A Pre-emptive bid?

A couple of months back, in an interview on CNBC, Dr. Raghuram Rajan mentioned that the Reserve Bank has developed and vetted with outside help, a value at risk (VaR) model to measure the price risks it faces in conducting its operations, in order to arrive at the balance sheet reserves it needs. This was done to help decide the profit that can be safely transferred to the owner, namely the Government of India. After viewing the interview, I made efforts to get some information on the issue and what was the provocation for creating such a model. However, I could not get much information. I was curious because VaR models are a standard methodology for measuring the price risk in a commercial bank's trading book: trading is, of course, a euphemism for speculation undertaken to make profits. And, surely the RBI does not speculate in financial markets.

After reading the Economic Survey, I have started wondering whether the model and the capital based thereon were pre-emptive bids to forestall any idea Delhi may have about using part of the RBI's capital and reserves to help recapitalise public sector banks. The recent budget has provided Rs. 25000 crores by way of additional capital to PSBs. Much more would be needed to meet the Basle III capital norms.

But to come back to the price risks in the RBI balance sheet, the Economic Survey identifies two:

- The value of the foreign exchange reserves in terms of the domestic currency; and
- The interest rate risk on the fixed income securities held by the central bank.

As for the first, given the significantly large inflation differential between India and the currencies in which the reserves are held and our hugely negative international investment position, it can be argued that, over time, rupee fluctuations will only add to the RBI's rupee profits; in that sense, currency fluctuation is not really a risk measurable by a VaR model which is based on the Gaussian normal distribution mathematics which assumes random fluctuations in prices. There could be paper losses on government securities portfolio should interest rates go up – here again, it is the RBI itself which changes interest rates and, at least in theory, expectations about the future which determine the yield curve. Perhaps even more importantly, profit making is not a central bank's primary objective.

As the Survey points out, comparison with other central banks' balance sheets suggests "*that RBI is an outlier with an equity share of about 32 percent, second only to Norway and well above that of the US Federal Reserve Bank and the Bank of England, whose ratios are less than 2 percent.*" Clearly, there is scope for using RBI's capital for recapitalising public sector banks, to mitigate fiscal constraints. In any case, this would not be the first time for the RBI to hold capital in public sector banks. For a long time, State Bank of India's capital was held by the Reserve Bank; again, the Industrial Development Bank of India (IDBI) started as a 100% subsidiary of the Reserve Bank.

Some analysts have argued that the only solution to the current woes of the public sector banks is to privatise them: empirical evidence suggests that this is no solution. The mortgage market crisis was created by private sector banks; and the huge losses on real estate lending in Ireland and Spain, as also in Japan in the early 1990s, were in private sector banks. In fact, globally, the common theme of private sector banking has been "private profits, public losses".

Another solution being talked about is consolidation of public sector banks into, say, half a dozen large banks. One is not convinced of this solution as well: will it not lead to the bulk of the banking sector falling into the category of "systemically important financial institutions (SIFIs)", which are, in effect, "too big to fail"; Basle III prescribes even higher capital for SIFIs. Yet another idea being talked about is employee stock ownership plans (ESOPs). In theory, ESOPs are meant to align the interest of the shareholders and the management. If at all, they can work where maximising profits is the sole objective of the institution: this is surely not the case with public sector banks who have multifarious and sometimes conflicting objectives. But even if this were not so, as a recent Harvard Business Review article argues "*Companies would benefit if executives got straight salaries; fixating on performance could weaken it.*"

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