Committee Report Summary

Economic Capital Framework of the Reserve Bank of India

- The Reserve Bank of India (RBI), in consultation with the central government, had constituted a Committee (Chair: Dr. Bimal Jalan) to review the current economic capital framework, in November 2018. The existing economic capital framework was developed in 2014-15, and was operationalised in 2015-16. The economic capital framework provides a methodology for determining the appropriate level of risk provisions and profit distribution to be made under Section 47 of the RBI Act, 1934. As per this provision, the central bank is required to pay balance of its profits to the central government after making provision for bad and doubtful debts, depreciation in assets, and contributions to staff.
- The terms and reference of the Committee included: (i) reviewing current provisions and reserves for RBI vis-à-vis other central banks, (ii) suggesting appropriate risk assessment methodology and level of risk provisioning, (iii) determining whether RBI is holding reserves in surplus/deficit, and (iv) proposing a suitable surplus distribution policy. Key recommendations of the Committee include:
- **International practices**: The Committee observed that there is no internationally laid down risk capital framework for central banks. Different central banks develop and adapt different risk management frameworks depending on their specific conditions and requirements. However, the Committee was of the view that financial resilience of the RBI must be maintained above the level of peer central banks, as would be expected of the central bank of one of the fastest growing economies.
- It noted that the RBI's central banking economic capital, at 26.8% of its balance sheet, is the fifth largest amongst central banks. Economic capital of a central bank includes its capital, reserves, risk provisions and revaluation balances. Revaluation balances are unrealized gains, net losses resulting from movement of exchange rate, gold price or interest rate. Note that revaluation balances are the major component of RBI's economic capital (73%).
- **Risk assessment**: The central bank is exposed to different types of risks. These include: (i) market risk arising out of currency, gold or interest rate fluctuations, (ii) credit risk, (iii) operational risks arising from managing multi-currency portfolios across multiple legal jurisdictions, and (iv) contingent risks (monetary and financial stability risks).
- Currently, market risk is assessed as per the Stressed-Value at Risk methodology (risk during stressed market condition). The Committee recommended adopting the Expected Shortfall (ES) methodology under stressed conditions (with a confidence level ranging between 97.5% to 99%) to assess market risk. ES at 99% confidence level denotes the expected loss that can be ascertained with 99% confidence.
- **Revised economic capital framework**: Realized equity is the component of RBI's economic capital comprising its capital, reserve fund and risk provisions. The risk provisions comprise of: (i) Contingency Fund, which includes provisions for unforeseen contingencies arising from depreciation of securities or monetary/exchange rate policy risks, and (ii) Asset Development Fund, which is the amount set aside for investment in subsidiaries and internal capital expenditure. The risk provisioning made from economic capital to cover monetary, fiscal stability, credit and operation risks is cumulatively referred to as the Contingent Risk Buffer (CRB).
- The Committee suggested that a distinction needs to be made between realized equity and revaluation balances in RBI's balance sheet, as the latter are highly volatile. Further, it recommended that the RBI should also include its revaluation balances as part of overall risk buffers. However, given their volatility, these balances should be treated as limited purpose risk buffers to be used against market risks only.
- **Surplus distribution policy**: The current surplus distribution policy targets only the total economic capital. The Committee recommended that the target should also include realized equity. The size of the realized equity, in the form of CRB, must be maintained between 5.5% to 6.5% of the RBI's balance sheet (current target: 3% to 4%). The total economic capital should be maintained between 20.8% to 25.4% of the balance sheet (current target: 28.1% to 29.1%). As of June 30, 2018, the CRB and total economic capital for the central bank were 7.2% and 26.8% of the balance sheet, respectively.
- If the realized equity is above the required levels, the entire net income of RBI will be transferred to the government. If it is lower, risk provisioning will be made to the necessary extent and only the residual net income will be transferred. This framework may be reviewed every five years.

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