How and why RBI transfers to government

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This article is related to General Studies-Paper-III (Indian Economy)

Indian Express

28 Aug, 2019

"Bank's Central Board has decided on a record transfer of Rs 1.76 lakh crore. On what basis are such transfers made? Why has it been sometimes contentious, and how was the amount settled this time?"

On Monday, the RBI Central Board decided to transfer a record surplus — Rs 1.76 lakh crore — to the government.

The issue of transfer of surplus or profits has often been contentious. The government often pitches for a higher payout, arguing it needs to spend to deliver on promises and to keep the economic momentum going, while a conservative central bank, which has medium- and long-term perspectives, prefers to salt away a good portion of the profits for a rainy day. Seldom has this battle been as bitter as it was last year when Urjit Patel was the RBI Governor and Subhash Garg was the Secretary, Economic Affairs in the Finance Ministry. At stake was the level of reserves the RBI should hold or maintain and the quantum of profits to be distributed. On Monday, the issue was settled.

The RBI transfers its surplus to the government every year. So what is special about the pay out this time?

Yes, the RBI does transfer its surplus annually to the government, the owner of the institution, after making adequate provisions for contingencies or potential losses. The profit that is distributed has varied, averaging over Rs 50,000 crore over the last few years.

On Monday, the RBI Board accepted the recommendations of a committee headed by former Governor Bimal Jalan on transfer of excess capital. Based on the panel's report, the Central Board decided to transfer a surplus of Rs 1.23 lakh crore and Rs 52,637 crore of excess provisions made over the years. This marks the first time the RBI will be paying out such a huge amount, a one-off transfer. Earlier, the government had budgeted for Rs 90,000 crore from the RBI as dividend for this fiscal year.

On what rationale was such a huge payout approved?

The level of surplus or profits the RBI pays to the government has been an issue of conflict two for long. Over the last decade or more, the government had sought higher payouts saying the RBI was maintaining reserves or capital buffers that were much higher than many other global central banks' buffers. The government has argued that such relatively lower transfers crimped public spending for infrastructure projects and social sector programmes, considering the pressure to meet deficit targets and to provide space for private firms to borrow. With the government amplifying its demand for a higher transfer, the Jalan committee reviewed the capital structure, statutory provisions and other issues relating to the RBI balance sheet. After making a distinction on the RBI's capital structure especially on unrealised gains (which are essentially gains not booked) and taking into account the role of the central bank in ensuring financial stability, potential risks and global standards, the committee suggested a total transfer of Rs.1.76 lakh crore.

How does the RBI generate surplus?

A significant part comes from RBI's operations in financial markets, when it intervenes for instance to buy or sell foreign exchange; Open Market operations, when it attempts to prevent the rupee from appreciating; as income from government securities it holds; as returns from its foreign currency assets that are investments in the bonds of foreign central banks or top-rated securities; from deposits with other central banks or the Bank for International Settlement or BIS; besides lending to banks for very short tenures and management commission on handling the borrowings of state governments and the central government. RBI buys these financial assets against its fixed liabilities such as currency held by the public and deposits issued to commercial banks on which it does not pay interest.

The RBI's expenditure is mainly on printing of currency notes, on staff, besides commission to banks for undertaking transactions on behalf of the government and to primary dealers that include banks for underwriting some of these borrowings. The central bank's total costs, which includes expenditure on printing and commissions forms, is only about 1/7th of its total net interest income.

Why are these called transfers to the government, rather than dividends?

That is because the RBI is not a commercial organisation like banks and other companies owned or controlled by the government to pay a dividend to the owner out of the profit generated. Though it was promoted as a private shareholders' bank in 1935 with a paid-up capital of Rs 5 crore, the government nationalised it in January 1949, making the sovereign the "owner". What the RBI does is transfer the surplus — excess of income over expenditure —to the government. Under Section 47 of the RBI Act, "after making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and for all other matters for which provision is to be made by or under this Act or which are usually provided for by bankers, the balance of the profits shall be paid to the Central government". This is done in early August by the Central Board.

