

INTERIM SOLUTION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

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FOR the second year running, the RBI has agreed to transfer an interim dividend or surplus profits to the government, with the pay out — at Rs 28,000 crore this time, more than double the Rs 10,000 it transferred to the exchequer last year. The early payout by the central bank and the mounting pressure on the RBI to transfer a much higher surplus is a reflection on fiscal management and government finances in an election year, with extra spending commitments and fiscal slippages. As the owner or controlling shareholder, it is natural, and justifiably so, for any government to seek a reasonable or fair return on the capital deployed by the sovereign, especially in the commercial enterprises promoted by it. But a distinction needs to be made when it comes to the central bank, even if the government is the sole owner, considering that the state of the bank's balance sheet is intrinsic to delivering on its objectives of monetary and financial stability and also to boost credibility, not just in the financial markets but also among credit rating agencies.

As the experience of the 2008 financial crisis and subsequent events show, there has been a dramatic change in the risk environment under which central banks operate. There is a recognition that these banks should be equipped to provide huge liquidity commitments and also build strong capital buffers as a cushion against unforeseen risks and potential losses. Notably, this has led to the Bank of England and the UK Treasury (the equivalent of the finance ministry in India) signing an MoU last year on the financial relationship between the two, which clearly lays down the capital principles and purpose and the ceiling above which net profits will be paid to the treasury as dividend. It helps that the Bank of England Act provides for 50 per cent of the bank's profits or such other sum to be paid to the treasury twice a year, including one as interim payment.

A committee headed by former governor Bimal Jalan is now reviewing the RBI's economic capital framework. As the monetary policy committee agreement has shown, a similar legislative framework agreement on capital and rules on surplus transfer can help narrow differences and smoothen ties between two critical arms of the government. But even that will be defeated if there is an escape clause for governments which are not fiscally prudent.

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