RESERVE BANK OF INDIA

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TALKING POINTS

- Thankful to Mr. Misra for giving me the opportunity to be with you.
- I recognise that a formal enterprise-wise risk management is a new approach introduced in the RBI. Therefore, I got a briefing from Mr. Misra. I am thankful to him.
- In the presentation today, I will share with you my experiences in regard to issues relating to risks addressed by RBI.
- I will follow this with brief narration of recent developments that attracted attention to risks faced by central banks globally.
- There have also been recent debates relevant to risks in respect of RBI.
- I would then argue that there are some unique features of RBI which are relevant, and should be taken into account in the risk assessment of RBI.
- I will conclude with broader issues that need to be addressed by RBI and the Government, together.

Experiences:

A major area that we in RBI addressed, related to the risks faced by RBI in the maintenance and management of forex reserves. It is very difficult to define adequacy of level of reserves. At the same time, maintaining a higher level of reserves than required, involves a cost. More important, we had to face a situation of adding to the level of reserves even when we thought we have exceeded that desirable level of reserves because of considerations relating to exchange rate.

In addition, the level of reserves has an impact on the balance sheet to the extent the valuation would be influenced by exchange rate movements. By and large, my own experience was that in initial years, we were very clear that we should build forex reserves. However, towards the end of my tenure, we were compelled to add to reserves due to exchange rate considerations.

The management of forex reserves requires assessment of risks. Traditionally, a view was taken that we will be passive in regard to gold. Liquidity, safety and return continue to define the policy of management of foreign currency reserves.

In early 1990s, the growth in assets was influenced by automatic monetization. We contained it through WMA agreement with Government in 1997. In the later years, the growth in the balance sheet was driven by foreign assets on account of large capital inflows and accumulation of reserves. In other words, RBI had to face pressures on its balance sheet from external sector, instead of fiscal conditions.

RBI faced a shock in terms of the liabilities arising out of the exchange rate guarantees given under FCNRA scheme in the run up to the crisis of 1991. Through an agreement with RBI, the government accepted the liabilities arising out of the exchange guarantees given by RBI. After that event, a policy decision was taken that RBI would avoid giving exchange rate guarantees.

As part of the reform and on the advice of the auditors, we had to consider three features of our balance sheet policies. We had accumulated ad hoc treasury bills, and the auditors suggested that they should be marked to market. If they were marked to market, we had to book valuation losses since the interest rate was frozen on 4.5 per cent, compared to the prevailing market rate which was indeterminate, but far higher. We convinced the auditors that we would unwind the ad hoc treasury bills over a period, and try converting them into marketable securities. The conversion which had to take place with the approval of the government would be at market related terms. This was done over the next few years and these were very useful for purposes of sterilisation. As in the case of FCNRA losses, this arrangement was possible only because the government was willing to cooperate.

The auditors also raised the issue of the considerations governing the transfer of surpluses to the government after meeting the requirement of reserves of RBI. The auditors rightly argued that the Board was determining the transfers on a year to year basis, without a said policy. We constituted Subramanyam Committee which recommended on the basis of global practices, our accounting procedures and our circumstances, a level of reserves at 12% of the balance sheet would be adequate. Since the then existing level was far lower, it was decided to adopt a policy of a gradual increase in the reserve cover ratio to reach 12 per cent over the medium term. Before approval by the Board, we had to discuss with the Government. This was approved based on "trust" and the fact that Subramanyam Committee incorporated the best wisdom available at that point of time.

Most important challenge was to explain to the Finance Ministry, Auditors and Board of RBI, how the balance sheet of RBI or any central bank is very different from that of other institutions.

The auditors had noted that the accounting procedures were very conservative. We argued that they are partly determined by the legal provisions and partly by our preference for conservative accounting. To the extent the central bank has to draw on its balance sheet in times of crisis, it should have a capacity to manage the crisis in its independent judgement, without seeking additional capital from the government. This was particularly relevant at a time when the Government was not in a position to borrow without the help of Reserve Bank of India either through monetization or financial repression.

There was an attempt to review the accounting procedures, but that was not approved by the Board – I think sometime in 2004.

The most interesting example of a central bank transferring the risks to its balance sheet arising out of excess capital inflows is market stabilisation scheme. Under this scheme, the open market operations warranted by normal liquidity conditions and those arising out of large volatility in capital inflows are differentiated for policy purpose. The later are generally described as sterilisation operations. The cost of sterilisation under the MSS has to be met by the Government of India. During my discussions with the Government, there was a view that the central bank is surrendering its independence by subjecting itself to constraints on its open market operations. Constraints arise because under the MS Scheme, a ceiling is placed on the issue of bonds under MSS. In this case, the risks to the balance sheet of RBI on account of volatility in capital flows were moderated by transferring excessive burden on this account to the Government through mutual agreement. However, such transfer of risks may not / cannot put restrictions on independence.