Globally, what are the rules relating to payment of dividends by central banks?

In many top central banks — US Federal Reserve, Bank of England, German Bundesbank, Bank of Japan— the laws make it clear that profits have to be transferred to the government or the treasury. The quantum of profits or percentage to be distributed is also specified in the laws.

So, what is the difference in India now and compared to the past?

The quantum is discussed and decided between the government and RBI. Periodically, this has been guided by policies set out internally, as last time when a committee headed by Y H Malegam recommended distributing 100% of the profits made during Raghuram Rajan's time. The difference now is that the Jalan committee's recommendation on a profit distribution policy has been endorsed by the Central Board. That will mean a more transparent and rule-based payout from next year, as in many other central banks, which could help narrow differences between the government and RBI.

What can the government do with this huge surplus?

Normally, the money is transferred to the Consolidated Fund of India from which salaries and pensions to government employees are paid and interest payments done, besides spending on government programmes. The large payout can help the government cut back on planned borrowings and keep interest rates relatively low. Besides, it will provide space for private companies to raise money from markets. And if it manages to meet its revenue targets, the windfall gain can lead to a lower fiscal deficit. The other option is to earmark these funds for public spending or specific projects, which could lead to a revival in demand in certain sectors and boost economic activity.

What are the potential issues relating to a higher payout?

That has been articulated by former Governor Rajan. According to him, much of the surplus the RBI generates comes from the interest on government assets (securities or bonds) or from capital gains made off other market participants. When this is paid to the government, the RBI is putting back into the system the money it made from it; there is no additional money-printing or reserve creation involved, he says. But when the RBI pays additional dividend, it has to create additional permanent reserves or, more colloquially, print money. So, to accommodate the special dividend, the RBI will have to withdraw an equivalent amount of money from the public by selling government bonds in its portfolio, he says.

Why do central banks hold back on transferring large amounts?

Especially after the global financial crisis when central banks had to resort to unconventional means to revive their economies, the approach has been to build adequate buffers in the form of higher capital, reserves and other funds as a potential insurance against future risks or losses. A higher buffer enhances the credibility of a central bank during a crisis and helps avoid approaching the government for fresh capital and thus maintain financial autonomy.

Given conflict in the past, how was the distribution of profits settled this time?

In his memoir, former RBI Governor D Subbarao had written how arguments on this would go on year after year but a settlement would be reached with some flexibility shown by both sides. "Even though contentious, (it) has never turned acrimonious," he wrote a couple of years ago. That wasn't the case last year and in the first half of this year. As the government's nominee on the Jalan committee, Garg had submitted a dissent note. His exit from the Finance Ministry and the entry of the new Governor, Shaktikanta Das, and Garg's successor Atanu Chakraborty and backroom talks, may have led to the flexibility of approach that Subbarao indicated in his book, and the resultant decision on a record payout.

Surplus transfer of RBI

Why in discussion?

- Recently, the Board of Reserve Bank of India (RBI) approved the proposal to give a surplus of Rs 1.76 lakh crore to the government.
- A major part of this (Rs 1.23 lakh crore) is the annual surplus, while the rest (Rs 52,637 crore) is from the surplus reserve.
- This will help the government to accelerate the sluggish economy without increasing the fiscal deficit.
- This amount of additional provision has been derived on the basis of the revised rules (ECF) related to the economic capital of RBI.
- It may be noted that the board of directors of the Reserve Bank has taken this step after accepting the recommendations of the committee headed by Bimal Jalan. The six-member Jalan committee was appointed on 26 December 2018.
- Three committees have been formed earlier to explain how much the reserves of Reserve Bank of India (RBI) should have ideal. For this a committee headed by V Subrahmanyam in 1997, Usha Thorat in 2004 and YH Malegam in 2013 was formed.
- RBI had given a surplus of 52679 thousand crores to the government in 2014, 65896 thousand crores in 2015, 65876 thousand crores in 2016, 30659 thousand crores in 2017, 50000 thousand crores in 2018. In 2019, this amount has increased to 1.76 lakh crore.

