# Issues with functioning of RBI

## What is the issue?

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There are unresolved issues revolving around the capital base, performance and autonomy of the RBI in recent times.

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## Is the RBI's capital base too large?

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- Central banks need to be adequately capitalised in order to perform their core functions which include being the lender of last resort for the banking system.
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- As per the latest available figures, total RBI capital is around 27% of its total assets.
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- This is more than in most central banks in the world.
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- However, the problem with this conclusion is the composition of the RBI capital base.
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- Only a third of RBI capital is actually contingency funds that can be deployed when needed.
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- The remaining two-thirds of its capital is primarily revaluation funds.
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- Revaluation funds is an accounting entry which rises and falls as the value of the assets of the RBI rises and falls.
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- Thus, over the past quarter, the depreciation of the rupee has led to an increase in the rupee value of RBI dollar assets by almost Rs 1.6 trillion.
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- But this is accounting income, not an earned income.
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- If one had reported the RBI balance sheet in dollars, then there would have

been no change on either side of the balance sheet at all.
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- The deployable capital base of the RBI is just about 7% of total assets.
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- This makes the RBI one of the most under-capitalised central banks in the world.
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- The Economic Survey of 2016 focus on the overall rupee size of the RBI capital base as opposed to its deployable capital base.
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- This projects the capital base of RBI higher than its deployable potential and hence are deliberately misleading.
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- These factors also bring us to the issue of RBI performance.
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## What are the concerns put forward against RBI?

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- The government criticised the Prompt Corrective Action (PCA) norms and the liquidity management of the RBI on the backdrop of the IL&FS crisis recently.
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- **On PCA framework** - The PCA norms were introduced as a way of getting scheduled commercial banks to begin a prompt recognition and clean-up of their asset base before they acquired any new risky assets.
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- This came on the back of a continued worsening of the balance sheets of a number of banks, especially public sector banks, with rising NPAs.
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- Banks are supposed to allocate the saving of households towards borrowers who are able to offer the highest returns at the lowest risk.
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- Hence, regulators devise measures to ensure that the lending process does not get compromised and PCA norms are one such measure.
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- A simple examination of credit growth in the Indian economy this year would suggest that the measures taken under PCA norms most certainly have worked.
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- Credit has been consistently growing at double digit rates since December 2017, including in September 2018 when it grew at 12.4%.

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- Crucially, this turnaround in credit growth has come after the low single digit rates of the last couple of years.
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- Greater lending is being undertaken by better capitalised banks that have weaker incentives to ever-green their stressed assets.
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- But the measure taken by RBI in forcing under-capitalised banks to stop lending until they clean up under PCA norms has been criticised heavily by the government.
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- The government also claimed that the PCA norms have failed to resolve the NPA crisis in the country.
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- These arguments are not based on facts but rather on political expediency and corporate rent-seeking.
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- **On IL&FS crisis** - The other criticism of the RBI is with regards to its post-IL&FS liquidity management, especially for NBFCs.
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- NBFCs had typically been funding their investments with debt and bank loans with an increasing reliance on shorter and shorter commercial paper (CP) over the past year.
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- Commercial Papers are issued by companies with high-quality debt ratings for raising money to meet their short-term liabilities.
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- Corporations, financial institutions, wealthy individuals and money market funds are usually buyers of commercial paper.
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- It is usually issued at a discount from face value and reflects prevailing market interest rates.
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- Maturities on commercial paper are usually no longer than 9 months.
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- Unlike banks, NBFC do not have access to low-cost public deposits and have to heavily rely upon commercial paper and commercial debt markets.
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- Banks and Mutual Funds are the main source of funding through commercial papers to NBFCs and housing finance companies.
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- While large MFIs have access to bank finance, the mid-sized and smaller ones depend on funds from NBFCs.
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- Small and mid-size NBFCs and Micro Finance Institutions (MFI) are going to face the liquidity crunch due to redemption of commercial papers due in November-March.
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- Anticipating liquidity crunch, the RBI has announced Rs. 40,000-crore liquidity infusion in November through open market operations recently.
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- However, the supposed liquidity crunch in the NBFC segment finds no supporting evidence in the CP rates which have only moved to the extent that the policy rates have moved.
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- Thus, there is no sustained independent effect of the IL&FS crisis on market rates.
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- However, the government pointing at the fall in new CP issuance in recent months as an effect of IL&FS crisis.
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- This is grossly misleading, as it is an attempt at drawing systemic conclusions from only one data point.
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- CP issues are a volatile series, wherein their growth rates (year- on - year) were negative in February, March and April of 2018 as well.
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- Hence, there is certainly no evidence of any aggregate liquidity crunch.
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## What should be done?

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- These criticisms bring us to the question of RBI independence.
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- A sovereign government finances itself from two sources such as taxes on its citizens and printing of money.
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- The taxes go directly to the government while revenues from money printing accrue to the central bank.
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- Governments face various political constraints that may induce them to take actions that create economic uncertainty.
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- One way for citizens to exercise control over the government is to hand over part of the revenues to the central bank and make it institutionally

independent of the government.
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- Hence, the prevailing argument that independence of RBI is earned through its performance is misleading.
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- The performance of the central bank is in itself depends on the independence granted to it and not the other way around.
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**Source: Indian Express**

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