The Bank’s Balance

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(The editorial is based on the article “The Bank’s Balance” which appears in the Indian Express for 23rd January 2019. The editorial makes a case for the RBI to not turn its excess capital to the Government, even though many observers have advised otherwise.)

The main question that this article asks is “How much equity should the Reserve Bank of India (RBI) hold?”* and whether it should pay its excess capital to the Government.

*****On the question “How much equity should the Reserve Bank of India (RBI) hold?”, a committee is currently examining this issue.

A brief look at RBI’s equity holdings and the structure of its holdings:

- **The RBI’s current equity holding is around 27 per cent of its total assets.**
- **This overall equity level can be divided into four categories:** Paid-up capital, contingency capital, revaluation capital and asset development fund.
- The two largest components of these are **contingency capital** (6.6 per cent) and **revaluation capital*** (around 20 per cent).

***The revaluation capital is an accounting entry that offsets changes in the rupee value of the foreign assets and gold holdings of the RBI** due to changes in the exchange rate of the rupee and changes in the dollar price of gold, respectively.

Why is this in News?

- It’s because the total equity of 27 per cent has attracted a lot of attention.
- **Arguments have been made that this is too high, especially when compared with other countries and that the RBI should transfer a part of this “excess” capital to the government as a one-time payment.**

Should the RBI pay up its excess capital to the Government?

This article is of the opinion that the RBI hold equity rather than paying it out to the government.

- **First, putting a part of the country's assets in a protected entity like the central bank builds fiscal credibility of the country as long as the central bank is viewed by markets as being independent of the government. This can improve the country's international credit rating.**
- It also gives the central bank greater credibility in committing to perform its emergency functions without worrying about the fiscal contingencies of the government.
- **Second, mandating payments from the capital of the central bank creates a policy moral hazard.**
- **For example, a cut in the policy rate raises the value of government securities that the central bank holds. If the resultant rise in the central bank's equity sparks a payment to the government then there would be greater spending and inflationary pressure in the economy. Anticipating this, the central bank would be tempted to not lower rates as much.** *[simply put, the RBI runs the risk of putting profits for the Government before the stability of the economy as a whole, if it were to pay up its excess capital to the Government]*
- A similar argument operates with exchange rate depreciations [i.e fall in value of exchange rate – exchange rate becomes weaker]. **More generally, legislating payments out of the central bank's excess capital will tend to compromise its operational independence in achieving its policy mandate.** [the RBI needs to be as independent as possible; ideally Governments should not interfere with its working]

Recommendations *(in this article)* for the committee currently looking into the RBI's capital structure:

1. The article recommends that a formal agreement between the government and the RBI is made.
2. The agreement should stipulate: **(a)** a target band for the equity level of the RBI based **VaR computations***; **(b)** the time frame within which the RBI needs to bring its capital level back within the band every time the bounds of the band are breached, and (c) explicitly prohibit any payments to the government that is based on the equity level of the RBI.

***VaR (Value at risk) is a measure of the risk of loss for investments.** It estimates how much a set of investments might lose (with a given probability), given normal market conditions, in a set time period such as a day. VaR is typically used by firms and regulators in the financial industry to gauge the amount of assets needed to cover possible losses.

Way Forward

- **A central bank should not be (ideally) judged like a commercial bank.**
- When the equity of a commercial bank becomes negative, they are bankrupt and their shareholders typically demand liquidation.
- **The central bank of a country, however, is not a commercial bank. Its owner is usually the government, which certainly will not demand liquidation of the central bank in the event its equity turns negative.**
- Even though there do exist central banks with negative equity, the RBI is not one of them. What is therefore crucial for the RBI is to maintain the level of its assets and contain the riskiness of the portfolio it chooses in terms of its term structure and currency composition.
- **In the event of an emergency, the RBI would need assets to fight it.** So, doing a VaR analysis of the asset portfolio of the central bank is very much recommendable (if only for determining its riskiness relative to the country's risk appetite).
