RBI Reviews Economic Capital Framework: Impact on Risk Buffer and Surplus Transfers

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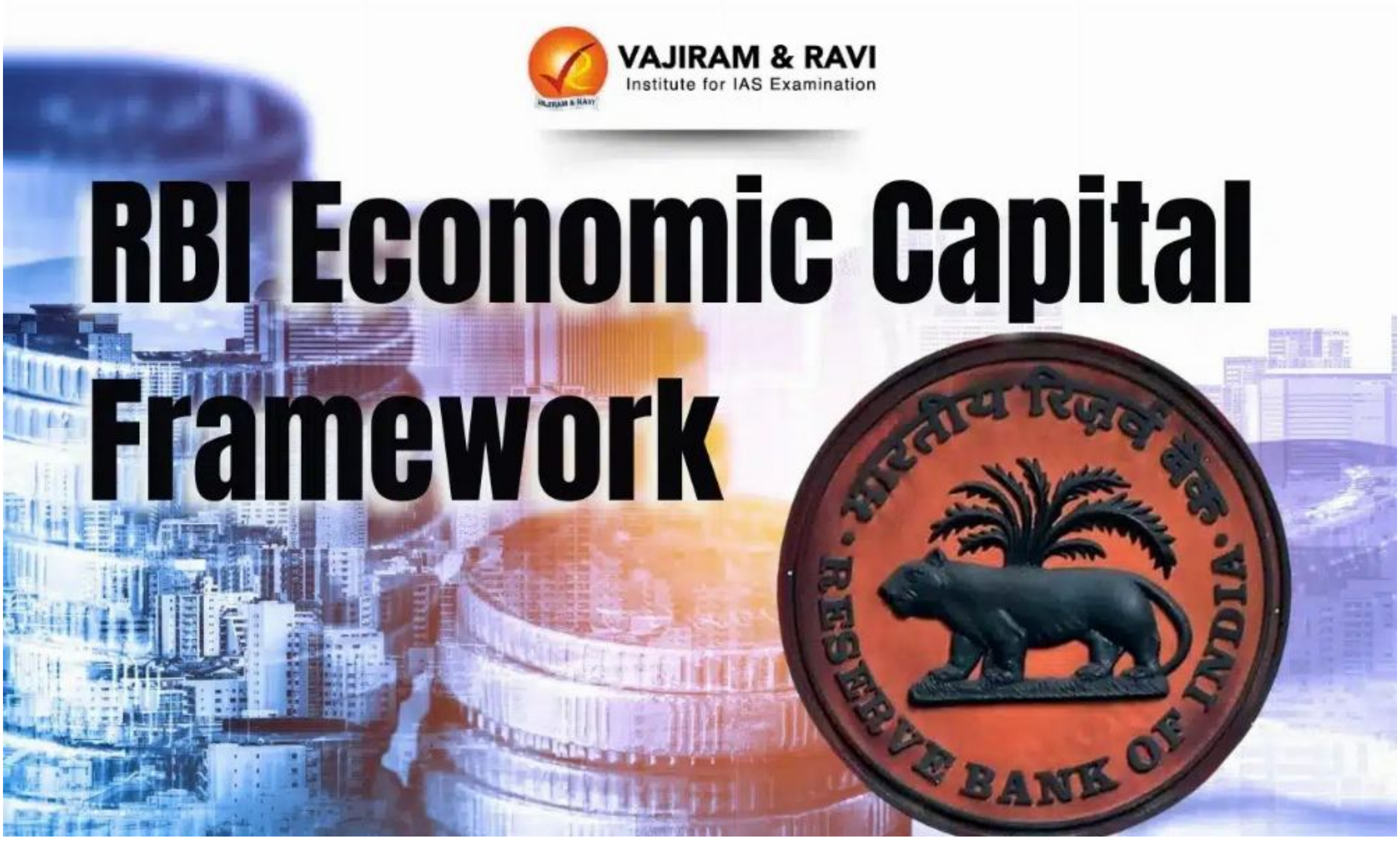

What's in Today's article?

RBI's Economic Capital Framework Latest News

- An internal committee of the Reserve Bank of India (RBI) is reviewing the entire economic capital framework (ECF) of the central bank.

Understanding the Economic Capital Framework (ECF)

- The **Economic Capital Framework (ECF)** is a policy that determines how the **Reserve Bank of India (RBI)** manages its financial reserves, risk provisioning, and surplus transfers to the central government.
- It sets guidelines for the **contingency risk buffer (CRB)**—a financial reserve maintained by the RBI to address unforeseen economic crises.
- The **Bimal Jalan Committee**, formed in **2018**, recommended that the **CRB should be maintained between 5.5% to 6.5% of the RBI's balance sheet**. This buffer acts as a safeguard for economic stability, ensuring that the RBI can function effectively as the **Lender of Last Resort (LoLR)** during financial crises.
- Since **2019**, the RBI has followed these recommendations, and any revisions to the framework could influence how much surplus the RBI transfers to the government in future years.