At one stage, the Government wanted to use the forex reserves for financing infrastructure. We took view that use of reserves to fund domestic entities would imply that they cease to be available for use as reserves. Further, by lending it to private entities, RBI is subjecting itself to commercial risks with no expertise or mandate to assume such risks. It may also have reputational risks. However, the Government was keen and finally they decided to establish an overseas entity through which the RBI was required to provide forex reserves. We agreed to invest in such an entity owned by the Government, but insisted that it should be through the route of refinancing, rather than through investments. Our insistence on refinancing was mainly because the end use of funds will be indeterminate. The Government argued that since the entity would be indirectly 100 per cent owned by the Government, there was no risk to the RBI in placing its forex reserves. We argued that there is a reputational risk if the lending entity were to invest in projects that could become controversial.

<u>Global Interest</u>:

There was interest especially in IMF in the impact of accumulation of forex reserves on the balance sheets of central banks in regard to emerging market economies. The issues related to the cost of maintaining higher level of reserves than necessary, and the impact of returns and valuation changes on the balance sheet. After the global financial crisis, there was a better understanding of the benefits of a comfortable level of reserves in the case of emerging market economies. In a way, therefore, as a consequence of global financial crisis, the global interest in regard to the balance sheets shifted from emerging market economies to advanced economies.

Global interest in the risks to balance sheet and, to some extent, reputational risks has arisen essentially due to the operations of the central banks of the advanced economies in response to the global financial crisis. Many of the central banks acquired assets of doubtful value and huge magnitudes. This went well beyond the traditional Bagehot rules of being a lender of last resort. Hence, there is a fear that these central banks may incur huge losses in due course, and may be forced to depend on the Government for necessary infusion of capital. There are two concerns: one, a confidence with which the central banks can discharge functions of lender of last resort in the near future is restricted by the already over-stretched balance sheets; two, they may have to depend on infusion of capital by Government when the unwinding takes place, resulting in possible capital loss.

Recent Developments in India:

There are three recent developments in India in this regard. The issue of transfer of surpluses to the Government after transfer to reserves was reviewed in the RBI recently. This review resulted in transfer of 100 per cent of the surpluses of the year to the Government.

Economic survey examined the issue of adequacy of reserves and came to the conclusion that the RBI is over capitalised. The analysis can be questioned on several accounts, but the fact remains that this issue has been raised.

RBI has established set procedures to address the issues of enterprise-wise risks. This could potentially result in arriving at proper level of economic capital.

Uniqueness of India:

Whenever risk is assessed in respect of a central bank and the requirement of capital determined, several institutional factors must be taken into account. In general, this includes the accounting procedures. It certainly includes vulnerability to shocks, in our case, monsoon conditions, petrol prices and capital flows. This also includes the credibility and the fiscal strength of the Government to provide capital when it is required by the central bank. to manage shocks.

In drawing upon globally recommended guidelines on risk assessment, we should recognise that Reserve Bank of India performs functions (a) assigned to it under the Act, namely, monetary and external sector policies (also non banking finance companies); (b) allocated to it under the Act in respect of Union Government, but by agreement with individual States, namely, public debt management; and (c) required under legislations other than RBI Act, namely, FEMA and Banking Regulation Act.

There are risks that do arise out of the, what I may call, functions somewhat unique to RBI, relative to other central banks.

More important, the Capital needs are computed on the responsibilities as lender of last resort also. In this regard, RBI's remit as per law (Section 18) extends to the whole financial system. Other central banks had a narrower remit, but the global financial crisis showed that, in reality, central banks had to become some sort of lender of last resort to non bank entities also.

Issues:

I have covered only some of the ground, what I consider especially relevant to us. At a system level, matter of special importance for RBI is the risks arising out of its relationship with Government.

Independence of central banks can be assessed in terms of personnel, policies and finance. In regard to personnel, Board, Governor and Deputy Governors are appointed by Government of the day. Senior executives can be removed virtually at will. Many regulations on staff are made by government. In personnel, it is among the least independent. In terms of policies, fiscal dominance continues. What is left is, perhaps, financial independence to run its affairs – especially the resources for addressing crisis situations without looking for support from government.

I think that this broader issue should be addressed by RBI and the Government together. I have given several examples where there were differences, but were resolved through discussion and a spirit of mutual trust between the two.

Thank you.