How big is the RBI balance sheet?

- RBI's balance sheet stood at Rs 36.2 lakh crore in FY 2017-18. The point to note is that the balance sheet of the central bank is not the same as the balance sheet of the company.
- The notes the RBI prints account for more than half of the central bank's liability. Around 26% is held by its reserves.
- They are invested in gold along with foreign and domestic securities.
- RBI has a little over 566 tonnes of gold. Gold and foreign exchange account for about 77 per cent of the total assets of the central bank.
- Sometimes a difference of opinion arises between the RBI and the government on how much reserves RBI should have to continue functioning.

Where does RBI's reserve come from?

- To understand what the transfer is, we must first understand where the funds come from. The central bank has three different funds that together comprise its reserves. These are the Currency and Gold Revaluation Account (CGRA), the Contingency Fund (CF) and the Asset Development Fund (ADF).
- Of these, the CGRA is by far the largest and makes up the significant bulk of the RBI's reserves. The fund, which in essence is made up of the gains on the revaluation of foreign exchange and gold, stood at ₹6.91 lakh crore as of financial year 2017-18. The CGRA has grown quite significantly since 2010, at a compounded annual growth rate of 25%.
- RBI's entire reserve is not one of a kind. Two types of reserves matter the most. These are Currency and Gold Revaluation Account (CGRA) and CF.
- They hold the largest share in the reserve. It was Rs 6.9 lakh crore in 2017-18. This reserve means gold and foreign currency. The central bank holds this reserve as a representative of the Government of India.
- Simply put, the value of this reserve keeps on fluctuating with the fluctuations in the market value of these assets.
- Thus, according to market conditions, the central bank continues to gain and loss in terms of reserves.

- For example, the previous CGRA had increased by 30.5 per cent. The weakness in the rupee against the dollar and the rise in the price of gold was due to this.

What did the Jalan Committee recommend?

- The Jalan Committee, as it was called informally, is actually called the Expert Committee to Review the RBI's Extant Economic Capital Framework.
- The committee recommended that the RBI maintain a Contingent Risk Buffer — which mostly comes from the CF — of between 5.5-6.5% of the central bank's balance sheet. Since the latest CF amount was about 6.8% of the RBI's balance sheet, the excess amount was to be transferred to the government. The committee also decided, for the year under consideration, to use the lower limit of 5.5% of the range it recommended. So, basically, whatever was excess of 5.5% of the RBI's assets in the CF was to be transferred. That amount was ₹52,637 crore.
- Regarding the RBI's economic capital levels — which is essentially the CGRA — the committee recommended keeping them in the range of 20-24.5% of the balance sheet. Since it stood at 23.3% as of June 2019, the committee felt that there was no need to add more to it, and so the full net income of the RBI — a whopping ₹1,23,414 crore — should be transferred to the Centre.
- That ₹1.23 lakh crore plus the ₹52,637 crore is what comprises the ₹1.76 lakh crore that the RBI has decided to transfer to the government. It must be noted that this ₹1.76 lakh crore includes the ₹28,000 crore interim dividend earlier transferred to the Centre and does not come over and above it.

Expected Questions (Prelims Exams)

1. Consider the following statements, in the context of surplus of Reserve Bank of India-

1. Y.H. Malegam committee recommended to distribute 100% of the surplus of RBI to the government.
2. This surplus of RBI is transferred to the government in the form of dividend.

Which of the above statements is/are correct?

(a) Only 1

(b) Only 2

(c) Both 1 and 2

(d) Neither 1 nor 2

Expected Questions (Mains Exams)

Q. What do you understand by the surplus of Reserve Bank of India? This surplus is transferred to the Central Government by RBI instead, of keeping it as an dividend, why? Explain. **(250Words)**

Note: Answer of Prelims Expected Question given on 27 Aug. is 1 (d)