Implications of RBI's fat dividend cheque

The significance of the Jalan Panel report can be better understood through the structural shift in the RBI's balance sheet

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The dividend payout of ₹1,75,987 crore from the RBI to the government for 2018-19 follows a paradigm shift in the way that the RBI's requirement of economic capital is viewed, calculated and supplied, as also an accounting rule-tweaking to ensure higher income from forex transactions. To understand the significance of this development, it is useful to focus on the 10-year period, subsequent to the unification of the exchange rate of the rupee in 1993.

This is when the RBI's balance sheet underwent a structural shift from dominance of domestic assets to dominance of foreign assets. This change entailed important macroeconomic trade-offs that were never well-understood or articulated.

The trade-off

The shift, as above, resulted in a lower proportionate income, on the one hand; and higher risk exposure, requiring more economic capital for the RBI, on the other. This is the flip-side from the narrow perspective of dividend payouts to the government. But the upside of the trade-off has been lower structural inflation, stronger external stability and, possibly, lower external borrowing cost for Indian entities. The Jalan Panel (Expert Committee to Review the Extant Economic Capital Framework) has missed an opportunity to articulate this trade-off well, which could have put the issues in proper perspective.

The Subrahmanyam Group (1997) recommendations to bolster the equity of the RBI by raising Contingency Fund plus Asset Development Fund (CF+ADF) to 12 per cent of assets of the RBI by 2005, saw somewhat tardy growth in dividends, as the retention of net income rose and the old issue of low income from forex transactions lingered on. CF+ADF rose to an all-time high at 11.9 per cent of assets in 2009. In the wake of the 'Taper Tantrum' in the fall of 2013, when the rupee fell steeply leading to the currency revaluation balance bulging to ₹5,20,113 crore (as on June 30, 2014), a policy decision was taken to put a stop to the retention of net income. The ratio of CF +ADF to assets fell in the subsequent years, as a consequence. It is rather ironic that in 2018, when this ratio at 7.04 per cent was a tad lower than in 1998-99 (the start year for strengthening its equity by higher retention of net income), it became almost a self-evident truth that the RBI was over-capitalised. The bulk of the logic — or rather, the absence of it — was that the currency revaluation balance was too high for comfort at ₹6,91,641 crore!

Core recommendation

The RBI will be required to maintain adequate 'realised equity' — CF+ADF, in practice — to cover the other risks besides its most significant one, namely, market risk arising out of its holding of domestic securities and foreign assets, including gold.

The revaluation balances should normally be a sufficient risk buffer against market risk, unless they fall below a threshold which will be determined each year based on the output of a risk model, the specifics of which have also been provided.

Capital confusion and pitfalls

The panel's report, by identifying accounting equity — subscribed capital, reserves, risk provisions and revaluation balances — with economic capital, lays the ground for deviation from the main tenets of enterprise risk management. Revaluation balances, although falling under broadly defined equity, are not in the same league as the CF, since they cannot be used on a 'going concern' basis for absorbing all types of loss. This difference is reflected in the RBI's regulation that permits banks in India to reckon forex translation balance as equity capital, but after discounting by 25 per cent.

Risk management The RBI will need to maintain adequate realised equity

One lesson of the global financial crisis was that only common equity matters in crisis situations. Incidentally, the panel acknowledges that several central banks do not consider revaluation balances as economic capital. A practical difficulty in considering revaluation balance as the main supply source of the economic capital required to meet the demand for capital for market risk on an on-going basis is that while the latter will be more stable over time, the former can be highly volatile and fleeting, leaving open the likelihood of large gap arising between the two.

This is not merely a hypothetical possibility, as it actually materialised in 2007, when the revaluation balance had fallen to a low of 2.2 per cent of the total assets. Even a back-of-the-envelope calculation would show that the shortfall in realised equity would have been as high as 10 per cent of total assets. It would have made no difference even if the entire dividend payout that year at ₹11,411 crore (only 1.14 per cent of total assets) was retained. Obviously, the shortfall would have been more pronounced if the CF+ADR then was lower at 5.5-6.5 per cent.

The upshot here is that revaluation balance alone cannot provide risk buffer against market risk. Hence, the reversal of the Subrahmanyam Group's recommendation to earmark 5 per cent of the realised equity to take care of forex volatility is unsound, based on empirical evidence. This conclusion is unlikely to be very different even if the risk estimations turn out to be somewhat lower. It is hard to imagine the response of the RBI and the government, should a similar situation arise in the future. To some, the option to weaken the rupee could have strong appeal.

Risk transfer mechanism

The panel prefers the term 'financial resilience' *vis-a-vis* 'capital' to denote the RBI's financial degree of freedom. It combines financial resources with the risk transfer mechanism (RTM) available to the RBI for absorbing/transferring losses to the government. The example of bonds issued by the government under the MSS for absorbing excess liquidity has been cited as an example in this regard. But it is also a fact that when the MSS was introduced in 2004 against the backdrop of a surge in liquidity caused by capital inflows, there was a tacit understanding that the interest cost of the bonds to be issued will be compensated by additional dividend payment by the RBI.

Similar was the case in another RTM in 1994, when the RBI was constrained to transfer to the government all the remaining liabilities under the FCNR(A) scheme, which was causing fast depletion of the CF. This deal too, had an understanding that RBI would offset the government's loss by way of higher dividend. Realistically, can anyone expect a general RTM with no strings attached, as in the US, the UK and South Korea, the examples of which are in the report? Not likely in the foreseeable future, particularly when one learns that the government is trying to mop up even the very modest internal reserves of SEBI as well.

The panel's report begins by stating a view that central banks do not need capital for their operations. While this point can be debated endlessly with strong arguments on both sides, in the Indian context, it is almost a certainty that the fiscal dominance over monetary and financial stability policies of the RBI will get entrenched and legitimised, if the net worth of the RBI were to turn negative.

Around the time the RBI was struggling with the financial burden of FCNR(A) liabilities in 1993, the central bank of the Philippines was liquidated on account of losses under more or less similar quasi-fiscal activities. As the cliché goes, fact is stranger than fiction.

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