RBI's Current Review of the ECF

- **RBI Governor's Statement on ECF Review**
  - On **Friday, RBI Governor Sanjay Malhotra** confirmed that the central bank is **reviewing the Economic Capital Framework**.
  - This periodic review, recommended by the **Bimal Jalan Committee**, is meant to assess whether any adjustments are needed in the CRB range.
  - Malhotra clarified that while the **current CRB stands at 6.5% (as of March 31, 2024)**, the review could lead to an **increase or decrease** in the required buffer, though no immediate changes have been confirmed.
- **Background on the Bimal Jalan Committee Recommendations**
  - The **Bimal Jalan-led panel** had suggested a **five-year review cycle** for the ECF, with its recommendations valid from **June 2019 to June 2024**. Given this timeline, the RBI has now begun an **internal assessment** to evaluate whether changes are necessary.
  - According to **RBI Deputy Governor M. Rajeshwar Rao**, the review will help determine if the **current framework remains effective** or if modifications are required to address evolving financial conditions.

Impact of the ECF Review on RBI's Surplus Transfers

- **Record Surplus Transfer to the Government in 2023-24**
  - For the **financial year 2023-24**, the **RBI approved a record surplus transfer of ₹2.11 lakh crore** to the central government.
  - This amount significantly boosts government revenue and helps finance fiscal policies, including infrastructure projects and social welfare programs.
- **How CRB Adjustments Could Affect Future Dividends**
  - Economists believe that **any revision in the CRB threshold** could directly **impact future surplus transfers**.

    - If the **CRB requirement is increased**, the RBI may need to **set aside more reserves**, reducing the **amount of surplus available for government transfers**.
    - Conversely, if the **CRB is lowered**, it could **free up more funds** for dividend payments.
    - However, Governor Malhotra stated that the decision to **revise the CRB is not linked to current global uncertainties**, and any change will be **based purely on economic factors** rather than short-term concerns.

Importance of ECF Review

- **Ensuring Economic Stability**
    - The **contingency risk buffer** serves as an essential financial safeguard against **global financial instability, banking crises, and currency fluctuations**.
    - Maintaining an adequate **buffer ensures that the RBI can respond effectively to any economic downturn**.
- **Impact on Government Budget Planning**
    - The **RBI's surplus transfers** play a crucial role in supporting **government spending and fiscal deficit management**.
    - Any change in the ECF could **influence the government's budgetary planning** for the upcoming fiscal years.
- **Balancing Risk and Development Needs**
    - The RBI must strike a balance between **maintaining financial stability** and **providing surplus funds** to the government.
    - If the **CRB is increased**, it could **strengthen the financial resilience** of the central bank but may **reduce funds available for government initiatives**.

Conclusion

- The **RBI's review of the Economic Capital Framework** is a crucial exercise that could determine the future **allocation of financial reserves and surplus distribution**.
- While the **current contingency risk buffer (CRB) stands at 6.5%**, the review will assess whether adjustments are needed to **maintain economic resilience**.
- A **higher CRB** could enhance financial security but reduce the **RBI's surplus transfers to the government**, while a **lower CRB** could provide the government with more fiscal resources but may **increase financial risks**.
- As the **five-year review process unfolds**, all eyes will be on the RBI's decision, which will have **long-term implications for India's economic and fiscal stability**.

Economic Capital Framework FAQs

Q1. What is the Economic Capital Framework (ECF)?

Ans. The ECF is a policy that guides how the RBI manages financial reserves, risk provisioning, and surplus transfers to the government.

Q2. What is the contingency risk buffer (CRB) and why is it important?

Ans. The CRB is a financial reserve maintained by the RBI to handle economic crises and ensure financial stability.

Q3. What was the Bimal Jalan Committee's recommendation on CRB?

Ans. The committee suggested maintaining the CRB between 5.5% to 6.5% of the RBI's balance sheet for financial resilience.

Q4. How does the ECF review impact RBI's surplus transfers to the government?

Ans. Any change in the CRB could increase or reduce the amount of surplus the RBI transfers to the government.

Q5. Why is the RBI reviewing the Economic Capital Framework now?

Ans. The review is part of a five-year periodic assessment recommended by the Bimal Jalan Committee, covering 2019-2024.

Source: BS | IE
