shortfall, if any, in revaluation balances vis-à-vis market risk.

9. **Methodology of finding the risk level and thus to determine the amount of capital reserves**

To keep the financial resilience of the RBI regarding the maintenance of capital reserves, the RBI adopts Expected Shortfall (ES) Methodology to measure the market risk (and thus to decide the amount to be kept as capital reserves).

10. **ADF can be used as risk provision:** Asset Development Fund should also be considered as a risk provision if needed.

11. **Balance sheet of the RBI to be reformatted**: The Committee recommended for the reformatting of the balance sheet of the RBI slightly.

12. **Emergency Liquidity Assistance (ELA) will be riskier if there is high level of NPAs**

The Committee observed that providing emergency money to banks will be riskier if banking sector has higher level of non-performing asset (NPA).

ELA is a crisis time financing given by a central bank to financial institutions including banks who need temporary liquidity needs.

On ELA, significant credit risk can arise from ELA operations during periods of stress. RBI can face ELA losses, even when though major part of the banking sector is in the public sector. Losses can occur when ELA support is provided to private sector banks.

13. **Government ownership has prevented runs in the banks; still recapitalisation is burdensome.**

According to the report, large public sector ownership was a positive factor preventing bank runs in the past. But the rise of NPAs has increased recapitalisation by the government.

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